transfer pricing - *are you prepared?*

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Overview of Canadian Transfer Pricing

Introduction

Considering the impact that transfer pricing has on global business and jurisdictional tax bases, it is somewhat surprising how little is known about this area. Transfer pricing issues arise whenever any goods, services (i.e. marketing, R&D, management) or intangibles (i.e. patent or trade-mark rights) are transferred between related parties across an international border. The underlying issue relates to the rational desire of multinational entities (MNEs) to minimize overall tax expenditures. Absent transfer pricing rules, MNEs could take advantage of differing tax rates to offset losses in various countries by shifting the profits of the global entity to a target jurisdiction.

For example, if a company earns $100 in profits and is forced to pay tax on the entire amount in Canada, its tax expenditure will be approximately $30. If, on the other hand, the enterprise was able to transfer the profits to Barbados, which has a 2.5 per cent corporate tax rate, that business entity would have a $27.50 overall saving. Absent transfer pricing rules, the global enterprise could simply inflate or deflate the value of any transaction passing between its Barbados corporation and the related Canadian corporation, so as to transfer the profits from Canada into the lower tax jurisdiction. Imagine the Barbadian subsidiary selling a light bulb to the Canadian subsidiary for $102 rather than at its $2 cost price. This would result in the entire $100 profit being transferred to the Barbadian company. The same result could be achieved by inflating or deflating the value of services or intangibles passing between these related parties. Most industrialized countries, including Canada, have responded to the risk of tax base erosion by introducing rules ensuring that any transaction between related parties passing a border be valued on an arm's length basis.

In this article, we discuss the regulatory framework of transfer pricing rules as well as the opportunities and pitfalls associated with complying with these rules. It is also important to be aware of the methodologies employed by taxing authorities to value related party cross-border transactions and current transfer pricing issues relating to specific industries. The purpose of this article is to give the reader a basic understanding of transfer pricing and its importance to MNEs.

Regulatory Basis for Transfer Pricing

Since 1979, the Organisation of Economic Co-operation and Development (OECD) has published the "*Transfer Pricing Guidelines for Multinational Enterprise and Tax Administrations*" (OECD guidelines). An updated version of the OECD guidelines was released on July 22, 2010, to encompass a number of changes to permanent establishments, business restructurings and other issues. The guidelines are aimed at getting developed countries to apply transfer pricing methodologies in a consistent manner. The OECD guidelines are premised on the arm's length standard which bases related party transactions on the value by which two unrelated parties would transact under identical circumstances.

Section 247 was introduced into the Canadian *Income Tax Act* in 1998 and essentially codifies the OECD guidelines. It is the core of the transfer pricing rules now being enforced in Canada. Section 247 has been the subject of many Canadian Revenue Agency (CRA) Information Circulars (ICs) and Interpretation Bulletins, as well as several transfer pricing memoranda.

How Do Transfer Pricing Issues Arise?

Every year corporations are required to file federal tax returns, which are subject to audit. Typically, the CRA appoints a manager responsible for the overall audit who will request the help of international specialists. These international auditors have specialized training in transfer pricing issues and will review the tax returns to evaluate the audit risk. As part of the audit process, the international auditor will request the taxpayer's section 247(4) contemporaneous documentation establishing the manner in which related party transactions are valued.

i) Contemporaneous documentation

Contemporaneous documentation serves as a blueprint for explaining the rationale for the prices of goods, services or intangibles established by the related parties. If the documentation is not provided to the CRA within 90 days of a request, transfer pricing penalties may be applicable if there is an adjustment to the company's transfer prices. For some MNEs, this documentary requirement may be relatively straightforward.

Canadian transfer pricing penalties are 10 per cent of the upward transfer pricing adjustments

For larger and more complicated enterprises, the contemporaneous documentation requirement can be staggering.

Contemporaneous documentation typically includes a transfer pricing study, which includes as a minimum the following:

- overview of the businesses involved and the corporate structure;
- description of the industry and competitors;
- identification of the related party transactions;

- functional analysis - assessing functions, assets, risks;
- choice of transfer pricing methodology, reasons for selection and exclusion of others; and
- economic analysis including selection of comparables and applying the OECD factors of comparability.

Contemporaneous documentation must be provided to auditors within 90 days of a request and must demonstrate that reasonable efforts were taken to substantiate their pricing. Preparing documentation in advance of transactions is crucial to effective tax management and avoiding the imposition of transfer pricing penalties.

In the absence of the required documentation, the CRA may apply a 10 per cent penalty on a transfer pricing adjustment. Prior to applying a transfer pricing penalty, the question of "reasonable efforts" is examined by the transfer pricing review committee comprised of senior CRA officials. Given that penalties are not deductible, it is in the interest of the taxpayers to prepare documentation demonstrating reasonable efforts have been made relating to transfer pricing policy.

ii) The audit adjustment

At the conclusion of the audit, the international auditor may disagree with the transfer prices set by the taxpayer. In such a case, the auditor will raise an adjustment. It is possible that taxes were paid in another jurisdiction on the revenue associated with the adjustment, and therefore, double taxation may exist unless the adjustment is somehow rectified. Additionally, interest will be imposed upon the value of the adjustment from the date when the payment was due. The financial repercussions to a company facing a transfer pricing adjustment are significant and may raise cash flow concerns for the taxpayer.

Faced with an adjustment, the taxpayer has a number of alternatives. The first, and likely least preferred, is to pay the additional taxes owing as well as any interest and penalties. Other options are to file a notice of objection with the CRA's Appeals Division and/or file a competent authority request, as outlined below. In some cases, it is advisable to request an Advance Pricing Agreement (APA) to set the transfer price into the future with a rollback to the audit period.

iii) The appeals procedure

The taxpayer can appeal the CRA assessment to the Appeals Division of the local tax services office conducting the audit. The taxpayer is entitled to make oral and written representations. While the case is under appeal, the taxpayer will be subject to the interest requirement. Large corporations are required to make an up-front payment of 50 per cent of the adjustment amount.

The Appeals Division will not negotiate the file, but will determine whether the amount assessed is reasonable based on the supporting documentation provided by the auditor. Even after an appeal decision is issued, it is still possible to have the file considered by competent authority, assuming that the time limits stipulated in the applicable treaty have been met. However, it may be more difficult to have the adjustment reversed after an unsuccessful appeal. Unless the taxpayer believes that a majority of the adjustment will be overturned by the Appeals Division, it may be more appropriate to begin with a competent authority request.

iv) The competent authority process

The competent authority process, also known as the Mutual Agreement Procedures, is set out in the various tax treaties between Canada and its significant trading partners. The Competent Authority Services Division (CASD) is designated by the Minister of Revenue to be responsible for the Canadian competent authority program. Within CASD are analysts and economists specializing in transfer pricing issues. A request for consideration by CASD can be made by a taxpayer either after a CRA international auditor has made an adjustment, or when a taxpayer wishes to make changes to previously filed tax returns, where the changes relate to intercompany cross-border transactions. This process is voluntary and at any point the taxpayer can exit the program and pursue other venues for relief, such as the appeals procedure. The program operates on a case-by-case basis and the factors which affect resolution of the double tax include taxpayer cooperation and reciprocity of foreign tax jurisdictions.

Keep in mind, the underlying issue is whether revenue is taxed in Canada or in another jurisdiction. Consistent with this approach, CASD representatives can negotiate with foreign governments to achieve particular tax results in respect of that taxpayer. When an auditor assesses an adjustment, additional tax assessed on the file begins to accumulate interest. CASD cannot waive or negotiate the interest or penalties that result from adjustments. However, CASD will consider waiving a part of the interest that accumulates while a file is in competent authority. Larger companies, normally required to pay 50 per cent of the adjustment, can put up a guarantee for the taxes owing if they file a competent authority request.

v) Advance pricing agreements

Another possibility relates to entering into an agreement with CRA for specified tax consequences for up to five years in advance of a transaction. Such an agreement is known as an Advance Pricing Agreement (APA). Depending on the nature of the tax solutions sought, an APA can be set unilaterally (i.e. with Canada alone), bilaterally (i.e. with Canada and one other country), or multilaterally (i.e. with Canada and a number of other foreign jurisdictions). Obviously, the more countries involved, the more difficult it will be to actually arrive at an APA. Substantial documentation is required to support a request for an APA, but it will count as the company's section 247(4) contemporaneous documentation. When filing an APA, the CRA may also accept a rollback of the agreed methodology to previous years not under audit.

Transfer Pricing Methodologies

The OECD has developed various methods, which have been accepted by Canada and other countries, to assist in establishing arm's length prices between related parties.

In order to apply the various methods, the functions, assets and risks of the related corporations must be considered against comparable transactions or entities. The OECD has established a framework called the Hierarchy of Methods, with methodologies at the top of the hierarchy considered better than those at the bottom - in terms of giving reliable returns. The guidelines suggest that valuators start at the top of the ladder and progressively work their way downward until they find an appropriate methodology. The OECD methodologies are broken down into traditional methods and transactional profit methods. The traditional methods include:

- the comparable uncontrolled price (CUP) method;
- the resale price method; and
- the cost plus method.

The transactional profit methods include the profit split method and the transactional net margin method (TNMM). A summary of the methodologies can be found in paragraph 48 of the CRA's IC 87-2R - International Transfer Pricing.

References:

- Section 247 of the Canadian *Income Tax Act* - http://www.canlii.org/ca/sta/i-3.3/sec247.html
- IC 87-2R - International Transfer Pricing
- IC 71-17R5 - Guidance on Competent Authority Assistance under Canada's Tax Conventions
- IC 94-4R - Advance Pricing Arrangements
- IC 94-4R (Special Release) - Advance Pricing Arrangements for Small Businesses

All of these circulars and other information about international transactions can be found on the CRA's website at: http://www.cra-arc.gc.ca/tx/nnrsdnts/cmp/menu-eng.html.

For competent authority information, go to: http://www.cra-arc.gc.ca/tx/nnrsdnts/cmp/wh-eng.html.

Federal Court of Appeal "Gets it Right" and Overturns Tax Court's Glaxo Ruling

Introduction

On July 26, 2010, the Federal Court of Appeal (FCA) overturned one of the most significant transfer pricing decisions in Canadian history in the case of *GlaxoSmithKline Inc. v. Canada*[1] (the Glaxo case). When examined from all avenues, the case yields important conclusions that both practitioners and multinational corporations alike should note when dealing with contentious transfer pricing issues. Specifically, the Court held that a comprehensive examination of all relevant facts, as well as the entirety of the GlaxoSmithKline Inc. (GSK) business model, must be undertaken in order to determine a reliable transfer price.

All relevant factors, including the use or provision of intangibles, must be considered when determining the arm's length nature of intercompany transfer prices

The adoption of such an approach is important on many levels. The real-world business circumstances in which related parties operate on a daily basis are far different to those of unrelated parties, making it difficult to find a true transfer price attributable to related party transactions. Nevertheless, when allocating profits within a related party setting, one must proceed with the assumption that related parties can indeed operate independently of one another, which creates a fictitious event. In such an environment, any transfer pricing conclusion can be subject to scrutiny and, as the many governments begin to understand the complexities of transfer pricing, we will continue to see increased audit controversy related to the arm's length standard, and increased efforts by companies to avoid double taxation. The Court's ruling that all factors, including the use of intangibles by related parties, be considered when determining whether the appropriate transfer price was correct, and should serve as a useful precedent for future disputes.

