Guide to International Transfer Pricing

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He was the National Reporter for the e-commerce topic at the 2001 IFA Congress and a panelist at the 2007 IFA Congress on Cost Sharing Agreements. He is a Board member of the Chartered Institute of Taxation, European Branch. He is a frequent contributor to various French and international tax journals. He is a co-author of two books on transfer pricing published in 2008, Prix de Transfert, Editions Francis Lefebvre, and Transfer Pricing Manual, BNA. He has been consistently named as a leading French transfer pricing expert by the Legal Media Group's Guide to the World's Leading Transfer Pricing Advisors.

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Green's work covers all aspects of transfer pricing and thin capitalization, including planning and design of transfer pricing policies (on a standalone basis or as part of wider tax planning and/or business change), preparation of compliance documentation, delivering tailored training workshops on transfer pricing to clients' staff, handling disputes/controversy with tax authorities, and negotiating APAs. His clients are primarily FTSE 100 and Fortune 500 companies and other companies of similar size, but also include several professional services firms and medium sized businesses, ranging down to a number of family-owned groups with turnover in the order of GBP 50–100 million. Clients are spread across a wide range of businesses, including professional services, insurance, investment management, consumer goods, online and traditional publishing, fashion, hedge funds, private equity houses, advertising, agriculture, engineering services, IT outsourcing, telecommunications hardware, websites, automotive parts, shipping, chemicals, food products, banking, real estate and freight. Green also works in association with several of the top ten UK law firms and with a number of independent transfer pricing firms outside the UK, including Duff & Phelps. Green is a prolific author on transfer pricing, including several articles for International Tax Review. He authored a comprehensive update of the part of Simon's Direct Tax Service (a major looseleaf reference work on UK tax) that deals with transfer pricing and thin capitalization and is the Technical Editor of Transfer Pricing Manual, a book published by BNA International in September 2008. He has regularly been listed by International Tax Review in their Guide to the World's Leading Transfer Pricing Advisers since the late 1990s. Green was the UK reporter on the topic of Business Restructuring at the 2011 IFA Congress. His latest publication is a chapter of UK Transfer Pricing (Lexis Nexis, October 2012).

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Previously, Michelle led the development of Ceteris' FIN 48 service line and pioneered several thought leadership publications on behalf of the firm. She is an award-winning speaker and has presented at numerous conferences and seminars regarding transfer pricing issues. She served as co-editor of Wolters Kluwer's Guide to International Transfer Pricing: Law, Compliance and Tax Planning Strategies, and is co-authoring an upcoming BNA Tax Management Portfolio on ASC 740-10 (FIN 48) and transfer pricing to be published in fall 2012.
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Prior to joining Duff & Phelps, Jill was an integral component in building the Boston practice of Ceteris. Prior to joining Ceteris, Jill was the Director of Deloitte's New England transfer pricing practice and the east coast transfer pricing leader at one of the largest international economic consulting firms.

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CHAPTER 7

Canada

Merv Edwards & Dean Morris

§7.01 IMPORTANCE OF TRANSFER PRICING FOR MULTINATIONAL COMPANIES OPERATING WITHIN CANADA

In 1998, Canada enacted a new transfer pricing regime. These rules permit the Canada Revenue Agency (CRA) to adjust the quantum or nature of amounts of transactions to what would have been agreed to between arm's length parties. These new rules also added a compliance penalty, which focuses on the taxpayer's efforts in determining an arm's-length price. Unless the taxpayer has prepared, obtained and updated the required supporting documentation ('contemporaneous documentation'), the taxpayer may be subject to penalties.

In 2005, the CRA was given a budget of CAD 30 million per year to address aggressive international tax planning. The CRA added 140 international auditors and avoidance auditors to Tax Service Offices (TSOs) across Canada, and they deployed thirty-nine experienced auditors to do research studies in eleven designated 'centres of expertise' in the larger TSOs to support the field.

In 2007, a Toronto lawyer at the New York American Conference Institute transfer pricing conference called the CRA the 'world's most aggressive' auditor. There have been claims that the CRA targets U.S. multinationals for audits and that they take extreme positions, proposing penalties even when taxpayers have provided thorough documentation. Also, the CRA are accused of forcing companies to seek double taxation relief through the Competent Authority process. In response, the CRA's Director General of the International Tax Directorate admitted that there is more audit activity in Canada, and that even though Canada's population is roughly one-tenth of that of the United States, the CRA has approximately half as many field auditors. During 2007, there were 5,800 auditors in Canada versus 12,000 to 13,000 in the United States.

Since 2007, Canada has continued to increase its resources for transfer pricing audits. Some of its communicated strategies include improvements to electronic data and data-matching systems for non-resident transactions, getting better information and analysis to assess overall international tax risk by transaction type and taxpayer, following the IRS best practices on improving access to additional taxpayer information for high-level strategic assessments, increasing use of tax treaties to request taxpayer information from foreign jurisdictions, improving expertise of international auditors in the Greater Toronto Area, and developing strategies for consistency of the international audit approach and coverage for large corporate taxpayers.

In this environment, the CRA and the private sector are devoting more resources to the recruitment of professionals who specialize in transfer pricing to ensure that arm's-length terms and conditions are followed in corporate transfer pricing policies.

§7.02 REGULATORY FRAMEWORK

[A] Legal Authority

Prior to 1 January 1998, transfer pricing was governed by subsections 69(2) and (3) of the ITA. The Canadian statute that currently governs cross-border related party transactions is embodied in section 247 in Part XVI.1 of the Income Tax Act[1] ('ITA' or the 'Act'). Section 247 of the ITA was enacted on 18 June 1998, and the general rules apply to taxation years and fiscal periods that begin after 1997. Subsections pertaining to penalties and documentation requirements commence with taxation years and fiscal periods that begin after 1998.

CRA's current administrative practices are summarized in Information Circular 87-2R, International Transfer Pricing, dated 27 September 1999 (IC 87-2R), which provides the CRA's views with respect to the legislative provisions in section 247 of the Act.

The CRA provides further guidance on transfer pricing matters in Transfer Pricing Memorandums that supplement IC 87-2R and provide further guidance on specific the CRA's administration of transfer pricing-related matters. To date there have been 14 transfer pricing memorandums released.

With almost four years since TPM-12 was released, TPM-13 and TPM-14 (with the issue date of 30 October 2012, and 31 October 2012, respectively) were released on 22 November 2012. TPM-13 is the second update since 2003 and addresses referrals to the Transfer Pricing Review Committee (TPRC). TPM-13 clarifies the following procedures:

(1) the procedure for the imposition of penalties;

(2) the procedure for the re-characterization of transactions; and

(3) the procedure in determining whether an arrangement is a Qualified Cost Contribution Arrangement (QCCA).

1. R.S.C. 1985, c. 1 and 2 (5th Supp.), as amended.

Updates of interest in TPM-13 include:

– Formalizing the provision of the TPRC proposal letter and the auditor's draft penalty referral report to the taxpayer. The taxpayer will be provided a reasonable period of time to respond and address any factual omissions or discrepancies with the auditor's report.

– The TPRC will determine whether an arrangement is a QCCA for transfer pricing adjustments exceeding the threshold for penalty consideration (the lesser of 10% of gross revenue and CAD 5 million).

TPM-14 addresses the CRA's position and guidance with respect to recent changes made in the 2010 version of the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines). Specifically:

– The CRA yielded from the 'hierarchy' method to the 'best' method in selecting the appropriate transfer pricing method. The 'best' will be based on the quality of the data that is available. In cases where each method can be applied in an equally reliable manner, the CRA prefers the 'hierarchy' method.

– The CRA endorsed the OECD 9-step comparability analysis for finding reliable comparable data, with a caveat that taxpayers used reasonable efforts in performing the analysis.

– The CRA has referenced and endorsed other additions of the OECD Guidelines including the transactional profit method and the transfer pricing aspects of business restructuring.

Canadian tax legislation includes general anti-avoidance rules (GAAR) in section 245 of the ITA that can apply to any transaction considered to be an avoidance transaction. Subsection 247(2) pertains to transfer pricing adjustments. In transfer pricing situations where the provisions of subsection 247(2) cannot be applied by the CRA, the CRA has the option to use GAAR to reassess a taxpayer.

The provision and receipt of intra-group service charges fall under the same legislative guidance and principles as transfers of tangible and intangible property. Section 247 of the ITA and Information Circular 87-2R govern the pricing of services. The withholding tax legislation in section 212 of the ITA assesses a 25% withholding tax on the payment of management or administration fees by Canadian taxpayers. However Article 7 of most income tax treaties exempts the withholding tax.

[1] Penalties Relating to Intercompany Debt

Canadian transfer pricing legislation does not address intercompany debt or and interest charges. As a result, contemporaneous documentation requirements and the associated penalty regime do not apply to related party debt and interest transactions. These transactions are dealt with as follows per the Canadian Income Tax Act (ITA):

[2] Section 15(2): Shareholder Debt

This provision applies where a loan or any other indebtedness that is owing to a corporation resident in Canada by a non-resident shareholder or a non-resident person not acting at arm's-length with a non-resident shareholder has not been repaid within one year from the end of the corporation's tax year in which the indebtedness arose. The amount is deemed to have been paid as a dividend, and is subject to non-resident withholding tax of 25%. The withholding tax may be reduced depending upon the provisions of a relevant tax treaty.

Anti-avoidance rules prevent a long-term loan from being disguised by a series of short-term loans and repayments. There are a number of exceptions to these rules, such as loans to a foreign corporation that is a foreign affiliate (defined as a foreign corporation in which the Canadian corporation has an equity interest of at least 1% and together with related parties has an equity interest of at least 10%).

The ITA provides a mechanism for the non-resident to apply for a refund of withholding tax paid, within a certain period of time, upon the repayment of the loan or indebtedness. A refund is only allowed if the repayment is not part of a series of loans and repayments.

[3] Section 17: Amount Owing by Non-resident

Where a loan or other indebtedness owing from a non-resident to a corporation resident in Canada is outstanding for one year or longer without a reasonable rate of interest being charged, the corporation is deemed to earn income computed at a prescribed rate of interest. The imputed interest, net of any interest actually received, is included in the corporation's income for tax purposes. Section 17 does not apply, however, if subsection 15(2) as described above applies to the loan or indebtedness. Loans to controlled foreign affiliates are excluded from the deemed interest rule, provided that the funds loaned are used by the controlled foreign affiliate to earn income from an active business. Accordingly, loans made to the applicable affiliates may be non-interest-bearing. However, the deductibility of any interest expense incurred in Canada relating to making such a loan must be considered under the general interest deductibility guidelines.

Avoidance of these rules through the use of a trust or partnership is not possible where a corporation resident in Canada is a beneficiary or partner of the trust or partnership. A further anti-avoidance provision imputes interest to the Canadian resident corporation on an amount owing between two non-residents when it is reasonable to conclude that such indebtedness arose because of a loan or transfer of property by the corporation to a person or partnership.

[4] Section 80.4 Loans

Where a related non-resident has received a loan from or become indebted to a corporation resident in Canada at a rate of interest less than the prescribed rate, or at a rate otherwise considered favourable to the non-resident, then the non-resident will be deemed to have received a shareholder benefit under subsection 15(1). The amount of the benefit is calculated by comparing the interest rate charged with the prescribed rate of interest. This benefit is deemed to be a dividend and is subject to non-resident withholding tax of 25%. The withholding tax may be reduced by the provisions of a relevant tax treaty. This section does not apply, however, where subsection 15(2) as described above applies, or where the non-resident is a foreign affiliate of the Canadian taxpayer.

[5] Section 78(1): Unpaid Amounts

Section 78(1) applies where a corporation resident in Canada has previously deducted an amount that is owing to a related non-resident, and has not paid or settled the liability within two tax years following the year in which the liability was incurred. In these circumstances, the unpaid amount is included in the income of the corporation in the third tax year following the year in which the liability was incurred. Alternatively, an election may be filed to have the liability deemed as paid and loaned back to the corporation on the first day of the third tax year, although this may result in a withholding tax liability on the amount deemed as paid. If such an election is filed late (i.e., more than six months after the third year), 25% of the unpaid amount will still be included in income in the third year.

[6] Consequences for Failure to Provide Documentation: Section 231.6: Foreign-based Information or Documentation

The CRA may formally serve notice requiring a person resident or carrying on business in Canada to provide foreign-based information or documentation where the information is relevant to the administration or enforcement of the ITA. Supporting documents for intercompany charges and transfer pricing are prime examples of the types of information likely to be formally required. If the information or documentation is not produced following the delivery of the notice, then that information may not be subsequently introduced by the taxpayer to support their position against a reassessment. Such notices requiring the taxpayer to provide certain information must set out the time frame for production, a reasonable period of not less than ninety days. Taxpayers can apply to have the requirement varied by a judge. Failure to provide the information or documentation may lead to possible fines or imprisonment as discussed in subsection 238(1).

[B] Relationship to OECD Guidelines

The CRA endorses the arm's-length principle as espoused by the OECD as the basic rule governing the tax treatment of non-arm's-length cross-border transactions. Information Circular 87-2R outlines the CRA's position in respect of the application of the 1995 Organization for Economic Co-operation and Development (OECD), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the OECD Guidelines). Information Circular 87-2R is generally a principle-based document and states that the OECD Guidelines should be consulted for a more detailed discussion of principles contained in the Information Circular.

[C] Transfer Pricing Penalty Framework

Section 247 of the ITA incorporates a penalty of 10% on any transfer pricing adjustment that exceeds the lesser of 10% of gross revenue or CAD 5 million. The penalty and any related interest is non-deductible for tax purposes. The penalty does not apply to transactions for which the taxpayer made reasonable efforts to determine and use transfer prices that are reflective of arm's-length terms and conditions. At a minimum, a 'reasonable effort' requires that contemporaneous documentation be available within six months after the year-end, and the documentation must be provided to the CRA within three months of its request.

[1] Transfer Pricing Adjustment Penalties

If the taxpayer has not followed the ITA and the Information Circular 87-2R, and a transfer pricing adjustment is deemed to be appropriate, then a penalty is imposed equal to 10% of the net result of certain adjustments, calculated as follows:

– *UT:* the total of the transfer pricing income and capital adjustments (upward adjustments, whether there are reasonable efforts to determine and use arm's-length transfer prices or arm's-length allocations or not); *minus*

– *UR:* The total of transfer pricing income and capital adjustments for which a taxpayer has made reasonable efforts (upward adjustments for which there are reasonable efforts); *minus:*

– *DR:* The total of transfer pricing income and capital setoff adjustments for which a taxpayer has made reasonable efforts to determine and use arm's-length transfer prices or arm's-length allocations (downward adjustments for which there are reasonable efforts).

The penalty will only apply when (UT minus UR minus DR) is greater than the lesser of CAD 5,000,000 or 10% of the taxpayer's gross revenue for the particular tax year. The amount of the penalty is calculated separately. The penalty calculation is: 10%× (UT minus UR minus DR).

This penalty threshold (i.e., the lesser of CAD 5,000,000 and 10% of the taxpayer's gross revenue for the particular tax year) is applicable on an annual basis, and is not cumulative over multiple years. The amount of the penalty is not reduced by the threshold.

The taxpayer must provide the records or documents specified by subsection 247(4) to the CRA within three months of the receipt of a written request to do so. If the taxpayer does not provide these documents within the three months, the taxpayer is deemed to not have made reasonable efforts to determine and use arm's-length transfer prices or allocations for purposes of the penalty in subsection 247(3) of the Act.

