2004

# The Allocation of Profits between Related Entities and the Oppression Remedy: An Analysis of Ford Motor Co. V. Omers

Kim Brooks

Anita Anand

# The Allocation of Profits Between Related Entities and the Oppression Remedy: an Analysis of *Ford Motor Co. v. Omers*

**KIM BROOKS* AND ANITA I. ANAND****

*In* Ford Motor Co. v. Ontario Municipal Employees Retirement Board, *the Ontario Superior Court of Justice reviewed the transfer pricing arrangements between parent and subsidiaries Ford US and Ford Canada in the context of a going-private transaction. Its review was the key to resolving the two main issues in the case: first, did the transfer-pricing arrangements understate Ford Canada's profits so as to undermine the fair value of Ford Canada's shares? And second, did the transfer-pricing arrangement oppress or unduly disregard the interests of Ford Canada's minority shareholders so as to give rise to the oppression remedy?*

*In this comment, the authors analyse the Court's reasoning and its implications for tax and corporate law. They review profit allocation methods that were available to the Court (and to Ford US) and the Court's rationale in adopting the profit split method. Although the authors agree with the Court's reasoning regarding the profit allocation methods, they argue that the reasoning with regard to oppression gives rise to some important questions regarding the proper analysis for oppression when board conduct is impugned. They disagree with the Court's use of reasonable foreseeablity as a basis for assessing whether the oppression remedy should be granted and argue that where board conduct is at issue in an oppression action, courts must consider whether directors have breached their fiduciary duties.*

*Dans l'arrêt* Ford Motor Co c. Ontario Municipal Employees Retirement Board, *la Cour supérieure de justice de l'Ontario a passé en revue le régime des prix de transfert entre la société mère Ford U.S. et sa filiale Ford Canada dans le contexte des opérations de privatisation. Cette révision était essentielle afin de trancher les deux principales questions en l'espèce : premièrement, est-ce que le régime des prix de transfert a sous-estimé les profits de Ford Canada afin de diminuer la juste valeur des actions de Ford Canada? Deuxièmement, est-ce que le régime des prix de transfert est abusif et porte indûment atteinte aux droits des actionnaires minoritaires de Ford Canada de façon à donner ouverture à des recours en cas d'abus?*

*Dans le présent commentaire, les auteurs analysent le raisonnement de la Cour et ses répercussions en droit fiscal et en droit des sociétés. Ils examinent les méthodes de répartition des profits dont disposait la Cour (et Ford U.S.) ainsi que les motifs de la Cour à l'appui de l'adoption de la méthode du partage des bénéfices. Bien que les auteurs soient d'accord avec le raisonnement de la Cour concernant les méthodes de répartition des profits, selon eux, son raisonnement concernant les abus soulève d'importantes questions lorsque les abus contestés se rapportent à la conduite d'un conseil. Ils désapprouvent l'utilisation du principe de la prévisibilité raisonnable par la Cour afin de déterminer s'il y a lieu de permettre des recours pour cause d'abus; ils soutiennent que lorsque la conduite d'un conseil est contestée dans une action pour abus, les tribunaux doivent établir si les administrateurs ont manqué à leurs devoirs de fiduciaires.*

* Assistant Professor, Faculty of Law, University of British Columbia and a senior research fellow in the Taxation Law and Policy Research Institute at Monash University.

** Visiting Olin Fellow, Yale Law School (2005-2006) and Associate Professor, Queen's University.
We would like to thank Jessica Penley for her excellent research assistance.

# Table of Contents

# The Allocation of Profits Between Related Entities and the Oppression Remedy: an Analysis of *Ford Motor Co. v. Omers*

ANITA I. ANAND AND KIM BROOKS

## I. Allocating the Profits of Integrated Businesses to the Related Corporate Entities

THE MANAGERS OF CORPORATIONS that are under common ownership and control and that form part of an integrated business have ample opportunity to locate the profits of the overall enterprise in whichever corporate entity they choose. One of the simplest methods of shifting profits within a corporate group is by manipulating the prices that are charged for the goods and services transferred between the members of the corporate group. For example, assume that in a corporate group under common control, ACo designs and engineers the development of automobiles and manufactures automobile parts and that BCo assembles the parts and sells the automobiles. If the corporate managers wish the profits of the enterprise to be located primarily in ACo—for whatever reason—they could set a high price for the parts that are transferred from ACo to BCo and charge BCo a good deal for the value of ACo's intangible design and engineering assets from which BCo clearly benefits. If these prices are set sufficiently high, it is possible that ACo could report a large profit from its operations in the common enterprise and that BCo could record a loss.

In tax law, the ability of managers in corporate groups to shift profits from one corporate entity to another through the manipulation of transfer prices—the prices charged for goods and services transferred between related persons—is primarily a problem when the corporate entities are located in different tax jurisdictions. If ACo were located in the United States and BCo in Canada, for example, both countries would have an obvious interest in ensuring that the profits earned by each corporate entity are accurately reported for tax purposes. Indeed, over the past 20 years, with increased intrafirm international trade,[1] the so called transfer pricing problem has

---

1. *The Economist* recently reported that sixty percent of international trade occurs within multinationals. "Corporate Tax: A Taxing Battle" *The Economist* 370:8360 (31 January 2004) 68, at 69, online: Economist.com <http://www.economist.com>. The sixty percent figure is a commonly relied upon statistic. See also OECD, *Economic Outlook (No. 71)* (2002) for a review of the trend to increasing intra-firm trade through the 1990s.

become one of the pre-eminent and daunting challenges of international tax. Although only a few cases have reached the courts in Canada,[2] there is a staggering amount of doctrinal, analytical, and critical literature in international tax law devoted to this issue,[3] and it appears that it will be an increasingly litigated matter in Canadian tax cases.

Transfer pricing arrangements also raise issues in corporate law. For example, in the illustrative case referred to above, assume that although ACo controlled BCo, minority shareholders held ten percent of BCo's shares. If the corporate managers were able to manipulate the prices of the goods and services transferred between the two corporations to shift profits to ACo, the value of the shares of BCo held by the minority shareholders would be affected. Two obvious legal issues are raised in such a case. First, what method should be used in determining whether the profits of the common enterprise are fairly allocated to the two separate legal entities? Second, if the minority shareholders conclude that the profits of BCo have been understated, and therefore their shares undervalued, should they be entitled to a remedy? If so, on what basis should it be granted?

These issues were raised in *Ford Motor Co. of Canada v. Ontario (Municipal Employees Retirement Board)*.[4] The case involved Ford Motor Co. (Ford US or Ford), located in the United States and its affiliate Ford Motor Co. of Canada Ltd. (Ford Canada), located in Canada. In 1995, Ford sought to force a buyout of the 6.17 percent of outstanding Ford Canada shares held by minority shareholders. Ford offered to pay the minority shareholders $185 per share. The minority shareholders contested this price and Ford Canada filed an application with the Court to fix the fair value of the shares. The minority shareholders counterclaimed alleging that their interests as minority shareholders had been oppressed because the transfer pricing policy followed by the corporate group had considerably understated the profits of Ford Canada and, therefore, the value of their shares.

---

2. There is surprisingly little tax case law on transfer pricing in Canada. For a review of the cases, see Patrick Boyle & Christopher Steeves, eds., *Canadian Transfer Pricing* (Toronto: CCH Canadian, 2002) c. 4; François Vincent, *Transfer Pricing in Canada: A Legal Perspective* (Toronto: Carswell, 2002) at 53–76 [*Transfer Pricing in Canada*]. See also François Vincent & Antonia Moquette, "New Wave of Transfer Pricing Appeals at the Tax Court of Canada" *Tax Management Transfer Pricing Report* 12 (15 October 2003) 562; François Vincent, "Canadian Transfer Pricing Litigation: A Growing Trend" *Tax Management Transfer Pricing Report* 6 (12 July 2000) 185.
3. For examples of the US literature, see Reuven S. Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of US International Taxation" (1995) 15 Va. Tax Rev. 89 [Avi-Yonah]; Stanley Langbein, "The Unitary Method and the Myth of Arm's Length" (1986) 50 Tax Notes 625; and Michael McIntyre, "The Use of Combined Reporting by Nation-States" in Brian J. Arnold, Jacques Sasseville & Eric M. Zolt, eds., *The Taxation of Business Profits Under Tax Treaties* (Toronto: Canadian Tax Foundation, 2003) 245. For Canadian examples, see Richard Bird & Donald Brean, "The Interjurisdictional Allocation of Income and the Unitary Taxation Debate" (1986) 34 Can. Tax J. 1377; Jinyan Li, "Global Profit Split: An Evolutionary Approach to International Income Allocation" (2002) 50 Can. Tax J. 823; and Jill C. Pagan & J. Scott Wilkie, *Transfer Pricing Strategy in a Global Economy* (Amsterdam: IBFD Publications, 1993).
4. [2004] 41 B.L.R. (3d) 74, O.J. No. 191 (Ont. Sup. Ct.) [*Ford Motor* cited to B.L.R.].

Justice Cumming of the Ontario Superior Court of Justice found that the transfer pricing arrangements between Ford and Ford Canada, which had resulted in losses to Ford Canada, would not have been maintained between independent parties and had reduced the value of the shares held by the minority shareholders. He held that the appropriate approach in determining the profits of Ford Canada was not to attempt to assign an arm's length price to each of the transactions that took place between Ford and Ford Canada, but instead was to start with the total profit of the Ford enterprise and then split it between Ford US and Ford Canada based upon their respective contributions to that profit. He also held that the minority shareholders were entitled to an oppression remedy. While the decision on the transfer pricing issue is sound, we disagree with the Court's analysis concerning the oppression remedy. The Court failed to fully analyze the relationship between the oppression remedy and the board's fiduciary duties. In addition, it overlooked important policy concerns relating to the legal rights of minority shareholders in the transaction at issue.

The next part of this comment reviews the facts of *Ford Motor*. To provide non-tax lawyers some context for of the nature of the problem in *Ford Motor*, Part III reviews the various methods that tax authorities use to allocate profits among related corporations. Part IV examines Justice Cumming's analysis of how the corporate group's profits should have been allocated between Ford US and Ford Canada. Part V critiques the court's analysis of the appropriate remedy for minority shareholders when profits of a corporation are found to be inappropriately determined. Part VI offers concluding comments about the importance of this case in tax and corporate law and argues there are fundamental problems with Canada's current approach to transfer pricing that should be rectified by legislative reforms.

## II. Why the Calculation of Ford Canada's Profit Became a Legal Issue

FORD'S NORTH AMERICAN BUSINESS operations are undoubtedly similar to those of many multinational enterprises. Ford had an incorporated business in the United States, Ford US, and an incorporated business in Canada, Ford Canada. For the period following the *Auto Pact*, Ford Canada had a well developed position in the market for Canadian automobiles. It had more than 20 percent of the Canadian new car and truck market, it owned the right to use one of world's best known brands, it had an extensive dealer network, it had built a new manufacturing plant in Oakville that was the only assembler in the world of the popular Windstar, and it had one of the highest revenues and number of employees of any business in Canada.

Ford divided its operations for the production of its automobiles into four divisions: design, engineering and the development of other intangibles; manufacturing; assembling the manufactured components; and vehicle sales. Of these four functions, Ford Canada only undertook the latter three. The development function, essentially the creation of intangible assets, was provided exclusively by Ford US, although one of Ford Canada's divisions, the Canadian Vehicle Sales Division (CVD), owned the intellectual property rights for Ford in Canada.

The relationship between the three business functions performed in Canada was straightforward. The manufacturing division transferred parts to the assembly division at prices fixed by Ford US in US dollars. The assembly division transferred assembled vehicles to the CVD also at prices fixed by Ford US in US dollars. These transfers from the manufacturing to the assembling and from the assembling to the sales divisions were made at a price that guaranteed a profit for these divisions. The only risk borne by those two divisions was the risk of reduced sales. Components manufactured or vehicles assembled in Canada may have been transferred either to the Canadian or US divisions, just as components manufactured or vehicles assembled in the US may have been transferred either to the US or Canadian divisions, but all transactions occurred in US dollars, at prices fixed by Ford US.

The CVD was responsible for selling the Ford vehicles and parts to independent dealers of Ford vehicles. Given the guaranteed profit for the manufacturing and sales divisions, the risk component of the business structure for Ford Canada rested with the CVD, as did the ultimate profit or loss. The business structure was identical in the US, where the risk, including the profit or loss, remained with the United States Vehicle Division (USVD). However, the CVD did bear some additional risks and costs that were not borne by USVD. First, since the prices charged on transfers from the assembling and manufacturing divisions to the CVD were in US dollars, if the US dollar appreciated in relation to the Canadian dollar, the CVD's cost of vehicles would increase relative to the price at which the vehicles were sold, which was denominated in Canadian dollars. That is, the CVD bore the risk of exchange gains or losses. Second, the CVD paid amounts to Ford US for the use of Ford's intangibles (the design and development expenses related to the production of Ford vehicles) and paid a charge to Ford US for administrative head office expenses. The payment for the design and development expenses was based on unit sales for most of the period. Between 1985 and 1995, Ford Canada paid Ford US approximately $3.586 billion in these fees for intangibles.

