The Rise and Dominance of Transfer Pricing in Canada

Alfred Zorzi and Al Rizzuto*

A B S T R A C T

This article reviews the importance and evolution of transfer pricing in Canada over the past 25 years. The authors briefly outline the history of transfer pricing in international taxation, noting in particular the leading role undertaken by the Organisation for Economic Co-operation and Development (OECD) in providing guidance on the principles and methods to be applied in establishing appropriate prices for transactions between related parties. Like other OECD countries, Canada endorses the arm’s-length principle as the basic rule governing the tax treatment of related-party cross-border transactions.

The authors review the development of administrative functions and procedures at the Canada Revenue Agency (CRA). They discuss the CRA’s published guidance on the application of Canada’s transfer-pricing rules, as well as the increase in transfer-pricing audits, and they comment on the increasing number of transfer-pricing cases decided by Canadian courts. The authors discuss the mutual agreement procedure provided under Canada’s bilateral treaties, focusing in particular on Canada-US relations in applying the procedure to settle transfer-pricing disputes. They also discuss the use of advance pricing arrangements in Canada, including recent changes to the CRA’s program that limit access to this mechanism for managing transfer-pricing issues between multinationals and the tax authorities. Finally, the authors discuss some foreseeable trends in this area of international taxation.

KEYWORDS: TRANSFER PRICING ■ INTERNATIONAL TAXATION ■ CROSS-BORDER ■ ARM’S LENGTH ■ INTERCOMPANY TRANSACTIONS ■ CANADA

C O N T E N T S

Interest in Transfer Pricing 416
Crown Jewels 417
Canada’s Approach to Transfer Pricing 418
Early Canadian Initiatives 419
Big Steps at the CRA 419
Meanwhile, in Local Offices . . . 420
Assisting Taxpayers 420

* Of Ernst & Young LLP, Montreal (e-mail: alfred.zorzi@ca.ey.com; al.rizzuto@ca.ey.com).
Interest in Transfer Pricing

It does not matter that transfer pricing is not an exact science or that it may be better described as an art. It does not matter that taxpayers may honestly believe that their transfer pricing is correct, if they cannot convince the relevant tax authorities that it is.

Transfer pricing used to be a term known only to those in the international tax field. However, surveys of multinational corporations conducted over the last two decades have consistently indicated that transfer pricing has become the most important international tax issue facing multinationals. The accelerating pace of globalization, together with tax administrators’ focus on getting their fair share of increasingly global tax revenues, has brought transfer pricing to the forefront of the international tax world. Today, both taxpayers and tax administrators face significant challenges in addressing increasingly complex transfer-pricing issues.

The term “transfer pricing” refers to the pricing of cross-border transactions between related parties. Transfer pricing is important for both taxpayers and tax administrators because transfer prices will affect revenue and expenses and, therefore, the taxable profits of the related entities in different tax jurisdictions.

During the last 25 years, we have witnessed a remarkable evolution of transfer pricing, both in Canada and around the world. In this article, we will undertake a historical journey through some of the most important developments in transfer pricing since 1987 and offer a glimpse of what the future may hold.
Crown Jewels

The focus of tax administrators on transfer pricing has been led by the United States, with other countries around the world, including Canada, reacting defensively (until recently) to the US initiatives.

Transfer-pricing concerns existed in the United States as early as the 1920s, but it was not until the 1960s that the US Internal Revenue Service (IRS) attempted to establish detailed rules for international transactions.

Following the issuance of US regulations under section 482 of the Internal Revenue Code\(^1\) in 1968, the Organisation for Economic Co-operation and Development (OECD) embarked on a study of transfer pricing during the 1970s and published guidelines (the first of several versions) on transfer pricing and multinational enterprises in 1979.\(^2\)

The IRS experienced difficulty in applying existing US tax regulations and became particularly concerned with the tax-free transfers of what it considered to be valuable intangibles. In 1986, the US Congress recommended a comprehensive study of the transfer-pricing rules. The results of the study (“the white paper”), issued on October 18, 1988, identified other concerns, including the lack of transfer-pricing information and documentation available to the IRS.\(^3\)

At this juncture, it became apparent that transfer pricing was taking on a life of its own. Crown jewels no longer belonged only to royalty; they also belonged to any corporation that believed it had something valuable, whatever that something was. The white paper was itself a comprehensive and creative piece of work. Expressions such as “commensurate with income” and “contemporaneous documentation” were slipping into the everyday vocabulary of tax practitioners. While the language of transfer pricing may initially have seemed weighty and dull compared to that found in other international tax areas (for example, “double dips,” “tower structures,” and “FAPI”), recent updates have made transfer pricing a clear contender in the battle over linguistic creativity, with the introduction of terms such as “halo effect,” “re-characterization,” “rollback,” and “location savings.”

Developments in the United States and the growing interest in transfer pricing around the world triggered another review by the OECD, leading to the issuance of revised transfer-pricing guidelines in 1995.\(^4\) The revised guidelines contained the

---

1. Internal Revenue Code of 1954, as amended; currently the Internal Revenue Code of 1986, as amended.
approval of profit-based methods, including the acceptance/introduction of a controversial “modified” comparable profits method, referred to in the guidelines as the transactional net margin method (TNMM).