A corporation, trust, partnership or individual who is resident in Canada at any time during the year, and has non-arm's-length transactions non-residents, in total, that exceed CAD 1,000,000 is required to prepare a Form T106, *Information Return of Non-Arm's-length Transactions with Non-Residents* on an annual basis. The form has to be filed at the time the taxpayer files their tax return. The CRA uses the information provided on the Form T106 for multiple purposes, including the identification of taxpayers for review and audit. The penalties applicable to the Form T106 include:

> Late filing penalties: assessed under subsection 162(7) of the Act where T106 documentation is filed after the due date. The penalty is equal to the greater of CAD 100 or CAD 25 per day, for each day that the failure to file continues, to a maximum of 100 days.
>
> Failure to file penalties: assessed under subsection 162(10) of the Income Tax Act where reporting persons or partnerships knowingly, or under circumstances amounting to gross negligence, fail to file or fail to comply with a request by the CRA for T106 documentation. The minimum penalty is a CAD 500 per month, to a maximum of CAD 12,000 for each failure to comply. Where the CRA has served a demand to file T106 documentation, the minimum penalty is CAD 1,000 per month, to a maximum of CAD 24,000 for each failure to comply.
>
> False statement or omissions penalties: assessed under subsection 163(2.4) of the Income Tax Act where information provided on the T106 is incomplete or incorrect. The penalty is CAD 24,000.

The T106 form asks for the North American Industrial Classification System (NAICS) codes for the transactions reported, whether any income or deductions are affected by requests for competent authority assistance or by assessment by foreign tax administrations, and whether an advance pricing arrangement in either country governs the transfer pricing methodology.

A separate T106 form is required for each related non-resident that transacted with the Canadian taxpayer. Each form asks if contemporaneous documentation has been prepared for transactions with that related non-resident.

For every type of transaction (tangible property, services, royalty arrangements, etc.) the transfer pricing methodology used must be identified using a numerical code from the following list:

(1) comparable uncontrolled price (CUP);

(2) cost plus;

(3) resale price;

(4) profit split;

(5) transactional net margin method (TNMM);

(6) qualifying cost-contribution arrangement; or

(7) other.

[D] Arm’s-Length Principle

The OECD Guidelines affirm the arm’s-length principle to be applied in determining transfer prices for transactions between non-arm’s-length parties. Similarly, Canadian legislation adopts the arm’s-length principle enabling the CRA to make transfer pricing adjustments if the terms or conditions of related-party cross-border transactions differ from those that would apply between arm’s-length parties.

The Canadian interpretation of the arm’s-length principle is similar to other OECD countries. However, as discussed in this section, the CRA applies the principle differently. The arm’s-length principle requires that, for tax purposes, the terms and conditions agreed to between non-arm’s-length parties in their commercial or financial relations be those that one would have expected had the parties been dealing with each other at arm’s-length.

The CRA also suggests that to arrive at the most precise approximation of an arm's-length price or allocation, the arm's-length principle should ideally be applied on a transaction-by-transaction basis. Therefore, in establishing transfer prices, taxpayers should set prices separately for each transaction they enter into with a non-arm's-length party. This separate determination usually provides the most reliable estimation of an arm's-length price. Thus, the CRA does not generally endorse bundling of transactions unless a taxpayer can prove that this is typically done by parties dealing at arm's-length under similar circumstances, or that the transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. In these situations, it may be necessary to bundle transactions.

In the application of the arm's-length principle, the CRA generally accepts business transactions as they are structured by the parties. The fact that a taxpayer has entered into a transaction with a non-arm's length, non-resident party in a form that would not exist between arm's-length parties does not necessarily imply that the transaction is inconsistent with the arm's-length principle. This may reflect the fact that parties not dealing at arm's-length operate under different commercial circumstances than do parties transacting at arm's length.

§7.03 DETERMINING THE APPROPRIATE INTERCOMPANY PRICE

[A] Method Selection

The OECD Guidelines provide guidance in applying the arm's-length principle, including a detailed explanation of the methodologies available for testing each transaction. The traditional transaction-based methods include the CUP method, the resale price method (RPM) and the cost plus method (CPLM). The transactional profit-based methods include the profit split method (PSM) and the TNMM. If none of these methods are suitable, then the taxpayer is free to apply other methods to establish an arm's-length price, provided such a method adheres to the arm's-length principle.

The OECD Guidelines recommend that traditional transaction-based methods should be used whenever possible. However, where traditional transaction-based methods cannot be reliably applied alone due to insufficient data or where such data is considered unreliable, practical considerations suggest the application of a transactional profit-based method either in conjunction with traditional transaction based methods or on its own.[2] The CRA accepts all of the transfer pricing methods listed by the OECD Guidelines and, in particular, expresses a preference for using traditional transaction-based methods over transactional profit-based methods and for following a hierarchy of methods to determine which method a taxpayer should

2. OECD Guidelines, para. 3.50.

use to set its transfer prices. Where a transactional profit-based method is used, the CRA has stated a preference for the PSM (in particular, the residual profit split versus contributory profit split) over the TNMM. The CRA also cautioned that, in their view, the TNMM is not necessarily the same as the comparable profits method (CPM) employed by some tax authorities, notably the Internal Revenue Service in the United States.

[1] Summary of Applicable Methods

Part 3 of IC 87-2R endorses all the transfer pricing methods allowed under the 1995 OECD Guidelines. Allowed methods are:

– *the traditional transaction methods*: the CUP; method, the resale price method; and the cost plus method; and

– *the transactional profit methods*: the PSM and the TNMMs).

The IC 87-2R states that traditional methods are preferable to the transactional profit methods, and that the TNMM is considered to be the method of last resort. The most appropriate method is the one that provides the highest degree of comparability. Once the most appropriate method is determined, the taxpayer is not required to make determinations under a lower-ranking method.

Conceptually, the CUP method can be considered for each party participating in the intercompany transaction; the cost plus method may be considered for the party performing manufacturing activities and the resale price method may be considered for the party performing distribution activities. The transactional PSM and the TNMM can be applied when the traditional transactional methods cannot be reliably used.

[2] Comparable Uncontrolled Price Method

The CUP method utilizes sales of tangible property between unrelated parties to determine arm’s-length consideration for controlled transactions. The OECD Guidelines recommend that ‘[w]here it is possible to locate comparable uncontrolled transactions, the CUP Method is the most direct and reliable way to apply the arm’s-length principle. Consequently, in such cases the CUP Method is preferable over all other methods.’[3] It is important that prospective CUP method comparables involve the same products as the controlled transaction, because similarity of products generally will have the greatest effect on comparability under this method.

3. OECD, Guidelines, para. 2.7.

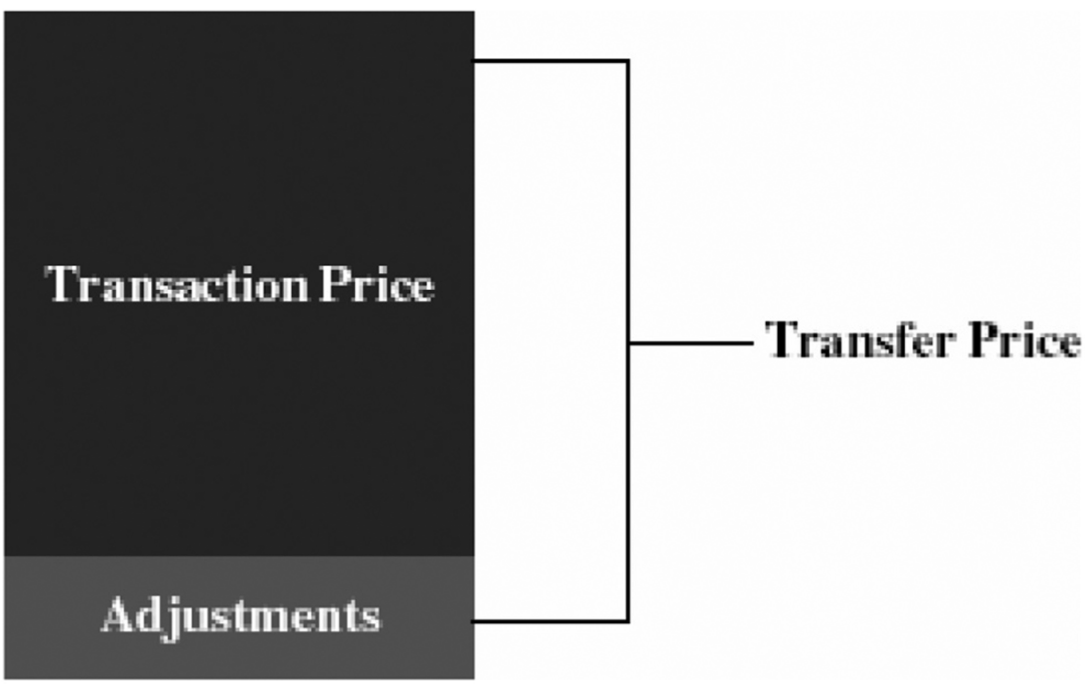
[a] CUP: Application

Paragraph 69 of IC 87-2R illustrates a typical example of the CUP. Canco, a Canadian company, sells commodity X to its German subsidiary, Germanco, for its own consumption (see Figure 7.1). Commodity X is actively traded in Germany with an average daily German price readily available. The average daily German transaction price represents a delivered price and includes any freight and duties. Under the agreement between Canco and Germanco, Germanco takes possession of the product at Canco's plant.

Average daily German transaction price per ton	*CAD 576*
Deduct:	
Adjustment for freight	CAD 32
Adjustment for duties	CAD 28
Total adjustments	CAD 60
Transfer price per ton	CAD 516

The CUP method is applicable in this scenario because commodity X is actively traded in the German market with an average daily price that is readily available to the general public. Therefore, this price can be used as the transfer price between Canco and Germanco.

Figure 7.1. Transfer Price under CUP Method



[3] Cost Plus Method

The cost plus method determines the arm's-length consideration that the seller should earn in an intercompany sale based on the gross profit earned by sellers in comparable uncontrolled transactions. Cost plus calculations start with the transferor’s cost of goods and compute an appropriate markup. The cost plus method ‘is most useful where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services’.[4]

In determining whether cost plus is an appropriate method, it is important that the functions between the related and unrelated parties be comparable. Data on the costs and the appropriate markup have to be reliable in order for the application of the method to be successful.

[a] Cost Plus Method: Application

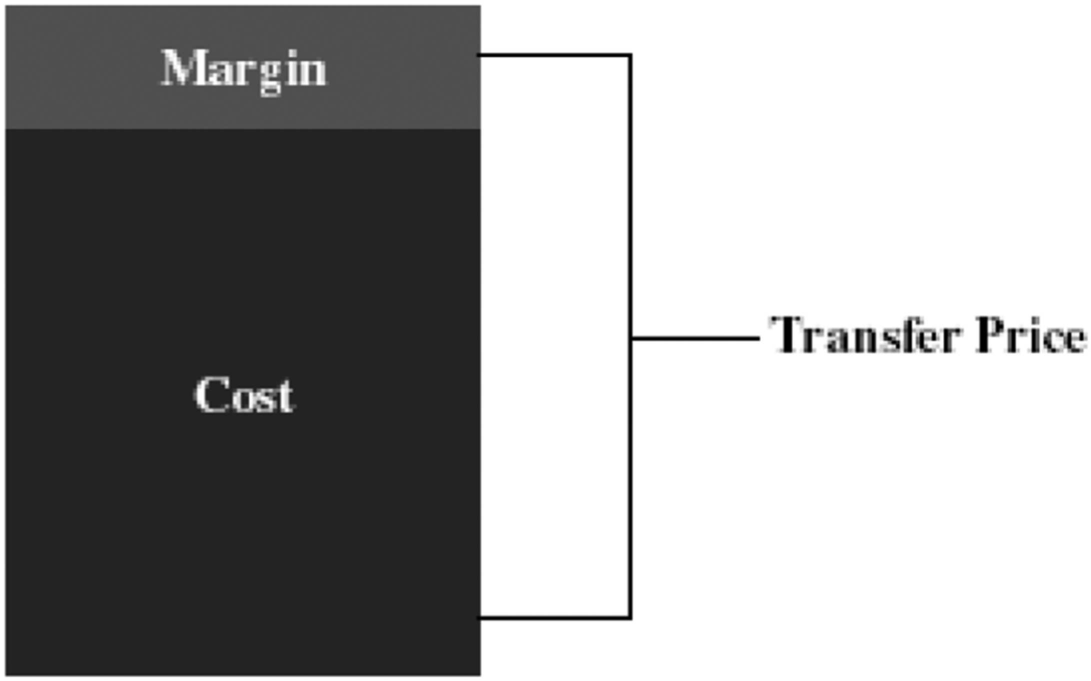
Paragraph 84 of IC 87-2R illustrates a typical example of the Cost Plus Method (see Figure 7.2).

Canco, a Canadian company, manufactures specialized stamping equipment for arm’s-length parties in the manufacturing industry using designs supplied to them by the arm’s-length parties. Canco realizes its costs plus a markup of 10% on this custom manufacturing. Under the arm’s-length agreements, costs are defined as the sum of direct costs (i.e., labour and materials) plus 50% of the direct costs. The additional 50% of direct costs is intended to approximate indirect costs, including overhead.

Canco also manufactures stamping machines for its United States subsidiary, Usco, using designs supplied by Usco. Under the Usco agreement, costs are defined as the sum of the direct costs plus the actual indirect costs, including overhead. It is assumed that the transactions between Canco and the arm’s-length parties are functionally comparable to the transactions between Canco and Usco.

4. OECD, Guidelines, para. 2.32.

Figure 7.2. Transfer Price under Cost Plus Method



Canco has calculated its indirect costs and has allocated them to the various projects based on the direct labour hours charge to each project. Based on Canco's calculations, indirect costs including overhead to be charged to each project is equal to 45% of the direct costs. The cost based of the comparable transactions must be restated to determine the appropriate markup.

Calculation of markup under the arm's-length agreements	
Direct costs	CAD 1,000
Indirect costs (50% × CAD 1000)	CAD 500
Total costs	CAD 1,500
Markup 10%	CAD 150
Price	CAD 1,650

Calculation of markup under the arm's-length agreements using restated costs	
Direct costs	CAD 1,000
Indirect costs (45% × CAD 1,000)	CAD 450
Total costs	CAD 1,450
Price established above	CAD 1,650
Markup based on restated costs (CAD 1,650 – CAD 1,450)	CAD 200
Gross markup based on restated costs (CAD 200/CAD 1,450)	13.8%

Calculation of the arm's-length transfer price	
Canco's direct costs related to Usco contract	CAD 900
Add:	
Indirect costs (45% × CAD 900)	CAD 405

Markup (13.8% × (CAD 900 + CAD 405)	CAD 180
Transfer price	CAD 1,485

The objective of the example is to emphasize that the cost base of the transaction of the tested party is calculated in the same manner as the cost base of the comparable transactions (i.e., if the comparable party includes a particular item as an operating expense, while the tested party includes the item in its COGS, the cost base of the comparable must be adjusted to include the item).

The cost plus method is applied to only one party (the tested party) of the group participating in the transaction. Therefore, this method generally produce the most reliable results where the functions performed by the tested party are the least complex, and the tested party does not contribute valuable or unique intangible assets.

[4] Resale Price Method

The resale price method can be employed to determine the arm's-length consideration to be earned by the related purchaser in an intercompany transaction when the purchaser, in turn, resells to unrelated parties.