Ford US and Ford Canada had been trading goods and services since as far back as 1904; however, the transfer pricing agreements between them were updated substantially following the enactment of the 1965 *Auto Pact*, which increased the degree to which Ford was able to integrate its North American business. Despite subsequent amendments, after 1965 the fundamental approach to transfer pricing did not change. Ford Canada was always required to charge the Ford US interdivisional price (in US dollars), whether the models were assembled in Canada or not, and Ford Canada was always required to pay fees based on sales for the use of Ford's intangibles. As concluded by the Court:

> Ford Canada is a price-taker, with the CVD bound to accept the same prices set by Ford [US] for USVD. Those prices are based on fully-allocated costs, including mark-ups for manufacturing and assembly. They are set by Ford [US]. The prices and mark-ups are not negotiated with Ford Canada.[5]

From 1965 to 1977 Ford Canada was well served by the transfer pricing arrangements with Ford US and the Canadian company prospered. However, between 1977 and 1995 (a 19 year period) the CVD realized consecutive losses. Changes in several market factors, coupled with the unchanged transfer pricing arrangements, explained the consistent losses. The Canadian dollar declined dramatically relative to the US dollar, the purchasing power of Canadian customers declined relative to US customers, Canadians began purchasing smaller more fuel efficient vehicles than Americans, competition by Asian automobile makers began earlier in Canada and was greater than in the US, more extensive warranties were offered in Canada in light of competitive pressures, increased government legislation increased costs in Canada on vehicle emission and safety standards, and Canada's economic downturn in the early 1990s was more significant than in the US.[6] Despite these changing economic conditions, which meant that the CVD was not able to charge the same prices to independent Ford retailers in Canada as Ford US was able to charge to its retailers, and despite the fact that the CVD had additional costs, like the foreign exchange losses, more extensive warranty costs and intangible fees based on unit sales, there were no significant adjustments to the transfer pricing arrangements. As a result, between 1985 and 1995, Ford Canada reported losses of approximately $709 million. In contrast, Ford US reported profits of over $29 billion in the same period, with a net benefit of approximately $6 billion derived from sales into Canada and revenue from payments for the use of intangibles by Ford Canada.

In 1995, the former President of Ford Canada, Roy Bennett, in his capacity as Director of the Board, expressed concerns to the boards of both Ford Canada and Ford US that the minority shareholders of Ford Canada were being treated unfairly because the transfer pricing arrangements appeared to result in an unreasonably low rate of return on Ford Canada's

---

5. *Ibid.* at para. 66.
6. *Ibid.* at paras. 66, 101–07. Some of these factors are revisited numerous times in the judgment; see *e.g.* paras. 366–68, 386–88.

assets.[7] At the time, Ford US held a majority (93.83 percent) of the shares in Ford Canada, with the remainder of the shares (6.17 percent) held by the Ontario Municipal Employees Retirement Board (OMERS) and other minority shareholders. This concern resulted in a proposal by Ford in 1995 to enter into a going-private transaction whereby it would redeem the shares held by its minority shareholders for $185 per share. The going-private transaction had two steps. First, Ford Canada was exported from the *Canada Business Corporations Act*[8] and continued under Ontario's *Business Corporations Act*.[9] This continuance permitted the second step, which saw Ford Canada amalgamate with two wholly-owned subsidiaries of Ford US that were incorporated in Ontario. The minority shareholders' shares were then redeemed and Ford Canada became a wholly owned subsidiary of Ford US.

Ford Canada held a special shareholders meeting on September 12, 1995, and not surprisingly was successful in obtaining the requisite two-thirds approval to proceed with the going-private transaction. Ford Canada subsequently redeemed the shares of the minority shareholders for $185 and became a wholly-owned subsidiary of Ford US. However, 53.3 percent of the minority shareholders dissented in respect of the price to be paid for minority shares.[10] These shareholders sought to exercise their statutory right to compel Ford Canada to pay them the fair value of the shares, which they claimed was $642.50.[11] In such a case, statute permits a corporation to refuse to pay dissenting shareholders and instead to apply to court to fix the fair value of the shares of the dissenting shareholders.[12] Exercising this right, Ford Canada made an application to the Court to fix the fair value of the dissenting shareholders' shares.[13] The dissenting shareholders contested Ford Canada's proposed purchase price for their shares and counterclaimed.

7. A letter written by Mr. Bennett to Ford Canada's directors dated February 6, 1995 read as follows: "I urge you to review the situation with Ford US in the hope that changes can be made whereby Ford of Canada has an opportunity of participating in the profitability of the North American automotive operations and making a reasonable return on the assets employed. ... If the Canadian operations are not granted such an opportunity, then Ford US should at least buy out the minority shareholder interests." *Ford Motor*, *ibid.* at para. 350.
8. R.S.C. 1985, c. C-44 [CBCA].
9. R.S.O. 1990, c. B.16 [OBCA]. Despite the continuance, both parties agreed that the CBCA would be considered as the governing statute. *Ford Motor*, *supra* note 4 at para. 23.
10. Separate minority shareholder approval was not required because the transaction proceeded under the compulsory acquisition procedures set out in section 206 of the CBCA.
11. See CBCA, s. 190(3), which allows a shareholder who complies with the procedure set forth in s. 190 "to be paid by the corporation the fair value of the shares in respect of which the shareholder dissents, determined as of the close of business on the day before the resolution was adopted or the order was made." The minority shareholders also had a right of dissent related to the amalgamation under sections 176(2) and 185(1)(c) of the OBCA. For simplicity, the parties agreed to be governed by the CBCA provisions. *Ford Motor*, *supra* note 4 at paras. 19, 23.
12. *Ibid.*, s. 190(9): "If a dissenting offeree has elected to demand payment of the fair value of the shares under subparagraph (5)(*b*)(ii), the offeror may, within twenty days after it has paid the money or transferred the other consideration under subsection (6), apply to a court to fix the fair value of the shares of that dissenting offeree."
13. Such an application is permitted under statute. See CBCA s. 190(9).

Their counterclaim alleged that they were unlawfully oppressed[14] as a result of Ford's intercorporate transfer pricing system. Although the minority shareholders claimed that their interests were oppressed as a result of the operation of improper transfer pricing from the period of January 1, 1966 through September 11, 1995, they decided to limit their claim for oppression to the period from January 1, 1985 to September 11, 1995.

The Court ultimately held that Ford's dissenting minority shareholders should be granted the oppression remedy and a higher value for their shares. However, in coming to this holding, the Court was faced with the potential operation of the *Limitations Act*.[15] Because the Court determined that the *Act* applied in this case to limit the claims of the minority shareholders, counterclaiming minority shareholders were only awarded a successful claim for historical oppression for the period from January 11, 1994 to September 11, 1995.[16] Therefore, shareholders received a sum of $52.36 for historical oppression, prorated where the shareholder did not own the shares for the entire period. Justice Cumming also required that the shares of Ford Canada's minority shareholders be redeemed at a price of $207.00 to reflect the benefit of a change in transfer pricing approaches on a go-forward basis. In total then, a shareholder who held their shares from January 11, 1994 received $259.36, an increase of $74.36 from the initially offered redemption price. Of course, the operation of the *Act* obscures the result of Justice Cumming's holding. In the absence of the *Act*, minority shareholders would have received $582.50, a figure quite close to their claim.

## III. The Appropriate Method for Calculating the Profits of Related Corporations: the Tax Context

TRANSFER PRICING IS ONE of the foundational concepts of international tax. If income earned by a multinational is to be fairly allocated to the various taxing jurisdictions in which it carries on its business, a method of attributing its profits to its corporate entities in each of those jurisdictions must be developed. The method chosen should, of course, allocate income to those enti-

14. Their claims relating to oppression were made pursuant to CBCA, s. 241. See *Ford Motor, supra* note 4 at para. 32.
15. R.S.O. 1990, c. L.15, as rep. by S.O. 2002, c. 24, Sch. B, s. 26 [*Act*]. Parts II and III of the 1990 Act, including the provision that was at issue in *Ford Motor*, were re-enacted under the 2002 Act. What remained of the 1990 Act (the definitions and Part I) was renamed the *Real Property Limitations Act*, R.S.O. 1990, c. L.15. See also *Ford Motor, ibid.* at para. 267.
16. *Ford Motor, ibid.* at para. 272. Section 45(1)(g) of the *Limitations Act* was held to restrict any claim that arose more than six years prior to the allegation of oppression. As OMERS' counterclaim alleging oppression was issued on January 11, 2000, any claim arising prior to January 11, 1994 was held to be statute-barred.

ties in the proportion to which they contributed to earning the overall profits of the multinational. In addition, the chosen method should satisfy the familiar tax policy criteria: it should result in similar corporate entities being treated alike whether they deal with related corporations or not; it should be neutral in its effect on the business operations of the corporation; and it should be relatively simple to administer, inexpensive to comply with, and difficult to manipulate. Finally, the method, or similar methods, should be widely adopted by the major nations of the world so that income earned by multinationals is taxed at least once in the most appropriate jurisdictions, but is not double taxed. A brief review of the various methodologies used for allocating profits to related corporations for tax purposes, and of the development of transfer pricing policies in international tax, will provide some context for the issues faced by Justice Cumming in *Ford Motor*.

### A. TRANSFER PRICING METHODS

There are three obvious ways of attempting to determine the profits of separate corporations that have substantial dealings with one another and are members of a related group. Tax authorities have used all three methods from time to time.[17]

#### *1) Transaction Method*

First, under the transaction method, a price is assigned to each transaction between the related corporations and the profits of each corporation are calculated on the assumption that these prices were in fact charged and paid. The assigned prices are meant to correspond to the prices that would be paid in comparable dealings between unrelated or arm's length persons. Three methods are used, in turn, by tax authorities in deciding what prices would be paid in comparable dealings between arm's length persons. Most obviously, an arm's length price for goods and services transferred between related corporations can be established by reference to the prices that are actually paid for comparable goods or services sold between unrelated persons. This is referred to as the comparable uncontrolled price method (CUP) and it is the traditional method that is preferred by the Canada Revenue Agency, Canada's tax administration body. This approach is obviously easiest to apply where the transactions entered into by related entities are exactly the same as the transactions entered into by unrelated entities. Where there are minor differences between the transactions, these can generally be accommodated in adjustments to the price charged, but where the

17. See Canada Customs and Revenue Agency [now Canada Revenue Agency], Information Circular 87-2R, "International Transfer Pricing" (27 September 1999) Part 3, online: Canada Revenue Agency <http://www.cra-arc.gc.ca/E/pub/tp/ic87-2r/ic87-2r-e.html> [IC 87-2R]; OECD Committee on Fiscal Affairs, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, (Paris: OECD, 2001) c. II and III [*Transfer Pricing Guidelines*].

transfers between the related corporations are unique this method requires a good deal of speculation in arriving at a price or is simply impossible to use.

If there are no comparable sales between unrelated corporations, in some cases an arm's length price for transfers between the related entities can still be estimated by starting with the price at which the good is ultimately sold to an unrelated purchaser by the related corporation distributing the product and then subtracting an appropriate mark-up or gross profit for that corporation. The resulting price is presumably the price at which the related corporation would have sold the good to the distributing corporation if they had been unrelated. The appropriate mark-up to be charged by the distributing corporation must be determined by examining the gross profits typically earned by distributors of comparable goods. This approach, referred to as the resale price method, can obviously only be used where the transaction is entered into by unrelated parties, and is most easily employed where the related purchaser adds little value to the product sold to the unrelated party.

Even if there are no comparable unrelated sales, and the related purchaser of the good or service does more than merely distribute the good or service, an arm's length price for goods and services transferred between related parties might still be estimated using a third method, the cost plus method. This method establishes an arm's length price by requiring the corporation selling to a related entity to determine its costs of producing the good and service and then add an appropriate gross profit mark-up to arrive at a deemed sales price paid by the related party. Determining an appropriate gross profit mark-up requires finding the gross profit mark-ups of a comparable corporation selling to unrelated parties. Thus, the cost plus method is appropriately employed only where the unrelated comparator entity has approximately the same costs for raw materials, repair and maintenance, operating and administrative costs, and so on as the related corporation.

### 2) *Comparable Profits Method*

Under the transaction method of determining the profits of related corporations belonging to a controlled group of corporations, a price is assigned to each transfer between them on a transaction-by-transaction basis.[18] Another method is to determine its' profits directly by comparing it to a similar unrelated corporation. The comparable profits method rests on the premise that over time corporations that are similarly situated and engaged in the same types of transactions will earn a comparable profit. Although this method raises many complexities, it basically involves two steps. First, some profit level indicator of a comparable business is found. For example, the

18. Although in some circumstances where transactions cannot be separated, bundling transactions may be acceptable. See IC 87-2R, *ibid.* at para. 37.

rate or return on capital employed (the ratio of operating profit to operating assets) of a similar business is determined. Second, that profit level indicator is applied to the financial data of the corporation that is a member of a related group of corporations and whose profits are in issue. Thus, if the comparable business is earning a ten percent rate of return on its invested capital, for example, the related corporation will be assumed to have profits equal to ten percent of its invested capital. Instead of examining the overall profit margins of comparable businesses, a variation of this method involves examining only the net margins normally earned on specific types of transactions. When used in this way this method is sometimes referred to as the Transactional Net Margin Method (TNMM).