Background

Transfer pricing can be defined as the price that a member of a multinational group charges a foreign related party for goods, services and/or intangibles.[2] A tax dispute will arise when the tax authority is of the view that the parties set the transfer price too high or too low in order to transfer profits from a high tax jurisdiction to a low tax jurisdiction.[3]

GSK, a Canadian company, is a wholly-owned subsidiary of Glaxo Group, which in turn is a wholly-owned subsidiary of Glaxo Holdings plc. The FCA described Glaxo Holdings as "the ultimate parent of the Glaxo Group of companies," which "discovered, developed, manufactured and distributed a number of branded pharmaceutical products."[4] Glaxo Holdings and Glaxo Group are both United Kingdom corporations. The Glaxo case involved the reassessment of GSK's income tax returns for the years 1990 to 1993. GSK is the Canadian distributor of Adechsa S.A. (Adechsa), a related Swiss company.

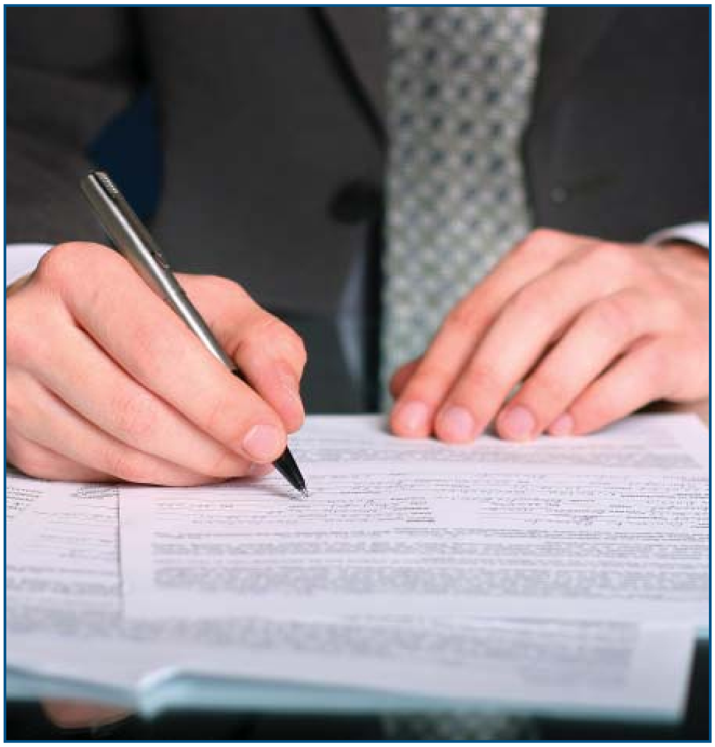
Contentious Issues

i) Purchase price of ranitidine

The dispute focused on the price that GSK paid to Adechsa for ranitidine, an active ingredient found in Zantac, a popular drug used to treat and prevent stomach ulcers. The Minister of National Revenue (MNR) believed that GSK had paid an excessive amount ($1,600 per kilogram) for this active ingredient, pursuant to subsection 69(2) of the Canadian *Income Tax Act* (ITA). MNR based its argument on the price that generic drug companies, such as Apotex Inc. and Novopharm Ltd., were paying third party manufacturers for the same product, which ranged from

1 *GlaxoSmithKline Inc. v. Canada* 2010 FCA 201.
2 Dale Hill & Mark Kirkey, "*Recent Developments in Transfer Pricing*" (2005) Gowlings Knowledge Centre at 1.
3 Pierre Alary, "*Pass the Zantac: The Glaxo Ruling and its Effects on Transfer Pricing in Canada*" (September 25 2008), Taxation Law @ Gowlings.
4 Supra note 1 at para. 7.

$200 to $300 per kilogram. MNR originally increased the income of GSK for the years in question by approximately $51 million, which represents the difference between the prices paid by the generic companies and GSK for their ranitidine. Further, MNR assessed GSK under Part XIII of the ITA with respect to GSK's failure to withhold tax on dividends deemed to be paid to a non-resident shareholder.



GSK's position was that the generics were not an appropriate comparator for two reasons, namely:

- GSK's actual business circumstances were wholly different from those of Apotex and Novopharm, such that the transactions were not comparable within the meaning of subsection 69(2) of the ITA and the CUP method; and
- the ranitidine that GSK purchased from Adechsa was manufactured under Glaxo World's standards of good manufacturing practices, granulated to Glaxo World standards, and produced in accordance with Glaxo World's health, safety, and environmental standards.

GSK submitted that independent third party licensees in Europe, which purchased the same ranitidine under the same set of business circumstances as GSK, were the best comparators.

ii) Contractual agreements

The Glaxo case was centered on two contractual agreements: 1) a Supply Agreement between GSK and Adechsa for the purchase of ranitidine; and 2) a License Agreement between GSK and the Glaxo Group. Under the License Agreement, GSK paid a 6 per cent royalty to the Glaxo Group for the rights to certain intangibles and services. These intangibles included trade-marks as well as marketing support, technical assistance and registration materials. Access to such intangibles and services were required to assist GSK in selling its drug in the Canadian market at a "premium".

GSK argued that both the Supply Agreement with Adechsa and the License Agreement with Glaxo Group should therefore be considered, and a failure to do so would not reflect the economic realities of GSK. Conversely, MNR argued that the two agreements were to be looked at separately, and that the only transactions relevant to the case were those with Adechsa.

The Tax Court Decision

The comparable uncontrolled price (CUP) method, according to the Tax Court of Canada (TCC), offers the most direct way to determining an arm's length price. The transfer price is set by reference to comparable transactions between a buyer and a seller who are not associated enterprises. The TCC concluded that the CUP method was the preferred method and that the price paid to Adechsa was not reasonable. Rather, it determined that Apotex and Novopharm were the appropriate comparators and that the "reasonable" price for ranitidine was the highest price paid by the generic drug companies, with a $25 adjustment to account for the fact that GSK was buying granulated ranitidine, while the generic drug companies were not.

GSK submitted that independent third party licensees in Europe, which purchased the same ranitidine under the same set of business circumstances as GSK, were the best comparators

The TCC also ruled that the License Agreement should not be considered when determining the amount that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, because the Supply Agreement and the License Agreement covered separate matters.

The Federal Court of Appeal Decision

A ruling on the Part XIII assessment hinged heavily on the findings regarding the subsection 69(2) assessment, namely whether the prices paid by GSK to Adechsa for ranitidine would have been reasonable in the circumstances if GSK and Adechsa had been dealing at arm's length. Thus, if the Court were to find that the TCC correctly ruled on the subsection 69(2) issue, the TCC's ruling with respect to Part XIII would also be upheld.

The FCA unanimously held that the TCC erred in failing to consider the License Agreement between GSK and the Glaxo Group. It decided that a determination of whether or not the purchase price of the ranitidine was reasonable would need to factor in all relevant circumstances, which an arm's length purchaser would have had to consider.[5] In coming to this conclusion, the Court relied on the test enunciated in *Gabco Limited v. Minister of National Revenue*:[6]

> "It is not a question of the Minister or this Court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or the Court coming to the conclusion that no reasonable business man would have contracted to pay such an amount having only the business considerations of the appellant in mind."

In the Court's opinion, the Gabco test requires an inquiry into those circumstances which an arm's length purchaser, standing in the shoes of GSK, would consider relevant in deciding whether it should pay the price paid by GSK to Adechsa for its ranitidine. Hence, the test mandated by subsection 69(2) does not operate, regardless of the real business world in which the parties to a transaction participate.[7]

The Court identified a number of "circumstances" which support the contention that the License Agreement was a crucial consideration in determining the amount that would have been reasonable in the circumstances, if the parties had been dealing at arm's length. These circumstances "arose from the market power attaching to Glaxo Group's ownership of the intellectual property associated with ranitidine, the Zantac trade-mark, and the other products covered by its License Agreement with GSK."[8] In light of these circumstances, any arm's length party would have had to consider the contents of the License Agreement in deciding whether or not to pay the price set by Adechsa for the sale of Zantac ranitidine.[9]

Conclusion

The FCA set aside the TCC's decision and returned the matter to the TCC for rehearing and reconsideration, in light of the FCA's reasons. The FCA's decision illustrates the complexities involved when determining whether or not a transfer price paid between related entities is reasonable. Such a determination must take into account all relevant circumstances that would factor into any purchaser's decision, in order to reflect the real-world circumstances in which such contracts are made. In the case of GSK, the active ingredient ranitidine was purchased by GSK in conjunction with a License Agreement affording them the right to use and sell several Glaxo products, including Zantac products. The FCA held that the License Agreement should be considered conjointly with the cost of the ranitidine. Thus, the Court acknowledged that the significant brand power associated to the drug affords the Glaxo Group a great deal of bargaining power when negotiating transfer pricing transactions, regardless of whether they are dealing with a related or arm's length party. While the adoption of an approach factoring real-world business circumstances was a necessary one, this less mechanical method of calculation makes it less likely that multinational corporations and governments will arrive at the same outcome. The intricacy of a case-by-case factual analysis, along with the Government's complete disregard for the value of intangibles, ensures that similar transfer pricing disputes will arise.

5 Supra note 1 at para. 69.
6 *Gabco Limited v. Minister of National Revenue* (1968), 68 D.T.C. 5210 (Ex.Cr.) at 5216.
7 Supra note 1 at para. 73-74.
8 Supra note 1 at para. 80.
9 Supra note 1 at para. 81.

The Impact of Restructuring in a Transfer Pricing Setting

Background

As the world's economy becomes increasingly globalized, multinational organizations must ensure that their operations are as efficient as possible, and structured in such a manner that allows their overall profit positions to be maximized. Sometimes this requires that entities within a multinational setting be restructured in order to meet efficiency and profitability targets.

When operations are restructured between related parties, the question arises as to whether or not the entities that are closed or diminished in some fashion (due to this restructuring) should be compensated in some manner. This issue becomes particularly contentious when a highly profitable restructuring entity shifts its profits to another tax jurisdiction.

In Canada, the Canada Revenue Agency (CRA), much like many other tax authorities around the world, takes no formal position on this restructuring. Following a series of public consultations on its discussion draft on business restructuring, the Organisation of Economic Co-operation and Development (OECD) released its final guidance on July 22, 2010. The guide addresses four main issues: the treatment of allocation and transfer of risk among related parties; whether restructuring requires arm's length compensation; how to apply transfer pricing rules to a given restructuring; and lastly, whether the government has the ability to disregard a restructuring transaction. The discussions showed that differences exist between various governments on some of these key issues.

The following discussion focuses on Canadian issues related to business restructurings, however since the position of Canada is very similar to the OECD views, much of this can also be applied to other countries around the world.