[a] Resale Price Method: Application

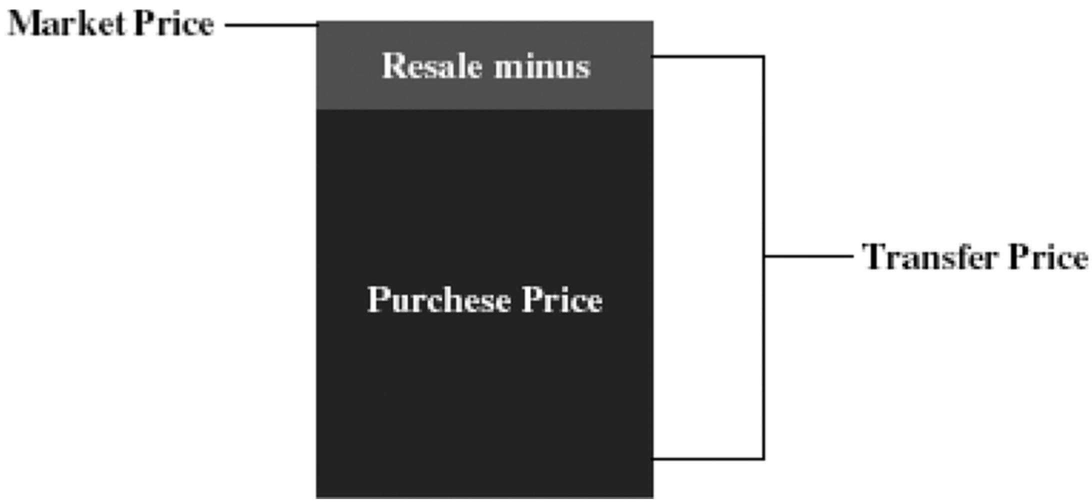
Paragraph 75 of IC 87-2R illustrates a typical example of the resale price method (see Figure 7.3).

Canco distributes widgets in Canada for its United States parent, Usco. Salesco, a Canadian company operating at arm's-length to Usco, distributes gadgets, a product similar to widgets, in Canada for Usco. The key functional differences, other than the minor differences in product, between the controlled transactions and the uncontrolled transactions are:

– Usco bears the warranty risk in the uncontrolled transaction, and Canco bears the warranty risk in the case of the controlled transaction.

– Usco provides samples and promotion materials to Salesco for free, while Canco produces its own samples and promotional materials and bears the related costs.

Figure 7.3. Transfer Price under Resale Price Method



The widget and gadget markets are similar in Canada. Salesco earns a commission of 15% of gadget sales net of discounts and allowances.

Calculation of sales commission:	
Canco’s net sales of widgets to arm’s-length parties	CAD 4,000
Arm’s-length sales commission rate 15%	CAD 600
Adjustments for function and risk differences:	
Promotion costs	CAD 10
Warranty costs	CAD 22
Total adjustments	CAD 32
Adjusted sales commission	CAD 632
Calculation of transfer price:	
Canco’s net sales of widgets to arm’s-length parties	CAD 4,000
Less adjusted sales commission	CAD 632
Transfer price	CAD 3,368

This method is most appropriate where the seller adds relatively little value to the goods. The greater the value-added to the goods, the more difficult it will be to determine an appropriate resale margin. This is especially true where the contribution pertains to the creation or maintenance of an intangible property (i.e., marketing intangible).

The resale price method is applied to only one party (the tested party) of the group participating in the transaction. Therefore, this method generally produces the most reliable results where the functions performed by the tested party are the least complex, and the tested party does not contribute valuable or unique intangible assets.

3.1.5.Profit Split Method

The PSM seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction. Under this method, the profits of the related parties are combined, and then divided on the basis of the contribution of value of each party to the transaction. It is most useful where transactions are highly integrated and cannot be evaluated on a separate basis, or where more than one party to the transaction possesses significant intangibles.

3.1.5.1.Profit Split Method: Application

Paragraph 102 of IC 87-2R illustrates a typical example of the PSM. Canco, A Canadian company, has developed and manufactures a unique computer chip. The chip is considered to be an innovative technological advance. Usco, a United States subsidiary of Canco, has developed and manufactures a computer which incorporates the new chip and technology developed by Usco itself. The success of the computer is attributable to both companies for the design of the computer and the computer chip.

Canco supplies Usco with the computer chips for assembly in the computers. Usco manufactures the computers and sells the computers to an arm's-length distributor.

In light of the innovative nature of the chip and computer, the group was unable to find comparables with similar intangible assets. Because they were unable to establish a reliable degree of comparability, the group was unable to apply the traditional transaction methods or the TNMM. However, reliable data are available on chip and computer manufacturers without innovative intangible property, and they earn a return of 10% on their manufacturing costs

(excluding purchases).

The total profits attributable to computer and chips are calculated as follows:	
Sales to the arm's-length distributor	CAD 1,000
Deduct	
Canco's manufacturing cost	CAD 200
Usco's manufacturing cost	CAD 300
Total manufacturing costs for the group	CAD 500
Gross margin	CAD 500
Deduct	
Canco's development costs	CAD 100
Usco's development costs	CAD 50
Canco's operating costs	CAD 50
Usco's operating costs	CAD 100
Subtotal	CAD 300
Net profit	CAD 200
Canco's return to manufacturing	
(CAD 200 × 10%)	CAD 20
Usco's return to manufacturing	
(CAD 300 × 10%)	CAD 30

Subtotal	CAD 50
Residual profit attributable to development	CAD 150
Based on proportionate development costs:	
Canco’s share of residual profit	
[CAD 100 / (CAD 100 + CAD 50)] × CAD 150	CAD 100
Usco’s share of residual profit	
[CAD 50 / (CAD 100 + CAD 50)] × CAD 150	CAD 50

Canco’s transfer price is calculated as follows:	
Manufacturing costs	CAD 200
Development costs	CAD 100
Operating costs	CAD 50
Routine 10% return on manufacturing costs	CAD 20
Share of residual profit	CAD 100
Transfer price	CAD 470

The key difference between the PSM and the TNMM is that the PSM is applied to all members involved in the controlled transaction, whereas the TNMM is applied to only one member.

[5] Transactional Net Margin Method

The TNMM examines the profit that is earned by one of the parties to the transaction (as opposed to the profits of the transacting companies as a whole) to determine the transfer price. ‘The transactional net margin examines the net profit margin relative to an appropriate base (e.g., costs, sales, assets) that a taxpayer realizes from a controlled transaction…the net margin of the taxpayer from the controlled transaction should be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions.’[5] If no similar transactions with third parties exist, the OECD Guidelines allow comparable transactions of an independent enterprise to serve as a guide.

There are two significant requirements that must be met to qualify to use the TNMM. First, comparables must meet strict standards of comparability that go beyond product and functional similarity. In fact, the OECD prescribes comparability adjustments to be made for factors which are unrelated to transfer pricing such as management efficiency, cost of capital and phase of business cycle. Secondly, the TNMM can only be applied to particular transactions, not on a company wide basis. In obtaining the comparable net margin from independent enterprises, the net margin should exclude other similar transactions as well as any controlled transactions of the enterprise.

According to Canadian practice, the TNMM should only be applied when other recommended methods do not produce a reasonable estimate for arm’s-length prices. As a result, the TNMM will be used when there is insufficient system profit to reliably apply the profit-split

5. OECD, Guidelines, para. 3.26.

method. The TNMM is applied from the perspective of the least complex party in the transaction.

[a] TNMM: Application

Paragraph 108 of IC 87-2R illustrate a typical example of the TNMM. Canco, a Canadian company, produces a liquid product for itself and three foreign subsidiaries of its Swiss parent. Canco and the foreign subsidiaries own the rights to the liquid product formulae for sales to their respective countries. Although Canco has no internal comparable transactions, it has been able to locate data relating to an arm's-length party who performs custom formulations for arm's-length purchasers using formulae supplied to them by those purchasers. Given the absence of valuable or unique intangibles, Canco has been able, after the appropriate functional analysis, to verify that the custom formulator is comparable. However, Canco cannot obtain the relevant information at the gross margin level. Therefore, it is unable to apply the cost plus method. The arm's-length formulator realizes a net markup of 10% on the custom formulations.

The transfer price of the liquid product is calculated as follows:	
Canco's cost of goods sold	CAD 1,000
Canco's operating expenses	CAD 300
Total costs	CAD 1,300
Add:	
Net markup (10% × CAD 1,300)	CAD 130
Transfer price	CAD 1,430

When relevant information exists at the gross margin level, taxpayers should apply the cost plus or resale price method. It is also recommended that tax payers follow a four-step approach in their search for external comparable transactions under the TNMM:

(1) Select entities with similar industry classifications to the tested party.

(2) Eliminate the entities that do not have comparable transactions as the tested party, based on the financial information available.

(3) Review in detail the entities selected in Step 1 and not screened out in Step 2 to determine if the information indicates that they could be considered to have comparable transactions.

(4) Material differences may affect comparability; therefore, make appropriate adjustments where possible and eliminate any entities for which necessary adjustments cannot reasonably be made.

[6] Application of Transfer Pricing Methods

[a] Method Selection for Intra-Group Services

The CRA's guidance in IC 87-2R in applying the arm's-length principle to intra-group services follows the OECD's two-step test. The first step is the determination if an arm's-length entity would be willing to pay for the activity, or undertake the activity themselves, and whether the activity confers a benefit of economic or commercial value. The CRA typically disallows the deduction of the service fee if this test is not passed.

The second step is the determination of the amount of the charge. The transfer pricing methods recommended by the CRA are CUP and cost plus. However, based on CRA practice, there should be no markup on cost of the intra-group services where the intra-group services are offered as a convenience to the group and not as an ordinary and recurrent activity. More specifically, if the activity is administrative in nature and is centralized to gain efficiencies, then the CRA generally disallows a markup. However, markups in intra-group services are acceptable if the services are operational in nature.

The CRA accepts the use of both the direct and indirect charge methods in the determination of intra-group service charges. Under the direct charge method, a specific charge is established for each identifiable service. Under the indirect charge method, an allocation to a particular entity of the cost of a service provided to more than one entity is made by referring to a basis or allocation key that indicates the share of the total value of the service attributable to the particular entity.

The CRA prefers the direct charge method over the indirect charge method. However, the indirect charge method is acceptable where a service has been provided to a number of non-arm's-length parties and the portion of the value of the service directly attributable to each of the parties cannot be determined. Under these circumstances, a taxpayer can use the indirect charge method.

The CRA, in IC 87-2R, recommends that when choosing an allocation key (e.g., sales, gross or operating profits, units used/produced/sold, number of employees, or capital invested), the taxpayer should consider the nature and use made of the service. For example, when allocating centralized resource costs, consider using proportionate head count as the allocation key, and when allocating centralized marketing costs, consider using proportionate sales.

In the case where a Canadian taxpayer is located in the province of Ontario, and the taxpayer is a recipient of intra-group services, an additional 5% withholding tax is assessed on management fees paid or payable to a related non-resident person. In order to be exempt from the add-back (i.e., the additional tax), the taxpayer must demonstrate that the management fee constitutes a reimbursement of costs incurred on its behalf.

[b] Method Selection for Transfers of Intangible Property

The CRA generally follows OECD guidance in applying the arm's-length principle to transfers of intangible property. However, the CRA's interpretation of the arm's-length principle in respect of intangible property as outlined in IC 87-2R, may lead to results that vary from the OECD guidelines. First, the CRA assumes that in most cases, both the supplier and the recipient share the risks and the benefits associated with using an intangible. For this reason the CRA suggests that arm's-length pricing for the transfer of intangible property must take into account the perspective of both the transferor of the property and the transferee. From the transferor's perspective, the CRA recommends a cost recovery plus a reasonable profit. While from transferee's perspective, the CRA recommends an expected benefit (additional profits) perspective. The 87-2R states that the overall expected benefit to the recipient is usually a key, however in practice, the CRA often defers to the cost-recovery perspective, especially for Canadian in-bound transfer of intangible property.

Similar to transfers of other property or services, the CRA recommends the CUP or the resale method, and suggests that the TNMM would not be appropriate. In circumstances where the intangible property is highly valuable or unique and generates significant excess profits, the residual PSM is recommended, ensuring that both the transferor and the transferee share the excess profits.

In establishing royalty rates for the right to exploit intangible property, the following items should be considered:

- prevailing industry rates;
- terms of the agreement, including geographic limitations, time limitations, and exclusivity rights;
- singularity of the invention and the period for which it is likely to remain unique;
- technical assistance, trademarks, and know-how provided along with access to any patent;
- profits anticipated by the licensee; and
- benefits to the licensor arising from sharing information on the experience of the licensee.

The CRA's position in IC 87-2R is that transferees of intangible property that do not own trademarks or trade names, and undertake marketing activities, should share in the returns attributable to marketing intangibles. More specifically, the Canadian position is that distributors who bear the costs of marketing activities would usually expect to share in the return from the marketing intangibles. Also, distributors who bear marketing costs in excess of those that an arm's-length distributor with similar rights to exploit the intangible would incur would expect an additional return from the owner of the trademark or trade name. The actual marketing activities of the distributor over a number of years should be given significant weight in evaluating the return attributable to marketing activities.

The use of hindsight in the determination of the value of intangible property is not appropriate. Under the arm's-length principle, an agreement that is, in substance, the same as one into which arm's-length parties would have entered, would not usually be subject to adjustment as a result of subsequent events. Thus the CRA typically does not make an adjustment solely on the basis that income streams or cost savings differ from those initially estimated by the parties. However, the CRA may consider factors that a reasonable person with some knowledge of the industry would have taken into account at the time the valuation was projected.

The CRA generally accepts business transactions as they are structured by the parties. However, the CRA would consider the re-characterization of a transaction where there is a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to intangible property arising as a result of future research. Generally, the CRA will review any long-term agreements between non-arm's-length parties for the right to use intangibles to ensure that they are consistent with the arm's-length principle and subject the transaction to re-characterization if they determine that:

– A long-term sale of intangible property would not have been entered into between persons dealing at arm's length.

– The sale was not entered into primarily for bona fide purposes other than to obtain a tax benefit.

[c] Methods to Price Qualifying Cost-Contribution Arrangements

Qualifying cost-contribution arrangements (QCCA) provide a vehicle to share the costs and risks of producing, developing or acquiring any property, or acquiring or performing any services. The costs and risks should be shared in proportion to the benefits that each participant is reasonably expected to derive from the property or services as a result of the arrangement.

Where a participant's contribution is not consistent with its share of expected benefits, a balancing payment may be appropriate.

Similar to the OECD guidance and most other countries, if the QCCA develops property such as an intangible, each participant in a QCCA is not required to be a legal owner of the property, but each participant must enjoy substantially similar rights, benefits, and privileges as a legal owner (effective or beneficial ownership).

QCCAs are typically used for the joint development of intangible property, with each participant being assigned an interest in the developed property. However, Canadian guidance provides for the use of QCCAs for participants to pool their resources to acquire any type of centralized services (e.g., accounting, computer technical support, human resources, or the development of an advertising campaign common to the participants' markets).

The arm's-length principle is used as the basis to determine each participant's contribution. That is, the contribution must be consistent with that which an arm's-length party would have agreed to contribute under comparable circumstances given the benefit it would have reasonably expected to derive from the arrangement. Therefore, only persons who can reasonably be expected to derive a benefit from the results of a QCCA can be considered participants in that QCCA. The requirement of an expected benefit does not impose a condition that the subject activity in fact be successful. The application of the arm's-length principle should take into account, among other things, the contractual terms and economic circumstances particular to the QCCA. The arm's-length principle also applies to capital contributions of tangible or intangible assets to a QCCA.