*3) Profit Split Method*

Finally, a third method sometimes used for determining the profits of a related corporation is the profit split method. Although it is listed by the OECD as a less radical method than the TNMM, in practice it is the most radical of the methods; it treats the related corporations as an economic unit. Thus, it may not depend upon an examination of individual transactions between the related corporations. Instead, an application of this method, at least as employed by the US courts, begins with the overall profits of the related corporations.[19] Then, that profit is allocated among the related corporations based upon their assumed economic contributions to the economic unit. The assumed economic contribution of each of the related corporations might be based upon the value of the invested capital employed by each corporation, or upon the proportion of the combined profits earned by unrelated corporations whose transactions and activities are similar, or upon some arbitrary allocation of profits such as a 50–50 split.

In *Ford Motor* all three methods for determining the profits of a related corporation were employed by the transfer pricing experts who gave evidence at trial. As will be shown below, traditionally, tax authorities have favoured the transactional method. What makes *Ford Motor* such a significant decision on the transfer pricing issue is that in determining the value of the minority's shares in Ford Canada, Justice Cumming adopted the profit split method. Before turning to the judgment, again to provide some context for the decision, we briefly trace the development and use of these three methods in international tax law.

Some countries expressed concern about the tax problems posed by the transfers of goods and services between related enterprises as early as the 1920s and 30s. For example, the US enacted a transfer pricing rule in

---

19. Although often the profit is the overall entity profit, or the profit for a particular business branch of the entity, in some cases, the profit of a particular transaction may be split.

1921.[20] The US rule authorized the Internal Revenue Service (IRS) to allocate gross income, deductions, credits and other allowances among two or more organizations, trades or businesses under common ownership or control whenever it determined that this action was necessary to prevent the evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses. This provision in the *Internal Revenue Code* has changed little since its introduction.[21] It was not clear from this general provision what methodology was to be used by taxpayers to allocate the income and deductions among corporations under common control; however, it appears that the IRS used transactional methods and required related corporations to assign prices to all transfers of goods and services among themselves on the assumption that they were dealing with one another at arm's length. Regulations promulgated in 1935 provided that:

> [t]he purpose of section 45 [the section then governing transfer pricing] is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer.... The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.[22]

International efforts to come to grips with the tax problems posed by transfers of goods and services between related corporations were initiated in the 1920s and 1930s by the League of Nations as part of its work on a proposed model tax convention to deal with the more general international tax problem of double taxation. Its 1935 Draft Model Convention contained a provision that was interpreted as requiring multinationals to price intracor-

---

20. *Revenue Act of 1921*, c. 136 § 240(d), 42 Stat. 227, which read:

> For the purposes of this section a corporation entitled to the benefits of section 262 shall be treated as a foreign corporation: *Provided*, That in any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses.

Walter E. Barton & Carroll W. Browning, *Barton's Federal Tax Laws Correlated*, 2d. ed., vol. 1 (Branford, Connecticut: Federal Tax Press, 1925) at 238 (footnotes omitted). For discussions of the history of the US rules see Avi-Yonah, *supra* note 3; Michael C. Durst & Robert E. Culbertson, "Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today" (2003) 57 Tax L. Rev. 37.

21. *Internal Revenue Code*, 1 I.R.C. § 482 (2001) currently reads as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property...the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

22. *Revenue Act of 1934*, Art. 45-1(b) of Reg. 86 (1935) in Avi-Yonah, *supra* note 3 at 97.

porate transfers as through they were dealing with arm's length parties.[23]

Canada first enacted a rule to deal with transfer prices in 1938.[24] Parenthetically, this trend—of the US acting first, followed by the relevant international body recommending rules similar to those accepted in the US, and then followed by Canada adopting rules or practices endorsed by the international body—is repeated throughout the development of the modern transfer pricing rules. The Canadian rule did not explicitly prescribe the method to be used in calculating the profits of related corporations that were dealing with one another; it simply provided that the Minister may adjust transfer prices where "an amount which is not in conformity with similar payments made by other persons in the same kind of business."[25]

Following this flurry of activity in the 1920s and 1930s, there was little focus on the problems posed by transfer pricing until the 1960s. Then, in response to concerns that its rules were too lenient,[26] the US revised its regulations to explicitly accept three possible transactional methodologies based on the arm's length principle—the comparative uncontrolled price method, the resale price method and the cost plus method.

In 1972, the Canadian rules dealing with transfer pricing were reformulated and became subsections 69(2) and (3) of the *Income Tax Act*.[27] These were the rules in place when Ford structured its transfer pricing arrangements. Essentially they provided that where non-arm's length parties across national jurisdictions agreed to pay a non-arm's length price, rental, royalty or other payment for goods or services, and the amount was not what would have reasonably been charged between arm's length parties, a reasonable amount would be used for the purposes of computing income. Other than requiring that the intercorporate transfer price had to be 'reasonable', and reflect arm's length prices, subsections 69(2) and (3) provided little guidance on the methodology a taxpayer should employ.

---

23. See Langbein, *supra* note 3 at 633.
24. Section 23B of the *Income War Tax Act*, R.S.C. 1927, c. 97 as am. by S.C. 1939, c. 46, s. 13 [*Income War Tax Act*] provided that:

    > Where any person carrying on business in Canada pays to a non-resident as price, rental, royalty or other payment for the use of any property or reproduction thereof, or for any right, an amount which is not in conformity with similar payments made by other persons in the same kind of business, then such payment may, for the purposes of determining the income of such person, be adjusted by the Minister accordingly, unless he is satisfied that the payor and the recipient are not associated, controlled one by the other, or controlled by the same interests.

    These rules were amended on several occasions, for example, in 1948 and 1952. For a brief history of Canada's rules, see Boyle & Steeves, *supra* note 2 at c. 2; *Transfer Pricing in Canada*, *supra* note 2 at c. II.
25. *Income War Tax Act*, *ibid.*
26. For a discussion of the need to strengthen the US rules on transfer pricing, see generally Stanley S. Surrey, "Treasury's Need to Curb Tax Avoidance in Foreign Business Through Use of 482" (1968) 28 J. Tax'n 75; Stanley S. Surrey, "Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions" (1978) 10 Law & Pol'y Int'l Bus. 409.
27. *Income Tax Act*, R.S.C. 1952, c. 148, as am. by S.C. 1970-71-72, c. 63.

Largely adopting the approach undertaken by the US in its 1968 regulations, in 1979, the Organisation for Economic Co-operation and Development (OECD) published its first significant report on transfer pricing, *Transfer Pricing and Multinational Enterprises*.[28] Not surprisingly, that report endorsed the three traditional methods listed in the US regulations—the comparable uncontrolled price method, the resale price method, and the cost plus method.

In 1987, following the US regulations by 19 years, a Canadian Information Circular was released that provided some guidance on appropriate transfer pricing methodologies.[29] This was the Information Circular in effect when Ford Motors engaged in the transactions at issue in *Ford Motor*. Information Circular No. 87-2 noted that a reasonable arm's length price was a fair market value price applied on a transaction-by-transaction basis.[30] In terms of methodologies for determining an arm's length price, mirroring the US regulations, the Revenue Agency endorsed first the comparable uncontrolled price method, then a cost plus or resale price method. If none of these methods could be employed, the Information Circular suggested that "other methods" may be adopted, but what constituted an "other method" was not described in detail.[31] There was no specific mention of the split profit method.

As multinationals began dominating world trade and investment, the transfer pricing rules not only became a more significant part of domestic tax systems but also became harder to apply. In 1988, the US released a White Paper on intercompany pricing.[32] The Paper recognized that it was often difficult to apply the transactional method since a comparables methodology was only applied appropriately when the transactions being compared were virtually identical. It endorsed a much broader range of transfer pricing methodologies, including a split profit approach and an approach that ultimately took some form as the US comparable profits method. The report did suggest that the priority for the comparable uncontrolled price method be retained, but that in the absence of comparables, the best method, whether a profit split or some other method, be employed.

In 1994, in response to the 1988 White Paper, the US regulations were significantly revised. These revisions introduced rules that were specific to certain categories of income, for example, commensurate with

---

28. OECD Committee on Fiscal Affairs, *Report of the OECD Committee on Fiscal Affairs: Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979).
29. Canada Customs and Revenue Agency, Information Circular No. 87-2: *International Transfer Pricing and Other International Transactions* (27 February 1987), online: IC 87-2 International Transfer Pricing (Archived) <http://www.cra-arc.gc.ca/formspubs/prioryear/ic87-2/README.html> [IC 87-2].
30. *Ibid.* at para 7.
31. *Ibid.* at paras. 19, 20.
32. US, Treasury Department, *A Study of Intercompany Pricing Under Section 482 of the Code*, Notice 88-123, 1988-4 I.R.B. 7, 1988-2 C.B. 458 (1988) (Lexis).

income rules for intangibles that essentially required intangible transfers to be priced as though a licence to use the intangible through its useful life was granted, and permitted a broader range of methods. The methods allowed were, however, not nearly as broad as the methods suggested in the earlier White Paper, and included the traditional three methods in addition to profit split and comparable profit methods. Until this time, the transactional methods were the preferred method. However, as suggested in the White Paper, the 1994 regulations were changed to require the adoption of the "best method" available to the taxpayer.[33] The best method is the "method that, under the facts and circumstances, provides the most reliable measure of an arm's length result."[34]

In 1995, almost simultaneously to the release of the US' revised regulations, the OECD released its updated report on transfer pricing rules, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.[35] Unlike the US regulations, this report continued to favour the traditional transaction methods approach to transfer pricing. The profit split method is seen as a method of last resort, employed only in "exceptional" cases where traditional transaction methods are impractical or unreliable.

In response to the release of the 1995 OECD report, in 1997 Canada adopted new, more detailed, transfer pricing rules in section 247.[36] Although it might have been argued that the transfer pricing methodology required under subsections 69(2) and (3), the subsections in force at the time of the facts in *Ford Motor*, was unclear, Canadian multinationals are now clearly required by subsection 247(2) to compare the terms and conditions of their transactions with the terms and conditions that would be charged by arm's

---

33. See the "best method" rule, 26 C.F.R. § 1.482-1(c)(1) (1994). That rule provides:

> [i]n general. The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result.

See § 1.482-8 for examples of the application of the best method rule. See also § 1.482-7 for the applicable method in the case of a qualified cost sharing arrangement.

34. *Ibid.*

35. *Transfer Pricing Guidelines*, *supra* note 17.

36. *Income Tax Act*, R.S.C. 1985 (5th Supp.), c. 1. See also *Income Tax Amendments Act*, 1997, S.C. 1998, c. 19, s. 107(1) and Summary at para. 3, online: CanLii <http://www.canlii.org/ca/as/1998/c19/part3760.html> [Summary], which repealed subsections 69(2) and (3). In its February 1997 federal budget, the Department of Finance announced that one of the objectives of the change in legislation was "to harmonize the standard contained in section 69 of the Act with the arm's length principle as defined in the revised OECD guidelines...". Canada, Department of Finance, *Budget 1997: Budget Plan Including Supplementary Information and Notices of Ways and Means Motions*, (Ottawa: Department of Finance Canada, 1997) 173 at 203, online: Department of Finance Canada <http://www.fin.gc.ca/budget97/binb/bp/bp97e.pdf>.

length parties. As with the American rules, and consistent with the historical development of the legislation and administrative guidelines addressing transfer pricing, Canada's new transfer pricing legislation does not set the arm's length methodology to be adopted; instead, after the introduction of section 247 the Revenue Agency released a revised Information Circular on transfer pricing, Information Circular No. 87-2R, that sets out its' position on appropriate methodologies.[37] The Revenue Agency simply accepts the methods, and the hierarchy of methods, endorsed by the OECD.[38]

From this brief review, it is clear that at the time the *Ford Motor* facts arose, the transactional method of determining transfer prices was the most widely accepted among Canadian tax authorities. The comparable profits method and the profit split methods were acknowledged as approved methods, but only as a last resort. However, these methods were becoming increasingly acceptable, and by 1995, the last year in review by the Court in *Ford Motor*, the US had made significant strides toward endorsing a profit split methodology. Canada was sure to follow, and in fact did follow the US lead, but not until 1997, and then only as a lower ranked method.

## IV. The Allocation of Profits in *Ford Motor*

THE FIRST ISSUE THAT HAD TO BE RESOLVED in *Ford Motor* was the determination of the profits of Ford Canada between 1985 and 1995. Ford contended that Ford Canada was profitable under the transfer pricing system, except during periods of recession. The minority shareholders of Ford Canada, including OMERS, contended that Ford Canada should have earned an overall profit in the ten year period. Interestingly, the case turns almost exclusively on which methodology should be used in determining the profits of Ford Canada. On one hand, Ford called experts who testified that using a transactional approach, either the comparable uncontrolled price method or the cost-plus mark-up method, Ford Canada had appropriately determined its profits, and had realized losses only between 1979 and 1982 and between 1990 and 1995. On the other hand, experts called by OMERS testified that using a version of the profit split method it was clear that Ford Canada should have been earning considerable overall profits in the 1985 to 1995 period.