Specific Tax Regulations for Business Restructurings in Canada

Although there has not been any public announcement on this issue in Canada, restructuring is treated as a transfer pricing issue, and as such, requires rigorous analysis to determine arm's length compensation for the transfer of functions, assets and risks between related entities. The transfer pricing issue surrounding restructuring requires that we ask the following question:

If the entity being restructured had been dealing at arm's length, what would it have received for closing down its operations?

Like any related party transaction, a restructuring often results in a transfer of functions, assets and risks to a related party for which arm's length compensation is required.

Despite the lack of formal legislation dealing with business restructuring in Canada, the CRA has dealt with this issue in many transfer pricing audits. The CRA has the power to re-characterize a transaction by virtue of section 247(2)(b) of the Canadian *Income Tax Act* (ITA).

This can be applied if the CRA deems the restructuring transaction as being one which has been done primarily for a tax benefit, and that the transaction would not have been entered into between persons dealing at arm's length. Like any non arm's length transaction between related parties, the CRA deals with this issue on a case-by-case basis.

Any investigation of a transfer price assigned to a related party transaction, such as restructuring, is based on an analysis of the functions, assets and risks transferred when a restructuring occurs.

In light of this, multinational firms operating in Canada should price restructuring transactions in such a way that firms are compensated at prices reflecting arm's length values. Failure to do so may result in the CRA raising significant transfer pricing adjustments.

Other General Regulations Related to Business Restructurings

There are no regulations specifically under section 247 of the ITA or within the various CRA Information Circulars related to restructuring. However, enough guidance currently exists in Canada to provide a framework that can be used to determine an arm's length price for restructuring activity. Section 247 of the ITA, as well as Information Circular 87-2R, lay out a framework for pricing related party transactions that deal with the transfer of goods, services, or intangible assets between non arm's length parties.

The Imputation of Compensation or Exit Charges

Upon a restructuring, the CRA determines where profits should be allocated based on the functions, assets and risks assumed by various related parties. A transfer of merely functions can result in a change in the manner in which intercompany profits are allocated. Generally speaking, transfer of any functions, assets, or risks from one related party to another will result in a change of the profits earned, if the transfer has resulted in a substantive change in the risk profile or functional intensity of the entity in question. The more functionally intensive a related party becomes, the more profits it is expected to earn in good years.

In today's economic environment, intangible assets are becoming a larger determinant of profits. Transfers of intangibles between related parties, due to restructuring, should result in a change in the manner in which intercompany profits are divided. Restructuring an entity such that functions and assets assumed are transferred to other related parties should lead to compensation. As a result, charges for business conversion will often occur when a change in the original mix of functions, assets and risks assumed by a related party changes after a business restructuring has occurred.

The Recognition of "Work Force – In Place" as an Intangible in Canada

Recognition by the CRA of "work force – in place" as an intangible will depend on the nature of the work force and the manner in which it contributes to the intercompany profits of the organization. An evaluation of this intangible will often be required in order to determine the value it brings to the organization being restructured. The transfer of work forces is often carried out in conjunction with transfers of other intangible assets. In such cases, the CRA attempts to unbundle the transaction to determine the arm's length price of the specific intangible in question, in these cases "work force – in place" intangibles.

The Importance of Other Commercial Justifications or Rationales

During transfer pricing audits, government authorities have used existing legislation to disallow a restructuring within a transfer pricing setting. Section 247(2)(b) of the ITA allows the government to re-characterize a transaction if two key requirements are met. First, it must be shown that the transaction in question was driven strictly for tax savings. Second, it must be illustrated that such a transaction would not have been carried out had the parties been unrelated (i.e. if the transaction had no commercial justification). The impact of applying section 247 of the ITA is to reverse a transaction, resulting in the potential for double taxation.

Contractual Terms vs. Actual Behaviour of the Parties

The CRA looks at each file on a case-by-case basis. Transfer of risks can take on many forms. In many circumstances, the nature of risks that an entity assumes may be inherently tied to the people employed within the specific entity. If the entity in Canada is deemed a full-fledged distributor (before the restructuring) that assumes many risks, a migration of these risks to other tax jurisdictions (along with key people or risk managers) may be seen as suspect. This is especially so if the Canadian entity continues to perform significant decision-making or risk management functions, which preclude it from being considered a limited-risk distributor. While key personnel may have been transferred, if the underlying functions, assets and risks assumed by the post-restructured Canadian entity remain the same (even though relevant people/risk managers have been transferred), then the CRA may want to attribute more profits to the Canadian entity, despite the fact that it has been "restructured".

The CRA looks at both the contractual terms and actual behaviour or conduct of the party in question, albeit placing significant emphasis on the economic substance of the transaction.

Reporting Requirements for Business Restructurings

There are no specific guidelines or requirements for reporting extraordinary transactions such as restructuring, although in theory all intercompany transactions should be documented. Any sizable restructuring transaction is likely to increase audit inspection by an auditor. As a result, an analysis should be performed to determine the arm's length price that should be paid to an entity that is being restructured. The arm's length price will be dependent on the functions, assets and risks assumed by the restructured entity and the industry in which it operates.

The Use of Guarantee Fees in a Transfer Pricing Setting

As international finance becomes more globalized and competitive, multinational companies (particularly those offering financial services) must ensure that the cost of borrowing money is as competitive as possible to reduce borrowing costs. This often requires that a financially superior foreign parent guarantee the loans of a weaker subsidiary, thereby ensuring the subsidiary access to lower borrowing rates and higher profits. Transfer pricing legislation requires the borrower to pay the guarantor an arm's length fee for providing such a service. Transfer pricing involves the price that a member of a multinational firm charges a related foreign entity for goods, services and/or intangibles. The provision of a guarantee fee falls within the realm of the transfer pricing legislation and, accordingly, must be transacted in an arm's length manner.

As part of their international audit activities, tax authorities are increasingly targeting what a member of a multinational firm (often the parent company) charges an affiliate for securing loans on its behalf. This charge is called a guarantee fee, and is a controversial issue in the area of transfer pricing. Determining the potential size of the guarantee fee, in theory, involves first determining the stand-alone credit rating of the subsidiary, whose debt will be guaranteed, and then comparing it to the rating of the guarantor. This is often achieved by using reputable credit rating agencies such as Standard & Poor's. The difference between the credit ratings of the two entities will correspond to an interest rate differential that will form the basis of a guarantee fee. Thus, the maximum amount of any guarantee fee is the interest rate differential (i.e. the interest rate with versus without the guarantee fee). The financial circumstances of the entities involved will often determine how the interest rate savings will be apportioned.

Other approaches that may be taken include utilizing the comparable uncontrolled price (CUP) methodology, which involves finding comparable guarantee fee transactions that are very similar to the company being reviewed. This approach is quite difficult to use as the level of comparability required is very high, and details of guarantee fees between unrelated parties are not readily available.

The potential size of guarantee fees and the corresponding movement of money across international borders have resulted in tax authorities taking views that may be contrary to the arm's length standard referred to in section 247 of the Canadian *Income Tax Act* (ITA). While the first approach (discussed above) clearly satisfies the arm's length principle found in legislation, it may be side-stepped by the taxing authorities in favour of taking a consolidated approach to credit ratings where the relationships between the parent company and the subsidiary are part of the analysis in determining the rating of the subsidiary. In order to avoid having this happen, it is imperative that documentation exists to support the stand-alone credit rating. The difficult question that arises in performing the analysis is: how do we remove the synergies that exist between the related parties in order to determine the stand-alone rating?

In our view, the parent guarantor and subsidiary receiving the guarantee must be treated separately in order to comply with the arm's length principle. To state that the parent company would not let the subsidiary default on its loans with or without the guarantee would be to ignore the arm's length principle.

What must be examined is how two independent parties would interact under similar circumstances. As stated above, finding a CUP is difficult, if not impossible in most situations, due to a variety of differences that may exist. Using segregated financial information, making reasonable adjustments, and considering the credit rating factors used by Standard & Poor's (as well as other credit rating agencies), we believe that reasonable conclusions can be made.

In some cases, the credit rating of the subsidiary may converge with that of the parent company, but in most cases a lower credit rating will be obtained by the subsidiary. Logically, the consolidated approach will often result in a smaller guarantee fee than in the stand-alone case. While theory and practice would suggest that a guarantee fee should exist, their application is more difficult. Due to the differing views on this subject and the fact that some economic adjustments are required, taxpayers will often find it difficult to obtain resolution with the taxing authorities in situations where the cost of paying the guarantee fee is material.

In Transfer Pricing Size Does Matter: The Case of General Electric Capital Canada Inc. and the Canada Revenue Agency

The following is a summary of the General Electric Capital Canada Inc. case as it stood in August, 2010. On January 4, 2010 the CRA filed an appeal with the Federal Court of Appeal.

Introduction

On December 4th, 2009, The Tax Court of Canada (TCC) ruled on one of Canada's most significant cases to date regarding guarantee fees, the case of General Electric Capital Canada Inc. (GEC). In the case, the TCC found in favor of GEC regarding the payment of guarantee fees to its parent, General Electric Capital Corporation (GEUS) for guaranteeing GEC's debt to third parties. GEC paid guarantee fees of over $135 million during the 1996 through 2000 taxation years.

The arm's length nature of the payment by GEC to its parent was at issue. The Canada Revenue Agency (CRA) audited GEC's guarantee fee and determined that an arm's length person would not have paid for the guarantee, as it provided no benefit. GEC disagreed, asserting that the guarantee reduced its borrowing costs.

The decision by the CRA to take such a rigid position is surprising given that they have assessed and negotiated inbound and outbound guarantee fees in the past, with fees ranging widely in size. Surely, the CRA understands that the application of guarantee fees is a commercial reality in the day-to-day running of a multinational corporation. While the TCC's decision was no doubt the correct one, the more interesting question is why the CRA chose to take such a rigid approach when the facts of the case suggested otherwise. This article provides an overview of the case and suggests why, given the facts and circumstances, the CRA chose to deviate from the arm's length principle. An interesting question arises as to whether the CRA proceeded based on principles or due to the size of the adjustment.

Background

This case involved an American parent company, GEUS and its wholly-owned, indirect Canadian subsidiary, GEC. GEC and GEUS did not deal with each other at arm's length during the years under appeal. During this time, GEC was a financial services company operating in Canada. GEC's operations essentially consisted of borrowing funds from the capital markets at low cost and then turning these funds into profits by lending or leasing to other parties. In order to implement this business model, substantial amounts of capital were obtained by GEC through the issuing of debt in the form of commercial paper and unsecured debentures. The exclusive purchasers of GEC's debt securities were third parties unrelated to GEC or GEUS.

GEUS guaranteed GEC's debt prior to 1995, however GEUS only started charging GEC for the guarantees in 1995. Written agreements were entered into by GEC and GEUS concerning the guarantee fee (the Guarantee). GEUS agreed to guarantee GEC's debt securities in return for the payment of a fee equal to 1 per cent, or 100 basis points, per annum of the principal amount of the debt securities outstanding from time to time during a year. The fee was deducted by GEC for the 1996 to 2000 taxation years.

The Minister of National Revenue (MNR) reassessed GEC because it believed that GEC had obtained no economic benefit from the Guarantee. MNR was of the opinion that the arm's length price of the Guarantee should be zero. The TCC was tasked with determining the arm's length price for the Guarantee.