Generally, each participant's share of the benefits may be determined by estimating the anticipated additional income or cost saving that each participant is expected to gain as a result of its participation in the arrangement. The CRA suggests certain allocation keys, including:

– sales;

– units used, produced or sold;

– gross or operating profit;

– number of employees; or

– capital invested.

It is critical that the allocation method takes into account the relationship between the allocation key and the expected benefits.

It is important to note that contributions and allocations are treated as though they were made outside the scope of the QCCA to carry on the activities that are the subject of the QCCA. More specifically, the deductibility of the costs allocated to a Canadian taxpayer is determined in accordance with the Act. The fact that a charge for the costs is itself justified for the QCCA does not automatically make the costs deductible under the Act.

Where a participant's contribution to a QCCA is not consistent with its share of the expected benefit, a balancing payment may be required between the participants to adjust their respective contributions. For tax purposes, the balancing payment is treated as an addition to the cost of the payer and as a reimbursement of costs to the recipient. Where the balancing payment is more than the recipient's expenditures or costs, the excess will be treated as a taxable amount.

The costs subject to allocation would be net of other QCCA receipts (i.e., royalties from licenses or proceeds from the sale of research assets). Costs subject to allocation for Scientific Research and Experimental Development (SR&ED) tax credits carried out in Canada under a QCCA will be calculated before deducting any tax incentives (i.e., SR&ED tax credits) earned with respect to the SR&ED, but after deducting subsidies granted by a government, unless there is evidence that arm's-length parties would have done otherwise.

Under the arm's-length principle, participants in a QCCA that transfer a part or all of their interests in the results of prior QCCA activities (such as intangible property, work in-progress, or the knowledge obtained from past QCCA activities) to a new participant should receive arm's-length compensation from the new participant for that property (a buy-in payment). The amount of a buy-in payment should be determined, based on the price an arm's-length party would have paid for the rights obtained by the new participant. This determination would take into account the proportionate share of the overall expected benefit to be received from the QCCA.

For tax purposes, a buy-in payment is treated as if the payment was made outside the QCCA for acquiring the interest in the rights being obtained (e.g., an interest in intangible property already developed by the QCCA, work in progress, or the knowledge obtained from past QCCA activities).

Similar issues arise when a participant to a QCCA disposes of part or all of its interest in a QCCA. The effective transfer of property interests should be compensated according to the arm's-length principle (a buy-out payment). However, taxpayers should exercise care in the event of either a buy-in or buy-out because the very nature of any intangibles in a QCCA may often make the buy-in or buy-out valuation difficult. This valuation is particularly difficult where the intangibles developed by a QCCA are valuable or unique. Buy-in and buy-out payments, in particular when a low-tax jurisdiction is involved, are often challenged by the CRA.

[B] Comparables Selection

The CRA closely follows the OECD Guidelines sections that emphasize the importance of comparability factors in evaluating compliance with the arm's-length principle; that is, the greater the degree of comparability, the greater the assurance that the results meet the arm's-length principle. Comparability is judged not only by product similarity but also by functions performed, risks undertaken, contractual terms, economic circumstances and business strategies.

The arm's-length standard is generally based on a comparison of the prices or margins used by non-arm's-length parties with those used by arm's-length parties engaged in similar transactions. Therefore, the selection of comparable transactions is crucial in the application of the arm's-length standard. To consider uncontrolled and controlled transactions to be comparable, there should either be no differences between the transactions which would materially affect the price in the open market, or in the case that differences do exist, reliable adjustments should be made to eliminate the material effects of such differences.

In addition, IC 87-2R (paragraph 51) suggests that multiple years of data for the taxpayer and the comparables should be taken into consideration when determining comparability and developing an arm's-length benchmark.

The CRA's interpretation is also consistent with paragraph 1.15 of the OECD Guidelines, and the application of the arm's-length principle is generally based on a comparison of the prices or margins used or obtained by non-arm's-length parties with those used or obtained by arm's-length parties engaged in similar transactions.

In IC 87-2R, the CRA also states that for such price or margin comparisons to be useful, the economically relevant characteristics of the transactions being compared must be at least sufficiently similar so as to permit reasonably accurate adjustments to be made for any differences in such characteristics. Transactions between other non-arm's-length parties should not be used for purposes of these comparisons, because the terms and conditions may not be arm's-length. It is the term 'sufficiently similar' that distinguishes the Canada from OECD countries. It is generally thought that Canada has a higher standard of comparability than most OECD countries.

The CRA follows paragraphs 1.19 through 1.35 of the OECD Guidelines in identifying factors that may influence the degree of comparability of transactions. These factors include:

– the characteristics of the property or services being purchased or sold;

– the functions performed by the parties to the transactions (taking into account assets used and risks assumed);

– the terms and conditions of the contract;

– the economic circumstances of the parties; and

– the business strategies pursued by the parties.

The CRA recognizes that transfer pricing is not an exact science and the selection of the most appropriate pricing method depends largely on the assessment of the comparability of transactions. As a result, the application of the most appropriate transfer pricing methodology may produce a range of results. The CRA relies on the facts and circumstances of the case to determine a range, or the point in a range, that is the most reliable estimate of an arm's-length price or allocation. Taxpayers should exercise care in assessing the reliability of each comparable transaction used to establish a range. Based on the CRA's position, it is not atypical to see fewer comparables within the range of acceptable results when compared to other OECD countries.

The CRA accepts that business strategies are factors that can affect comparability because they influence the price that arm's-length parties would charge for a product. IC 87-2R provides the following example:

> Where an arm's-length party attempts to introduce a product into a new market or increase its market share, it may be reasonable for that party to temporarily charge a price lower than it would otherwise charge in an attempt to establish that market or market share. This assumes that an arm's-length party would have estimated the potential long-term benefits of such a strategy. It is unlikely, however, that an arm's-length party would maintain such a strategy for an extended period of time.

§7.04 DEVELOPING SUPPORT FOR ACTUAL PRICING

[A] Transfer Pricing Documentation Requirements

CRA's Transfer Pricing Memorandum 09 *Reasonable Efforts Under Section 247 of the Income Tax Act*, dated 18 September 2006, provides guidance as to what constitutes reasonable efforts to determine and support arm's-length terms and conditions. This Memo provides a number of examples on how to present and incorporate specific aspects of documentation. The Memo also provides insightful examples of taxpayers who received transfer pricing penalties for not satisfying the reasonable efforts standard.

Documentation has to be prepared on a contemporaneous basis, and a reasonable effort has to be made. Although the term 'contemporaneous documentation' is not defined in the ITA, the respective CRA administrative policy is found in paragraph 190 and 191 of IC 87-2R.

> 190. In light of the obligations set out in subsection 247(4), taxpayers will generally produce or obtain the required documentation at the time the transaction is entered into.191. Taxpayers may, after a transaction has occurred but before the filling due date, recognize that the transfer price recorded for that particular transaction does not represent an arm's-length price.

The reference to subsection 247(4) of the ITA states that the taxpayer must make or obtain, on or before the taxpayer's documentation-due date for the taxation year or fiscal period, certain records or documents.

A reasonable effort means the degree of effort that an independent and competent person engaged in the same line of business or endeavour would exercise under similar circumstances. What is reasonable is based on what a reasonable business person in the taxpayer's circumstances would do, having regard to the complexity and importance of the transfer pricing issues that arise in the taxpayer's case. The determination of whether a taxpayer has made reasonable efforts to determine and support arm's-length terms and conditions is a question of fact. The CRA will consider taxpayers to have made reasonable efforts if they have taken all reasonable steps to ensure that their transfer prices or allocations conform with the arm's-length principle.

The reasonable efforts test is contained in subsection 247(4) of the ITA.

The reasonable efforts test provides that the taxpayers must make reasonable efforts:

– to determine arm's-length transfer prices or arm's-length allocations; and

– to use those prices or allocations.

The ninth transfer pricing memorandum raises this point a number of times to ensure that reasonable efforts are made to follow the policies that have been established through use of reasonable efforts. In two examples, cited in the Appendix of the ninth memorandum, taxpayers received penalties due in part to inconsistencies in applying established transfer pricing policies.

Pursuant to subsection 247(4), a taxpayer is deemed not to have made reasonable efforts unless the taxpayer makes or obtains, on or before the documentation-due date, records or documents that provide a description that is complete and accurate in all material respects of:

– the property or services to which the transaction relates;

– the terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the participants in the transaction;

– the identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into;

– the functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction;

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

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

This is similar to the type of documentation suggested by the OECD Guidelines, and it is consistent with the type of information required by other countries, including the UNITED STATES For each subsequent taxation year in which the transaction continues, the taxpayer must review the existing documentation and update it for material changes in fact and/or circumstance.

[B] Relationship between Fulfilling Documentation Requirements and Protection from Penalties

See section §7.02[C], 'Transfer Pricing Penalty Framework' for a discussion of these issues.

[C] Sufficiency of Compliance Reports for Purposes of Applying Penalties

Contemporaneous documentation must provide complete and accurate descriptions of the following:

- the property or services to which the transaction relates;

- the terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the participants in the transaction;

- the identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into;

- the functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction;

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

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

This is similar to the type of documentation suggested by the OECD Guidelines, and it is consistent with the type of information required by other countries, including the United States. For each subsequent taxation year in which the transaction continues, the taxpayer must review the existing documentation and update it for material changes in facts and circumstances.

The Transfer Pricing Review Committee (TPRC) is responsible for reviewing all cases where a transfer pricing penalty may be assessed due to threshold levels being reached, to evaluate whether reasonable efforts have been made and to ensure fair and consistent application of the law. Each submission to the TPRC by the CRA Transfer Pricing Auditor is examined on a case-by-case basis.

The CRA had announced in 2011 that 52.8% of subsection 247(3) penalty proposals considered by the TPRC have been approved since its inception in March 2003. USD 339 million in 247(3) penalties were assessed in 2009 on approximately 1,100 completed files audited by CRA international tax auditors during that year.

When the TPRC is evaluating whether a taxpayer has made reasonable efforts to determine and use arm's-length terms and conditions, the TPRC will first review if the deeming provision contained in subsection 247(4) applies. That is:

(1) whether the documents obtained or prepared contain a description that is complete and accurate in all material respects of the items listed in subsection 247(4);

(2) whether the documents were prepared or obtained by the documentation-due-date; and

(3) whether the documents were provided within three months of a written request to do so.

A number of different factors are then considered, including but not limited to:

– Compliance versus accuracy.

– Demonstrated efforts.

– Administrative burden.

[1] Compliance versus Accuracy

A taxpayer's complies with contemporaneous documentation requirements if the documentation is prepared within the required timeframe while the accuracy of the pricing generally refers to extent of any adjustment made by the CRA. However, taxpayers have to take reasonable steps to search for arm's-length data, apply adjustments to the arm's-length data, select the transfer pricing methods, apply the selected methodology and ensure that the method followed is current with changing facts and circumstances of the taxpayer.

The CRA recognizes that data may be available at the time of a transfer pricing audit that was not available when the terms and conditions were established. The TPRC assessment of the penalty is not solely based on the ultimate accuracy of the transfer price but on efforts that a taxpayer makes to determine arm's-length terms and conditions. That is, a transfer pricing penalty would likely not be imposed on a taxpayer for failing to consider data to which the taxpayer did not have access, or for failure to apply a transfer pricing method that would have required data that was not available to the taxpayer when the access to or availability of the data was beyond the taxpayer's control.

The CRA is less likely to accept documentation if the taxpayer has not made reasonable efforts to consider applying a recommended transfer pricing methodology in accordance with the natural hierarchy of recommended methodologies referred to in IC 87-2R. The CRA may assess a penalty for transfer pricing on a taxpayer that made an insufficient effort to apply available arm's-length transactional data, even though significant effort was expended in the support and application of a profit based method, assuming the transfer pricing adjustment exceeds the threshold.

The CRA has stated that less effort to find detailed comparable information may be acceptable to support relatively small controlled transactions. The term 'small controlled transactions' refers to the size of the business. However, the degree of compliance effort must also be assessed against the size of the controlled transactions. Thus, it would be reasonable for taxpayers to devote proportionally more effort to find comparables for larger controlled transactions, regardless of their relative importance in the taxpayer's business. The ninth memorandum provides an example of a Canadian taxpayer that had relatively insignificant revenues compared to the worldwide operations. The taxpayer, was assessed a transfer pricing penalty for not making reasonable efforts, including not preparing a transfer pricing study. In essence, the taxpayer was not held to a lesser standard due to relatively lower revenues compared to its global operations.

[2] Demonstrated Efforts

The ninth memorandum state that the most effective way for taxpayers to demonstrate that they have made reasonable efforts to comply with the arm's-length principle is through the use of proper documentation. The term 'proper documentation' is not defined but it is understood to mean documentation that is complete and accurate in all material respects. The taxpayer should maintain sufficient documentation to establish that the taxpayer reasonably concluded that, given the available data and the applicable pricing methods, the method and the application of the method, provide an arm's-length result. The steps taken to ensure compliance with the arm's-length principle also need to be explained within the documentation.

The list of documents in subsection 247(4) of the ITA is not intended to be an exhaustive list of the documents necessary to substantiate that a taxpayer has made reasonable efforts to determine and use arm's-length terms and conditions for their related party transactions. IC 87-2R explains that the documentation should include:

– the general organization and description of the business;

– the selection of a particular transfer pricing methodology, including an explanation of why the selected method is more appropriate than any higher-ranking methods;

– the projection of the expected benefits as they relate to the valuation of an intangible;

– the scope of the search and criteria used to select comparables;

– an analysis of the factors determining comparability, including a review of the differences and attempts made to make adjustments; and

– the assumptions, strategies, and policies as they relate to the tangible property, intangible property, and services being transferred.

The CRA cautions against inconsistencies in methods, data and factual representations, as these can undermine the reliability of the documentation, and affect the CRA's consideration of whether reasonable efforts have been made.

[3] Administrative Burden

The CRA's view on the appropriate administrative burden is consistent with paragraph 5.28 of the OECD guidelines:

> … the extensiveness of this process [compliance to arm's-length] should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. Moreover, the need for the documents should be balanced by the costs and administrative burdens, particularly where this process suggests the creation of documents that would not otherwise be prepared or referred to in the absence of tax considerations. Documentation requirements should not impose on taxpayer's costs and burdens disproportionate to the circumstances.…

§7.05 HOT TOPICS/SPECIAL CONSIDERATIONS IN CANADA CONCERNING TRANSFER PRICING

[A] Range Issues

The CRA recognizes that a taxpayer's transfer pricing analysis may provide for a range of acceptable results. The CRA's position is that the full range does not necessarily reflect an arm's-length result due to potential comparability defects between the comparable transactions. As a result, the CRA expects taxpayers to rely on the facts and circumstances of the case to identify a narrow range or point within a range that provides the most reliable estimate of an arm's-length price or allocation. Thus the CRA, unlike the IRS for example, does not believe that the application of an interquartile range to determine an arm's-length range enhances reliability of the comparable data considered in producing a range. The CRA's general position is as follows:

– Results from independent transactions that have a relatively high degree of comparability with the targeted transaction's key economic characteristics are preferred.

– Secondary evidence, such as unique characteristics of the target that are not present in the comparable transaction, can assist in judging the impact of comparability defects that could not be removed via screens or adjustments.

– Consider employing the residual PSM if the comparables for implementing a one-sided methodology (cost-plus, resale price and transactional net margin) are not sufficiently comparable.