Ford's chief expert on transfer pricing was Delores Wright, then with Charles River Associates Inc. in Boston. Wright employed a transactional approach to the intrafirm transfers—using a comparable uncontrolled price method and a cost-plus method to determine arm's length prices between divisions. Wright concluded that the basic structure of Ford's transfer pricing was in accordance with the US transfer pricing rules. Wright opined that

37. IC 87-2R, *supra* note 17. Summary, *ibid.* at para. 3.
38. *Ibid.* at para. 52.

Ford Canada's profits or losses were therefore justified given the risk of the Canadian marketplace and the ownership of the intellectual property rights.

Brown, also an expert called on behalf of Ford and a transfer pricing expert formerly with KPMG LLP, claimed that the adoption of the split profit approach, the approach proposed by OMERS' experts, would incorrectly result in "a forced expropriation of intellectual property without compensation."[39] In other words, Brown contended that the profit split approaches applied by OMERS' experts incorrectly reallocated the intellectual property ownership between Ford Canada and Ford US. Instead, Brown argued that if an adjustment was to be made the comparable profits method, a method common in the US, but not acceptable for tax purposes in Canada, ought to be adopted in this case.

Then OMERS called three experts. Richard Clark of Deloitte & Touche LLP in Washington, D.C., recommended a transfer pricing method that the Court called a "comparables" approach, although from its description in the case his approach appears to be a form of profit split. Clark looked at each of Ford Canada's business operations and determined a notional arm's length operating margin for each based on comparisons with similar manufacturers. This calculation was refined by the application of a "market adjustment factor", which was intended to account for market differences between the conditions faced by Ford Canada and those faced by similar manufacturers. Ultimately, Clark concluded that Ford Canada's total operating profit should have been $2.573 billion greater in the ten year period under review.

Another expert for OMERS was Thomas Horst of Horst Frisch Inc. in Washington, D.C. He reviewed the various transfer pricing methodologies, including the comparable uncontrolled price method, and ultimately recommended an approach that used an asset-based profit-split method. To effect this approach, which Horst argued provided, "the most reliable method for determining an arm's length transfer price,"[40] Horst split Ford's overall profit or loss based on the relative share of net fixed assets for each division. Horst supported his adoption of this approach by noting that it was consistent with the kinds of arrangements entered into between Ford and Mazda. Using this method, Horst decided that an additional $3.035 billion should have been allocated to Ford Canada between 1985 and 1995.

OMERS' third expert was Gregory Ballentine, who was then with Bates, White & Ballentine LLC in Washington, D.C. He used a return on investment approach. Ballentine calculated that the understatement of income to Ford Canada was approximately $2.8 billion for the ten year period.

Justice Cumming was persuaded by the split profit approach adopted

39. *Ford Motor*, *supra* note 4 at para. 433.

40. *Ibid.* at para. 401.

by Clark and Horst. In other words, Justice Cumming accepted that the combined profits of the Ford enterprise should be allocated based on the share of assets owned by each company. Justice Cumming reasoned that a split profit method was appropriate because it achieved arm's length results, and reflected the integrated nature of the Ford business.[41] Justice Cumming was also persuaded by the critiques of Wright's approach raised by Ballentine. Ballentine argued that Wright's approach would lead to an average rate of return on investment for the CVD of negative 23.5 percent between 1985 and 1995, and an average rate of return for USVD of 26.8 percent during that period. Ballentine opined that these rates of return could not be justified given the market conditions. Justice Cumming agreed that these rates of return would not be acceptable to arm's length parties. He also disputed the approach endorsed by Brown on behalf of Ford Canada on the basis that it was "too simplistic to look at the nominal ownership of intellectual property as logically governing the allocation of entrepreneurial risk."[42]

After reviewing the testimony of these transfer pricing experts and their reports, Justice Cumming's principal finding was that the results of the transfer pricing arrangements between Ford US and Ford Canada, namely that the CVD had suffered consecutive losses, would not have been sustained if the parties had been dealing at arm's length. Instead, if the parties were unrelated they would have renegotiated their arrangements so that Ford Canada made a larger profit. Therefore, he concluded that instead of a transactional method, a profit split method should be used in determining the profits of Ford Canada. Accepting the evidence of OMERS' experts meant that the understatement of Ford Canada's income was in the range of $2.6 to $3 billion for 1985 to 1995:

Justice Cumming supported his conclusions by noting that the transfer pricing method adopted by Ford's competitors General Motors and Chrysler permitted a profit to be realized in their Canadian subsidiaries. The Court also looked at the way risks were allocated in arrangements between Ford US and Mazda and between Ford US and Kia. In each case, the Court found that the pricing arrangements were different from those established

---

41. Cumming J. wrote:

> [m]y observation is that the profit split method is appropriate not only from the standpoint of better achieving arm's length results but also accords with the substantive reality of the Ford enterprise. Ford was operating in an integrated market by reason of the Auto Pact. With the asset of the directing mind of Ford Canada the Ford enterprise was seen simply as being a single entity, that is, the enterprise was indifferent to the internal divisional impact of the profit/loss allocation due to the realities of the unavoidable market differences in pricing in the two jurisdictions. Ford Canada was operating *de facto* as a wholly-owned subsidiary where such realities would not matter (leaving aside tax considerations, given different tax rates in the two jurisdictions) in the internal transfer pricing. As a wholly-owned subsidiary there would be only one consolidated loss or profit for the enterprise which would not change whatever the internal pricing structure might be.

*Ibid.* at para. 402. See also *ibid.* at para. 434.

42. *Ibid.* at para. 423.

between Ford US and Ford Canada, but stated that the mere fact that the risks were allocated differently did not mean that the system established between Ford US and Ford Canada violated Canada's transfer pricing rules.

Justice Cumming's decision to endorse a split profit approach is defensible. As reviewed above, under the Revenue Agency's guidelines in place at the time that Ford was engaged in the transfers under review by the Court, a profit split approach was not obviously acceptable. The guidelines, however, did permit the use of "other methods" when one of the three listed methods was not appropriate, and the United States was moving in the direction of broadening its acceptable methods. Also, the Revenue Agency's Information Circular is not binding law. It is simply a guideline. Provided a Court finds that the transfer pricing arrangements reflect arm's length prices, the method used should not be important.

Justice Cumming's acceptance of a split profit approach is sensible for at least four reasons. First, a profit split method is at least *prima facie* the appropriate method where a transactional approach results in large differences in the profits of two related corporations. The reason for this is that if one related corporation is continually operating at a loss it is very likely that it is contributing to the profits of the overall enterprise in ways that are not manifest through an arm's length pricing of individual transactions. The OECD *Transfer Pricing Guidelines* provide, "[a]nother strength [of the split profit approach] is that under the profit split method, it is less likely that either party to the controlled transaction will be left with an extreme and improbable profit result, since both parties to the transaction are evaluated."[43] This, of course, was precisely the situation in *Ford Motor*. Using transactional methods, Ford Canada was "left with an extreme and improbable profit result."[44]

Second, a profit split method should be used where there are no comparable transactions to establish prices for individual transactions. In this case, while there were some comparable transactions they were not entirely appropriate. For example, the experts reviewed the transfer pricing arrangements used by General Motors and Chrysler, but those companies transfer goods and services among related entities in controlled transactions, like Ford. Clark highlighted arrangements between Ford and Kia and Ford and Mazda, unrelated companies, but prices for goods and services transferred between those companies were based on ensuring each earned a reasonable profit. In fact, because of the difficulties of finding comparables, many commentators suggest that, in practice, transaction methods can rarely be employed and that profit split approaches are frequently used instead. Robert Couzin, a leading Canadian tax practitioner, has stated that:

---

43. *Transfer Pricing Guidelines*, *supra* note 17 at III-3, para. 3.7.

44. *Ford Motor*, *supra* note 4 at para. 150.

> both business representatives and tax administrations seem to have discovered that profits methods, whatever their theoretical weaknesses have a significant role to play. Notwithstanding the short shrift they were given in the TP [transfer pricing] Guidelines, such methods are widely applied by multinational enterprises and often serve as the basis for both Advance Pricing Agreements and competent authority settlements.[45]

Similarly, François Vincent has observed "the realities of transfer pricing practice have seen the residual profit split method being used more often by the Canadian and US tax authorities both as a 'sanity check' and as a primary method."[46] As identified by Vincent, similar trends can be identified in the US practice and case law. Notably, as remarked by one commentator, "[v]irtually none of these [US transfer pricing] cases ultimately was decided by reference to comparables."[47] Similarly, Avi-Yonah reports:

> [i]f one takes only the cases surveyed in the White Paper...and the few major cases decided between 1988 and 1992, one finds that up to 1973, the ALS [arm's length standard] based on comparable transactions was employed in 9 of 14 cases (64%). From 1974 onward, comparables were found only in 4 of 13 major section 482 cases (31%). In all of these four cases...the Service argued that the comparable was inappropriate....[48]

Third, a profit split method is particularly appropriate where there are significant intangibles being transferred between related corporations, as there were in *Ford Motor*, because the valuation of intangibles presents intractable problems for transactional methods. Many, if not most, intangibles are unique and it is impossible to find a comparable transaction in order to establish an arm's length price. For this reason, the US Congress amended the transfer pricing provision of the IRC, section 482, to expressly provide that in the case of a transfer of a license of an intangible "the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."[49] This amendment meant that royalties paid by related corporations for intangibles would have to be adjusted each year to reflect the income that the intangible was in fact generating. Moreover, it also meant that a profits-based method, such as the profit split method, was expressly endorsed in the case of the transfer of intangibles.[50]

The difficulty of assessing the value of the use of intangibles and the weight to be attached to their ownership is reflected in Justice Cumming's judgment. In *Ford Motor*, the Court held that:

---

45. Robert Couzin, "Beyond our Borders: Some Global Tax Developments" in Canadian Tax Foundation, *Report of Proceedings of the Fifty-Fifth Tax Conference Held September 21–September 23, 2003* (Toronto: Canadian Tax Foundation, 2003) 3:1 at 3:4-5.
46. Vincent, *supra* note 2 at 82.
47. Durst & Culbertson, *supra* note 20 at 59.
48. Avi-Yonah, *supra* note 3 at 112, n. 104. Of course, it could be the case that only cases without comparables proceed to litigation.
49. *Supra* note 21.
50. See 26 C.F.R. §§ 1.482-4(c)(1) and 1.482-4(f)(2).

> [t]he allocation of intangibles...and the price paid therefore, is one aspect of the overall transfer pricing system.... The ownership of intangibles and the allocation of risk need not be coincidental. Ford [US] has rights to the intangibles that are superior to those of Ford Canada yet allocates the risk of the Canadian market to the CVD. Ford attempts to rationalise the allocation of residual risk to the CVD on the basis that the CVD owns intangibles, assigned to it by Ford.[51]

Even more explicitly, Justice Cumming stated, "[t]he historically assigned ownership of intangibles is meaningless and of no real value to an entrepreneur who has no realistic foreseeable prospect of making a profit from the ownership of those intangibles...."[52] This reasoning, which is sensible, runs counter to much of the literature on the role intangibles play in transfer pricing. Generally, the ownership of intangibles is seen to justify increased risk and, consequently, the allocation of increased profits. In fact, the Court determined that, in the absence of the payment for intangibles, Ford Canada had a trade surplus for its trade in tangible goods. However, it paid $3.586 billion to Ford US for the use of the intangibles, which resulted in an overall loss for Ford Canada of $709 million.

Fourth, the profit split method should be used where the corporations are highly integrated. It may well make sense to a parent corporation to set up a subsidiary in a jurisdiction where an independent third party would not be able to make a sufficient profit to justify incurring all of the costs of operations. For example, Justice Cumming recognized that the Canadian market may well have been a worthwhile one, despite the possibility that it could not bear the fully allocated costs of the production of Ford vehicles. In fact, *Ford Motor* presents a model example of the integration of corporate entities across borders. As noted in the judgment:

> [t]he two entities, Ford Canada and Ford [US], have operated in an integrated North American market (United States and Canada) since the inception of the Canada-United States Auto Pact in 1965. The removal of tariff barriers resulted in the incremental integration of Ford's manufacturing and assembly operations in the two countries so as to achieve specialization and economies of scale.[53]

Justice Cumming explicitly recognized the advantage and purpose of an integrated market. He stated:

---

51. *Supra* note 4 at para. 342. See also para. 423:

    [i]n my view, it is too simplistic to look at the nominal ownership of intellectual property as logically governing the allocation of entrepreneurial risk in the case at hand...No rational, independent entrepreneur in Ford Canada's position would agree to continue operations destined only to generate foreseeable, inevitable losses year-in, year-out, due to foreseeable continuing adverse economic conditions coupled with a known, static transfer pricing system. The simple ownership of intellectual property does not mean that such owner will irrationally buy and re-sell goods at an inevitable loss.