Credit Ratings

Standard & Poor's and Moody's Investors Service, two credit rating agencies based in the United States, assigned an issuer rating of AAA to GEUS, the highest issuer rating assigned by them. GEC also received the highest credit quality ratings by two Canadian based credit agencies. The consensus between GEC's representatives and experts is that the AAA investment rating for GEC's debts would not have been possible without the Guarantee.

At trial, several experts explained their findings based on different methodologies. The TCC concluded that the yield curve approach provided the best method to determine the guarantee fee. This approach is a reflection of the expenses incurred when borrowing money, given different maturities and credit ratings. It compares the interest rates that GEC could obtain when borrowing money with the Guarantee versus without the Guarantee.

GEC's Experts

According to GEC, the yield approach determined that the spread was between 100 and 300 basis points, or 1 to 3 per cent. In general, experts for GEC analyzed the spread between AAA- rated bonds, and bonds that are an average of single B and BB. One expert concluded that the overall spread was about 352 basis points between a AAA rating and the B+ to BB- rating for GEC in the absence of an explicit guarantee. Therefore, the value of the Guarantee was determined to be approximately 1.83 per cent based on a BB+ to BBB- credit rating range.

GEC's experts assigned a B+ to BBB- credit rating to GEC as a stand-alone entity for various reasons. GEC was a profitable entity growing rapidly in a very stable marketplace. However, GEC was thinly capitalized and had a high degree of leverage. GEC's profitability was also decreasing during the period in question. Despite GEC's reduced leverage and rapid growth, it was unable to generate or increase profits on a continuous basis. Further, GEC was part of an intensely competitive environment. Experts claimed that, in general, when a weak entity is owned by a strong parent, the entity will often receive a stronger rating than it would on a stand-alone basis. Some experts were of the opinion that GEC was only able to borrow the amount of funds it did in the Canadian commercial paper market because of the Guarantee from GEUS.

The GEC experts' opinions were also influenced by the fact that GEUS had provided a guarantee from 1988 to 1996 for no charge.

MNR's Experts

One of MNR's experts used a quantitative approach to measure the creditworthiness of GEC. This approach is generally based on financial market data, such as stock prices, bond prices and CDS spread. He determined that GEC was a core subsidiary of GEUS, and should thus receive a AAA rating. At the very least, GEC could have been rated AA if classified as having been strategically important to GEUS at the relevant time, rather than of core importance. As a result, in the opinion of the MNR's expert, the fee would have been between 15 and 24 basis points. He therefore classified the 1 per cent fee as a very high-risk adjusted return on capital.

GEC's Position

GEC claimed that all distortions that arise from the parties' relationship must be eliminated to arrive at an arm's length result. GEC believed that its credit rating prior to the implementation of the Guarantee should be determined on a stand-alone basis without factoring in GEUS's credit rating. GEC's evidence showed that GEC's credit rating on a stand-alone basis was, at best, BB for the relevant years. The yield approach determined that, under these circumstances, GEC's economic benefit from the Guarantee exceeds the fee paid to GEUS.

MNR's Position

MNR claimed that, in the absence of the Guarantee, GEC's credit rating should be equal to the one of GEUS by reason of their affiliation. MNR believed that GEC could have borrowed at the same interest rates with or without the Guarantee, and therefore did not receive an economic benefit from the Guarantee. MNR claimed that the Guarantee was simply a confirmation of GEUS's pre-existing support in favour of GEC, and that no fee should have been charged.

TCC Decision & Analysis

The TCC believed that GEC's counsel incorrectly applied the arm's length principle when they suggested that the concept of "implicit support" should be ignored because it is rooted in the non-arm's length relationship. However, the TCC also stated that:

> "Implicit support is nothing more than one's expectation as to how someone will behave in the future because economic reasons will cause the person to act in a certain manner. Economic circumstances can change quickly, as evidenced by the recent credit market meltdown. A guarantee is a much more effective form of protection. It is something that investors in the present case would have been reluctant to give up in

> light of the fact that substantially all of [GEC's] debt had been guaranteed for a very long period of time."[1]

The TCC agreed with GEC's experts' testimony that the removal of the Guarantee would have elicited negative reactions from the investment community and the rating agencies. It also concluded that the evidence did not show on a balance of probabilities that the unguaranteed debt of GEC would be rated close to AAA. The TCC stated that, despite the implicit support of GEUS towards GEC, it would be an unwarranted leap of faith to conclude that GEC's credit rating would be equalized with that of GEUS if the Guarantee were not in place.

The TCC did not accept the testimony of MNR's only expert who provided evidence as to the market price of the Guarantee because he did not consider the impact of the removal of the guarantee, and failed to perform a stand-alone rating in his initial report. He also incorporated the wrong risk capital requirement and failed to consider the rate of return on the risk capital, which is required as compensation for expected loss. By only allowing a charge for expected loss, the expert did not allow for a return in the form of profit. Therefore, the method he employed only allowed the guarantor to recover its cost. This is not an accurate assessment for companies operating in an arm's length world, where a service is generally provided for profit. The TCC concluded that GEC's final credit rating without explicit support would be in the range of of BBB /BBB+.

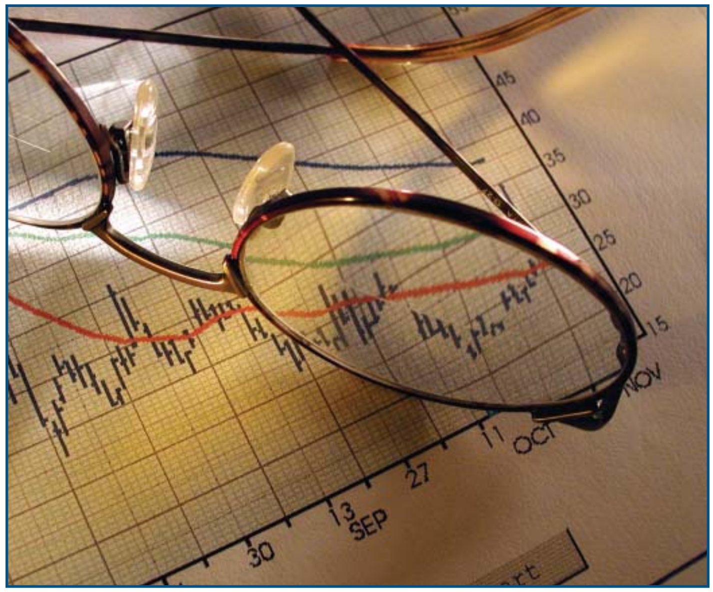
TCC Conclusion

> "Under the yield approach, the interest cost savings based on the rating differential between BBB /BBB+ and AAA, the latter being the rate achieved with the GEUS guarantee in place, work out to approximately 183 basis points or 1.83 per cent. I am of the view that a 1 per cent guarantee fee is equal to or below an arm's length price in the circumstances, as the Appellant received a significant net economic benefit from the transaction. The net economic benefit exceeds the 1.83 per cent calculated under the yield approach. Without a guarantee, the Appellant would have been unable to procure standby letters of credit in an amount sufficient to cover its commercial paper program."[2]

With regards to the Part XIII withholding tax, this tax was not sustainable in light of the TCC's conclusion that the fee paid by GEC did not exceed the amount of an arm's length price.

Conclusion

At the very heart of transfer pricing is the notion that intercompany prices between related parties be set as if the parties were independent of one another. This principle is enshrined in the OECD guidelines on transfer pricing, which the CRA generally adheres to. The CRA adjustment that led GEC to court is troubling on a number of levels, especially given the fact that certain transfer pricing principles, namely the idea that prices be set to represent arm's length standards, were ignored.



The CRA's position is unfortunately another example of where the Agency did not follow its own principles or past decisions, and decided to take a tough stance based on the pure quantum of the adjustment. The CRA must be more consistent in the manner in which they approach transfer pricing, particularly in respect to guarantee fees, considering it has accepted guarantee fees in the past on both an inbound and outbound basis. It is important to note that the size of the fee should not matter, as long as such fees meet the commercial and economic realities of the given transaction. In the final analysis, any fee negotiated should be based on sound economic theory and principles that meet the economic reality of the transaction.

Fortunately, the TCC agreed to uphold the arm's length principle and set the price of the transaction (the Guarantee) between GEC and GEUS, at a price that two independent parties would have agreed to. The case has since been appealed to the Federal Court of Appeal, so we will have to see whether the TCC ruling stands and where it will take the analysis of guarantee fees in the future.

1 Para. 281
2 Para. 305

Knowing Where to Report Your Income: Permanent Establishments

Introduction

Virtually all sophisticated tax treaties use the concept of 'permanent establishment' as a key mechanism when determining which jurisdiction has taxing authority over business activities conducted by a foreign owned business or corporation. There are two alternative analyses to be followed when determining whether a permanent establishment exists:

- the fixed place of business analysis; and
- the dependent agent analysis.

The case law and the commentary of the Organisation of Economic Co-operation and Development (OECD) and the Canadian Revenue Agency (CRA) illustrate how the CRA and the courts determine whether a permanent establishment exists.

Following the July 17, 2008, "*OECD Report on the Attribution of Profits to Permanent Establishments*," the OECD made a few changes to the final version released on July 22, 2010, which are included in the updates to the OECD's Model Tax Convention also released on July 22, 2010.[1]

Analysis of the Law

Whether a permanent establishment exists is a question of fact, thus its meaning changes from one industry and activity to another. Recent case law has offered some guidance as to how the CRA and courts may interpret the relevant provision of the Canada-U.S. Tax Treaty (the Treaty).

Since the Treaty is derived from the OECD Model tax treaty, OECD commentary is frequently resorted to by the courts and the CRA in analyzing the meaning of the Treaty's provisions. The case *Knights of Columbus v. R.*, 2008 TCC 307 noted that the use of OECD commentary to interpret the Treaty was permissible when it found, at paragraph 48:

> "It is important to note that the Canada-U.S. Treaty is modelled after the OECD Model, and commentary with respect to that model is useful in interpreting the Canada-U.S. Treaty. As mentioned earlier, the Supreme Court of Canada was clear in the case of *Crown Forest Industries Ltd. v. R.* [1995] 2 S.C.R. 802, that it is appropriate for the courts to interpret treaties liberally, relying upon extrinsic materials such as commentaries to do so."

According to the recent case *American Income Life Insurance Company v. R.* at paragraph 34, in determining whether a permanent establishment exists, one looks at the fixed place of business analysis first, and if this threshold is not met, one goes to the dependent agent analysis.

1 For more information and copies of the reports please refer to the OECD website at www.oecd.org.

> "The Treaty provides a two-pronged analysis to the question of "permanent establishment": Article V(1) (fixed place of business) and Articles V(5) and (7) (dependent agent). If the fixed place of business analysis does not result in a finding of permanent establishment, then one turns to the dependent agent permanent establishment analysis. While there is some overlap between the factors to consider in the two analyses, it is important, for clarity's sake, not to lose sight of which analysis is being undertaken."

The key factors in the fixed place of business analysis are:

- the existence of a place of business;
- a degree of permanence to such place; and
- the carrying on [by the entity] of business through this fixed place.