The CRA's policies in regards to use of ranges, adjustments within a range, and use of multi-year data originate from an article released at the 2002 Canadian Tax Foundation Conference by the then existing Chief Economist of the International Tax Directorate.[6] The intent of the article was to provide helpful guidance in regards to range issues. Unfortunately, the guidance has and continues to cause conflict between the CRA and other tax jurisdictions. This use and application of ranges in Canada is fairly unique and may cause a taxpayer concerns if they attempt to prepare documentation to satisfy multiple tax authorities including Canada.

The CRA prefers that taxpayers use single-year comparable data in the construction of the comparable range when estimating arm's-length prices or allocations. As a result, the averaging of comparable multi-year year data used in many jurisdictions is not endorsed. The CRA's believes that the use of multi-year data may not be reliable due to difficulties in determining the appropriate period over which to average and the variability by which averaging can be performed. Neither IC 87-2R nor the Transfer Pricing Memoranda series address the issue of multi-year averaging versus a single-year's results. The CRA relies on the Simkover paper for their position on this issue.

6. See Ron I. Simkover, Transfer Pricing: Acceptable Arm's-length Prices Within the Range, Canada Tax Foundation, 2002 Conference Report, Chapter 17.

The CRA’s single-year approach places a significant burden on taxpayers. For example, a taxpayer over a three year period may be profitable in two of those years but incur losses in a particular year that are not related to transfer prices. The taxpayer could be subject to a reassessment in that particular year if the taxpayer uses the TNMM and the comparable companies are profitable, even though the taxpayer’s results meets the arm’s-length standard over the three-year period.

Although the CRA has a preference for using a single-year for comparative purposes, Canadian transfer pricing legislation provides opportunities for taxpayers to deviate from using a single year’s comparative information. Subparagraph 247(4)(a)(vi) of the Act requires transfer pricing documentation to be complete and accurate and include the following:

The assumptions, strategies, and policies, if any, that influenced the determination of the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, for the transaction.

Thus, where a taxpayer’s has taken a multi-year view in determining and using arm’s-length transfer prices, and can document those assumptions, strategies and policies, this provision would seem to provide support for a taxpayer adopting multi-year pricing approach.

[B] Business Restructuring

Business restructuring transactions have been a significant priority for the CRA for several years, and they are typically subject to intense scrutiny under audit. The CRA’s transfer pricing division is particularly concerned with business restructuring that result in lower income in the Canadian entity. Examples include:

- changing the risk-profile of an entity such as converting a full-fledged Canadian distributor to a limited-risk Canadian distributor;
- transfer of functions and risks such as closing a Canadian manufacturing plant and increasing manufacturing capacity in a non-resident related company that then sells the products back to the Canadian entity for distribution in Canada;
- transfer of certain rights such as disenabling a Canadian company from developing intangible property and enabling a related company to develop the transferred property.

Additionally, the CRA has reassessed taxpayers by disallowing the deductibility of a significant expense where the decision to incur the expense was deemed to be made by a non-resident related party. For example, if a Canadian company incurs significant costs while reducing staff levels, and the decision was deemed to be made by a non-resident, the CRA has disallowed the deduction in certain cases.

Prior to the 2008 release of the OECD discussion draft on business restructuring, the CRA's approach to business restructuring transactions could loosely be termed as aggressive but inconsistent. Taxpayers are hoping that the CRA will adopt the OECD position, and acknowledge that business restructurings can be commercially rational. Such restructurings should be allowed if a purpose of the restructuring is for the multinational enterprise to obtain tax savings, the parties' conduct is consistent with the reallocation of risks and functions and the associated transactions are priced using arm's-length principles.

[C] Customs

The Canada Border Services Agency (CBSA) is responsible for customs-related issues in Canada. In 2006 IC 06-1 and the CBSA's Memorandum D13-3-6 were issued to provide guidance on selecting the transfer pricing method that works best with a particular customs valuation method. The guidance also describes how to adjust customs valuations or transfer prices so that the two approaches do not conflict, how to determine an acceptable value for customs based on transfer pricing calculations and the factors that contribute to differences in customs valuations and transfer prices.

Generally, Canadian taxpayers do not receive a refund if a transfer pricing adjustment results in lower customs duties. Although the CRA and CBSA are coordinating their policy initiatives, they generally do not engage in joint audits or communicate their audit results to each other. While transfer pricing compliance does not ensure acceptance of values for customs purposes, the CBSA usually requests a taxpayer's contemporaneous documentation at the commencement of an audit. The CBSA's use of transfer pricing documentation to evaluate value for customs purposes has added an additional perspective to consider in the preparation of the documentation.

[D] Bundled Transactions

A bundled transaction occurs when a single price is established for a number of different types of transactions, tangible property and services for example, have been combined together to form a single transaction. The CRA is generally concerned with whether the transferred properties and services would differ if they were transferred in an unbundled form. The CRA also looks at whether withholding taxes are lowered or avoided when transactions are bundled.

Section 247 of the Act does not specifically address bundled transactions. However, CRA guidance provided in IC 87-2R, paragraph 36 states:

> … to arrive at the most precise approximation of an arm's-length price or allocation, the arm's-length principle should ideally be applied on a transaction-by-transaction basis. Therefore, in establishing transfer prices, taxpayers should set prices separately for each transaction they enter into with a non-arm's-length party. This separate determination usually provides the most reliable estimation of an arm's-length price.

Thus although the CRA generally accepts business transactions as structured by the parties, their general position is that properties and services should be priced and evaluated individually. However, the CRA acknowledges that there are circumstances so closely linked or continuous that they cannot be evaluated on a separate basis. Three examples of closely linked or continuous transactions are provided in paragraph 38 of IC87-2R:

– long term contracts for the supply of commodities or services – Where the price of a commodity would otherwise be low and easily discerned in the marketplace but for the fact that it is provided (presumably with a guarantee of supply) over a specified period of time; this term or condition of the transaction may contribute to and increase the price the commodity would otherwise command;

– rights to use intangible property – Where the synergy or integration between intangible and/or tangible properties is so significant that neither element can be valued separate and apart from the other. A possible indicator of integration is significant differences in the end-market selling price of the final product – where customers perceive value in the way the various products or services are combined; and

– the pricing of a range of closely linked products when it is impractical to determine pricing for each individual product or transaction (e.g., in a product line).

In the examples above, there may be more comparable information available to judge the arm's-length nature of the transaction as a bundle. However, even if bundled for valuation purposes, the transaction may still need to be unbundled for non-resident tax and withholding purposes.

The CRA suggests that a taxpayer's contemporaneous documentation for closely linked or continuous transactions should address the decision whether to bundle or unbundle the transactions. Paragraph 39 of IC87-2R provides a specific list of factors that taxpayers should consider, as follows:

– intangibles associated with various transactions;

– availability of quality information on comparable transactions;

– functional comparability of transactions; and

– additional costs associated with valuing transactions separately.

The decision to bundle or not bundle should be clearly communicated within the taxpayer's contemporaneous documentation to withstand challenge by the CRA. When there is commercial evidence for bundling transactions within an industry, it demonstrates that arm's-length data to evaluate the separate components is not available.

The distinction between know-how and other royalties and services are often issues identified by the CRA during audits. Know-how is exempt from withholding taxes, but royalties or services that are related to the transaction are typically not exempt. A bundled transaction that includes a fee for know-how that incorporates add on services may be unbundled during an audit. For example, after-sales service, payment to receive opinions from a technical expert such as an engineer, or payments related to access to a database not incorporating confidential information are candidates to be unbundled.

The CRA's Transfer Pricing Memorandum 06 cautions taxpayers that improper bundling may inadvertently lead to transfer pricing penalties. The memorandum references paragraph 182 and 198 of 87-2R.

> … taxpayer must have records or documents that provide a complete and accurate description … of the terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the persons or partnerships involved in the transaction.

Paragraph 198 impacts bundling decisions indirectly by requiring the taxpayer to consider a hierarchy of methods in determining an arm's-length transfer pricing. To be seen as making a reasonable effort, taxpayers must not only explain their choice of methodology but they must document why higher-ranking methods were rejected. Therefore, bundling may result in transfer pricing penalties if transactions are not properly described or if the taxpayer has not properly documented their justification for pricing the transaction as a bundle.

§7.06 NATIONAL ADMINISTRATIVE PRACTICES

[A] Availability of Advance Pricing Agreements

[1] Advance Pricing Arrangements

Information Circular 94-4R (IC 94-4R), dated 16 March 2001, outlines the procedures and guidelines for obtaining advance price arrangements (APAs) in Canada. The APA service is intended to assist Canadian taxpayers in determining transfer prices acceptable to the CRA for the purposes of the ITA and, where negotiated with tax authorities of other jurisdictions, the relevant treaties with those countries. An APA is intended to consider proposed pricing arrangements or methodologies that have prospective application. The APA is designed to seek agreement on an appropriate transfer pricing methodology for a specified cross-border transaction between related parties, as opposed to seeking agreement on specific prices. The service is offered in addition to competent authority assistance to determine the appropriateness of historic transactions that have been challenged by one or both of the jurisdictions involved.

APAs can be unilateral, bilateral or multilateral. At the conclusion of the procedure there is a ‘binding agreement’ between the taxpayer and the CRA and, in the case of bilateral or multilateral APAs, between the CRA and the other tax authorities involved.

On 18 March 2005, the CRA released Information Circular 94-4R (Special Release) on the topic of advance pricing arrangements for small businesses. The Special Release provides that:

- The program will have a fixed non-refundable administration fee of CAD 5,000.
- Taxpayers must have gross revenues of less than CAD 50 million or a proposed transaction to be covered by the APA of less than CAD 10 million.
- The program will cover only transactions of tangible property and routine services.
- Site visits will not be performed.
- The minimum information required from a taxpayer is a functional analysis.
- The CRA will perform the economic analysis if requested to do so.
- The program will pertain only to a unilateral APA.

Taxpayers’ annual reporting under the program will be limited to stating, in writing, whether the critical assumptions have or have not been breached.

The CRA has an Advance Pricing Arrangement (APA) program available to assist taxpayers to determine appropriate transfer pricing methodologies (TPMs) for transactions or arrangements they participate in with non-resident persons with whom they do not deal at arm’s length.

The International and Large Business Directorate (ILBD) is part of the Compliance Programs Branch of the CRA. The Competent Authority Services Division (CASD) within the ILBD has responsibility for the APA Program. The Director of the CASD is also a delegated Competent Authority for Canada on matters of double taxation, and is responsible for the administration of the APA program.

Any taxpayer may apply for APA consideration, regardless of the size of the organization, the type or scope of its operations, or the nature of the transactions and proposed TPMs. An APA is the only means by which a taxpayer can receive assurance that they have complied with section

247 of the Act. Of course, this assumes that the taxpayer has complied with the terms and conditions of an APA for the transactions and periods specified in the APA.

The APA process is designed to produce an APA specifying the:

- taxpayer and the non-resident entities;
- nature and scope of transactions to be covered;
- appropriate TPMs to be employed;
- period for which an APA is to be effective; and
- other terms and conditions.

The CRA typically accepts APA requests for current transactions and specified future transactions that are not hypothetical. An APA will apply only to the taxpayer who is party to it, and to the participants, transactions, and time periods specified in it. The CRA also accepts issues similar or related to transfer pricing, such as the proper attribution of income between a permanent establishment and other parts of the same entity.

The CRA offers ‘First-Step’ calls and pre-filing meetings, free-of-charge and without commitment, to discuss the taxpayer’s transfer pricing issues. The primary purpose of these meetings is to determine the suitability of an APA for the related party transactions and to provide preliminary comments on the taxpayer’s proposed TPM. These initial calls or meetings may also be conducted anonymously.

A taxpayer may apply the terms and conditions of an APA retroactively to non-statute-barred tax years under certain circumstances. Generally this occurs when the facts and circumstances of the open prior years were similar to those on which the APA was concluded. A retroactive application of the results from an APA require approval from the taxpayer's local Tax Services Office and the non-resident entities' tax administrations if the APA is bilateral in nature. A request to retroactively apply the terms and conditions of an APA is separate and distinct from an APA request.

A taxpayer may request an APA while a transfer pricing audit is in process. The requested APA would be for future years, with an additional request for ITD and the local TSO to apply the APA findings retroactively to the years under audit. However, filing an APA request or submission will not prevent or defer an audit of the years prior to the proposed APA years.

The APA process includes the following stages:

(1) pre-filing meeting(s);

(2) the APA request;

(3) the acceptance letter;

(4) the APA submission;

(5) preliminary review of the APA submission and establishment of a case plan;

(6) review, analysis, and evaluation;

(7) negotiations;

(8) agreements;

(9) the post-settlement meeting; and

(10) APA compliance.

The filing of an APA request or submission does not initiate an audit. CRA has distinct departments that are responsible for each program. However, the staff responsible for each of these programs co-ordinate their efforts where possible.

The CRA prefers to enter into bilateral or multilateral APAs. Taxpayers requesting a unilateral APA must state why they are not requesting a bilateral or multilateral APA. Where the proposed transactions involve countries with which Canada has income tax treaties, the CRA may consider notifying the treaty partner that they have accepted a unilateral APA request.

The CRA has the discretion to not accept or pursue all requests for APAs. However, once a request is accepted, the CRA would only decline to pursue or conclude an APA in extraordinary circumstances. In circumstances where the CRA decline an APA request, or propose not to pursue an APA, the CRA will generally communicate the reasons and provide the taxpayer an opportunity to make further representations. Conversely, a taxpayer can withdraw an APA request at any time.

The CRA levies a non-refundable user charge for each accepted APA request or renewal to cover anticipated 'out-of-pocket' costs, such as travel and accommodation expenses. There is no charge for staff time. The user charge is typically outlined in the CRA's APA acceptance letter, and it is payable upon the taxpayer's reply to the CRA's APA acceptance letter.

The CRA's APA team is typically led by a case officer, and usually comprises an accountant/auditor, an economist, TSO audit personnel, other CRA specialists, and legal counsel. The case officer will usually contact the taxpayer within thirty days after receiving the signed acceptance letter to discuss any concerns that the taxpayer may have about preparing the APA submission. The case officer will co-ordinate further work and information requirements regarding the APA request with the taxpayer, the non-resident entities, the team, and, in the case of a bilateral or multilateral APAs, with the relevant tax authorities.

The APA submission must include detailed information about the taxpayer and about the non-resident entities involved in the proposed APA. The particulars of the case will determine the information to be submitted. The checklist in Table 7.1 is a general outline provided by the CRA.

Upon completion of an APA, the taxpayer is required to file annual APA reports according to the terms of the APA. An APA report will describe the taxpayer's actual operations for the period and demonstrate compliance with the terms and conditions of the APA. An APA report has to address all items called for by the APA, and any requests to revise or cancel the related APA. Each APA is unique, and each will set out the particular requirements of its APA report, such as content, scope, filing date and joint APA reports in the case of a bilateral or multilateral APA.

An APA may be revised if there are material changes in the law of Canada or the foreign affected country, or a material change in the particular circumstances of the taxpayer. An APA may also be revised if a taxpayer fails to meet one of the critical assumptions spelled out in the APA, or if the foreign country alters or cancels the APA. Instead of revising an APA, the CRA may choose to cancel an APA for one of the previously mentioned reasons. The CRA may also cancel an APA if it is determined that a taxpayer made material misstatements or omissions at any time in the process or in an annual APA report.

In March 2005, the CRA issued IC94-4R(SR) *Advance Pricing Agreements for Small Businesses* with the purpose of attracting interest in the APA program from taxpayers that have historically represented a small portion of total APA requests. This program addresses Canadian taxpayers that have revenues of less than CAD 50 million, or covered transactions of less than CAD 10 million. The program only applies to transactions of tangible goods and routine services. The program does not cover payments for the use of intangible property or financial transactions. Taxpayers that meet the requirements of the program do not have to submit an economic analysis to support the transactions. The only required submission is a functional analysis. The taxpayer's fee for the program is CAD 5,000. There are no bilateral APAs or roll-back options under this program.