52. *Ibid.* at para. 429.
53. *Ibid.* at para. 57.

> [o]ne sees the advantages of a single, integrated, large market in this approach [the allocation of responsibilities for design and engineering functions for vehicles sold in the North American market to Ford US]. Free trade does not lead to a 'zero sum' gain, but rather leads to a 'win-win' situation with gains in both countries.[54]

Requiring a multinational to determine an appropriate arm's length price, when the whole purpose of the multinational company is that a fully allocated arm's length price would be unsustainable, is absurd. As summarized by Justice Cumming, "a market is still profitable to a vendor, provided the incremental costs are recovered and some contribution is made to fixed costs."[55] In other words, it may well make sense for a parent company to operate a subsidiary in a jurisdiction despite not being able to fully recover the costs of the vehicle production from sales in that jurisdiction. This is particularly true where intangibles that have been developed can be shared among entities. Here, once Ford US had spent money to develop engineering designs, trademarks and so on, that intangible property could be shared with Ford Canada at no incremental cost to Ford US. The Court, in confirming its analysis, was influenced by the approach to pricing adopted by Chrysler and General Motors, which did not require cars to be sold in Canada based on a fully-allocated cost basis.

Assuming the transfer pricing arrangements that Ford had put in place were inappropriate for tax law purposes, the question remains as to whether or not they should therefore be found to be inappropriate for corporate law purposes. Both parties argued that a finding that the transfer pricing regime violated tax law was synonymous with a finding that it was oppressive to minority shareholders. Justice Cumming appeared to be of the view that a transfer pricing arrangement might be acceptable for tax purposes, but unacceptable for corporate purposes. As he stated:

> it is not sufficient for a taxpayer to simply have a transfer pricing regime that does not find objection with the tax authorities. The transfer pricing system must not result in unfairness to minority shareholders such as to constitute oppression within the ambit of the CBCA.[56]

---

54. *Ibid.* at para. 361.
55. *Ibid.* at para. 134.
56. *Ibid.* at para. 129. Similarly, Justice Cumming concluded: "[n]or does the fact that a transfer pricing system is acceptable to the tax authorities necessarily mean the system provides prices that are not unfair to minority shareholders of a corporate party." *Ibid.* at para. 131. See also *ibid.* at para. 143:

    [a] transfer pricing system that is found to be unlawful from the standpoint of the tax authorities might well not be oppressive to shareholders. Indeed, a transfer price system that meets with tax problems is usually to the benefit of the narrow, private self-interest of all the shareholders while being at the expense of the public interest through the loss of tax revenue. Conversely, a transfer pricing system that meets the criteria of the tax authorities does not in itself necessarily establish that there cannot be a finding of oppression in respect of shareholders. Rather, the proper question is: does the overall evidence of the corporate operations of Ford Canada establish oppression in respect of the minority dissenting shareholders within the ambit of s. 241 of the CBCA?

Although Justice Cumming's judgment is clear that different transfer pricing methodologies may be appropriate for tax and corporate law purposes, he expressed no firm view on whether or not the transfer pricing regime adopted by Ford Canada actually violated section 69 and the then-governing Canada Revenue Agency administrative guidelines. He did note that the Canada Revenue Agency had audited Ford Canada's transfer pricing regime a number of times between 1965 and 1995 and had not apparently identified any major transfer pricing issues. However, Justice Cumming emphasized that neither the Canada Revenue Agency nor the IRS had conducted a full scale audit on the transfer pricing arrangements.[57] He also reported that although Ford US had hired a transfer pricing expert to conduct a review of its transfer pricing regime in the early 1990s, no similar report was prepared on behalf of Ford Canada.[58] Justice Cumming's ambivalence about whether or not the regime actually did meet with approval by tax authorities is reiterated in several places throughout the judgment.[59]

On the one hand, it is surprising that Ford Canada was never comprehensively audited after the CVD realized consecutive losses for 19 years, and Ford Canada realized an overall loss of $709 million between 1985 and 1995. Consecutive losses sustained by one member of a multinational are considered one of the key indicators of an inappropriate transfer pricing system. In fact, the OECD expressly states that no independent enterprise would accept consistent losses; instead, that entity would only continue to operate if it exacted some higher fee to compensate for its services.[60] On the

57. *Ibid.* at 118. Justice Cumming reports: "[t]he record indicates that the transfer pricing system has never been given a comprehensive evaluation by the CCRA. The only transfer pricing audit apparently done by CCRA in respect of Ford Canada was of Essex engine transfer prices at some point between 1991 and 1993." *Ibid.* at para. 132.

58. *Ibid.* at paras. 123–24, 131. That transfer pricing report, prepared by Deloris R. Wright, resulted only in a slight change in the approach to determining charges for intangibles. This change resulted in a reduction of approximately $30 million a year in intangible charges owed by Ford Canada to Ford US.

59. *Ibid.* at para. 142: "the issue is not simply whether transfer pricing was or was not consistent with tax norms. This is a matter between the taxpayer and the tax authorities. As has been stated, the existing transfer pricing system has met with the approval of the tax authorities in both countries or, at least, has not met with disapproval. See also *ibid.* at para. 151: "[t]he fact that the existing transfer pricing is acceptable from the standpoint of tax authorities (or more precisely, has not been challenged) does not mean in itself that there cannot be a finding of oppression." *Ibid.* at para. 157:

> [t]he Court's view of the evidence and issues differs somewhat from the expression of the issues by the parties during the hearing. In my view, the matter of whether or not a transfer pricing regime of an enterprise meets the criteria of the tax authorities does not, *in itself*, form either the basis for a cause of action or the basis for a defence to an oppression action.

60. The OECD wrote:

> [t]he fact that there is an enterprise making losses that is doing business with profitable members of its MNE group may suggest to the taxpayers or tax administrations that the transfer pricing should be examined. The loss enterprise may not be receiving adequate compensation from the MNE group of which it is a part in relation to the benefits derived from its activities.... An independent enterprise would perform such a [loss] service only if it were compensated by an adequate service charge.

*Transfer Pricing Guidelines*, *supra* note 17 at I-21.

other hand, perhaps it is not so surprising it was not audited in Canada since, as experienced commentators Brian Arnold and Michael McIntyre have noted, "[i]n practice, the only country that has an international reputation for systematic and aggressive enforcement of its transfer pricing rules is the United States...".[61] The IRS's vigilance, compared to the Canada Revenue Agency's, was raised as a serious concern by the Technical Committee on Business Taxation, which noted:

> because of the statutory and administrative framework in the United States, there has been a tendency for businesses to establish transfer pricing practices that result in a greater proportion of income being recorded in the United States than would otherwise be the case.... These phenomena are of special concern to Canada because of the very significant volume of related-party transactions between the two countries and the potential for serious erosion of the tax base.[62]

It is difficult to imagine a basis for holding that a transfer pricing regime might be appropriate for tax purposes but inappropriate for corporate law purposes.[63]

Although the purposes of these two areas of law are clearly different—the tax rationale for requiring companies to appropriately allocate profits between jurisdictions is to ensure that companies are taxed in the jurisdiction in which their income is earned and the rationale of the corporate law remedy for oppression is to ensure that conduct that results in unfairness to minority shareholders is sanctioned—the different objects of the regimes do not suggest that different conclusions should be drawn about how profits should be allocated between related corporations. Instead, employing the same test in both areas of the law would lead to greater transparency and reduced administrative burdens. Of course, it is not surprising that Justice Cumming's judgment reflects ambivalence about the use of the transfer pricing tests for tax in the context of corporate law. The Canada Revenue Agency had not reassessed Ford, yet Justice Cumming found Ford Canada's profits were inappropriately determined. Thus, either the tax authorities were incorrect in not reassessing Ford Canada (and it is understandable that Justice Cumming would be reluctant to explicitly make that claim) or the tests he applied were in fact different, which would impose a significant additional administrative burden on corporations and securities regulators.

---

61. Brian J. Arnold & Michael J. McIntyre, *International Tax Primer*, 2d ed. (New York: Kluwer Law International, 2002) at 56.

62. Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, 1997) at 6.33.

63. It might be possible for a particular transfer pricing regime to be unacceptable for tax purposes, but not oppressive to minority shareholders, say, where the minority shareholders were offered some kind of advantage in exchange for the depression of their share value.

## V. Oppression Remedy Analysis

AFTER DETERMINING THAT Ford's transfer pricing practices were inappropriate, Justice Cumming was left to decide whether the minority shareholders were entitled to an oppression remedy. This remedial claim was the crux of the minority shareholders' action, who alleged that the intercorporate transfer-pricing system created an unfair disadvantage to Ford Canada in order to benefit Ford US. Specifically, they argued that it had the effect of shifting the corporate income to Ford US, making it unlikely that Ford Canada would ever earn a profit. Justice Cumming held in favour of the minority shareholders and ordered a higher price to be paid for their shares.

Our concerns with Justice Cumming's analysis relate not to the conclusion he reached on the issue of oppression but to his failure to analyze the concept of fiduciary duty in reaching this conclusion. We argue that the Court should have assessed whether the Ford Canada board breached its fiduciary duties and should not have employed the concept of "reasonable foreseeability" instead. We contend that when board conduct is impugned, the board's fiduciary duties must be considered in the oppression analysis. We further argue that, given the nature of the transaction at issue, the majority shareholder of Ford Canada, Ford US, should be held to owe a fiduciary duty to the minority shareholders of Ford Canada. We begin by setting out the legal parameters of the oppression remedy and then turn to an examination of these issues.

The oppression remedy is the most significant remedial tool that stakeholders have in the corporation. It provides a broad based right not only to minority shareholders but to all current and former registered or beneficial shareholders, current and former officers and directors, and anyone who classifies as a "proper person" in the view of the Court.[64] The remedy allows courts to provide relief to these complainants if an act or omission of a corporation or its directors or managers is oppressive, unfairly prejudicial or unfairly disregards the interests of the complainant.[65] Case law has indicated that in determining whether conduct meets this threshold, courts must also have regard to shareholders' reasonable expectations,[66] a concept

---

64. CBCA, *supra* note 8, s. 238. See *Peoples Department Stores Inc. [Trustee of] v. Wise* (2004), 244 D.L.R. (4th) 564 at paras. 49–50, 2004 SCC 68 [*Peoples* cited to D.L.R.] (regarding a creditor as a "proper person").
65. CBCA, *ibid.*, s. 241.
66. See e.g. *Ebrahimi v. Westbourne Galleries Ltd.*, [1972] 2 All E.R. 492 at 499 (H.L.); *Westfair Foods Ltd. v. Watt* (1991), 79 D.L.R. (4th) 48, 79 Alta. L.R. (2d) 363 at 367–72 (C.A.) [*Westfair Foods* cited to Alta. L.R.]. See also statement of rule in *Maple Leaf Foods Inc. v. Schneider Corporation*; *Pente Investment Management Ltd. et al. v. Schneider Corporation et al.* (1998), 42 O.R. (3d) 177 at 201, [1998] 44 B.L.R. (2d) 115 (C.A.) [*Maple Leaf* cited to O.R.]: "[w]hile s. 248 protects the legitimate expectations of shareholders, those expectations must be reasonable in the circumstances and reasonableness is to be ascertained on an objective basis...." The reasonable expectations test is also present in US legislation and case law. See Robert B. Thompson, "Corporate Dissolution and Shareholders' Reasonable Expectations" (1998) 66 Wash. U.L.Q. 193.

that will be discussed in greater detail below. While the oppression remedy was originally intended to relieve shareholders in the closely held corporation, it has been employed by shareholders of public corporations in a wide variety of circumstances.[67] Thus, it is not surprising that the minority shareholders in the Ford transaction claimed relief under the oppression remedy.[68]

Oppressive conduct need not entail a breach of a fiduciary duty[69] and it need not involve decisions made in bad faith.[70] The oppression remedy targets oppressive results, not the board's or any other person's intent to act in an oppressive manner. The Court will examine whether the conduct in question was oppressive in light of the reasonable expectations of the minority shareholders. However, if the complainant who launches an oppression remedy claim impugns board conduct, then the Court will likely examine whether the board complied with its fiduciary duties. These duties are governed primarily by statute. For example, section 122 of the CBCA specifies that the board's duty is to "act honestly and in good faith with a view to the best interests of the corporation."[71] The standard that the board must exercise in discharging this duty is one of "care, diligence and skill that a reason-

67. See *e.g. Redekop v. Robco Construction Ltd.*, [1979] 5 B.L.R. 58 (B.C.S.C.) (director who was a minority shareholder in closely held corporation alleging oppressive conduct in relation to conflict of interest of one of the directors of the corporation); *Re Ferguson and Imax Systems Corp.* (1983), 43 O.R. (2d) 128, 150 D.L.R. (3d) 718 (C.A.) (minority shareholder in closely held corporation who was the divorced wife of the majority shareholder alleging oppressive conduct for the refusal to pay dividends in accordance with her reasonable expectations); *Thermadel Foundation v. Third Canadian Investment Trust* (1998), 38 O.R. (3d) 749, 77 A.C.W.S. (3d) 983 (C.A.) (minority shareholder in publicly traded corporation alleging oppression in share repurchase price). For a comprehensive empirical analysis of the judicial treatment of oppression remedy in Canada, see Stephanie Ben-Ishai & Poonam Puri, "The Canadian Oppression Remedy Judicially Considered: 1995–2001" (2004) 30 Queen's L.J. 79 [Ben-Ishai & Puri].
68. Indeed, minority shareholders have made this claim in previous going-private transactions though with minimal success. See *Samos Investments Inc. v. Pattison* (2002), 5 B.C.L.R. (4th) 389, 2002 BCSC 1360; *FMCI Financial Corp. v. Curtis International* (2003), 126 A.C.W.S. (3d) 767, 2003 OTC 1020; *LSI Logic Corp. of Canada v. Logani* (2001), 100 Alta. L.R. (3d) 49, 2001 ABQB 968; *Stern v. Imasco Ltd.* (1999), 1 B.L.R. (3d) 198; *Iverson v. Westfair Foods* (1996), 38 Alta. L.R. (3d) 331, 1998 ABCA 337.
69. *Brant v. Keeprite* (1991), 3 O.R. (3d) 289 at 301-02, 80 D.L.R. (4th) 161 (C.A.) [*Brant* C.A. cited to O.R.]. The Court of Appeal stated:

    [a]cting in the best interests of the corporation could, in some circumstances, require that a director or officer act other than in the best interests of one of the groups protected under s. 234. To impose upon directors and officers a fiduciary duty to the corporation as well as to individual groups of shareholders of the corporation could place directors in a position of irreconcilable conflict, particularly in situations where the corporation is faced with adverse economic conditions.