The key factors in the dependent agent permanent establishment analysis are:

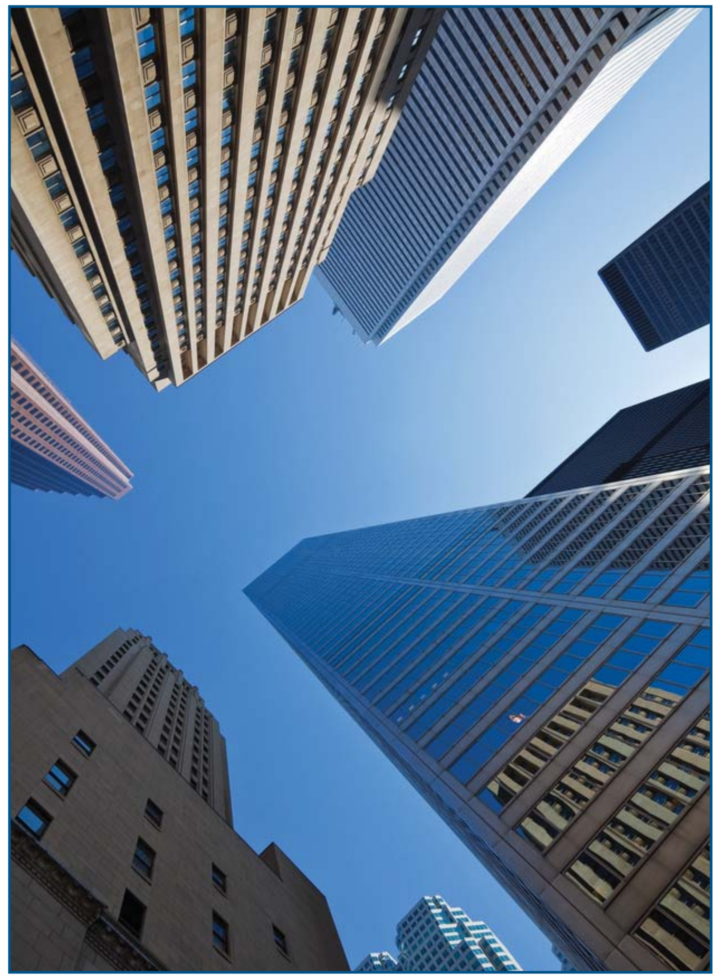
- an agent's authority to conclude contracts in Canada;
- if the agent was of independent status, both legally and economically; and
- if the agent was acting in the ordinary course of his or her business.

The OECD commentary to the OECD Model Treaty identifies the following conditions for a permanent establishment arising from a fixed place of business:

- the existence of a "place of business" (i.e. a facility such as premises or, in certain instances, machinery or equipment);
- this place of business must be fixed (i.e. it must be established at a distinct place with a certain degree of permanence); and
- the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel), conduct the business of the enterprise in the state in which the fixed place is situated.

Conclusion

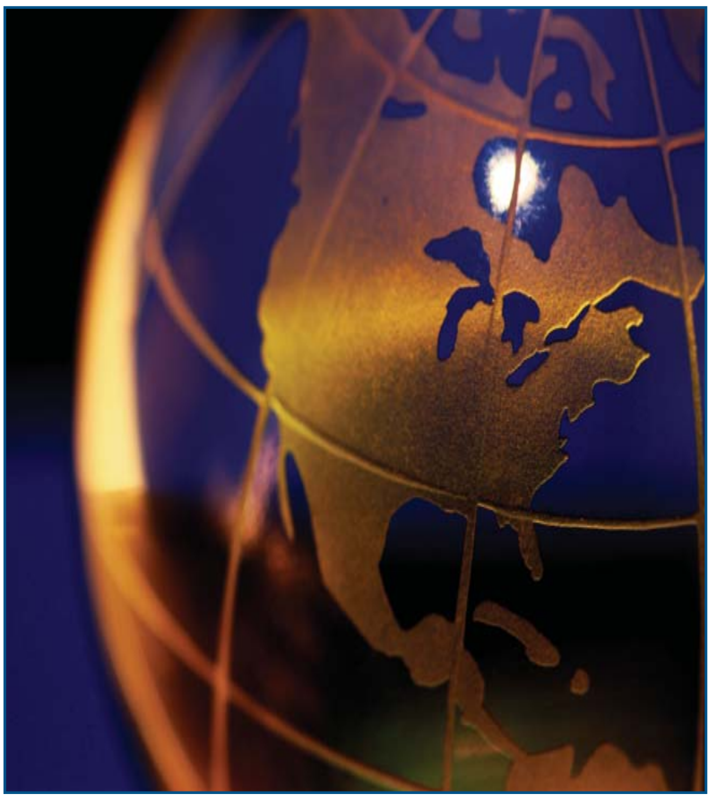
In making a determination of whether or not a permanent establishment exists, there are numerous factors to be considered. Which factors are most relevant in any particular case will be largely dependent upon the nature of the taxpayer's business and the particular facts and circumstances in question. Before any determination is made, all facts of a particular case must be considered.



The presence of a permanent establishment can be determined by the requirements of the fixed place of business or the dependent agents' analyses set out in the Treaty.

Mandatory Arbitration Makes Debut in Canada-U.S. Treaty

It is not surprising that mandatory arbitration has finally worked its way into the Canada-U.S. Tax Convention. In 2007, both the Canadian and U.S. Treaty negotiators concluded negotiations on the fifth protocol (the protocol). Article 21 of the protocol states that paragraph 6 of article XXVI of the convention is deleted and replaced by a new paragraph 6, which maintains that where the competent authorities have attempted, but are not able to arrive at a consensus, the case shall be settled through arbitration. Having met some administrative requirements, and cleared the hurdle that the case is not one that the competent authorities both determine is not suitable for arbitration, the case will be eligible for settlement.



Arbitration is the process whereby a dispute between two parties is left in the hands of an independent third party(ies) for consideration. In the case of the Canada-U.S. Treaty there will be three arbitrators, one appointed by each government and one appointed by the two arbitrators. The arbitrators will listen to both sides of the dispute, and after consideration of the facts and circumstances, will arrive at a final decision or solution. Arbitration is very significant in many areas of business and, in particular, plays a vital role in resolving disputes in the employment, commercial insurance and financial sectors.

The new protocol amends the mutual agreement procedure (MAP) article XXVI of the convention, and puts in place a process referred to as "mandatory arbitration". This should provide welcome relief to those companies that have been stranded in the existing MAP process for some time, as well as those that have incurred double taxation.

Certain clarifications to this process should be understood by those affected. Arbitration is mandatory to the extent that the competent authorities must participate and engage themselves where each of the conditions to arbitration are met. The diplomatic notes to the protocol provide that three criteria must be met. First, tax returns for the years under consideration must have been filed in at least one of the two countries; second, the case must not be considered a case that the competent authorities both agree, before the date on which arbitration proceedings would otherwise begin, is not suitable for arbitration; the third, and very important criteria, is that the taxpayer and all other "concerned persons" whose tax liability would be directly affected by the result of the arbitration process, as well as their authorized representatives, must agree in writing to keep all information exchanged in the process, by and between the authorities, confidential. According to the notes, this confidentiality agreement does not extend to the final determination, which is arrived at by the arbitration board.

In the case of the Canada-U.S. Treaty there will be three arbitrators, one appointed by each government and one appointed by the two arbitrators

The diplomatic notes go on to state that arbitration proceedings are to begin on the later of the following two dates: two years after the "commencement date" (this term being defined as the earliest date on which the competent authorities have both received the information necessary to undertake substantive consideration for a mutual agreement), or the date on which the taxpayer and other concerned persons have provided the required confidentiality agreement.

In fact, where formerly the competent authorities were only "endeavoured" to reach a mutual agreement, they are now forced into participating in the arbitration process. As with the existing process of mutual agreement by the competent authorities, the taxpayer is not permitted to participate in any discussions, and cannot influence the decision of the arbitrator. The arbitration board will in effect have to decide between two government proposals (i.e. the proposal submitted by the Canadian competent authority and that of the U.S. competent authority).

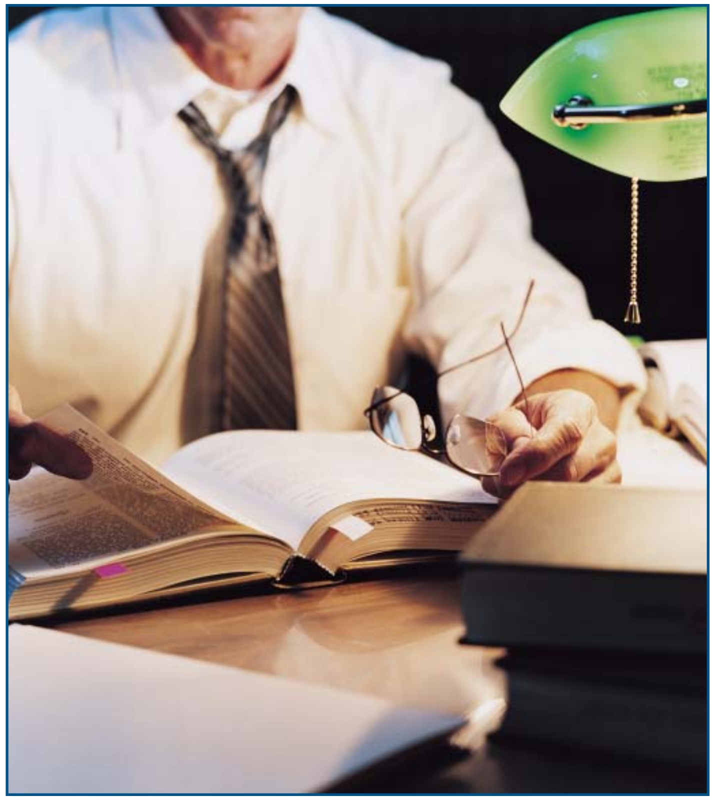
The taxpayer can choose to reject the final determination of the arbitration board and thereafter pursue their rights under the judicial system

The arbitration team is restricted to choosing between one of the two proposed resolutions. The taxpayer has no say in their proposals, nor does the taxpayer have an influence on the decision by the arbitration board. Once the decision by the arbitration board is rendered, and if the decision is accepted by the taxpayer, the arbitration determination is binding on the two contracting countries. In addition, the arbitration board is not subject to revision and does not have to provide an explanation for its decision. The contracting states must abide by their decision and accommodate the parties involved in a transfer pricing dispute accordingly.

One very important right the taxpayer does maintain, however, is with the final determination. The taxpayer can choose to reject the final determination of the arbitration board and thereafter pursue their rights under the judicial system.

It will be interesting to see how the whole process of mandatory arbitration will play out. In fact, the creation of such a vehicle puts a very positive spin on the actual operations of competent authority. It is quite possible that the competent authorities will have more incentive to try and arrive at a mutual agreement. Having too many cases go to arbitration would certainly not do them any good. The risk that their proposal would be dismissed by the arbitration board is likely to be a great deterrent to letting cases drag on or remain unresolved.