Table 7.1 APA Submission Checklist

Item	*Notes*
Introduction	
Taxpayer, non-resident entities and representatives **(names, addresses, telephone numbers, relationships)**	
Fiscal periods and business identification numbers of the taxpayers and non-resident entities	
Proposed term of the APA including any request for retroactive application of the APA terms and conditions to non-statue-based taxation years	
Proposed transactions to be covered under the APA **(Description of the property or services to which the proposed APA relates)**	
Proposed TPM(s)	
Proposed terms and conditions, and critical assumptions for the APA	
Identify whether this is a request for a BAPA, MAPA or unilateral APA	
Declaration statement	
History and background of the multinational enterprise	
General description of business and product/services	
Multinational structure, organizational arrangement, operational set-up including major transaction flows	
Identify all other transaction flows of the multinational enterprise (volumes, directions and amounts) that may have an impact on the pricing of the covered transactions	
Functional currency for each entity and the currency which is used for the proposed transactions to be covered under the APA	
Accounting and costing system, policies, procedures, and practices, including any significant financial and tax accounting differences that may affect the TPMs	

[2] When Should a Taxpayer Consider an APA?

There is frequently uncertainty about the decision to proceed with an APA. Often described as a voluntary audit, before initiating an APA, a taxpayer should be fully prepared to understand the level of commitment required and to quantify when possible the benefits to be obtained. The following is a list of issues to consider before requesting an APA:

– The TPRC will not be referred if a ninety-day letter has not been issued by the auditor. This may create an incentive to apply for an APA with a rollback when contemporaneous documentation was not prepared. This may also reduce exposure to transfer pricing penalties that may arise in a transfer pricing audit.

– Are the other countries involved tax treaty partners, and if so, are they participating in the APA?

– Does the present transaction and pricing methodology have a high likelihood of resulting in a dispute or double tax in the event of an audit?

– Is a timely agreement likely to be reached? That is, are the participating tax authorities taking a critical role in analyzing the transfer pricing method, or are they expected to contribute to the establishment of the transfer pricing method? Does any particular tax authority involved in the APA have prior positions on the proposed methodology, comparable data used, or the arm's-length outcome? Is there sufficient complexity to warrant the level of certainty provided by an APA?

– Is the related party international dealings material in the context of the business?

– Will the APA serve as an alternative dispute resolution mechanism by rolling back the APA to earlier unresolved years?

– What is the expected savings from reduced compliance effort during the term of the APA?

Another aspect of APAs that companies should be aware is that advising to complete an APA is viewed as a transfer pricing advisor's largest moral hazard. That is, the investment in an APA requires significant time and resources from your transfer pricing advisor. There is a financial benefit for transfer pricing advisors to have clients enter the APA program. As a result, the benefits of an APA for a company may be overstated by a transfer pricing advisor in order to influence the decision to pursue an APA. An objective analysis of the cost versus benefits of an APA program will help to ensure an APA is appropriate. Also, the CRA will also inform a company after the pre-file meeting if they believe the covered transaction is not well suited to the APA program.

Fiscal year 2009–2010 marked the twentieth anniversary of the inception of the APA program in Canada which began as a joint pilot programme with the Office of the Chief Counsel in the United States in 1990. The usage of APAs in Canada remains high. A total of sixteen APAs were completed in 2009–2010, just shy of the historical high of seventeen APAs in both 2003–2004 and 2004–2005. The number of countries involved in bilateral and multilateral APAs has been increasing in recent years, but bilateral APAs with the United States still account for three-quarters of all cases.

[3] Annual Report

The CRA has released twelve reports updating the accomplishments of the APA program. Since 1990, there have been a total of 192 completed APAs.

A material component of the APA annual report is to produce various completion time statistics. In the effort to continually focus on the efficiency and timeliness of an APA, the program has shifted more rigor in the earliest phases of the APA process. This has served to reduce the time required to complete the due diligence and to negotiate successful APAs.

Over the past twelve reports, the following observations can be noted:

(i) Bilateral APAs are the majority of APAs completed.

(ii) Tangible property, Intangible property and services are the majority of the transactions addressed.

(iii) Top industries have included:

- Auto and Other Transportation Equipment.
- Metals and Minerals.
- Computer and Electronics.
- Finance and Insurance.
- Construction Equipment and Materials.

- Retail Trade.
- Machinery.
- Chemical and Allied Industries.
- Health.
- Wood and Paper.
- Petroleum.

(iv) The TNMM method has been the most popular transfer pricing method applied.

(v) The operating margin is the most common profit level indicator used in the TNMM application. This PLI is most often applied to transactions involving Canadian or foreign distributors which have neither contributed to the creation, nor the exploitation, of non-routine intangibles.

(vi) The total cost-plus method is often applied to transactions involving manufactures, which similarly have not contributed to the creation or exploitation of non-routine intangibles.

(vii) A return on assets has not been frequently used in completed APAs. When it was used, it was applied where a manufacturing plant was relatively new. At an earlier stage, the age of plant property and equipment did not pose a significant issue in the choice of this profit level indicator. In one instance, the total cost-plus profit level indicator was also compared to ensure ongoing reliability of the return on asset profit level indicator.

(viii) The berry ratio has been used for cases that involved a service organization that trans-shipped goods, but had no sales function. Also, the berry ratio was used for a sales organization where application of the operating margin profit level indicator would have been less reliable due to the presence of both non-arm's-length purchases and sales.

(ix) The top countries that have completed an APA with Canada have include:

- Australia

– Denmark

– Germany

– Japan

– New Zealand

– United Kingdom

– United States.

[B] Access to Competent Authority

The primary purpose of tax conventions is to eliminate double taxation and to prevent fiscal evasion. Canadian Competent Authority seeks to resolve issues of double taxation provided under the Mutual Agreement Procedure (MAP) article contained in Canada's tax conventions. In certain situations other articles may apply to allow for competent authority assistance.

The MAP process is the only mechanism under Canada's network of tax treaties to relieve double taxation or taxation not in accordance with a convention. The resolution of double taxation is a service offered by the CRA on a no-fee basis.

The competent authority assistance available in most treaties contains time limitations that may be shorter than the Canadian statutes of limitations. The protocol with the US has a time limitation of six years from the end of the tax year of the taxpayer, which is shorter than the Canadian statute of limitation.

Canada's tax conventions define the Canadian Competent Authority as the Minister of National Revenue or the Minister's authorized representative. Requests for competent authority assistance in respect of specific cases and related enquiries may be sent to:

Canada Revenue Agency

Director, Competent Authority Services Division

International Tax Directorate

Compliance Programs Branch

5th floor, 344 Slater Street

Ottawa ON K1A 0L5

The ILBD is part of the Compliance Programs Branch of the CRA. The CASD within ILBD has responsibility for the MAP Program. The Director of CASD is an authorized Competent Authority for Canada on matters of double taxation and taxation not in accordance with a convention related to specific taxpayers, and the Director is responsible for the administration of the MAP Program.

The CRA does not have a prescribed form for requesting Competent Authority assistance. However, IC 71-17R5 requests that taxpayers submit the following relevant information:

(1) the name, address, and social insurance number, or corporation identification and business number, of the Canadian taxpayer;

(2) the name of the foreign tax administration involved, the tax convention articles that the taxpayer asserts are not being correctly applied by Canada or the other country, and the taxpayer's interpretation of the application of the articles;

(3) the name, address and, if possible, the identification number of any related foreign taxpayer involved;

(4) the relationship between the Canadian taxpayer and any related foreign taxpayers involved. (Applicants should also keep the Canadian Competent Authority informed of any changes in these relationships that occur after the request has been filed);

(5) the taxation years or periods involved;

(6) the Tax Services Office or Taxation Centre that has made or is proposing to make the adjustment, if applicable;

(7) a summary of the facts and an analysis of the issues for which competent authority assistance is requested, including any specific issues raised by the foreign tax administration or CRA affecting the Canadian taxpayer and the related amounts (in both Canadian and foreign currency), each supported by calculations;

(8) contemporaneous documentation as described in subsection 247(4) of the Act;

(9) a copy of the competent authority request and all the relevant documents filed, or to be filed, with the relevant foreign competent authority, including copies of

any correspondence from the other tax administration, and copies of any briefs, objections, etc., submitted in response to the action or proposed action of the other tax administration (if such copies are in a foreign language, an English or French translation must be supplied);

(10) a statement indicating whether the taxpayer or a predecessor has made a prior request to the Canadian Competent Authority on the same or a related issue;

(11) for each taxpayer involved in the request, a schedule of the statute-barred dates in each jurisdiction (domestic time limits) in respect of all years for which relief is sought;

(12) a statement indicating whether the taxpayer has filed a notice of objection or a notice of appeal in Canada;

(13) where the request for competent authority assistance involves issues that are currently or were previously considered as part of an Advance Pricing Arrangement in Canada or in similar proceedings in the foreign country, a statement to that effect;

(14) if consent has not already been provided for a person to act as an authorized representative, a signed statement that the representative is authorized to act for the taxpayer in making the request;

(15) any other relevant facts;

(16) a copy of any settlement or agreement reached with the other jurisdiction which may affect the MAP process; and

(17) the taxpayer's views on any possible bases on which to resolve the issues

The request should be signed by the taxpayer, or by an authorized person on behalf of the taxpayer, confirming the accuracy and completeness of the facts and information presented in the request. Canadian Competent Authority has the right to deny any request due to identifiable misrepresentations or inaccuracies.

The Canadian Competent Authority will accept a request for assistance if:

– the issue or transaction relates to a foreign country with which Canada has a tax convention;

– it is evident that the actions of one or both countries have resulted or will result in taxation not in accordance with the tax convention;

– the taxpayer notifies the competent authority within the time limits specified in the applicable tax convention. (If the applicable tax convention does not specify a time limit for notification, the notification must be received within the time allowed to make an adjustment under the Act if the relief is to be provided by Canada, or within the time allowed to make an adjustment under the law of the treaty country if the relief is to be provided by the other country); and

– the issue is not one that the Canadian and/or the foreign Competent Authority have decided, as a matter of policy, not to consider.

The Canadian Competent Authority does not provide assistance for adjustments for notional expenses as a result of a notional income adjustment raised by a treaty partner, or deductibility of interest expense as a result of thin capitalization under subsection 18(4) of the Act.

The taxpayer has the following general obligations once the Competent Authority process has begun:

– To cooperate with the Canadian Competent Authority by providing information and assistance when requested.

– To not make self-correcting adjustments or filing amended income tax returns.

– To supply complete and accurate information on a timely basis.

– To ensure the affected tax years do not become statute-barred.

It is of special importance to note that failure to provide requested information within a reasonable time may result in a rare case of the denial of assistance from the Competent Authority.

[1] Accelerated Competent Authority Procedure

The CRA also has an Accelerated Competent Authority Procedure (ACAP) to resolve issues pertaining to the years subsequent to the reassessed years. The issues must be recurring and similar to the specific issues that were reassessed. The CRA may request any additional information pertaining to the ACAP period. The CRA will determine the nature and extent to which the taxpayer's books and records for the ACAP period need to be examined. The

Canadian Competent Authority typically consults with the foreign competent authority under the MAP process to resolve these issues. It is important to note that the CRA may still audit a taxpayer even if an ACAP is accepted.

An ACAP request generally will be considered if all of the following criteria are met:

- an ACAP request is made at the same time as the related MAP request;
- the issues in the ACAP request are the same as those in the MAP request;
- tax returns for years subsequent to those included in the MAP request and for which the taxpayer has requested ACAP consideration have been filed and initially assessed;
- after consultation between the appropriate tax services office (TSO) and the CASD, the CRA is satisfied that the facts and circumstances have remained unchanged between the MAP and ACAP taxation years;
- the other Competent Authority agrees to include the ACAP period with the related MAP request; and
- there are no issues involving unusual situations or transactions that would render the application of an ACAP impractical.

The CRA will review the ACAP in accordance with the above criteria. If the ACAP request is not accepted, the taxpayer may make a request for competent authority assistance through the regular MAP process.

[2] Binding Arbitration

The fifth protocol to the Canada-US Income Tax Convention introduced a binding arbitration clause to further ensure that taxpayers are not subject to double taxation. On the occasion when the competent authorities are unable to reach an agreement, taxpayers can compel the competent authorities to refer the dispute to binding arbitration. Under this 'baseball' arbitration process, an arbitration board comprised of three members will select one of the resolutions proposed by the competent authorities. Arbitration is available during the two-year period that commence on the date the taxpayer filed the complete competent authority submission. 15 December 2010 was the first effective date for the arbitration of cases pending two years or more.

A memorandum of understanding of the arbitration process[7] as well as operating guidelines for the arbitration board was released on 26 November 2010.

The three members on the arbitration board consist of one member appointed by each country, and a third person those two arbitrators select who will take the role as the chair. If the two country representatives cannot decide on a third member, the OECD will appoint a person to act as the chair.

Once the chair of the board has been appointed, each country must submit its proposed resolution within sixty days. Each country may respond to the other country's proposed resolution or position paper within 120 days from when the chair of the board has been appointed. The arbitration board must submit its decision in writing within six months from the appointment date of the board chair. The competent authorities must present the decision to the taxpayer who has thirty days to accept it.

The operating guidelines provide that the written decision from the arbitration board shall not include any rationale or analysis; the determination will have no precedential value; and after the determination each board member must immediately destroy all documents or other information received in connection with the proceedings.

Arbitration also applies to ACAP requests and APA cases between Canada and the US.

7. U.S.-Canada Memorandum of Understanding on Arbitration of Double-Tax Cases, 26 Nov. 2011.

The commencement date for the APA arbitration will be the 'earlier of i) the date on which the competent authorities have exchanged position papers setting forth their initial negotiating positions or ii) two years from the earliest date on which the information necessary to undertake substantive consideration for a mutual agreement has been received by both competent authorities'.[8]

> The arbitration procedure also applies to permanent establishment cases. For permanent establishment cases, each country submits the proposed resolution and position paper in a sealed envelope that is opened after the board determines a permanent establishment does exist. The board is to choose one of the proposed resolutions. If the board determines the permanent establishment does not exist, the proceeding is terminated.

[3] Annual Report

The CRA has issued ten annual reports on the MAP Program. The most recent report covers 1 April 2012 to 31 March 2013. The latest report shows that the average time for resolving cases for Canadian-initiated adjustments has decreased to 26 months from 31 months, which is still above the 21-month target. Average time for resolution of foreign-initiated adjustments increased to 22 months from 20 months.

The report reports other statistics for the 'negotiable' cases, which means that bilateral negotiations with another tax authority are still required. Of the negotiable cases, there have been a few reported that do not receive relief from double taxation. The reasons for no relief from any of the past reports are as follows:

– Request for competent authority assistance was filed outside the time limitation provisions in a specific tax convention.

– Request for refund of withholding tax filed outside the time limitation provisions in a specific tax convention and the Canadian Income Tax Act.

– Disagreement between the competent authorities as to the use of multiple-year data for the purpose of economic analysis.

– Disagreement between the competent authorities as to whether certain restructuring expenses represented extraordinary items.

8. *Ibid*., para. 19.d.

- Disagreement between the competent authorities as to the valuation of fixed assets.

- The domestic tax law provisions in the other tax jurisdiction prevented the other competent authority from providing relief from double taxation.

- The taxpayer failed to provide information requested by the competent authorities.