**CANADA’S APPROACH TO TRANSFER PRICING**

Since the mid-1980s, the volume of global trade has greatly increased, with a significant portion of this trade taking place between related parties. Canada’s merchandise trade with the United States grew from US$131 billion in 1987 to US$596 billion in 2011. Anecdotal evidence suggests that a very large percentage of Canada’s international transactions take place between related parties. Therefore, it is not surprising that transfer pricing has become a critical issue in Canada.

The free trade agreement between Canada and the United States (effective January 1989) followed by the North American free trade agreement between Canada, the United States, and Mexico (effective January 1994) caused concern among international auditors at the Canada Revenue Agency (CRA) regarding the effect that these agreements would have on their approach to transfer-pricing issues. Would Canadian subsidiaries of US companies become distribution warehouses and contract manufacturers carrying out limited functions in Canada? How should the CRA deal with situations where major departments or functions of Canadian subsidiaries were repatriated to the United States, or where full-fledged manufacturers were converted to or presented as contract manufacturers? What might be the potential impact of such changes on Canada’s corporate tax base? It had become clear that transfer-pricing issues were becoming more complex and the stakes were rising in terms of their fiscal impact.

Prior to the introduction of revised transfer-pricing rules in section 247 of the Income Tax Act in 1997, transfer pricing for related-party transactions was governed by subsections 69(2) and (3). In fact, although the CRA had endorsed the 1979 OECD guidelines, there was no formal guidance from the CRA until it issued Information Circular 87-2 in February 1987. The statutory provisions of section 69 were brief and may have appeared to be straightforward, but the dominant expression “reasonable in the circumstances” was too general and too flexible. Taxpayers and tax administrators were expected to exercise proper judgment; however, the statutory language permitted the use of very subjective views in the determination of arm’s-length prices.

5 United States, Department of Commerce, Census Bureau, “Trade in Goods with Canada” (www.census.gov/foreign-trade/balance/c1220.html).

6 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.

Early Canadian Initiatives

Canada’s interest in transfer pricing originated more than a quarter-century ago. The CRA had introduced its large file program in the late 1970s, whereby particular industries and certain large corporations were subjected to a more comprehensive audit from the CRA. Transfer-pricing issues turned out to be among the primary concerns raised in certain industries. For example, for companies in the pharmaceutical industry, the field auditors were given guidance and support from headquarters personnel in Ottawa who were considered to be transfer-pricing specialists in the industry and who had contact with industry experts at Health Canada. Also, when deemed necessary, the CRA engaged external consultants and industry experts who provided behind-the-scenes advice.

The CRA established mandatory referral procedures with respect to international transactions, which included transfer pricing. It was apparent that the CRA had very little information and limited access to the appropriate documentation relating to transfer pricing. CRA auditors had difficulty obtaining information that was in the possession and control of non-residents, particularly those residing in non-treaty countries. The amendments to the Act in 1988 demonstrated that the Department of Finance was willing to address some of the underlying statutory weaknesses constraining the CRA in its administration of the transfer-pricing rules. The CRA was given considerable powers to identify and screen cross-border related-party transactions and to obtain information that was not voluntarily provided by taxpayers. The legislative amendments extended the reassessment period by an additional three years, to six or seven years, for transactions with related non-residents; introduced the initial T106 return; and implemented the use of foreign-based requirements under section 231.6.

Big Steps at the CRA

In 1991, the CRA created the International Tax Directorate, from the former International Tax Division, which was a part of the Audit Directorate. The creation of this directorate, with its own director general and expanded organizational structure, demonstrated the additional importance accorded to international transactions by the CRA. The International Tax Directorate became the focal point for all international tax issues. Shortly after, the “international auditor” concept was introduced: a few field auditors in certain tax services offices (TSOs) were provided with specialized training in transfer pricing. The objective was to have the international auditor conduct the transfer-pricing portion of the audit of selected large corporations. For example, initially the Montreal TSO had two international auditors dedicated to this initiative. The Montreal TSO also appeared to be the first in Canada to use the services of the newly appointed (and, at the time, the only) economist in the International Tax Directorate.

---

8 CRA form T106, “Information Return of Non-Arm’s Length Transactions with Non-Residents.”
In 1995, in order to enhance and facilitate the sharing of best practices at both the TSO and headquarters levels, a regional international tax adviser was appointed in each of Canada’s six regions. This was followed by the addition of over a dozen newly hired analysts and economists in 1999, and the creation of three field advisory services units shortly thereafter within the International Tax Directorate. The TSO international auditors were able to obtain assistance and support from their regional international tax adviser and from the field advisory services teams located in Ottawa. After significant training and on-the-job experience, the team of analysts and economists provided technical, economic, and analytical expertise to the international auditors in the TSOs.

Meanwhile, in Local Offices . . .

In the Quebec region, TSOs had also increased the importance and the resources dedicated to the international sections. The organizational model introduced at the Montreal TSO took into account the complexities of dealing with international and non-resident issues. The Montreal TSO’s international auditors were to concentrate in certain specified areas of international tax: transfer-pricing auditors would conduct transfer-pricing audits; foreign affiliate auditors would verify foreign accrual property income (FAPI) and other foreign affiliate issues; and other general auditors would handle permanent establishment issues, interpretation and application of tax conventions, dispositions of taxable Canadian properties, and other non-resident issues. The international groups in the other TSOs in the Quebec region (Laval, Montérégie-Rive-Sud, Sherbrooke, and Quebec City) also experienced growth and specialization. The additional and specialized training given to auditors, as well as the support from the headquarters in Ottawa, resulted in more complex issues being audited and challenged. The CRA auditors no longer focused their attention only on management fee issues; royalties, intangibles, and tangible goods transactions were now being reviewed and vigorously challenged.