The entire decision to proceed with arbitration lies in the hands of the taxpayer. In addition, it is entirely in the taxpayer's discretion to withdraw from competent authority process even if the case is in the hands of the arbitration board.



Should the case be referred to arbitration, the timetable to render a decision by the board is quite short and clear. The arbitration decision must be provided in writing no later than six months following the date that the committee has been appointed. From a taxpayer's perspective, this is very encouraging, given that a matter that has been languishing for a long period in competent authority can now have closure within a reasonable timeframe.

Transfer Pricing - Reducing Audit Controversy

Introduction

The primary goal of preparing transfer pricing documentation is to avoid costly transfer pricing penalties and reduce audit risk. In order to avoid transfer pricing penalties, reasonable efforts must be made. The term "reasonable efforts" is very subjective and is not defined anywhere in Section 247 of the Canadian *Income Tax Act*, although the Canada Revenue Agency (CRA) does provide some guidance in Transfer Pricing Memorandum (TPM) 09.[1]

The CRA has issued several TPMs to explain their policies and views. Refer to the CRA website for details.

What should a taxpayer do with respect to transfer pricing documentation? First, the taxpayer must ensure that those creating this documentation are skilled in covering off all transfer pricing issues, such that the auditor cannot logically conclude that reasonable efforts were not met. Secondly, the transfer pricing documentation must properly address the economic substance of each transaction. While some transactions will naturally increase the likelihood of audits, other factors must be properly managed.

Common Transfer Pricing Audit Triggers

The following are some common issues that can trigger a CRA audit.[2] Quality documentation that describes the transaction, and sets the intercompany price according to the arm's length standard, can mitigate the effect of these audit triggers.

Persistent Losses and High Variances in Profits

Persistent losses experienced by the Canadian related party are often a trigger for a CRA audit. While it is entirely possible that one party in a transaction can experience recurring losses or increased volatility in profit levels, the fact that transfer pricing occurs between related parties raises the suspicions of tax authorities. If it is determined that one of the parties to the transaction should earn negative profits (i.e. a downturn in the economy should have the largest effect on the profits of the party assuming the most risks), those creating the transfer pricing documentation must sufficiently articulate this in order to show reasonable efforts, and to mitigate the risks of a full-blown audit and/or audit adjustments.

Persistent losses experienced by the Canadian related party is often a trigger for a CRA audit

As a rule, profits attributable to a tested party (i.e. the less complex party to the transaction) should not be below industry norms. Depending on the characterization of the tested party, a risk-taking entity could incur negative and reoccurring losses, though this should be reversed in better economic times. If the tested party is routine in nature and assumes little risk, its profitability should be relatively stable and positive. If the returns attributable to a tested party are outside the realm of economic reasoning and below industry norms, this may increase the suspicion of tax authorities and raise a full-blown transfer pricing audit.

Royalty Payments

Royalties are generally paid when one party uses the trade-mark, trade-name, patents or other intangible assets of another party. Usually, a related party would be willing to pay a royalty if access to such intangible assets would result in it earning profits that are in excess of what it would have earned had it not had access to such intangibles. Utilizing

1 For details on this memorandum and others related to transfer pricing please visit the CRA website at: www.cra-arc.gc.ca/tax/nonresidents/common/trans/menu-e.html.
2 This statement would also apply to the foreign jurisdiction. Where the foreign related party to the transaction is losing money, the foreign government would be more likely to commence a transfer pricing audit.

a related party's intangible assets should result in the tested party being better off (even after the royalty payment is made). However, all too often, royalties are used to "strip" profits from a related party. This is contrary to what economic theory suggests should happen. In such circumstances, aggressive royalty payments often increase the suspicions of tax authorities. Properly structuring a royalty based on sound economic principles is required.

Management Fees

Subsidiaries often pay management fees to a related parent company for the provision of services. Services that are considered ancillary in nature, but nevertheless are economically valuable, should be allocated at cost. Value-added services, such as marketing, must be allocated at arm's length, usually with a mark-up. Proper explanation of the benefits received from the services, and an economic comparables study to support any mark-up on the services, is key to reducing audit controversy.

Guarantee Fees

As international finance becomes more globalized and competitive, multinational companies, particularly those offering financial services, must ensure that the cost of borrowing money is as competitive as possible to reduce borrowing costs. This often requires that a financially superior foreign parent company guarantee the loans of a weaker subsidiary, thereby ensuring the subsidiary access to lower borrowing rates and higher profits.

Transfer pricing legislation requires the borrower to pay the guarantor an arm's length fee for providing such a service. Failure to adequately address this issue can result in an auditor undertaking a full-blown audit. The difficulty lies in the determination of the arm's length amount for the guarantee fee. See the GE Capital case (found in *"The Use of Guarantee Fees"* on page 11) for more details.

Royalties or management fees that are aggressive and that strip too much profit out of a subsidiary, will often be a red flag to auditors

Intangibles Transfers

Firms have an incentive to structure their affairs in such a way that profits are migrated to tax jurisdictions imposing lower tax rates. This often involves the transfer of valuable intangible assets to low tax jurisdictions.

Tax authorities around the world have begun to target these structures and, as a result, multinational companies need to ensure that documentation is sufficient to support the migration of such intangible assets, and to ensure that they meet the arm's length standard. Failure to sufficiently document these transactions based on sound economic considerations will increase the risk of an audit.

Conclusion

The CRA's auditors are gaining experience with respect to international transactions, and taxpayers must ensure that their analysis is sufficient to withstand an audit by the CRA. There are many issues in a transfer pricing study that must be dealt with effectively to reduce the need for a detailed transfer pricing audit. It is important to adequately compensate a related party so that profits are properly allocated within a related party setting, and that such profits fall within industry norms. Royalties or management fees that are aggressive and that strip too much profit out of a subsidiary, will often be a red flag to auditors. Implementing transfer pricing strategies that are economically sound is the best way to reduce the chance of a transfer pricing audit.

Transfer Pricing Penalties in Canada Subsection 247(3): A Consequence to Avoid

Introduction

The demand for corporate reporting and compliance documentation in the world today is daunting. The financial reporting requirements imposed by Sarbanes Oxley is one example of such measures. Similarly, documentation with respect to transfer pricing transactions has also become a major concern for multinationals around the world. Most taxing authorities have revisited their transfer pricing legislation and have adopted revised positions requiring multinationals as well as medium and small business enterprises to prepare transfer pricing documentation in support of related party transactions. While this is an expensive and time consuming exercise for the entities involved, failure to comply with such requirements may prove to be extremely costly when taking into account potential penalties.

Since Canada's enactment of new transfer pricing legislation in 1997, and commencing in 1999, taxpayers have been required under subsection 247(4) to have available at the time of filing their respective tax returns in Canada, a transfer pricing documentation package that is complete in every respect. Failure to do so may result in the application of penalties.

Transfer Pricing Penalties in Canada

Subsection 247 of the Canadian *Income Tax Act* (ITA) incorporated under Part XVI.1 of the ITA was enacted by Parliament on September 11, 1997, applicable for taxation years starting after 1998. Subsection 247(4) requires that specific documentation be maintained by a taxpayer to support related party transactions. Failure to provide such documentation to the CRA when requested will be cause for computation of a penalty in accordance with the provisions of subsection 247(3).

...failure to comply with such requirements may prove to be extremely costly when taking into account potential penalties

When the Canada Revenue Agency (CRA) undertakes a transfer pricing audit, it will normally issue a letter at the outset requesting the contemporaneous documentation be provided within 90 days of the date of the letter. If the documentation is not completed by the time the return is to be filed (six months after year end) and is not made available within 90 days of a request by a CRA auditor, a subsection 247(3) penalty will automatically apply if the adjustment meets the threshold levels (i.e. 10 per cent of sales or $5 million per year). There seems to be minimal tolerance in this respect should one fail to comply.

In circumstances where a penalty is being considered, for the reasons mentioned above, the file will be submitted by the field auditor to the Transfer Pricing Review Committee (TPRC), situated in the International Tax Division (Ottawa Headquarters). A referral to the TPRC for transfer pricing penalties must be considered by the field office in all cases where the total of transfer pricing capital and income adjustments for a taxation year exceed $5 million, or exceed 10 per cent of gross revenue for the year, as per subparagraph 247(3)(b)(i).

The penalty is equal to 10 per cent of the transfer pricing adjustments. The penalty applies to the total income adjustments resulting in either an increase in operating income or, very surprisingly, a decrease in operating losses. Capital adjustments are also contemplated whereby the penalty calls for a 50 per cent reduction to the adjusted cost base of certain capital assets and similar reductions to the capital cost of depreciable property. The very punitive nature of the penalty is derived from the fact that the adjustment itself is the vehicle for the computation of the penalty and not the resulting additional tax that is imposed. In addition, downward adjustments are not netted against upward adjustments in determining whether the penalty applies.

Although the CRA field auditor is responsible for determining the factual circumstances of the case, and whether the documentation was prepared contemporaneously, he/she is not responsible for determining if the penalty is applicable or not. According to the CRA's transfer pricing memorandum TPM-01, dated March 26, 2003:

> "The CRA's policy on transfer pricing legislation is found in IC 87-2R, International Transfer Pricing. In the paragraphs reproduced below, the CRA states that before any assessment under paragraph 247(2)(b) or subsection 247(3) is issued, the file will be referred to the TPRC for review to ensure that the law is applied fairly and consistently.
>
> Taxpayers must be made aware of the transactions under review and the potential for a penalty under subsection 247(3). Before the files are referred to Field Advisory Services (FAS), taxpayers should be asked to submit any information they wish to have considered."

Therefore, taxpayers should be advised in writing of transactions under review for possible penalty application. They will be requested by the CRA to submit representations prior to this initial referral to the TPRC to give their version of reasons for the non-application of the penalty. A taxpayer facing this situation should take the time to formulate solid arguments against such application, since failing to do so may exhaust your chances of future representations prior to the committee's decision.

One must be sensitive to the fact that penalties and interest arising from transfer pricing adjustments are not negotiable issues with respect to competent authority resolution of double taxation cases under Canada's tax treaties.

Penalty: Canada vs. U.S.

For the sake of comparison, let us take as a hypothetical example the following scenario: Canco is a manufacturer and in 2005, sold $100 million of tangible goods to its U.S. related subsidiary for distribution in the United States. The CRA determines that the transfer price should have been $110 million, and therefore a $10 million upward transfer pricing adjustment is proposed. Although Canco provided the documentation within 90 days of a request to do so, the field auditor submits the file to TPRC. Following its review, the committee decides that the documentation is inadequate, and therefore "reasonable efforts" were not made. The Committee therefore considers a penalty under subsection 247(3) applicable.

The resulting tax consequences in Canada would be computed as follows:

- transfer price adjustment: $10 million (247(2));
- assuming for purposes of illustration a 40 per cent tax rate, additional tax of approximately $4 million;
- subsection 247(3) penalty of $1 million (10 per cent of $10 million); and
- approximate additional interest of $560,000 (non-deductible in Canada).