    Courts impose fiduciary duties only in situations where someone stands in a particular position of trust by virtue of an agreement or as a result of the circumstances and relationship of the parties....
70. *Ibid.*
71. CBCA, *supra* note 8, s. 122(1)(a). In the recent case of *Peoples*, *supra* note 64, the Supreme Court of Canada held that the duty of the board is owed not to any one stakeholder in particular but to the corporation as a whole. See Anita I. Anand, "Supreme Ambiguity" *National Post* (18 November 2004) FP15.

ably prudent person would exercise in comparable circumstances."[72] This two-pronged rule is the test against which board conduct has historically been evaluated.

The two concepts of fiduciary duty and oppressive conduct are, on their face, distinct and the law has understood this to be so. The leading case appears to be *Brant v. KeepRite*, a case that involved KeepRite's purchase of the assets of its subsidiary, Brant.[73] The minority shareholders of KeepRite brought an action arguing that the transaction was oppressive and unfairly prejudicial to their interests. The oppression action was dismissed at both the trial and appeal levels. Referring to the fiduciary duties provision (then section 117) and the oppression remedy provision (then section 234) of the CBCA, McKinlay J.A. explained:

> [i]t must be recalled that in dealing with s. 234, the impugned acts, the results of the impugned acts, the protected groups, and the powers of the court to grant remedies are all extremely broad. To import the concept of breach of fiduciary duty into that statutory provision would not only complicate its interpretation and application, but could be inimical to the statutory fiduciary duty imposed upon directors in s. 117(1)...of the CBCA.[74]

The Court in *Brant* thus drew a distinction between fiduciary duties and the oppression remedy. The essence of the distinction was that even though the conduct of officers or directors may be consistent with their fiduciary duties, these individuals may be subject to an oppression action by minority shareholders or other complainants *ex post*. This distinction was confirmed in the 1991 *Harold Ballard* case where Farley J. stated that:

> a director may, after a proper analysis, act in good faith in what he considers to be the best interests of the corporation; if he does so he will not run afoul of s. 134 [i.e. the fiduciary duties provision]. However, the result of such action may be such that it oppresses or unfairly deals with the interests of a shareholder; in which case s. 247 [i.e. the oppression remedy section] comes into play.[75]

While this distinction may seem tenable in theory, it overlooks an implicit connection between the two concepts. The oppression remedy is an extremely broad remedy based essentially on fairness considerations, such as whether the actions of the board met the reasonable expectations of the minority shareholders. The test for fiduciary duty is similarly broad, requiring an assessment of board conduct and in particular whether its members acted honestly and in good faith. The connection between the two concepts

---

72. CBCA, *ibid.*, s. 122(1)(b).
73. *Re Brant Investments Ltd. and KeepRite Inc.* (1987), 60 O.R. (2d) 737, 42 D.L.R. (4th) 15 (H.C.J.). For discussion and analysis, see Deborah A. DeMott, "Oppressed but not Betrayed: A Comparative Assessment of Canadian Remedies for Minority Shareholders and Other Corporate Constituents" (1993) 56 Law & Contemp. Probs. 181.
74. *Brant* C.A., *supra* note 69 at 301.
75. *820099 Ontario Inc. v. Harold E. Ballard Ltd.* (1991), 3 B.L.R. (2d) 113 at para. 119, 26 A.C.W.S. (3d) 637 (Ont. Div. Ct.).

arises when board conduct is impugned in an oppression action. In such a case, courts can in effect impose fiduciary obligations through the back-door.[76] That is, in a successful oppression action where directorial conduct is at issue, it seems that directors can be made subject to a fiduciary standard without a fiduciary analysis being undertaken. The close relationship between the legal concepts of oppression and fiduciary duty has not been explicitly recognized in the case law. Indeed, *Brant* confirmed the notion that the two are distinct in law.

What are the reasons for the separation of these concepts? Why have courts been reluctant to undertake a fiduciary analysis in oppression cases? The Court of Appeal in *Brant* stated that importing the concept of fiduciary duty into the oppression remedy provision would complicate both the interpretation and the application of the remedy. In particular, using fiduciary duty to analyze oppression could be inimical to the statutory fiduciary duty to act in the best interests of the corporation. In any given instance, acting in the best interest of the corporation could mean something other than acting in the best interests of the protected groups under the oppression remedy.[77]

In light of this reasoning, it is perhaps not surprising that in *Ford Motor*, there was minimal consideration of whether the board breached its fiduciary duty to the corporation under section 122.[78] However, in cases decided after *Brant*, courts have employed a fiduciary duty analysis in determining whether the complainant was oppressed. In both *CW Shareholderings v. WIC*[79] and *Maple Leaf v. Schneider*[80], bidders in a takeover transaction claimed oppression for inducements offered to a white knight bidder and for accepting a competing offer respectively. While the remedy was denied to both bidders, the respective courts based their oppression analyses on whether the directors of the target had acted in the best interests of the corporation. Breach of fiduciary duty was a central facet of the judgments on oppression.[81]

Strong precedent exists, therefore, for employing a fiduciary analysis in cases where an oppression remedy is sought. In the *Ford Motor* case also, a more comprehensive consideration of the board's conduct seems warranted. The Court should have analyzed whether the board of Ford Canada exer-

---

76. See also Jeffrey G. MacIntosh, "Minority Shareholder Rights in Canada and England: 1860–1967" (1989) 27 Osgoode Hall L.J. 561 at 599–605; Jeffrey G. MacIntosh, Janet Holmes & Steve Thompson, "The Puzzle of Shareholder Fiduciary Duties" (1991) 19 Can. Bus. L.J. 86 at 130 (speaking of fiduciary obligations of majority shareholders towards minority shareholders, an issue discussed below) [MacIntosh, Holmes & Thompson].
77. *Brant* C.A., *supra* note 69 at 301.
78. *Ford Motor*, *supra* note 4 at para. 262. The Court stated: "Ford Canada is an independent entity with its own board of directors who were charged with acting in the best interests of Ford Canada i.e. all of Ford Canada's shareholders."
79. *CW Shareholderings Inc. v. WIC Western International Communications Ltd.* (1998), 39 O.R. (3d) 755, 160 D.L.R. (4th) 131 (Gen. Div.)
80. See generally, *Maple Leaf*, *supra* note 66.
81. See Ben-Ishai & Puri *supra* note 67 at 96.

cised its judgment in a manner consistent with its fiduciary duties. It should also have examined whether the board's decisions were motivated by considerations other than the best interests of Ford Canada. Indeed, in our view, board conduct should not be considered to be oppressive unless a fiduciary analysis has been first undertaken. Thereafter, the results of the corporation's actions may be found to be oppressive, but only if the reasonable expectations of the complainants have been breached. The analysis must be a two step process. Without analyzing the fiduciary duty, the board could be tainted by a finding of oppression in cases where it is unjustified. There will be cases where the board adequately discharged its fiduciary duty but where the actions of the corporation are found, *ex post*, to be oppressive. The board's and company's reputations stand to suffer unless it is made clear that the fiduciary standard was not breached. Ultimately, it will be shareholders who will suffer if this occurs. Following this two step process, therefore, helps protect the reputation of the board members and the corporation where an oppressive result may not have been intended.

Thus, it is not persuasive to assert, as did the Court in *Brant*, that including the concept of fiduciary duty in an analysis of oppression could interfere with the obligation to act in the best interests of the corporation. This is not the case; the issue is one of timing. At the time of the action, boards will continue to be bound by their fiduciary duties only (i.e. their duties to the corporation). They need not structure each transaction with a view to furthering the interests of minority shareholders. The analysis of oppression occurs by the Court *ex post* the impugned conduct. At the stage of judicial evaluation, the concepts of fiduciary duty and oppression need not, and should not, be divorced. To do so is possibly to hold the directors to the fiduciary standard without providing the analysis to support such a holding.

It may have been the case that Ford Canada's board believed the transfer pricing arrangements were in the best interests of the corporate entity, and that they therefore retained those arrangements. The argument of Ford Canada would likely be that the decisions relating to the transfer pricing system were in the ordinary course of business by the board and senior management. We are told that tax authorities audited Ford Canada, but that only minor issues were raised about the transfer pricing system. Given that no significant issues were raised, perhaps the board thought that the transfer pricing system was appropriate. Nevertheless, the Court does not analyze this issue and a finding of oppression on the part of Ford Canada therefore seems unsupported without such an analysis. Indeed, a fiduciary analysis in this instance would produce a stronger foundation on which to order the oppression remedy and would be less likely to taint the reputation of the board and the corporation.

### A. REASONABLE FORESEEABILITY

Although the Court in *Ford Motor* did not analyze the fiduciary duties of the board, it did introduce another element into the analysis of oppression: reasonable foreseeability. Cumming J. asserts that the board should have recognized that the transfer pricing system was disadvantageous to minority shareholders and therefore needed to be amended. In his view, the board should have had the foresight to appreciate that the transfer pricing system had problems and it should therefore have amended it. As Cumming J. states:

> [t]he impact of the transfer pricing system is to understate profits or overstate losses earned from the Canadian market for Ford Canada. This realization does not arise from the benefit of hindsight. The results would be reasonably foreseeable to the management of Ford Canada from, at least, 1984 onwards.[82]

This statement is significant because the law relating to oppression has not explicitly included reasonable foreseeability as an element in analyzing board conduct.

The reasonable foreseeability analysis adds confusion to the test for oppression. To begin, at least one concept of reasonableness is already present in the test for oppression. As noted above, case law has indicated that in determining whether conduct is oppressive, unfairly prejudicial, or unfairly disregards a shareholder's interests, courts must also have regard to shareholders' reasonable expectations.[83] While the Court in *Ford Motor* certainly addresses this concept of reasonableness (i.e. from the standpoint of the complainant),[84] it also conflates this idea with another concept of reasonableness (i.e. from the standpoint of the board). The Court's rationale for doing so appears to be that the expectations of shareholders are in part dependant on the actions of management.[85] Thus, Cumming J. rejects the Ford Canada view that the dissenting shareholders had to establish that they had reasonable expectations that the historic transfer pricing system would be changed into a profit-sharing arrangement.[86] Rather, Cumming J. concludes that management should have reasonably foreseen Ford Canada's "continuing mammoth losses."[87]

In light of current law, reasonable foreseeability is not a valid basis for impugning board conduct. Boards are constrained by their fiduciary duties.

---

82. *Ford Motor*, *supra* note 4 at para. 300.
83. See *Westfair Foods*, *supra* note 66. See also statement of rule in *Maple Leaf*, *supra* note 66 at 201 and accompanying text. The reasonable expectations test is also present in US legislation and case law. See Thompson, *supra* note 66.
84. *Ford Motor*, *supra* note 4 at para. 448: "The reasonable expectations of the minority shareholders were that the management of Ford Canada would at all times act in the best interests of *all* the shareholders to make best efforts to earn a reasonable profit from Ford Canada's business operations."
85. *Maple Leaf*, *supra* note 66 at 201: "shareholders' interests are typically intertwined with the expectations that have been created by the company's principals." Cited in *Ford Motor*, *ibid.* at para. 222.
86. *Ford Motor*, *ibid.* at para. 298.
87. *Ibid.* at para. 300.