Assisting Taxpayers

In the early 1990s, Canada initiated its advance pricing arrangement (APA) program as a pilot project. Initially, two bilateral APAs with the United States were accepted on a trial basis. A positive evaluation of the pilot project and continued interest by taxpayers led to the formal acceptance of the APA program in July 1993. To provide guidance to taxpayers, the CRA issued Information Circular 94-4 in December 1994, with subsequent updates culminating in the current version issued in March 2001. During the 1994-1997 period, the number of APA requests in Canada grew dramatically. The introduction of new transfer-pricing legislation in 1997, the release of Information Circular 87-2R in 1999, and promotion of the program by the CRA

---


resulted in a sharp increase in APA interest, with 20 pre-filing meetings and 10 acceptances in the 1999-2000 fiscal year. The APA program became popular with taxpayers seeking prospective certainty with respect to their intercompany transfer pricing. If the facts and circumstances of non-statute-barred taxation years were similar to those on which the APA was concluded, the terms and conditions of the APA could be applied retroactively. A request to roll back and apply the terms and conditions of an APA is separate and distinct from the APA request, but it has proved to be popular in dealing with transfer-pricing issues of prior years.

Shortly after the introduction of the APA program, it became apparent that the International Tax Directorate, which was responsible for providing assistance to the field as well as resolving double taxation cases and APAs, was underresourced. The directorate had difficulty coping with both the rising demand for APAs and a growing double taxation caseload. As a result, the number of APA requests fell, even though the program was viewed as the transfer-pricing compliance tool of choice.

**Modernizing Canada’s Transfer-Pricing Rules**

Without a doubt, Canada needed to amend its transfer-pricing legislation. Section 69 and all related provisions were inadequate to deal properly with the complexities of cross-border transactions. Canada waited until the 1995 OECD guidelines were finalized before introducing its new transfer-pricing rules. The provisions under section 247 require that taxpayers who participate in cross-border transactions with non-arm’s-length parties must conduct such transactions in accordance with the terms and conditions that would have prevailed had the parties been dealing with each other at arm’s length. The legislation, effective for taxation years commencing after 1997, also introduced documentation requirements, which essentially require taxpayers to contemporaneously document their transfer-pricing transactions and the steps taken to ensure that the terms and conditions of those transactions satisfy the arm’s-length principle. A penalty is imposed, in certain circumstances, where a taxpayer fails to make reasonable efforts to determine and use arm’s-length transfer prices or arm’s-length allocations in respect of transfer-pricing transactions. The rules also include a highly controversial recharacterization provision allowing the CRA to recharacterize the nature of the intercompany transactions in certain circumstances. However, taxpayers are also allowed to implement downward or offsetting adjustments if certain conditions are met.

The Act does not define or provide details on how arm’s-length terms and conditions are to be established; rather, it is left to the CRA, and ultimately the courts, to provide guidance.

Consequently, in September 1999, the CRA issued IC 87-2R. IC 87-2R provides guidance on a number of transfer-pricing matters, including the methods endorsed by the OECD guidelines to determine arm’s-length transfer prices or allocations for transfer-pricing transactions and the considerations that enter into the selection of the most appropriate method in the circumstances of a particular transaction. In IC 87-2R, the CRA accepts all of the transfer-pricing methods listed in the OECD guidelines. While the Act does not impose an explicit hierarchy of methods, the CRA’s
view is that there is a natural hierarchy, with the traditional transaction methods (comparable uncontrolled price, cost plus, and resale price) being preferred to the transactional profit methods (profit split and TNMM).

IC 87-2R provides very little guidance on the practical use of a range of comparable data where profit-based transfer-pricing analyses are prepared using publicly available financial information. At the Canadian Tax Foundation’s annual conference in September 2002, the CRA’s chief economist presented a somewhat controversial paper providing guidance on the CRA’s approach to the use of ranges in testing a taxpayer’s compliance with the arm’s-length principle. The paper’s conclusions have been the subject of considerable debate, and its guidance has not always been followed, particularly in the selection and use of specific comparables from the range and in the use of multiple-year data.

IC 87-2R does provide guidance regarding the nature and extent of the documentation required to ensure that the taxpayer will be considered to have made reasonable efforts to determine arm’s-length transfer prices or allocations, as well as the application of the transfer-pricing penalty.

Having observed the introduction and application of penalty provisions in other jurisdictions, such as the United States, in preparing the revised information circular the CRA recognized the potential risk of inconsistent or unfair application of the transfer-pricing penalty at the TSO level. Therefore, according to CRA procedures, where the net transfer-pricing adjustments exceed the threshold amount (the lesser of $5 million and 10 percent of the taxpayer’s gross revenue for the particular year), the case must be referred to the Transfer Pricing Review Committee (TPRC) at headquarters for review before a penalty, if any, is assessed. The penalty is intended to be a compliance penalty, focusing on the efforts made by the taxpayer to determine and use arm’s-length prices. Whether a taxpayer made reasonable efforts is a question of fact. The TPRC must rely on the facts presented by the CRA auditor and the representations submitted by the taxpayer in determining whether reasonable efforts were in fact made by the taxpayer. Although obtaining and maintaining proper contemporaneous documentation will not guarantee the non-application of the penalty, it should definitely influence the TPRC’s judgment. Penalties have been applied in just over 50 percent of the cases referred to the TPRC.