Let us assume that the situation is reversed and that the Internal Revenue Service initiates the adjustment. The resulting tax consequences in the U.S. would be computed as follows:

- transfer price adjustment: $10 million (S 482));
- assuming for purposes of illustration a 40 per cent tax rate, additional tax of approximately $4 million;
- S 6662 penalty of $800,000 (20 per cent of $4 million); and
- approximate additional interest of $560,000 (deductible in the U.S.).

Clearly, this example demonstrates that the effect of the penalty in Canada is more severe than one would expect in the U.S. under these circumstances. In addition, it is important to note that since the penalty in the U.S. applies to the additional tax generated, should a substantial adjustment be made whereby the U.S. company remains in a negative or loss position after the adjustment is processed, no additional tax would be generated and thereby no penalty would result. In Canada, although no additional tax would result from the adjustment, the penalty on the adjustment would nevertheless be computed and applied. This represents a significant difference that one should remember when contemplating the proper documentation package to present to the CRA.

Reasonable Efforts: How Far Should One Go?

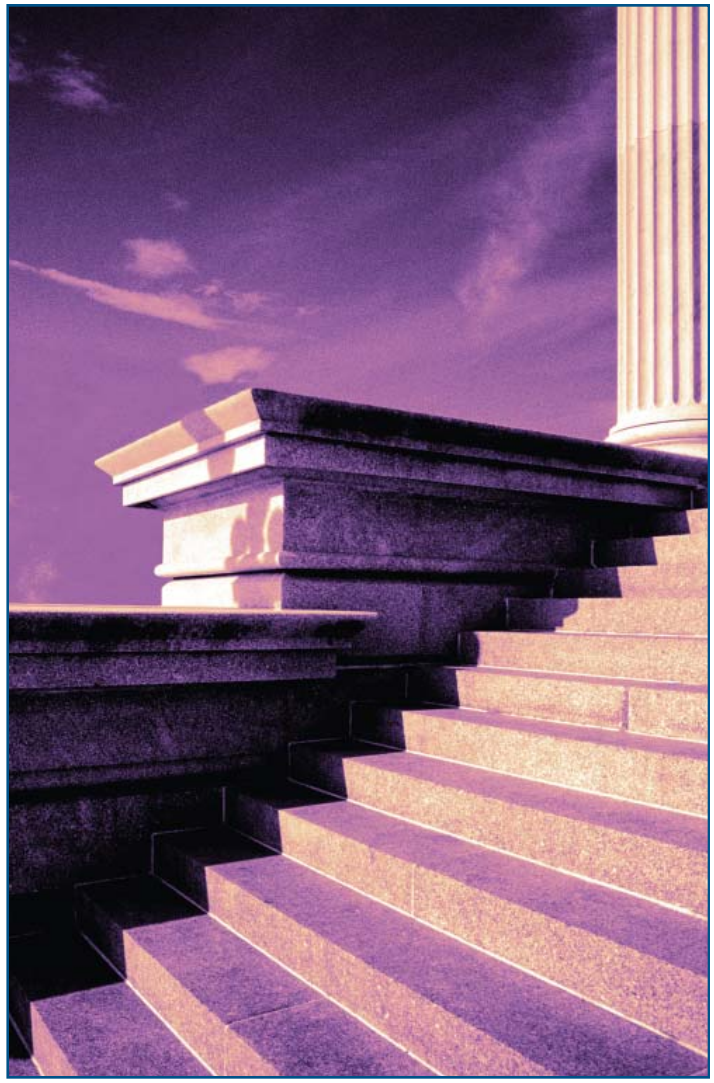
The key to the establishment of defensible transfer pricing documentation in Canada is to ensure that one addresses, as clearly as possible, the requirements spelled out by subsection 247(4). In effect, the following items must clearly be established and must be current as to the year being addressed:

- a complete and detailed functional analysis, which clearly defines the roles of the parties to the transaction and provides sufficient evidence to permit a reader to characterize the entity with respect to those characteristics.
- a clear indication as to the bearer of risk within the related party transaction. The risks to address will normally include, without limiting the scope of the analysis: inventory risk, product liability risk, credit risk, foreign exchange risk, and market risk.
- a complete description of intangibles maintained by the parties within the transaction. The intangibles must be identified as to type (manufacturing, marketing, hybrid, etc.) and a clear understanding of the legal versus economic ownership conditions must be specified.
- a complete and accurate description of transfer pricing methods considered (i.e. why one and not the others).
- data with respect to comparables considered, analysis performed, adjustments made, and justification as to the methodology used.
- a description of assumptions, strategies and policies affecting the transfer price.
- a study of economic factors to consider and adjust for.

In accordance with TPM-09, dated September 18, 2006, reasonable efforts are defined by the CRA as follows:

> "The general determination of whether a taxpayer has made reasonable efforts to determine and use arm's length transfer prices or allocations 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 in both subsections 247(3) and 247(4) also refers to a dual obligation in that taxpayers must make reasonable efforts: (1) to determine arm's length transfer prices or arm's length allocations; and (2) to use those prices or allocations.

> Therefore, in determining whether the transfer pricing penalty is applicable, it will be necessary to show that reasonable efforts were made both in establishing and using arm's length pricing.
>
> 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."



Therefore, it is quite clear from TPM-09 that the TPRC, in determining if the penalty applies or not, will evaluate whether a taxpayer has:

- complied with the documentation required in subsection 247(4);
- made reasonable efforts to determine competently the appropriate price; and
- consistently used that price accordingly.

This being said, the results of penalty recommendations by the committee to date seem to suggest that if essential ingredients in the documentation package are missing or poorly reported, a penalty under subsection 247(3) is a strong possibility, one that any taxpayer would be wise to avoid.

Conclusion

Penalties are alive and flourishing in the transfer pricing arena and their application is increasing as tax authorities become more vigilant in their audits. Tax administrations, such as Canada as well as many other foreign jurisdictions, have equipped themselves well with respect to both legislation and policies to enforce compliance in this field. Although world organizations such as the Organisation of Economic Co-operation and Development (OECD), Pacific Association of Tax Administrators (PATA), and the EU Council are concerned with the aggressiveness of countries in this area, there is little that one may do to soften the domestic penalty blows that may be felt by those who underestimate their application. Therefore, a word of caution to all multinationals, as well as medium to small enterprises: ensure your documentation packages are well prepared with regard to each respective jurisdiction or you may face undesired and serious financial consequences.

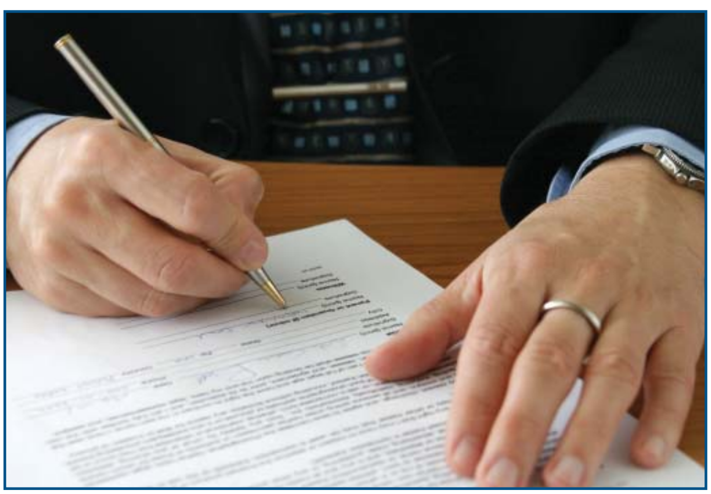
Transfer Pricing and Recharacterization in Canada: A Closer Look

Redefining of Transactions a Reality

The concept of recharacterization in a Canadian transfer pricing setting permits tax authorities to redefine transactions undertaken by related, non-arm's length parties, when it is determined that the transactions are not consistent with similar transactions that would normally be undertaken by arm's length parties. Take, for example, a situation where related parties in a cross-border structure enter into a financing arrangement, or loan agreement, where one party pays interest to the other party. The Canada Revenue Agency (CRA) may disregard the financing arrangement. Instead, for fiscal purposes, rather than recognizing the interest expense of the debtor, the CRA may consider the creditor to have injected equity into the debtor. Therefore, the loan agreement is, In effect, disregarded for tax purposes. The reality is that the CRA has in place the legislative tools required to challenge the structure of these arrangements.

Legislation Under Paragraph 247(2)(b)

The legislation under paragraph 247(2)(b) of the Canadian *Income Tax Act* (ITA) permits the CRA to restructure the transaction so that it conforms to what two unrelated parties would normally have done under similar circumstances. According to the legislation, the CRA will recharacterize a transaction if the following two conditions are met:



- the transaction would not have been undertaken between persons dealing at arm's length; and
- the transaction can reasonably be considered to have been undertaken primarily to obtain a tax benefit, rather than for bona fide business purposes.

Organisation for Economic Co-operation and Development (OECD)

In its 1995 guidelines, the OECD made explicit reference to two examples of transactions that may be subject to recharacterization by member states. One example concerns "interest" and the other "royalty". Transactions of this nature are very common within a multinational group, or any related group of companies for that matter. The possibility of being caught within the recharacterization web has become a realistic concern to any person involved in related party cross-border undertakings.

Having been targeted and identified by the OECD, one can be assured that transactions involving debt or royalty payments are certainly areas that taxing authorities will be interested in reviewing. An interesting question becomes whether the action of possible recharacterization by taxing authorities stops at the two reported issues identified by the OECD, or whether it can apply to any transaction, regardless of its nature.

CRA Policy

Information Circular 87-2R (IC) - *International Transfer Pricing* does not provide insight into what types of transactions the CRA will challenge. Interestingly enough, the IC does confirm that the OECD guidelines provide two fairly limited instances where characterization would be considered.[1]

The question as to whether a leasing arrangement or a rental agreement would be cause for recharacterization is a question that many have asked without any clear-cut answer. Whether the situations are restricted to the OECD examples, or whether paragraph 247(2)(b) means open season for all transactions, is an important concern to related parties as they structure their arrangements.

1 Information Circular 87-2r, paragraph 44.

IC 87-2R states that the CRA would normally not challenge the form in which business transactions are undertaken by related parties. In addition, the CRA also indicates that depending on business circumstances, it is possible that the arm's length principle is being respected, notwithstanding that arm's length parties would have transacted differently.[2] Disregarding the actual arrangements undertaken between the entities, and forcibly interposing a completely different arrangement among them, goes as far as treating the transaction as lacking economic substance, whereby the arm's length principle is no longer an important factor in the transaction.