However, under a foreseeability test, the board is constrained by another requirement: if the board could reasonably have foreseen that a corporate policy would be oppressive to minority shareholders if implemented, it should not adopt it, even if it would be in the corporation's best interest to do so. Arguably, reasonable foreseeability adds a conceptual layer to the already complex fiduciary duties required of corporate managers: if boards do not reasonably foresee harm, have they fallen short of their fiduciary duties? As we know, the Court did not venture into a determination of whether the board breached its fiduciary duties, and so we are unsure of how reasonable foreseeability relates to this concept or the concept of reasonable expectations. In any case, from a policy perspective, we doubt that reasonable foreseeability is the standard to which boards should be held. If boards must assess all the potential outcomes of their actions and then question whether certain potential adverse outcomes are reasonably foreseeable, the flexibility that they need to respond to the changing demands of the corporation will be severely limited. They will likely become more divided and indecisive as the board (or certain members of the board) second guess proposed courses of action.

In sum, the concept of reasonable foreseeability should not replace or be added to the fiduciary duty test. It may be the case that although the board has not breached its fiduciary duties, the complainants in the case were, nevertheless, oppressed because their reasonable expectations were not met. We do not deny that oppression may be found even where no fiduciary duty has been breached. However, the analysis should proceed on the basis of fiduciary duty and then reasonable expectations; such a broad based analysis will serve to protect the reputations of the board, the corporation and ultimately shareholders themselves.

### B. DUTY OF MAJORITY TO MINORITY

The argument thus far has revolved around the scope of a board's duties and the importance of analyzing fiduciary duty where board conduct is impugned in an oppression action. The concept of fiduciary duty is important not only in examining board conduct, but also in analyzing minority shareholders' rights vis-à-vis majority shareholders. In this section, we argue that where the parent is a majority shareholder of a subsidiary that is being taken private, the majority shareholder should owe a fiduciary duty to the minority shareholders of the subsidiary.

Cumming J. expresses dissatisfaction with the way in which Ford US treated Ford Canada at the expense of the minority shareholders.[88] However, he appears constrained by current Canadian law under which majority shareholders owe no fiduciary duty to the minority.[89] Courts have held that the relationship between the majority and the minority lacks the characteristics of a fiduciary relationship[90] in which a dependent party relies upon the power holder to control one aspect of the dependent's life,[91] as in the trustee-beneficiary structure. As stated in *Brant*, "[c]ourts impose fiduciary duties only in situations where someone stands in a particular position of trust by virtue of an agreement or as a result of the circumstances and relationship of the parties."[92] In other words, the majority-minority shareholder relationship does not create hierarchy and dependency of this sort and cannot therefore be classified as fiduciary.

Despite current law, the argument in favour of a fiduciary duty flowing from majority to minority shareholder is strong, especially in the case of a going-private transaction where a hierarchical and dependent relationship does indeed exist. First, the Dickerson report, which preceded the implementation of modern Canadian business statutes, suggests that implicit in an oppression application is the "...premise that dominant shareholders, who are in a position to control management, owe a fiduciary duty to minority shareholders comparable to the duty that directors and officers owe to the corporation."[93] Historically, therefore, early drafters of Canadian company law recognized that fiduciary duties should flow among shareholders.

Second, in the US, it has long been the case that majority shareholders owe fiduciary duties to the minority. As Mr. Justice Brandeis stated in *Southern Pacific Co. v. Bogert*, "[t]he majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority; as much so as the corporation itself or its officers or directors."[94] This rule has been reit-

88. See *ibid.* at para. 263: "a majority shareholder cannot treat a subsidiary corporation with minority shareholders as its wholly-owned subsidiary. The majority shareholder cannot direct corporate decisions which enure to its benefit to the detriment of minority shareholders."
89. See *e.g. Brant* C.A., *supra* note 69.
90. *Ibid.* at 302.
91. See Lawrence E. Mitchell, "Trust. Contract. Process." in Lawrence E. Mitchell ed., *Progressive Corporate Law* (Boulder: Westview Press, 1995).
92. *Brant* C.A., *supra* note 69 at 302.
93. Robert W.V. Dickerson, John L. Howard & Leon Getz, *Proposals for a New Business Corporations Law for Canada*, vol. 1 (Ottawa: Information Canada, 1971) at 164. See also DeMott, *supra* note 73 at 191.
94. 250 U.S. 483 at 487–88, 39 S. Ct. 533 (1919). See also *Pepper v. Litton*, 308 U.S. 295 (1939).

erated in a number of cases[95] and is broadly accepted broadly in the US.[96] The rationale underpinning the rule is straightforward: the majority has the power to direct and control corporate transactions. Without a fiduciary duty owed to the minority, the majority has the ability to exclude the minority "...from their proper share of the benefits accruing from the enterprise."[97] Thus, the broad concern is one of fairness in how the minority shareholders will be treated.[98]

Now, it is true that in the case of a going-private transaction as in *Ford Motor*, the duty of the parent, as a majority shareholder, has other parameters that must be considered. US law differentiates between the fiduciary duties owed by the parent and those owed by the board of the subsidiary. Obviously, the subsidiary board's fiduciary duties do not cease. The test of the parent's fiduciary obligation is one of "intrinsic fairness," where fairness incorporates two elements: fair dealing towards the minority and fair price in the transaction.[99] Furthermore, where the equity interests of the minority shareholders are eliminated in the transaction, US law states that the controlling shareholder must demonstrate that the transaction advanced "a general corporate interest."[100]

The US law is instructive because it underlines the strong case that can be made for imposing fiduciary duties on the majority shareholder in a going-private transaction. In the type of going-private transaction effected by Ford US, a parent company completes an amalgamation of its public subsidiary and another shell corporation for the purposes of squeezing out the minority shareholders of the subsidiary. Often in the parent-subsidiary going-private context, the majority holds almost all of the shares of the subsidiary. For instance, before the amalgamation, Ford US held approximately

95. See *e.g. Jones v. H.F. Ahmanson & Co.*, 81 Cal.3d 592 (Sup. Ct. 1969) (under California case law, majority shareholders owe a fiduciary duty to minority shareholders). See also *Bingham Consolidation Company v. Groesbeck*, 2004 UT App 434 (Utah, 2004): "When an entity controls a majority of shares and the management of the company, it has a fiduciary duty to 'deal fairly and openly' with the minority shareholders."
96. L. Clark Hicks Jr., "Corporations–Fiduciary Duty–In a Close Corporation, a Majority Shareholder Owes a Fiduciary Duty Towards the Minority When Seeking a Controlling Share" (1990) 60 Miss. L.J. 425 at 435.
97. *Hornsby v. Lohmeyer*, 364 Pa. 271 at 275, 72 A.2d 294 (Pa. Sup. Ct. 1950). See also *Ferber v. American Lamp Corporation*, 503 Pa. 489, 469 A.2d 1046 (Pa. Sup. Ct. 1983).
98. See *e.g. Sinclair Oil Corp. v. Levien*, 280 A.2d 717 at 720 (Del. Sup. Ct. 1971).
99. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. Sup. Ct. 1983). See also DeMott, *supra* note 73 at 199.
100. *Alpert v. 28 Williams St. Corp.*, 473 N.E.2d 19 at 28, 483 NY.2d 667 (N.Y. C.A. 1984).

93.83 percent of Ford Canada's outstanding shares.[101] If it owed a fiduciary duty to the minority of Ford Canada, perhaps the price offered to the minority would have been higher.

Using the US test, we should ask whether the Ford transaction advanced a general corporate interest, and if so, whether the minority were treated fairly with respect to price. Ford US introduced and maintained the transfer pricing arrangements. Ford US could have taken steps to amend the severity of the effects of the transfer pricing system, such as reducing the mark-up on manufactured components so that the assembly division would have had to pay less. As the Court notes, these actions would have had a positive effect on Ford Canada's profit margins.[102] In addition, the Court found that there was no arm's length relationship between the parent and the subsidiary it controlled. Thus, in our view, the blame for the deleterious consequences of the transfer pricing system should not rest with the subsidiary alone. It must rest at least in part with the entity that controlled it.

In this case and in the going-private context generally, there should be an exception to the general rule that majority shareholders owe no duty to the minority. In these transactions, the majority shareholder is usually a parent or company that controls the entity that is ostensibly affecting the going-private transaction (in this case, Ford Canada). The controlling company generally is very involved in setting the terms of the transaction, including the price that will be offered to the public shareholders of the controlled entity. The fiduciary obligation binds the majority *ex ante* whereas the oppression remedy is available to minority shareholders only *ex post* the transaction only.

There is some legal basis for this argument in Canada since the conduct of a controlling shareholder has been equated with that of the corporation.[103] The reason for this is that the controlling shareholder alone, essentially, makes the decisions of the corporation. Under corporate law, deci-

---

101. *Ford Motor*, *supra* note 4 at para. 4. Indeed, a US parent that holds a majority of shares in a Canadian subsidiary and seeks to take the subsidiary private has been a common scenario in going-private transactions in Canada over the past decade or so. For example, in 1993, Goodyear Tire & Rubber Co. sought to take the minority shareholders of its Canadian subsidiary private at $48 per share. The minority shareholders rejected the offer, but when the parent increased the price to $65 per share, they overwhelmingly approved the transaction. Similarly, in 1994, US-based Texaco Inc. offered to buy out the minority shareholders of its Canadian subsidiary at $1.40 a share. The minority shareholders, led by Canadian 88 Energy Corp., rejected the offer. In 1995, the minority shareholders, led by Canadian 88 again, agreed to be bought out at $1.48. In March 1995, the US-based Dana Corp. originally offered minority shareholders of its Canadian subsidiary, Hayes-Dana Inc., $17.50 per share. See Anita I. Anand, "Fairness at What Price: An Analysis of the Regulation of Going-Private Transaction and OSC Policy 9.1" (1998) 43 McGill L.J. 115.

102. *Ford Motor*, *ibid.* at para. 377. The Court states: "the overall impact would have ameliorated the situation for Ford Canada by reducing the costs of assembling Ford vehicles...sold in Canada..." See also paras. 378–79 for further actions Ford US could have taken.

103. See *e.g. Foss v. Harbottle*, 2 Hare 461, 67 E.R. 189 (Ch. D. 1843); *Northwest Transportation Co. Ltd v. Beatty* (1887), 12 App. Cas. 589 (Ont. J.C.P.C.); *Allen v. Gold Reefs of West Africa Ltd.*, [1900] 1 Ch. 656, All E.R. 746 (Eng. C.A.); *Greenhalgh v. Aderne Cinemas Ltd.*, [1951] Ch. 286, [1950] 2 All E.R. 1120 (Eng. C.A.). See also MacIntosh, Holmes & Thompson, *supra* note 76.

sions require, at most, two-thirds approval for fundamental changes to be approved. Thus, any controlling shareholder holding more than two-thirds of the outstanding shares of the company does not need minority shareholder support before such decisions are made.[104] It is true that securities legislation attempts to regulate conflicts of interest that arise in these transactions by requiring a majority of the minority vote as discussed below. However, a general duty between majority and minority shareholders would certainly lessen the need for such legislation and more effectively protect the interests of minority shareholders *ex ante*.

Rather than dealing with the obligations of the majority through a broad fiduciary duty standard in these transactions, Ontario utilizes legislation comprised of detailed rules. Rule 61-501 is the securities legislation that governs going-private transactions (now called "business combinations") and governed the Ford transaction. One of the purposes of Rule 61-501 is to ensure that investor interests are not compromised when non-arm's length parties engage in certain transactions. The Rule requires formal valuations of shares to be completed by an independent valuator. It also requires certain disclosure about the transaction, and once the appropriate disclosure has been made, majority of the minority approval at a meeting of shareholders. These requirements are intended to cleanse transactions that may otherwise be tainted by conflicts of interest.[105]

Given that disclosure to minority shareholders is a central aspect of the regime in Rule 61-501, it bears mentioning that there was a point in time (by 1992), at which Ford's disclosure documents contained information about the transfer pricing system. At least by this date, the corporation was conveying information relating to the arrangements to investors in its disclosure documents. Given this disclosure, one may question the necessity to compensate shareholders who had information about the corporation, including non-profit maximizing initiatives such as the regime in place. Certainly with this disclosure, minority shareholders could dispose of their shares if they believed that the transfer pricing system unfairly disregarded their interests. Finding oppression in this case arguably compensates investors for their failure to review disclosure documents.

---

104. Note that Ontario Securities Commission Rule 61-501 requires a majority of the minority approval in some instances such as in the transaction proposed in Ford. However, the Controlling shareholders held over 90 percent and were therefore able to effect a compulsory acquisition under section 206 of the CBCA. Ontario Securities Commission Rule 61-501 "Insider Bids, Issuer Bids, Business Combinations and Related Party Transactions," online: OSC <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part6/rule_20040625_61-501_amend.jsp> [Rule 61-501].

105. See Section 1.1 Companion Policy 61-501CP to OSC Rule 61-501, online: OSC <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part6/rule_20040625_61-501_amend.jsp>: "The Commission regards it as essential, in connection with the disclosure, valuation, review and approval processes followed for insider bids, issuer bids, going-private transactions and related party transactions, that all security holders be treated in a manner that is fair and that is perceived to be fair."