Following the issuance of IC 87-2R, the International Tax Directorate provided additional guidance to its field auditors on transfer-pricing matters, made available to the public in the form of transfer-pricing memorandums (TPMs). The TPMs provide guidance on policies and administrative procedures covering a variety of topics, including referrals to the TPRC, contemporaneous documentation and reasonable efforts, downward adjustments, repatriation of funds and part XIII assessments.

---


bundled transactions, and the use of confidential third-party information. It is now nearly five years since the last TPM was published, and the tax community is eagerly awaiting further guidance from the CRA on a number of complex and contentious transfer-pricing issues.

Use of Secret Comparables and the Emergence of Atypical Intangibles

At the same time as the CRA was revising its administrative practices, the concepts and tools used to determine arm’s-length transfer prices were evolving at a rapid pace. Advancement in technology, the use of public databases, and public pressure reduced the CRA’s reliance on, and the use of, secret comparables. Although the CRA continues to use confidential third-party information as an audit tool for screening purposes and for so-called sanity checks, we understand that auditors can use the information only as a last resort to form the basis of any reassessment and only if they obtain approval from headquarters in Ottawa.

The statutory and administrative changes outlined above transformed the Canadian transfer-pricing landscape. Multidisciplinary teams of auditors, economists, and lawyers became involved in transfer-pricing issues. CRA economists were more involved at earlier stages of an audit and worked closely with the international auditors, who generally had accounting backgrounds. The economists began interpreting the Act’s transfer-pricing provisions and offered their views on such issues as recharacterizations under paragraph 247(2)(b) and the deduction of interest on loans used in certain double-dip structures. Lawyers representing clients became involved in debating operating margins, profit-level indicators, and statistical analysis.

Meanwhile, increasing attention was being devoted to the newly created concepts of location savings and marketing intangibles. The location savings argument was put forward by some CRA auditors to claim significantly higher margins for taxpayers operating in Canada. Their reasoning was that local tax incentives obtained, or lower subsidized costs incurred, should result in higher margins earned in Canada. Similarly, significant marketing activities and expenditures incurred by Canadian subsidiaries in the development of local market intangibles should contribute to higher margins in Canada. These arguments added to the ongoing debate over the economic versus the legal ownership of intangibles.

Transformation at the CRA

In November 1999, the status of Canada’s federal tax authority was changed from a government department to an agency.¹³ This, and other developments, provided the opportunity for further organizational changes.

13 Initially, the new agency was called the Canada Customs and Revenue Agency. The name was changed to the CRA effective December 2005. For simplicity and convenience, in this article we use the latter term in all references to the Canadian tax authority, past and present.
In 2001 and 2002, the Office of the Auditor General of Canada (OAG) included in its annual report a series of observations and recommendations regarding CRA audits of non-residents and of the international transactions of Canadian residents.\(^\text{14}\) In particular, the OAG concluded that the CRA lacked an effective approach to assessing risk in non-resident files and noted problems in the level of audit expertise in key TSOs that handled the complex international tax audits of large corporations.

Partly in response to these conclusions, as well as for other unrelated reasons, the CRA conducted a “functional activity review” and implemented important organizational changes in the Compliance Programs Branch. At the CRA’s headquarters, the previously separate Tax Avoidance Division and International Tax Directorate were combined with the Large Business Division to form the International and Large Business Directorate (ILBD). These previously separate programs were also integrated in the field offices. In a followup status report tabled in the House of Commons in 2007,\(^\text{15}\) the OAG concluded that overall the CRA had made satisfactory progress in implementing its 2001 and 2002 recommendations.

The 2005 federal budget provided $30 million in new annual funding to the CRA. This was supplemented in the 2007 federal budget by an additional $20 million per annum, which was specifically earmarked for transfer-pricing transactions and complex international tax-avoidance cases.

With this funding, the CRA increased its international audit staff in the field, proceeded to create 11 “centres of expertise” across the country, and designated certain local TSOs for the conduct of large business audits in key industries, including pharmaceutical, automotive, and financial services.

More recently, the CRA transferred responsibility for the basic file program (which included most businesses with annual gross revenues between $20 million and $250 million) from the Small and Medium Enterprise Directorate to the ILBD. This substantially increased the audit exposure of small and medium-sized enterprises and the risk that they could be subject to a transfer-pricing review by the CRA. The CRA is now using formal risk-assessment models to verify compliance and to select files for audit.

The CRA was now more aggressive in ensuring that taxpayers complied with the transfer-pricing rules. In October 2004, it adopted a new policy and instructed its auditors to formally request the taxpayer’s contemporaneous transfer-pricing documentation at the initial stage of every audit, using a standardized letter. Taxpayers who did not provide their contemporaneous documentation within three months after service of the letter for the taxation year being reviewed were deemed not to have made reasonable efforts, and were automatically subject to the transfer-pricing


penalty if transfer-pricing adjustments over the threshold were raised. In addition, the CRA began making more frequent use of all enforcement tools available under the Act and increased its use of formal requirements for information relating to transactions with non-residents under sections 231.2 and 231.6. Previously, this had generally been a means of last resort. Authorization to issue such requirements was delegated to the manager level at the TSO.