Of interest is the disagreement between competent authorities to the use of multiple-year data. Use of single-year versus multiple-year data in economic analysis has been a recurring point of contention between the US and Canadian tax authorities.

The top three transfer pricing methods applied on completed negotiable MAP cases has been consistent since the annual report was released: (i) Not applicable method, (ii) the cost plus method, and (iii) the transactional net margin method using the operating margin.

The report did not comment on the cases that have proceeded to arbitration.

[C] Other Items

[1] Transfer Pricing Audit

The tax audit process is described in Information Circular IC 71-14R3, which was last updated in 1984. A regular tax audit is conducted by the Taxation Service Office (TSO) that has jurisdiction over the particular taxpayers. The tax audit generally is conducted at the taxpayer's place of business, where the auditor examines the company's financial statements, detailed books and records, and any other relevant sources of information. Transfer pricing auditors are called during the tax audit to assist with audits of multinational enterprises, as part of a team approach to auditing. Depending on the size and nature of the international related party transactions, a transfer pricing auditor may be assigned to the case, or the auditor may simply provide technical support. The statue of limitations for most taxpayers is four years from the date of initial assessment, and the statue of limitations for transfer pricing and other international matters is up to seven years.

It is not uncommon for transfer pricing audits to commence towards the end of the seven-year time limit for a reassessment. In April 2009, the time limits for waivers of the statute of limitations were modified to allow a taxpayer to file a waiver within the three years after the end of the normal reassessment period. Prior to this, taxpayers had been unable to file waivers to extend the time limitation period.

There has been no public communication on factors that influence the likelihood a taxpayer will be selected for a transfer pricing audit. Historically, taxpayers selected for audit include those taxpayers with related cross border transactions that are either material in magnitude or material as a percentage of total revenue. Taxpayers that incur consistent losses in Canada, significant fluctuations in annual profit, and poor profitability compared to industry averages are frequently selected. Taxpayers in the pharmaceutical, forestry, oil and gas, and telecommunications industries are frequently audited. Management fees, royalties and license fees, as well as cost contribution arrangements are frequently audited as well. Significant transactions with low tax jurisdictions and recent restructuring also receive attention.

The T106 form is used as a tool by the CRA for audit selection. Screening criteria include changes in transfer pricing methodology, indication that contemporaneous documentation has not be prepared, and magnitude of transactions reported.

The typical stages in an audit include the following:

(1) CRA desk review and preliminary investigation.

(2) Commencement of the audit.

(3) Audit at the taxpayer's premises.

(4) CRA's communicated position from the audit.

(5) Taxpayer's response to the CRA.

(6) CRA Notice of Assessment to the taxpayer.

The desk review forms part of the preliminary investigation. Readily available information including annual tax returns, regular tax audit files, SEC filings and annual reports are reviewed by the auditor. During the desk review, information on the T106 is often compared to the relevant schedules on the tax return to verify consistency. Ensuring the T106 matches the tax return during the preparation of the tax return will be important in the event of an audit.

The CRA's transfer pricing memorandum 05, dated 13 October 2004, states:

> Effective immediately, requests for contemporaneous documentation must be issued at initial taxpayer contact stage in all cases where there are transactions or arrangements between a taxpayer and a non-resident person with whom the taxpayer does not deal at arm's-length.

Providing contemporaneous documentation, close to the date of issue of the letter, versus on day eighty-nine or ninety, will assist in demonstrating that effort has been invested in establishing a transfer pricing policy.

It has often proved beneficial to spend time with the auditor during the early stages of the audit. At the commencement of the audit, if the transfer pricing policy can be clearly shown to follow strong principles based on the OECD guidelines and 87-2R with reliable arm's-length data, the CRA may determine that there is a low potential for a transfer pricing adjustment, and reallocate their resources accordingly.

It is not unusual for a transfer pricing audit in Canada to last over a year. Due to the drawn-out process, it is a best practice to document communications with the CRA. The auditor often will interview management and gather additional information to confirm or supplement the contemporaneous documentation. If the first discussions with the auditor on transfer pricing do not satisfactory address the auditor's initial issues, the auditor may identify potential adjustments, and a higher number of subsequent meetings and queries may result. It is beneficial to have control over the information gathering process, and to help set and document agendas for meetings, prepare minutes of meetings and build a central depository of all audit queries and responses.

There are a number of secure electronic repositories that help organize and centralize the information generated during the audit. Often these tools are efficient when multiple parties are in defending the taxpayer's position and they are in disparate locations. Unfortunately, the CRA's IT policies preclude them from granting access or receiving a number of documents through electronic delivery, with the exception of electronic data requests.

During the audit, especially during the early stages, it may be difficult to determine the aims of the auditor. Without knowing what potential adjustments are being considered, it is difficult to negotiate at that stage. It is often more efficient for taxpayers to negotiate with the auditor when the CRA communicates their initial position, either verbally before the proposed adjustment letter, or upon delivery of their proposed adjustment letter. The auditor typically provides the taxpayer with a proposed adjustment letter describing the CRA position. The position paper sets out the auditor's position on:

– the fiscal year to be adjusted;

– the transactions to be adjusted;

– the rational for the adjustment;

– calculation of the adjustment;

– timeframe to respond (typically thirty or sixty days) and

– consideration of potential penalties.

If the level of the proposed adjustment meets the dollar threshold of a transfer pricing penalty, the auditor will refer the case to the TPRC. The TPRC is the ultimate arbiter in determining if the reasonable efforts standard was met.

If the taxpayer sees potential to negotiate with the auditor based on its position, the negotiations are typically improved if a less adversarial approach is taken. A positive and cordial relationship with the auditor throughout the process will assist in understanding the auditor's position and to gauge flexibility.

Depending on the taxpayer's success with the auditor, it may be beneficial to have discussions at a higher level within the TSO, and to include the regional advisor. If the auditor's position has significant implications for the taxpayer, or if the issues involved are more complex, a taxpayer may invite the Assistant Director of Audit, the Director of the TSO, or the ITD in Ottawa to participate in the discussions.

The taxpayer's response to the proposed adjustment letter has to demonstrate that the transfer pricing policy produces an arm's-length result. The letter will draw on analysis that is reflective of the business environment and the scope and responsibilities of the taxpayer to demonstrate that the arm's-length result is consistent with the functions performed and assets and risks held. Typically, a series of meetings with the CRA and the taxpayer follow the taxpayer's submission.

Once the discussions with the CRA have been completed, the taxpayer receives the final position and notice of reassessment for each tax year that an adjustment is proposed. Depending on the nature of the negotiations, the CRA may request that the taxpayer waive their rights to appeal the reassessment. In these circumstances, the taxpayer can submit their case to competent authority, but the taxpayer is precluded from proceeding to appeals.

Certain concessions become more difficult to obtain after prior to receiving the notice of reassessment. Concessions may include relief of interest, T106 filling penalties, or moving the proposed adjustment into other years.

The audit protocol is an initiative developed in 1997 to enhance the audit of large businesses. The audit protocol is designed to increase cooperation, openness, and flexibility in the audit process. The audit protocol, although not a legal document, is developed between the taxpayer and the CRA, and it represents a mutually agreeable framework that establishes guidelines for the audit process and relationship.

Proposed benefits of the audit protocol include:

– Availability of audit compliance checks, which normally result in a reduction in the time required to complete an audit.

– Enhanced certainty in the audit process resulting from a more co-operative, consultative, and open approach to audit.

– Enhanced ability to become current and remain current, thereby resulting in a more efficient use of resources as the parties will be working with current records and people involved will likely still be with the company.

– Decreased interest expense for corporations, since reassessments will be issued sooner.

– Higher priority for real-time audits.

– Higher priority for technical and legal opinions.

– Quicker resolution of audit issues and faster closing of the audit itself.

An option under the audit protocol is the real-time audit (RTA). In an RTA, the CRA conducts an audit of issues before the taxpayer files their income tax return. Taxpayers may also provide a letter of cooperation to request an RTA. The letter or the protocol of an RTA sets out the prerequisites and process. Due to the complexity of transfer pricing issues for multinationals, an RTA that incorporates transfer pricing issues has been used infrequently.

Canadian taxpayers are allowed to pursue their rights to appeal a notice of reassessment by filing a notice of objection. The appeal doesn't affect their rights to seek assistance in relieving double taxation through the competent authority process. However, Canadian Competent Authority only provides assistance if full relief is not provided by Appeals and the taxpayer does not agree with the Appeals decision. If the taxpayer concurs with Appeals Branch and there is double taxation, the Competent Authority will present the case to the other Competent Authority, but will not negotiate the issue. Under these circumstances relief from double taxation will only occur if the foreign Competent Authority fully agrees with the determination made by Canadian Appeals.

The notice of objection has to be filed within ninety days of receiving the notice of reassessment to maintain appeal rights. While appealing the notice of reassessment, a large corporation is required to either remit or provide security for 50% of the reassessed tax and 100% of related withholding taxes. An August 2008 report by the Transfer Pricing Subcommittee prepared for the Advisory Panel on Canada's System of International Taxation recommended change in this policy due to the financial burden it imposes on taxpayers that may have already paid tax for the transaction in question in another jurisdiction.

§7.07 SIGNIFICANT TRANSFER PRICING LEGAL CASES

Canada has historically had few transfer pricing cases requiring the involvement of the courts. With the introduction of new Canadian transfer pricing legislation in 1998 and the subsequent ramping up of transfer pricing related resources by the CRA, there is the expectation of increased court cases. However, up until approximately 2005 most transfer pricing-related controversy was typified by an audit followed by a request for correlative relief through the Competent Authority process. If a taxpayer was not satisfied with the results after Competent Authority, the taxpayer filed a Notice of Objection and sought assistance from the CRA Appeals Division. If the taxpayer was still unsatisfied after review by the CRA's Appeals Division, the taxpayer could seek assistance from the courts.

Canadian transfer pricing litigation focused on a few general issues. Older cases involved tax havens. More recent cases involved industries specifically targeted by the CRA. Since 1998, most cases have involved interpretation of the new transfer pricing legislation.

[A] Tax Haven Cases

Tax haven-related transfer pricing cases are some of the oldest cases involving product transfers between related parties. Examples of these cases include Spur Oil Ltd., Irving Oil Ltd. and Indalex Ltd.

[1] Spur Oil

In 1970, Spur commenced purchasing oil from its Bermuda-based affiliated company. Prior to 1970, Spur purchased oil from a US-based affiliate at a lower price than the price subsequently paid to the Bermuda affiliate. The central issues in the case were whether the increase in purchase price can be considered to be artificial, whether the price paid to the Bermuda affiliate is reflective of arm's-length terms and conditions (CUP), and whether there was a binding contract between Spur and the U.S. affiliate. The court sided with the Canadian tax authorities and found that the price increase was artificial. However, the decision was reversed at the Federal Court of Appeals (FCA), and the court found that the price paid was close to fair market value. Interestingly, the Trial Court found the contract to be binding while the FCA found that the contract was not binding. As a result, there was no reassessment of income.

[2] Irving Oil

The Irving Oil case relates to the 1971–1975 taxation years, during which Irving purchased oil from its Bermuda-based affiliate. Similar to the Spur Oil case, the FCA determined that the price paid by for the oil was similar to a market price. As a result, there was no reassessment of income.

[3] Indalex

The Indalex case relates to the 1971 to 1974 tax years, during which an unrelated company based in Canada supplied Indalex with raw materials. Purchase orders were sent to Indalex's Bermuda-based affiliate, who in turn forwarded the purchase orders to the unrelated Canadian supplier. The supplier would subsequently invoice and receive payment from the Bermuda Company. The Bermuda Company would in turn invoice their Canadian affiliate for the same amounts that they paid to the supplier. The Bermuda Company would then receive discounts for acting as the buyer for the Canadian company, as well as other related companies. The discounts were retained by the Bermuda Company and not passed along to the Canadian or other related companies.

Both the Trial Court and FCA found that the price charged by the Bermuda company to Indalex was not arm's-length, and that it did not provide any value in respect of the transactions. The full reassessment was confirmed.

The three tax haven cases cited above were assessed on both tax avoidance and transfer pricing principles. As a result, they offer minimal guidance or precedents in the application of transfer pricing principles. However, they demonstrated to Canadian tax authorities need to strengthen their capability in addressing transfer-pricing related issues. The Indalex case was also interesting, unlike the Spur and Irving cases, in that the focus was not necessarily whether the transfer price was appropriate, but whether the activities performed in the tax haven company merited the income earned by that company. Today, the CRA routinely reviews the functions performed, risks assumed and assets used by both parties in transfer pricing transactions.

[B] Targeted Industries

[1] The Pulp and Paper Industry

[a] Crestbrook

From 1984 to 1986, Crestbrook, a joint venture that included two unrelated Japanese companies, produced pulp products that were exclusively sold to the two Japanese participants in the joint venture. During the period at issue the Japanese companies retained a discount of approximately

5.5% from reselling the pulp products. The tax authorities claimed that only a 2.5% discount should have been retained.

The central issue in this case was the means by which the tax authorities gathered information on Crestbrook. An industry wide information gathering study was conducted. While the study was not intended for use by the tax authorities, information from that study was used in the case against the taxpayer. The transfer pricing principles were never fully explored, as the case focused on the determination of whether the information can be used against the taxpayer. The Minister ultimately vacated the reassessment, and there was no reassessment.

[2] Pharmaceutical Industry

[a] Wyeth

Wyeth Canada is the only pharmaceutical-based transfer pricing litigation in Canada where the transfer pricing method was not in dispute. The focus in the litigation was the appropriate markup for research and development services performed in Canada. Wyeth Canada was receiving a markup of 8%, where the Ministry found that, based on their own research, a 10% was more appropriate for 1996, and a 12% markup was more appropriate for 1997 and 1998. This difference resulted in a final assessment of approximately CAD 6.5 million.

[b] GlaxoSmithKline

GlaxoSmithKline Inc. (GSK Canada) packaged and sold Zantac, a patented and trademarked medication prescribed to treat stomach ulcers without surgery. The active ingredient, ranitidine, was purchased by GSK Canada at a price that exceeded a price paid by a group of Canadian generic pharmaceutical companies. The Tax Court of Canada (TCC) ruled in favour of the CRA and found that the price paid by GSK Canada had exceeded the ‘fair market price’.

GSK Canada paid a 6% royalty on net sales of Zantac, as well as other drugs, in the Canadian market through a license agreement (the ‘LICENSE AGREEMENT’). The LICENSE AGREEMENT granted GSK Canada the right to manufacture, use and sell the listed products, and the right to use the trademarks owned by the GSK Group, including Zantac. The LICENSE AGREEMENT was treated as a separate transaction and was excluded by the TCC. The TCC focused on just a supply agreement (the ‘SUPPLY AGREEMENT’) between GSK Canada and Adechsa, a Switzerland-based related party. The SUPPLY AGREEMENT provided GSK Canada rantidine without associated intangibles. Associated intangibles were provided to GSK Canada from its UK parent company through the LICENSE AGREEMENT. The TCC made its decision on the Supply Agreement on the basis that the sole issue was the price of rantidine. The business circumstances that allowed Zantac to sell at a premium to generics were not considered relevant to the TCC in making its decision because ‘one must look at the transaction in issue and not the surrounding circumstances, other transactions or other realities'.