However, with Ford US holding about 94 percent of Ford Canada's shares, the remaining stock was extremely illiquid. Dissenting shareholders could not trade in the shares of Ford Canada easily. Furthermore, while shareholders could gain some information about the transfer pricing system from disclosure documents, they would likely face some difficulty in concluding that the transfer pricing arrangement was not profit-maximizing. Calculating value in the context of intercorporate transfer pricing systems is extremely complex. The various valuations that were conducted in the context of both the transactions underscore this fact. Thus, while on a general level, the law expects that investors will review disclosure documents, it should not expect that they will analyze and understand the effects of a transfer pricing arrangement on the price of the corporation's stock.

In sum, we agree that the minority shareholders were treated in an oppressive manner. However, we have raised here certain concerns with the Court's judgment that relate primarily to its failure to consider and apply principles relating to fiduciary duties. In addition, we have raised some policy concerns about the rights of minority shareholders in a going-private transaction. It is on these bases that we respectfully disagree with the Court's analysis relating to oppression in *Ford Motor*.

## VI. Conclusions

*FORD MOTOR* WILL UNDOUBTEDLY BECOME a significant case in Canadian international tax and corporate minority protection jurisprudence. From a tax perspective, if the decision is not reversed on appeal, it should encourage Canadian tax authorities to apply in each case the best method of determining the profits of related corporations instead of presuming that transactional methods are superior to profit split methods. Given the well known theoretical and practical difficulties of applying traditional transactional methods, this in turn should result in greater use of the profit split methods.

The case also has important implications for corporate law scholars, practitioners, and managers. At a practical level, it raises questions for corporate boards that govern corporations with minority shareholders. They will have to pay closer attention to their transfer pricing arrangements to ensure that they are fair to minority shareholders. They will need to ensure that they comply with their fiduciary duties (to act in the best interests of the corporation), as well as, to concern themselves about whether they can "reasonably foresee" harm to shareholders.

Finally, the case dramatically illustrates the complexities, the indeterminacy and perhaps even the incoherence of transfer pricing regimes (of any kind) as a method for allocating profits to corporations in a controlled group. Despite the apparent wide acceptance of the transactional approach to arm's length pricing, it has been subject to much criticism. Most fundamentally, there are two obvious theoretical problems with the transactional approach. First, there is what might be described as the imprecise prices problem. For goods and services that are not unique in any way and for which there are well developed markets, in theory, there is likely to be one price at which they sell and that price will be relatively easy to determine. However, most goods and services that are transferred between related corporations will be unique in some respects, and it is unlikely that well developed markets are available for their purchase and sale. Indeed, as explained below, these facts likely explain why these goods are being subject to intrafirm transfers instead of interfirm trades, and, therefore, the price that would be established for these goods in an uncontrolled market is unknowable. To elaborate, in a market transaction, a seller of the good or service will have some minimum price at which it is prepared to sell, and a buyer will have some maximum price at which it is prepared to buy. Both of these minimum and maximum prices are, in theory, determinable even in the absence of a market transaction. However, because the infinite number of variables that affect the market forces of supply and demand and that ultimately determine the actual price at which the good or service would trade in an uncontrolled market (including the knowledge, skills, and needs of the parties) cannot be known, in the absence of a sale the price must remain, even in theory, indefinite. Although the range of prices for tangible goods and services might, in some cases, be relatively narrow, and therefore, this theoretical difficulty might not be too great. More often the range is likely to be extremely broad, and for unique intangible properties the range could be almost infinite. Indeed, the transactional approach has become increasingly difficult to apply as technology and intangible assets have become an important part of business relationships. The nature of intangibles may make it difficult, or impossible, to set comparable prices, or to imagine what an appropriate transfer price might be.[106]

---

106. Taxpayers trying to find comparables to implement the arm's length methodology often testify to this difficulty. The OECD is currently holding discussions on the comparability issues encountered when applying the transfer pricing methods promoted in their 1995 guidelines. See OECD, "Transfer Pricing: The OECD launches an invitation to comment on comparability issues" online: OECD <http://www.oecd.org/document/47/0,2340,en_2649_201185_2508655_1_1_1_1,00.html>. The OECD has received written submissions from several firms and individuals. For example, Price Waterhouse Coopers notes: "[w]ithin certain industry sectors, independent comparables are virtually non-existent or not meaningful. This is especially the case in industry sectors where vertical integration has taken place." *Submissions of Price Waterhouse Coopers to the OECD on Comparability Issues* at 3, online: OECD <http://www.oecd.org/dataoecd/62/63/14554576.pdf>. Similarly, as noted by Ernst & Young:

> MNE's exist to the extent the vertical integration across the value chain is an efficient form of economic organisation. An increasingly common way of achieving efficiencies is to streamline the business model by adopting processes and management and control mechanisms which are integrated as seamlessly as possible across international and therefore fiscal borders. The resulting relationship between legal entities are often therefore of a fundamentally different character to those which can be negotiated between unrelated parties. Almost by definition, it is not possible to identify good comparables.

*Submissions of Ernst & Young to the OECD on Comparability Issues* at 2, online: OECD <http://www.oecd.org/document/47.0,2340,en_2649_33753_2508655_1_1_1_37427,00.html>.

The second theoretical problem with the transactional approach for allocating profits between related corporations has been referred to as the problem of the residual profits. Even if all the prices that would be charged between unrelated parties for the goods and services that pass between related corporations could be determined, it still would not be theoretically possible, on that basis alone, to allocate a multinational's profits between the individual corporations of which it is comprised. The reason for this is that in integrated businesses invariably the profits earned will exceed the profits that could be earned if unrelated corporations carried on the separate parts of the integrated businesses. Indeed, the reason why multinationals form and prosper is because they have advantages over and are, therefore, much more profitable than firms carrying on the same activity as several independent businesses. These advantages include such things as the more efficient use of management systems, the reduction of the risk of contractual breaches, and economies of scale.[107] In other words, the whole purpose of a multinational corporation is to reduce costs by eradicating the expense of bargaining with unknown parties with information asymmetries, and by reducing expenses by creating goods and services in large quantities, or by sharing intangibles.

In addition, being forced to determine market prices in nonmarket conditions is costly, particularly so where the price of a good or service is difficult to determine, as is the case with many intangibles.[108] Whatever the explanation for their higher profits, however, the fact is that multinationals earn a profit in excess of that which would be earned by several independent businesses conducting the same enterprise. Attempting to account for the profits of the multinational, on the assumption that it was comprised of a number of unrelated parties dealing at arm's length with one another, means that a substantial amount of profits might remain unallocated.

Not only is the transaction-based approach to allocating the profits of multinationals incoherent in theory, but also it is also difficult and expensive to attempt the hypothetical determinations that it requires.[109] An unwieldy

---

107. There is a large body of economic literature that details the advantages and purposes of transacting business as a multinational enterprise. See *e.g.* Oliver E. Williamson & Sidney G. Winter, eds., *The Nature of the Firm: Origins, Evolution, and Development* (New York: Oxford University Press, 1991); Bengt Holstrom & Jean Tirole, "Transfer Pricing and Organizational Form" (1991) 7 J.L. Econ. & Org. 201.

108. See Charles E. McLure Jr., "U.S. Federal Use of Formula Apportionment to Tax Income from Intangibles" (1997) 14 Tax Notes Int'l 859 at 861: "modern corporations exist precisely because of the difficulties of relying on market transactions under certain circumstances. When know-how is an important input, as it is when intangible assets are important, there are 'transactions difficulties'."

109. See Matthew Bishop, "Gimme Shelter: is tax competition among countries a good or a bad thing?" *The Economist* (29 January 2000) S18, online: Economist.com <http://www.economist.com/surveys/displayStory.cfm?Story_id=276995>: "In theory the transfer price is supposed to be the same as the market price between two independent firms, but often there is no market, so nobody knows what the market price might be. This is particularly true of firms supplying services or intangible goods. So multinationals spend a fortune on economists and accountants to justify the transfer prices that suit their tax needs."

amount of documentation is required to support intracompany transfer prices.[110] *Ford Motor* has amply demonstrated that simply an audit of a company's transfer pricing regimes internally can be expensive and time consuming, as can disputes with the revenue agency and potential litigation through the courts.[111] The Court notes that Wright's report, prepared in 1994, and relating only to Ford US, took 2500 hours of Wright's time, and the time of a team of ten to 15 people who worked on the project fulltime for nine months, as well as the time of five to seven people in the pricing group of each division at Ford US. The documents reviewed by this team filled 30 to 35 bankers' boxes. *Ford Motor* took 49 days of evidence and oral submissions before Justice Cumming required a joint book of documents that was 49 volumes. The case required over 130 marked exhibits during trial, and the testimony of eight expert witnesses who gave evidence on the transfer pricing and the valuation issues.

Justice Cumming's decision is lengthy, especially compared to the usual length of tax cases, which are generally quite short. This is not unusual, however, for transfer pricing decisions that require arm's length comparables.[112] Of course, the effects of an audit or case in one jurisdiction will not be restricted to that jurisdiction. Inevitably, an adjustment in one country will raise issues about whether a corresponding adjustment should be made in other jurisdictions. Hence, any reassessment in one country can lead to a series of adjustments, cases, reconsiderations, and negotiations with competent authority in another jurisdiction.

Moving from transactional methods to profit split methods will solve some of these problems; however, there is an even more rational method of allocating profits between related corporations. Multinationals could simply use a formula based upon a weighted average of readily identifiable characteristics of a related corporation, compared to those characteristics of the total corporate group such as sales, property owned and payroll. For example, if a corporation in a corporate group had 40 percent of the sales of the group, owned 50 percent of the property and had 60 percent of the payroll,

---

110. See *e.g. Income Tax Act*, *supra* note 36. In Canada, for example, even if a taxpayer's transfer pricing arrangements are not contentious, the taxpayer is still required under subsection 247(4) of the *Income Tax Act*, to prepare a long list of contemporaneous documentation.

111. The audit and litigation is expensive not only for the taxpayer, but also for the Canada Revenue Agency. For example, the Canada Revenue Agency has hired over 238 international auditors. See Canada, Report of the Auditor General of Canada to the House of Commons, *Chapter 4—Canada Customs and Revenue Agency—Taxing International Transactions of Canadian Residents* (Ottawa: Office of the Auditor General, 2002) at 11, online: Office of the Auditor General <http://www.oag-bvg.gc.ca/domino/reports.nsf/html/02menu_e.html>.

112. See Durst & Culbertson, *supra* note 20 at 60:

> [a] striking element of the cases is the often extreme length of the resulting opinions—sometimes much more than 100 pages in the official printed reports—and the apparently huge resources expended by both sides. In many cases, the expert testimony plainly required months of preparation by prominent economists and senior members of the tax bar.

assuming the factors were weighted equally, 50 percent of the profits would be allocated to it.

There are many obvious difficulties with the use of formulary apportionment as a means of allocating profits among related corporations, but it is the method used in Canada to allocate corporate profits to provinces, and it has been used by the State of California to determine the profits of multinationals earned in California. Its adoption worldwide has been urged by numerous commentators.[113] In Canada, almost 40 years ago, the Carter Commission recommended that tax authorities consider the feasibility of a formulary approach.[114]

A formulary approach has numerous advantages. First, it provides certainty to calculations. Second, it is difficult to evade, avoid, or manipulate. Third, it recognizes that it is the enterprise as a whole that gives rise to the income and, therefore, respects the underlying economic rationale for multinational enterprises. Fourth, the formulary approach promotes interjurisdictional equity because the formula applied can be one that is perceived to be fair by all jurisdictions that are affected.[115] Fifth, it avoids the difficulty of finding comparable arm's length transactions. Finally, the choice of the factors to privilege in the apportionment formula might be based on the ease with which they can be manipulated, with their relationship to the economic nexus to a jurisdiction, and with relevant policy considerations in mind. This is not the place to rehearse, in detail, the arguments for and against a system of formulary apportionment but simply to note that *Ford Motor* raises, in stark form, whether our present system of allocating profits is sensible and whether it can be fairly administered.

---

113. See *e.g.* McIntyre, *supra* note 3; Stanley Langbein, "A Modified Fractional Apportionment Proposal for Tax Transfer Pricing" (1992) 54 Tax Notes 719; Jerome Hellerstein, "Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment" (1993) 60 Tax Notes 1131; Reuven Avi-Yonah, "Slicing the Shadow: A Proposal for Updating U.S. International Taxation" (1993) 58 Tax Notes 1511.

114. See Canada, *Report of the Royal Commission on Taxation*, vol. 4 (Ottawa: Queen's Printer, 1966) at 562 (Chair: K. M. Carter):

> [w]e recommend that the Canadian tax authorities study the implications of adopting a formula as an alternative to the adjustment of the books of account and of giving that formula official sanction by regulation. Where possible such a formula might be incorporated into some of the international tax treaties to which Canada is a party.

115. Some commentators have raised concerns that nations will bargain for a formula that suits their best interests at the expense of other nations. See *e.g.* Arthur J. Cockfield, "Formulary Taxation Versus the Arm's-Length Principle: The Battle Among Doubting Thomases, Purists, and Pragmatists" (2004) 52 Can. Tax J. 144. While this is a risk, surely open negotiations on a formula between nations (assuming some consensus can be reached), will result in a fairer, more transparent outcome than corporations essentially deciding where to locate their profits, as sometimes happens under the current approach.