Quebec’s Move
In a move to mirror the federal transfer-pricing legislation, the Quebec government introduced its own transfer-pricing legislation in 2001. A 10 percent penalty would apply to transfer-pricing adjustments exceeding a certain threshold if the taxpayer had not made reasonable efforts to establish arm’s-length prices. However, in response to complaints that Quebec taxpayers were unjustly exposed to a potential 20 percent penalty, Quebec abolished the 10 percent penalty retroactive to its effective date of December 31, 1998. As a result, taxpayers that conduct business in Quebec are no longer subject to additional transfer-pricing penalties.

Recommendations of the Advisory Panel on Canada’s System of International Taxation
In 2008, the Advisory Panel on Canada’s System of International Taxation released its final report. The panel’s mandate was to make recommendations to guide the government in establishing an international tax policy framework with respect to investment abroad by Canadian businesses, as well as investment in Canada by foreign businesses. The panel included a separate transfer-pricing subcommittee. A number of the committee’s recommendations, including the application of the Canada-US binding arbitration provisions to APAs, secondary adjustments, and a specified time period for filing waivers, have since been implemented.

GATEKEEPERS
Competent Authority Traffic
Successive Liberal and Conservative governments over the last decade have committed Canada to an internationally competitive tax system, as part of their policy platform to attract and retain foreign investment. A key element of that policy is the promise to reduce the statutory corporate income tax rate to the lowest level in the Group of Seven. Another key element is the provision of an efficient, effective, and transparent process and mechanism for eliminating double taxation and for administering and resolving cross-border issues. The mutual agreement procedure (MAP) provided for in Canada’s bilateral tax treaties plays an important role in achieving this objective.

The MAP is the process by which the competent authorities of the two treaty partners interact in an effort to eliminate taxation that is not in accordance with the provisions of the treaty. Generally, taxpayers must approach the competent authority of their country of residence to request relief under the treaty in respect of a specific reassessment. In addition, with the accelerated competent authority procedure (ACAP), a taxpayer may request assistance for subsequent-filed taxation years on the same issue. Normally, the issue must be one that is recurring and relevant to the specific reassessment. In the case of a Canadian-resident taxpayer, the appropriate TSO(s) must be consulted and must agree that the ACAP would be suitable for the taxpayer. Our own experience with recent ACAP requests indicates that TSOs are more receptive to these requests than they were in the past.

The majority of MAP cases dealt with by the Canadian competent authority are Canadian-initiated—that is, the underlying assessment that created the double taxation was made by the CRA—suggesting that Canada is a relatively aggressive jurisdiction with regard to cross-border transactions. In part, this may reflect an increase in transfer-pricing audits coming through the pipeline following the increase in the CRA’s international audit resources in the mid-2000s.

Going forward, the percentage of foreign-initiated MAP cases is expected to increase as developing countries, and also most notably the United States, focus more attention on, and assign more resources to, international audits.

The time required to complete Canadian-initiated MAP cases now averages over 32 months. This far exceeds the Canadian competent authority’s targeted timeline of 24 months, as well as the expectations of most taxpayers. The delay is probably due to several factors, including the stretched resources in the CRA’s MAP program and the push to resolve older Canada-US cases before they became eligible for binding arbitration under the Canada-US treaty.17

The results from the CRA’s latest MAP report18 sound a cautionary note. Increased transfer-pricing audit activity in Canada and other jurisdictions will result in more taxpayers seeking assistance through the MAP mechanism. At the same time, the Canadian MAP program appears to be struggling to meet existing demand in an environment of government restraint and tight resources. The caseload is likely to continue to grow. Constraints on resources will require competent authorities to be creative in order to meet timelines. Other things being equal, taxpayers can continue to expect long delays in resolving double taxation cases under the MAP.


Canada-US Relations

The CRA’s enforcement of its transfer-pricing rules has created double taxation situations for many taxpayers with cross-border operations in Canada and the United States. Over time, these cases have increased because of conflicting interpretations and application of the arm’s-length principle. By 2005, according to most insiders and external observers, relations between the Canadian and US competent authorities were deteriorating. As a result of the strained relationship, MAP cases remained unresolved for a longer period of time. To address this situation, the Canadian and US competent authorities signed a series of three memorandums of understanding (MOUs) establishing principles and guidelines to improve the performance and efficiency of the competent authority process.19 The third memorandum established a novel independent review process to resolve factual disputes between the two countries, which was eventually superseded by the new arbitration provision in the Canada-US treaty.20

On November 25, 2010, the Canadian and US competent authorities released another MOU and a set of operating guidelines regarding the conduct of the new mandatory arbitration proceedings under the treaty.21 The first wave of cases became eligible for arbitration on December 15, 2010. Arbitration may be requested two years after the “commencement date” of the case. The commencement date is defined as the earliest date on which the information necessary to undertake substantive consideration for a mutual agreement has been received by both competent authorities. The arbitration board must adopt one of the proposed resolutions submitted by the competent authorities, and must deliver its determination in writing to the competent authorities within six months of the appointment of the chair of the board.

The manner in which the arbitration process will apply to APAs has been the subject of much debate. Although it is still too early to assess the arbitration process, the inclusion of APAs in the arbitration process is a positive development.

In June 2012, the Canadian and US competent authorities agreed to implement the “functionally separate entity” approach to attributing business profits to a permanent establishment,22 as recommended in the 2008 OECD Report on the Attribution of Profits to Permanent Establishments.