In an appeal, the FCA found that the Tax Court of Canada judge had erred in deciding that GSK Canada paid more than a reasonable amount for the purchase of ranitidine. The FCA found that all relevant circumstances in determining the reasonable price, including the existence of the LICENSE AGREEMENT, the ownership of the Zantac trademark, the premium that the Zantac brand name commands in the marketplace, the ownership of the patent for ranitidine, and other relevant factors would be required. The FCA concluded that the TCC judge erred in ignoring the business circumstances of GSK and its License Agreement with Glaxo Group in reaching his decision and did not sufficiently take the marketing intangibles attached to a brand name (versus a generic drug) into account. According to the FCA, to make a finding without considering the circumstances which were the business realities of Glaxo was tantamount to making a determination in a fictitious business world. The FCA found that the TCC should have taken both the LICENSE AGREEMENT and the SUPPLY AGREEMENT into consideration in coming to a decision. The FCA did not make any finding as to the proper transfer price but instead referred the matter back to the TCC for rehearing and reconsideration of the ultimate transfer price, having regard to the guidance which the FCA has put forth.

The Supreme Court of Canada ('SCC') has granted both an appeal to the Crown as well as GSK Canada's application to cross-appeal. This will be the first transfer pricing case to be decided by the SCC.

The Crown's appeal to the SCC is consistent with their arguments to the TCC and the FCA. The Crown emphasizes the legal structure adopted by the taxpayer in separating the brand and product in the LICENSE AGREEMENT and the SUPPLY AGREEMENT respectively. The Crown's interpretation of the OECD Guidelines is that transfer pricing should be assessed on a 'transaction by transaction' basis. In this circumstance the Crown is positioning that the transactional transfer pricing methodology of Comparable Uncontrolled Price ('CUP' should prevail over the profit-based transfer pricing methodology of the Transactional Net Margin Method ('TNMM') that tests the bottom line result. By bundling the brand and product transactions together, the Crown argues that the OECD Guidelines are not being respected since separate transactions are not being examined to compare arm's length prices, but instead are determining the reasonableness of how GSK acted. In response, GSK Canada is interpreting the OECD Guidelines that the LICENSE AGREEMENT is a relevant circumstance on analysing the circumstances of the SUPPLY AGREEMENT. This relevant circumstances principle is endorsed by the OECD Guidelines, and GSK Canada is not claiming that is either recharacterizing or bundling the two transactions of brand and product for the Zantac drug. In addition, GSK Canada is challenging the FCA order to return to the TCC and that the FCA was entitled to have the matter set aside.

The SCC released its decision on 18 October 2012. The SCC denied the appeal from the Crown and denied the cross appeal from GSK Canada. There was no final resolution; the SCC sent the parties back to the TCC and is allowing for new evidence to be provided.

The SCC provided constructive guidance that provided greater certainty on certain Canadian transfer pricing issues, and will be of benefit to GSK Canada in future rounds of this dispute. However, there is some expectation that GSK Canada and the Crown may settle at this juncture. The constructive guidance included:

– Business and economic factors that an arm's length party would consider in determining a transaction price are also to be considered by non-arm's length parties in determining a transaction price. The SCC rejected the Crown position of viewing one transaction in isolation without considering business factors such as a license agreement that provided Glaxo rights to the product in question.

– There should be no adjustment to a transfer price when it falls within a reasonable range. If the price is not in a reasonable range, then some point in the range should be selected based on the specific factors of that transaction. This point may be a statistical measure such as the average, median, or other.

– The scope of the parties' functions and their risks should be consistent with the transfer pricing policy. In the case of Glaxo, the position of the Crown would result in an increase of income to GSK Canada of CAD 51 million. GSK Canada has the scope and responsibility of a secondary manufacturer and marketer. Glaxo Group Ltd. has the scope and responsibility of the owner of the intellectual property and also provides other benefits to GSK Canada.

[3] Technology Industry

[a] Alberta Printed Circuits

Alberta Printed Circuits Ltd (APC Canada) was founded and initially owned by Mr and Mrs Bamber. The company manufactured and distributed prototype circuit boards. In 1995, functions related to pre-manufacturing (set-up function) were moved to APCI Inc., which was incorporated as an international business corporation under the Barbados Companies Act. Starting in 1997, APC Canada paid two types of intercompany fees to APCI; a fixed set-up fee based on the type of set-up, and a non-set-up fee similar to a 'bonus' calculated based on a 'square inch fee'. This non-set-up fee was the same as the fixed fee charged by APC Canada to its arm's length customers. The CRA audited APC Canada's taxation years ending 31 January 1999, 2000 and 2001. During those years APC Canada paid a total of USD 4.4 million in fees to APCI. The CRA reassessed APC Canada and disallowed USD 3.6 million in fees paid to APCI.

The Tax Court of Canada validated APC Canada's use of the CUP method and admonished the CRA for not using the 'best method'. The CRA argued that the transfer prices should be set by using TNMM to establish a mark-up on APCI's activities, treating APCI as the tested party, instead of the taxpayer's selected CUP method. As a result, the CRA's downward transfer pricing adjustment to APC Canada was reduced to USD 880,000.

[C] *Guarantee Fee*

[1] General Electric Capital Canada Inc.

General Electric Capital Canada Inc. (GE Capital Canada) is a financial services company providing financing and leasing services. GE Capital Canada was provided an unconditional guarantee from its parent Company GE Capital. A 1% per annum fee on the amount of the debt securities was paid for the unconditional guarantee.

The CRA disallowed the guarantee fee on the basis that the affiliation between GE Capital Canada and GE Capital would cause both entities to have the identical credit rating. The TCC held, in December, 2009 in the taxpayer's favour that the guarantee fee did not exceed an arm's-length price. The court rejected the notion that the credit ratings should be identical due to their affiliation.

In 2010, the Crown appealed based on formal grounds consisting of alleged errors of law and fact as well as denial of procedural fairness, and seeking to exploit the finding by the Tax Court of Canada that there is some measurable value to implicit parental support for GE Capital Canada. In December, 2010, the FCA dismissed the appeal finding no errors of fact or law and no procedural bias.

[D] *Other Cases*

[a] Teletech

Teletech Canada Inc. is a company familiar with the transfer pricing community. It is a frequent company that is used to benchmark tested parties that provide certain comparable call centre services. As a result, this court case has a special interest from the Canadian transfer pricing community. It is also the first Canadian transfer pricing case where a taxpayer requested for an order for mandamus that would command the Canada Revenue Agency to accept a request for competent authority that it had refused. In Teletech's case, the request for competent authority was refused twice prior to the court's consideration of this unusual judicial request.

Background:

- Following a restructuring in 2000, TeleTech Canada became a subcontractor of TeleTech U.S. TeleTech US provides administrative services to TeleTech Canada.

- It became apparent to TeleTech, after the fact, that there were internal accounting errors on the pricing of the inter-corporate administrative services. This resulted in an over-reporting of income in Canada and an under-reporting of income in the U.S.

- TeleTech US amended the U.S. tax returns and requested competent authority assistance in Canada and the US for relief from double taxation.

- In November 2006, the CRA denied the competent authority request for assistance that was requested in May of 2006. The basis of the denial was that there was no action by the CRA or the IRS caused the double taxation.

- In December 2006, the IRS sent the CRA a letter that the IRS had assessed the amended tax return. The IRS invited the CRA to participate in the competent authority process. The CRA did not respond or notify TeleTech Canada it had received this invitation.

- In July of 2008, the IRS adjusted TeleTech U.S.'s 2001 and 2002 returns by a further increase of $11.2 million. This was an increase from the $38.3 million already increased from the amended tax return from 2000 through 2002.

- In December 2009, TeleTech Canada submitted a second request to the CRA for competent authority assistance that also include the second dollar amount $11.2 million. This increased the request of relief of double taxation from the first application. However, the double taxation from 2000 was not included in this second request. It was found that this was outside the six-year notification period provided by the Canada-US Tax treaty.

- In May of 2011, Teletech Canada sought an order for mandamus from the Federal Court to compel the CRA to accept the request for competent authority assistance

- This process was held in abeyance pending the CRA's determination of the second request, which the CRA then denied on the basis they had not received notification as required by the Canada-US Tax Treaty within six years from the end of the taxation years in issue.

The application for Mandamus was denied in May 2013. The Federal Court found that the each of the two denial letters were discrete decisions and there is a thirty-day time limitation for certiorari, the judicial review of a reviewable error committed. The order of Mandamus is the judicial review a continuing course of conduct. The court found the judicial review of certiorari was appropriate and not Mandamus. In addition, Mandamus is to order the CRA to make a decision, not the specific outcome. The CRA made the decision to deny the competent authority request, and hence had made the decision. If Teletech disagreed with the outcome of that decision, then jurisprudence has established mandamus will not be granted, and the process is to request certiorari within the thirty-day time limit.

[b] McKesson

McKesson Canada Corporation ('McKesson Canada') is a Canadian provider of logistics services, software applications, and automation solutions in the Canadian healthcare market place. On 16 December 2002, McKesson Canada entered into a Receivables Sales Agreement ('RSA') with McKesson International Holdings III SARL ('McKesson International'). Under the RSA McKesson Canada sold all existing and ongoing eligible trade accounts receivable for the next five years. McKesson International received a discount rate in 2003 of 2.2% and McKesson Canada received a service fee for collecting and administering the accounts receivable for McKesson International.

The CRA reassessment in 2006 of McKesson Canada for CAD 26.6 million on the basis that the discount rate received should have been 1.0127%. The trial concluded on 3 February 2012 and Judgment was released on 13 December 2013.

Crown counsel criticized the methodology used by McKesson Canada to defend the discount factor on a number of issues. These included the use of a methodology that had no indication it is used between arm's length parties; capital of the immediate Parent company was used instead of the entire corporate group; and certain attributes of the discount rates were fixed with no reserves or periodic adjustments typically found between arm's length parties.

McKesson Canada's council critiqued the Crown's experts that they overlooked the cost of capital, prompt payment discounts and servicing fees. McKesson Canada's council also argued that in the opinion of one of the Crown's experts the discount factor is not to be less than 1.7863%.

McKesson Canada's council noted in the appeal that the CRA did not follow its normal procedures for making an audit adjustment. The CRA officials indicated to McKesson Canada the reassessment was completed more quickly than usual to meet the terms of the Canada-Luxembourg Income Tax Convention which sets a limit of five years from the end of the relevant year. It is also due to timing that the TCC is hearing simultaneously McKesson Canada's appeal of the CRA's reassessment of the income taxes under Part XIII of the ITA as a consequence of the transfer pricing adjustment. The Part XIII reassessment is on the basis that a larger discount than would have been provided to an arm's length party represented a shareholder benefit to McKesson International. The notice of reassessment had a date after the five-year limit; however the Crown's council argues the five year limitation period of the Convention does not apply to the Part XIII tax reassessment.

Justice Patrick Boyle dismissed both of McKesson Canada's appeals for the transfer pricing adjustment and the withholding tax assessment.

Justice Boyle found the predominate purpose of McKesson Canada entering into the factoring transaction was the reduction of its Canadian tax on its profits. McKesson Canada had neither an immediate need to free up capital nor to reduce the credit risk from its customers that had a 0.043% bad debt experience with its customers. The transaction was not recharacterized in the judgment. The lower discount rate was withheld in the judgment after addressing three components of the discount: the Yield Rate, the Loss Discount, and the Discount Spread.

In the judgment for the Withholding Tax Assessment, Justice Boyle was 'more inclined to see it as an enforcement and collection provision than a tax charging provision' and concluded that the five-year limitation of the Treaty did not apply to the withholding tax assessment.

McKesson Canada has appealed the decision to the Federal Court of Appeal.

[c] Soft-Moc Inc.

Soft-Moc Inc. is a Canadian footwear retailer with related companies in the Bahamas. The related companies provided Soft-Moc's related companies in the Bahamas provided various services including merchandising, information technology, business development and software licensing. The court characterized the service fees as "substantial amounts".

During the course of a transfer pricing audit for the 2005 and 2006 tax years, the CRA issued a formal Foreign-Based Information Request (subsection 231.6(2) of the Income Tax Act of

Canada) to obtain financial and operational information in respect of the related Bahamian companies. Soft-Moc did not provide the information to the CRA stating that the information requested was confidential and proprietary and releasing the information would harm the company's competitive advantage. Soft-Moc applied for judicial review from the Tax Court of Canada on the basis that the information request was too broad and unreasonable.

The decision of the court was not in favour of Soft-Moc's noting the wide-ranging statutory powers of the CRA to collect information and the low threshold to be met in determining whether the requested information is relevant and reasonable. Soft-Moc's appeal to the Federal Court of Appeal on 21 January 2014 was dismissed.

§7.08 NATIONAL PLANNING OPPORTUNITIES

The majority of transfer pricing planning opportunities involve the strategic location of multinational's functions, assets and risks in a manner that is acceptable to the tax authorities involved. With the increased focus and attention in the United States on the recent regulations on Cost Sharing Arrangements, there are opportunities for Canadian taxpayers to implement a CSA that involves U.S.-related parties with increased certainty of acceptance by the IRS. Canada's generous research and development tax credits, Canada's decreasing corporate tax rate, and the elimination of withholding tax on interest also provide planning opportunities for Canadian taxpayers.

The parallel to the U.S. Cost Sharing Arrangement is referred to in Canada as a Qualified Cost Contribution Arrangement (QCCA). Paragraph 120 of 87-2R defines a QCCA in general terms as:

> … an arrangement whereby two or more parties share the costs and risks of producing, developing, or acquiring any property, or acquiring or performing any services, in proportion to the benefits which each participant is reasonably expected to derive from the property or services as a result of the arrangement.

There are circumstances where developed intangibles under a QCCA provide tax efficiencies in a manner that is acceptable to the relevant tax authorities. There is now greater certainty about implementation and treatment of relevant buy-in payments when dealing with U.S. participants in a QCCA.

Canada is an attractive country to perform research and development. investment tax credits are available for qualified expenditures in respect of scientific research and experimental development (SR&ED). The general rate is 20% and an enhanced rate of 35% may also apply.

Corporate tax rates in Canada are falling, and the general corporate tax rate is 33.0% for 2009. The rate, includes federal and provincial tax. While it is lower than the United States, it is much higher than most OECD member countries. The corporate tax rate continues to fall, and is expected that the federal rate will decrease at least 4% by 2012. Also, several provinces are expected to decrease their corporate tax rates.

The fifth protocol to the Canada-US Income Tax Convention eliminates withholding tax on interest between related parties. The withholding rate dropped to 7% in 2008, 4% in 2009 and it is eliminated altogether in 2010.

§7.09 LIST OF ABBREVIATIONS

ACAP	Accelerated Competent Authority Procedure
APA	Advance Price Arrangement
BAPA	Bilateral Advance Price Agreement
CAD	Canadian Dollar
CASD	Competent Authority Services Division
CBSA	Canada Border Services Agency
COGS	Cost of Goods Sold
CPLM	Cost Plus Method
CPM	Comparable Profits Method
CRA	Canada Revenue Agency
CUP	Comparable Uncontrolled Price
FCA	Federal Court of Appeals
GAAR	General Anti-avoidance Rules
IC	Information Circular
ILBD	International and Large Business Directorate
IRS	Internal Revenue Service
ITA	Income Tax Act
MAP	Mutual Agreement Procedure
MAPA	Multilateral Advance Price Agreement
NAICS	North American Industrial Classification System
OECD	Organization for Economic Co-operation and Development
PLI	Profit Level Indicator
PSM	Profit Split Method
QCCA	Qualifying Cost-Contribution Arrangement
RPM	Resale Price Method
RTA	Real-Time Audit
SEC	Securities and Exchange Commission
SR&ED	Scientific Research and Experimental Development
TCC	Tax Court of Canada
TNMM	Transactional Net Margin Method
TPM	Transfer Pricing Methodology
TPRC	Transfer Pricing Review Committee
TSO	Tax Service Offices