---


20 Supra note 17.

21 “Memorandum of Understanding Between the Competent Authorities of Canada and the United States of America,” signed on November 9 and 12, 2010; and “Arbitration Board Operating Guidelines—Canada-United States,” released on November 25, 2010.

Profits to Permanent Establishments:\textsuperscript{23} This approach should allow for the deduction of notional expenses in computing income attributable to a permanent establishment, a deduction previously not accepted in all cases by the CRA.

Impact of Recent Changes to Canada’s APA Program
The availability of APAs continues to expand around the world. In 2012, the IRS announced that it hopes to process 150 or more APA cases a year\textsuperscript{24}—nearly four times the 43 cases completed in 2011. Since one-third of US APAs have historically been completed with Canada, it is expected that this will result in a significant increase in demand for new bilateral Canada-US APAs. The CRA will need to radically increase its output of APAs if it is to keep pace with the IRS.

Over the last two years, the CRA has made several changes that have served to restrict access to the APA program. These changes have largely been driven by resource constraints within the CRA. The 2010-11 APA program report\textsuperscript{25} explains that the CRA is exercising increased due diligence at the pre-filing stage in order to reduce the risk that APA cases may turn out to be non-negotiable. The CRA will also not accept cases where there have been business restructuring transactions during or before the APA period. The CRA suggests that the APA program is best suited to transactions that will likely continue in the future with little change, and that issues such as business restructurings are better addressed through the CRA’s audit compliance program. It is interesting to note that these changes were introduced at virtually the same time as the new treaty arbitration process discussed above. One can only wonder if a further reason for these changes may be the risk of binding arbitration for bilateral Canada-US APA cases that cannot be completed within the mandatory deadlines. These restrictions to the Canadian APA program seem to mark a break from the CRA’s previous philosophy of adaptability to most taxpayer circumstances. These policies also put Canada out of step with major treaty partners that consider APAs to be the ideal mechanism to address situations such as business restructurings.

The CRA’s current approach to APAs is a short-term fix and may serve only to delay the resolution process. In the longer term, many transactions that might otherwise have been dealt with more efficiently through an APA, including contentious transfer-pricing issues, will be subject to an audit at a later date and will have to be resolved through the MAP or by the CRA’s Appeals Branch or Canada’s court system.

Funding and staffing restrictions will require competent authorities in general to be creative in finding alternative ways to take on more APA work. This may include


the reshuffling of resources and a fundamental change in the way the CRA approaches APA cases.

Nevertheless, some perceived damage may have been done to Canada’s APA program. The increased scrutiny being applied to restrict entry into the program, in addition to the other issues referred to above, has discouraged some multinationals from considering pursuing a bilateral APA with Canada. According to the CRA’s 2010-11 report, the number of APA pre-filing meetings was reduced to 25 from 31 in the previous period, the lowest recorded since 2006-7.

**International Cooperation and Collaboration**

Tax administrators recognize the need to work together on a global basis. For many years, tax administrations cooperated on a bilateral basis, using the provisions of their bilateral tax treaties to exchange information. Tax authorities have been responding to globalization with increased international cooperation and collaboration. Taxpayers can expect increased “simultaneous” or “joint” audits. Simultaneous audits have been around for some time and involve audits conducted independently by two or more tax authorities at the same time, with the sharing of information. The new approach that tax administrations are now exploring is the joint audit, in which the staffs of two or more tax authorities audit the cross-border activities of related parties at the same time and location. The CRA is currently piloting one such audit with the IRS.

In addition, Canada is a member of various new international groups and forums being created to identify and share information on a real-time basis. One example is the Joint International Tax Shelter Information Centre (JITSIC), created in 2004 to identify tax shelters. Since 2009, the role of JITSIC has expanded, and member countries also collaborate on transfer-pricing compliance.

**Exchange of Information**

Canada and other tax administrations are improving their access to international sources of taxpayer information through the signing of tax information exchange agreements (TIEAs) with non-treaty countries, typically referred to as tax havens. As an incentive for entering into these agreements, Canada has modified its international tax rules by permitting the tax-free repatriation of dividends derived from the active business income of foreign affiliates residing in a jurisdiction with which it has concluded a TIEA. For Canada, this is an opportunity to obtain taxpayer information from these jurisdictions to enhance the CRA’s compliance capabilities, including in the area of transfer pricing.

**FOCUS AT THE OECD**

**Revisions to the OECD Guidelines**

Canada is a member of and an active participant in the OECD. The CRA’s representative is currently the chair of Working Party No. 6 on the taxation of multinational enterprises and of its special session on the transfer-pricing aspects of intangibles.
The OECD continues to be very active in providing guidance to both multinationals and tax administrations in dealing with a variety of transfer-pricing issues. In addition, Canadian court decisions have recently cited support from the OECD guidelines.

In July 2010, the OECD released final revisions to chapters I through III of its guidelines concerning the comparability and selection of transfer-pricing methods, along with a new chapter IX dealing with transfer-pricing aspects of business restructuring.\(^\text{26}\) Chapters I through III are critical building blocks to a common framework for transfer pricing on the international stage; they address, respectively, the arm’s-length principle, transfer-pricing methods, and comparability analysis.

Key changes to these chapters include the adoption of the “most appropriate method to the circumstances of the case” principle, additional guidance on the application of the transactional profit methods, and a discussion of the importance of a “comparability analysis.”

The adoption of the “most appropriate method” rather than a hierarchy of methods is different from the CRA’s stated policy in IC 87-2R. The CRA has indicated that it is working on a TPM to address this development. The revised OECD guidelines now state that “[t]here are situations where transactional profit methods are found to be more appropriate than traditional transaction methods.”\(^\text{27}\)

Chapter IX of the guidelines addresses how transfer-pricing principles should apply to business restructurings. As a general principle, the transactions of entities that have been through a restructuring should be treated no differently than other transactions for transfer-pricing purposes. The OECD recognizes that multinationals are free to organize their business operations as they see fit, and that the non-recognition of actual transactions should be limited to exceptional cases. As long as functions, assets, and/or risks are actually transferred, it can be commercially rational for a multinational to restructure in order to obtain tax savings. Complying with the guidance requires keeping comprehensive documentation on the restructurings, including a “before and after” functional analysis.

**Other OECD Initiatives**

The issue of transfer pricing for intangibles has emerged as raising some of the most complex issues. In June 2012, the OECD published proposals for revised guidance on the transfer pricing of intangibles.\(^\text{28}\) The draft places considerable emphasis on the functions performed, assets used, and risks assumed by the parties (in practice often referred to as economic substance) in determining whether an intangible exists for transfer-pricing purposes, and in determining which entity should be entitled to


\(^{27}\) Ibid., at paragraph 2.4.

the returns from an intangible. The draft contains an unusually large number of examples (22) illustrating the application of the principles it sets out. However, some key issues remain unresolved, such as the treatment of an assembled workforce.

Another OECD initiative, which may ultimately affect the CRA’s approach to compliance and enforcement, is the OECD’s simplification project, which is designed to improve the administrative aspects of transfer pricing, including a review of techniques that may be implemented by countries to optimize the use of taxpayers’ and tax administrations’ resources.29

Other OECD initiatives include the development of an online Manual on Effective Mutual Agreement Procedures (MEMAP),30 part of a broader project to improve the functioning of existing international tax dispute procedures and to develop supplementary dispute resolution mechanisms.

In general, the recent OECD revisions and initiatives point to a more descriptive approach, presenting examples to provide guidance in a way that is similar to US regulations.

While the OECD continues to be recognized as the centre of transfer-pricing guidance for developed countries, for some time the United Nations (UN) has also had a model tax convention and commentary for developing countries. The UN published an updated convention in 201131 and followed up in October 2012 with the release of a draft manual on transfer pricing for developing countries.32 The UN convention and manual both adhere to the arm’s-length standard as set out in the OECD guidelines.

**INCREASED LITIGATION**

Over the last quarter-century, there have been only a few transfer-pricing cases going through the Canadian court system. Many transfer-pricing issues have traditionally been resolved at the audit and appeals levels or settled by competent authorities through the MAP under Canada’s tax treaties. More recently, there has been an increase in the number of transfer-pricing cases making their way through the Canadian courts. Both taxpayers and the CRA have adopted a more aggressive litigation approach to the resolution of transfer-pricing disputes. *Alberta Printed Circuits Ltd. v. The Queen*33 is an example of a case where the amounts involved were relatively small and non-recurring beyond the years in dispute.

---


33 2011 TCC 232.
There are at least three Canadian transfer-pricing cases dealing with financial transactions. In *McKesson Canada Corporation v. The Queen*,³⁴ the CRA challenged the agreed-upon discount rate for factoring accounts receivable. In *General Electric Capital Canada Inc. v. The Queen*³⁵ ("GE Capital") and *General Electric Canada Company v. The Queen*³⁶ ("GE Company"), the CRA challenged the guarantee fees paid to the subsidiaries’ US parent. In *GE Capital*, the Federal Court of Appeal dismissed the Crown’s appeal of the Tax Court of Canada’s decision to vacate the CRA’s assessments. After digesting the diverse opinions of possibly too many “expert witnesses,” and taking into consideration the implicit support or halo effect derived by GE Capital from being a member of the GE Group in pricing the guarantee, the Tax Court found that the 1 percent guarantee fee was below an arm’s-length price based on the circumstances. It is believed that the Tax Court’s decision has far-reaching implications and will affect many aspects of transfer pricing well beyond the matter of financial guarantees between related parties. The *GE Capital* case has served as support for both taxpayers and tax authorities in other jurisdictions to defend their positions. However, in another attempt to disallow the guarantee fees paid by GE Company to its US parent, the CRA reassessed GE Company relying on the recharacterization provision of paragraph 247(2)(b) to deny the guarantee fees paid. The stated basis for the reassessment was that the transactions in respect of the guarantee fees

would not have been entered into between persons dealing at arm’s length and can reasonably be considered not to have been entered into primarily for *bona fide* purposes other than to obtain a tax benefit. No persons dealing at arm’s length would have entered into the transaction or series of transactions.³⁷

On January 13, 2012, the Supreme Court of Canada heard its first transfer-pricing case, which involved the pharmaceutical company GlaxoSmithKline Inc.³⁸ While the case dealt with former subsection 69(2) and the term “reasonable in the circumstances,” which no longer appears in the current transfer-pricing provisions of section 247, the court’s comments will certainly be relevant in applying the arm’s-length principle for the purposes of section 247. It is expected that the decision will provide valuable guidance on a number of transfer-pricing principles, including, for example, whether transfer prices in independent transactions between the Canadian taxpayer and different entities of the multinational group should be assessed separately or bundled together.

---

³⁴ As of the date of writing, the Tax Court decision had not yet been released.
³⁵ 2009 TCC 563; aff’d. 2010 FCA 344.
³⁶ 2011 TCC 564.
³⁷ Ibid., at schedule B, paragraph C(21).
OTHER FORESEEABLE TRENDS

Continuing Support of the Arm’s-Length Principle

In an effort to simplify the application of the transfer-pricing rules, particularly for smaller taxpayers and straightforward smaller transactions, such as low-value services and interest rates, some observers are suggesting the adoption of safe harbours by the OECD.39

In a more drastic move away from the arm’s-length standard, some observers are suggesting some form of formulary apportionment. To the believers, global formulary apportionment is an alternative approach in determining the proper level of profits across the national taxing jurisdictions. It would yield acceptable results and eliminate perceived transfer-pricing manipulations. Under this approach, the global profits of a multinational group would be allocated on a consolidated basis among the associated enterprises in different countries, using a predetermined and mechanistic formula.

The 2010 OECD guidelines reiterate that the OECD member countries support the use of the arm’s-length principle that has emerged over the years among member and non-member countries, and agree that the theoretical alternative represented by global formulary apportionment should be rejected.40

Cash and Intellectual Property

Although some multinationals are bursting with excess cash, their cash reserves may not be with the right group members. In a move to use the surplus cash of some participating members to fund the operating requirements of other participating members, a multinational will set up a cash-pooling arrangement. Cash pooling is becoming more prevalent among multinationals since it provides a way of using cash more effectively and reducing external financing costs to the group. However, cash pooling presents many potential transfer-pricing issues, as well as the possible application of other provisions of the Act such as subsection 15(2).

But what about the real crown jewels, namely, intellectual property? After all, it's all about the crown jewels and how to make them available to the other members of a multinational group. Intellectual property could be shared by licence or through a cost contribution arrangement. Cost contribution arrangements have become more popular, not only among related members of a group but also between parties dealing with each other at arm’s length. A cost contribution arrangement is normally used to share the costs and risks of developing intellectual property that is not substantially

39 See the 2010 OECD guidelines, supra note 26, at chapter 4, E., for a discussion on safe harbours. Also see Organisation for Economic Co-operation and Development, Discussion Draft: Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines (Paris: OECD, June 6, 2012).

40 2010 OECD guidelines, supra note 26, at chapter 1, C.3 (1.32).
developed at the start of the cost contribution arrangement. A valid cost contribution arrangement must satisfy the arm’s-length principle, whereby each member’s contribution must be consistent with that which an arm’s-length party would have agreed to contribute given the benefit that it would reasonably have expected to derive from the arrangement. These arrangements also raise complex tax and transfer-pricing issues and are closely scrutinized by the CRA, particularly if a member resides in a low-tax jurisdiction and is involved in the arrangement.

**Reporting Requirements**

A major challenge that companies face in implementing their transfer-pricing policies is how to make it all come together in their accounting and financial systems, from invoices to the books to setting up the tax provisions for reporting purposes. In recent years, tax administrations have made efforts to elevate tax issues to a corporate governance level. Management and boards of directors are expanding their focus to a broader consideration of tax risk management. Because financial reporting requirements now demand that taxpayers be more transparent, multinationals find themselves in the challenging position of documenting and defending their transfer pricing in more countries. They are putting more emphasis on substantiating their transfer-pricing positions from the outset, but they are feeling the burden of the country-by-country compliance rules and reporting requirements. Many countries, including Canada, have introduced the application of substantial penalties in the event of a transfer-pricing adjustment.

**Compliance**

Because governments around the world are focused on raising revenues through taxation, and tax administrations are directing increased attention to transfer pricing, multinationals can expect more transfer-pricing audits by tax authorities around the globe. It has become crucial for multinationals to adopt a global approach to their transfer-pricing documentation, to ensure that it is consistent across jurisdictions, and to make sure that the answers provided to a tax administration’s questions are answered in a similar manner with the same information. Auditor’s questions related to transfer pricing tend to be similar, no matter what jurisdiction is conducting the audit, and the information provided to one tax authority can easily be shared with those in other jurisdictions.

The CRA and other tax authorities will likely continue to target sectors that typically report high margins and rely on significant intangible assets, such as the pharmaceutical industry, or that rely on significant international content in their production, such as the automotive industry. Consumer products will also continue to be a favourite target of the CRA because they involve straightforward transactions, because comparable data are often available, and because so-called marketing intangibles are often presumed to be present. In addition, there is ongoing debate over the appropriate valuation methods to be used in valuing brand names and corresponding royalties on consumer products.
Increased Controversy

Controversy will continue and will likely increase as well-staffed tax authorities around the world apply ever more sophisticated transfer-pricing tools. Many emerging markets, such as China, India, Russia, and Brazil, are ramping up their enforcement efforts and focusing on transfer pricing. Developed nations, such as Canada and the United States, are also not backing down. While there has been a significant increase in the CRA’s resources over the last few years, the IRS added 1,200 employees in 2009 and another 800 through the end of 2010 to deal specifically with international tax issues.

FINAL THOUGHTS

Fortunately for the many practitioners in the transfer-pricing field, it does not matter that transfer pricing is not an exact science; their future will be interesting and unpredictable—as it should be for those who appreciate art!