Avoiding Recharacterization

Preventive measures should be considered when structuring transactions:

- make sure that the reasons (economic and commercial) for entering into the transaction are clearly supported. The less the undertaking reflects a clear intention, the greater the risk of recharacterization. Intentions should be clear.
- tax havens. If one of the participants is from a low or no tax jurisdiction (i.e. Barbados, Bahamas, Cayman Islands), the risk of an audit is significantly greater. The CRA and other tax authorities take special interest in the arrangements involving these types of jurisdictions. Proper structuring of such transactions, and documentation that supports the creation and bona fide existence of such entities, is important.
- ensure that any flow-through entities, such as conduits or hybrids, have a business purpose for their existence. A company is allowed to structure its affairs in a tax-efficient manner. The use of a particular vehicle may be adequate for tax purposes but equally as beneficial for business purposes. The use of Limited Liability Companies (LLCs) in the U.S. and Nova Scotia Unlimited Liability Companies (NSULCs) in Canada are examples of this. Proper documentation that defines the entity's purpose will be essential in reducing compliance risks.
- the OECD has identified both debt financing and intangibles as possible areas of concern with respect to recharacterization. As a result, special attention must be directed toward such transactions within the related group to ensure that the trap is avoided. Again, planning and a clear statement of intentions will be necessary to counter unfavourable compliance measures by the CRA.
- if the intention is to transfer intangible property offshore, one should ensure that the property is properly valued at the time of transfer. A certified valuation of the property may satisfy concerns that could be raised later. Risks associated with the intangible property should be carefully considered. Functions within the acquiring affiliate should be sufficient to support the associated risk of maintaining the intangible property.

Conclusion

Transactions that the CRA considers for recharacterization will be reviewed by the Transfer Pricing Review Committee under the direction of the International and Large Business Directorate. In most recharacterization challenges, CRA will provide the taxpayer with its reasons as to why an arm's length party would not have entered into a similar transaction. In order to properly defend its position, one must be able to support the contention that an arm's length party would undoubtedly be in a position to undertake the same actions. Being ready and able to stand up to that test is the best defence against recharacterization.

2 Information Circular 87-2r, paragraph 43.
3 KellwoodCo., N.Y. Div. Tax App., no. 820915, 3/27/08.
4 Information Circular 87-2r, Paragraphs 150, 151.
5 Financial Accounting Standards Board Interpretation Number 48 (FIN 48), was issued July 13, 2006, in the U.S. - effective for all entities, taxable as well as exempt, that issue U.S. GAAP financial statements for fiscal periods commencing after December 15, 2006. Fin 48 requires that all uncertain tax positions be identified, evaluated and measured with their probable positions and effects being recognized for financial reporting within the specified period.

Moving Intellectual Property Offshore in a Transfer Pricing Setting

If a multinational corporation had the luxury of perfect hindsight, it would optimize its global positioning and operational efficiencies by migrating intangible assets before they proved valuable. Most companies, however, do not have that luxury, and the decision to migrate assets often comes well after their value is realized. In light of this, it comes as little surprise that governments are increasingly considering crackdowns on tax havens as more and more multinational organizations move profits offshore to low tax jurisdictions.

The Canada Revenue Agency (CRA) and other tax authorities have stepped-up enforcement activities related to various industries, including the pharmaceutical sector, that employ valuable intellectual property (IP). The CRA has 11 centres of expertise to deal with aggressive international tax planning. These centres, located in regional tax services offices across Canada, bring together international tax auditors and tax avoidance officers. One of the priorities of the centres is to develop new ways to address aggressive international transactions. A major target in the CRA's audit compliance reviews is transfer pricing transactions, specifically the migration of IP.

...tax authorities have used existing legislation to recharacterize related party transactions after settlement negotiations have broken down, resulting in transfer pricing adjustments

With increased resources available to it, the CRA is combining its rapidly improving knowledge of transfer pricing disciplines with improved legislative powers, to raise transfer pricing adjustments within the pharmaceutical industry.

From a tax perspective, any financial planning that involves multinational corporations moving profits offshore can be justified if the corresponding functions, assets and risks borne to earn these profits are also shifted offshore, and if the appropriate buy-in payments have been made.

The world economy has become increasingly globalized, and the need to maximize after-tax profits is not only advantageous to improving corporate profits, it is also necessary to remain competitive. Although implementing such a framework is a long and complex process, it can result in material tax savings.

Although there are many clear benefits to migrating intangibles, the strategy poses risks, including the potential for significant transfer pricing adjustments. Ideally, intangibles should be migrated when they do not possess considerable economic value. However, as stated earlier, companies do not have the benefit of hindsight and often decide to migrate after the intangibles prove valuable.

During transfer pricing audits, tax authorities have used existing legislation (for example, section 247(2)(b) of the Canadian *Income Tax Act*) to recharacterize related party transactions after settlement negotiations have broken down, resulting in transfer pricing adjustments.

Migrating Intangibles

Tax authorities around the world have begun to target structures that migrate profits offshore. As a result, multinational companies need to ensure that their documentation is sufficient to support the migration of valuable intangibles, and the profits they drive. Three methods commonly used to migrate these intangible assets are:

- cost-sharing agreements;
- buy-in payments; and
- sale of intangibles.

Cost-Sharing Agreements (CSAs)

CSAs are one of the most effective ways to migrate intangibles. A CSA is an agreement between two parties that defines the contributions each party will make, in terms of costs expended and the associated benefits that will be returned to the parties for such an investment. For a CSA to be effective, the following are necessary:

- the CSA must make business and economic sense;
- it must include upfront and well-documented terms;
- it must indicate costs incurred by each party relative to the reasonability of expected profits; and
- if providing entry, exit or termination of a CSA, provisions must involve arm's length prices.

Failure on the part of companies to draft effective CSAs, serves only to increase audit risk. In this respect, great care must be taken to ensure that CSAs make both economic and business sense.

CSAs are often found in industries that require substantial research and development (R&D) activities, such as the pharmaceutical industry. In such an industry, some of the costs associated with performing the R&D activities are incurred in low tax jurisdictions. Given these related parties pay for a portion of the R&D, they are entitled to exploit an interest in the IP that was developed. As a result, no royalty on the CSA must be paid.

Buy-In/Buy-Out

Buy-in/buy-out payments are another way to migrate intangible income offshore. Buy-in payments require a party in a related party setting to buy into a CSA, or buy out of one. To do so, the buy-in/buy-out payments must be payments that represent arm's length prices. Buy-in options are valuable, given they provide many opportunities, considering the associated risks, and must be reflected in the price. Subsidiaries must pay fair market value to buy in. Failure to do so will increase the firm's audit risk for an unfavourable audit.

Sale of Intangibles

The final approach regarding the migration of intangibles is through the sale of intangibles. Intangibles are a large source of profit, and selling them to offshore affiliates will help build support for the argument that profits generated from these assets should be taxed in these offshore jurisdictions. It is important, as in the other two cases above, to ensure that this is done at arm's length. Determining the arm's length sale of intangibles is complicated. The most common way of determining the price at which this should be transacted involves the comparable uncontrolled price (CUP) method. The CUP method requires finding external comparables that involve the sale of similar intangibles, which is often difficult to achieve.

The Merck Case

The power of governments to recharacterize a particular transaction was seen in a transfer pricing dispute between the CRA and Merck Frosst Canada (Merck). The CRA examined Merck's tax returns from 1998 through 2004 and reassessed Merck for "adjustments related to certain intercompany pricing matters." The CRA issued a notice of reassessment related to various intercompany transactions totalling approximately US$1.4 billion plus US$360 million in interest. It was reported in Montréal's *La Presse* (October 2006), that the adjustments relate to Merck's patent for its asthma drug Singulair, and that the patent was later transferred from Canada to Barbados. The CRA used its ability to recharacterize the transaction, thus raising the corresponding adjustment. Eventually Merck was able to reach a settlement with the CRA for a reduction in the reassessment to C$786 million, still a very substantial amount. This case clearly shows the risks involved in migrating intangibles.

Conclusion

The migration of intangibles is an acceptable tool in an effort to maximize after-tax profits. However, doing so normally requires the migration of functions, assets and risks. One should be cautioned, for intangibles that have proven valuable and subsequently migrated, tax authorities will certainly be on the alert to scrutinize the transactions - as the Merck case has shown. It is imperative that any strategic decision to transfer intangibles be supported by comprehensive transfer pricing documentation that incorporates as much evidence as possible supporting an arm's length price.

Customs Valuation and Transfer Pricing

Can They Work Together to Find Efficiencies?

For years, multinational corporations valuing goods for the purposes of customs and duties have asked why they are unable to use methodologies commonly employed to price goods in a transfer pricing setting. Recent developments will now make this desire a reality.

The Canada Revenue Agency (CRA) and the Canada Border Services Agency (CBSA) respectively recognize not only their similar objectives and policies, but also their own unique interests. For example, both organizations attempt to satisfy the main objective of determining fair market value (in essence applying the arm's length principle). However, the interests inherent in each organization are different.

There are conflicting objectives in the valuation of goods between the CRA and the CBSA. It is to the CRA's advantage to price goods entering into Canada in such a way that they increase the profits reported by the taxpayer, and therefore tax collected, by lowering the value of the taxpayer's costs. On the other hand, it would be in the CBSA's best interest to increase the valuation of these same goods entering Canada, therefore increasing the amount of duty paid when the goods enter into Canada.

For transfer pricing issues, the main body of the legislation is found in Section 247 of the Canadian *Income Tax Act* and the CRA's guidelines as set forth in the IC 87-2R. For the purpose of customs valuation, the applicable sections of the *Customs Act* are sections 44-57. The CBSA's D-series memoranda also provide additional information with respect to the application of the valuation rules.

It appears that the CBSA has concluded that the breadth of expertise of the CRA, combined with private sector influence surrounding transfer pricing in recent years, eliminates the need to establish new valuation techniques.

Consequently, when determining customs valuations, the CBSA will rely heavily on transfer pricing documentation and policies that determine the methodologies used for the valuation of goods in a transfer pricing setting. This transfer pricing documentation requires both a functional and economic analysis. The CBSA may therefore use the methodologies utilized to value goods in a transfer pricing setting to determine the amount of duties to be paid. This seems to be the first step taken in determining customs valuations for duty purposes. The base amount now being paid and payable should equal the amount obtained from the CBSA's valuations used for tax purposes.

The CBSA's apparent acceptance of the methodologies used for tax purposes has been witnessed in practice. In the ever-changing environment of the international community, it has been determined that 60 per cent of all international trade is performed by international parties who are related to each other. In addition, as outlined by the CBSA, it has accepted 95 per cent of all the values that have been put on the Customs sheet. Given that a significant scope of international trade is related to intercompany transactions, the acceptance of the valuations of goods by the CBSA implicitly suggests that it has accepted the price determined by the methodologies used for tax purposes (or transfer pricing values). Consequently, whether attempting to value goods with respect to customs valuations or from a transfer pricing perspective, the starting point must be a functional analysis, which is a crucial element in determining a transfer price for the CRA's purposes.

One difficulty in relying on a functional analysis for customs purposes is the fact that a functional analysis and the corresponding transfer pricing report might not be segmented or detailed enough to provide the accurate information necessary to determine the value of those goods for duty purposes. The new approach taken by the CBSA is not without limitations. A significant issue surrounds what should happen when retroactive adjustments made by the CRA, with respect to intercompany pricing, significantly alters the value of the costs of goods coming into Canada. In particular, if the CRA raises an adjustment on a taxpayer by altering the methodologies used by the taxpayer, would this necessarily result in the CBSA allowing a reduction to the value declared under 485(c), thus giving a refund back to the taxpayer?

This will naturally create timing issues and refunding limitations. It is our opinion that under the new CBSA regime, a refund is possible and an application for a refund should be taken into consideration if a company has had a transfer pricing adjustment that has also changed its valuation for customs purposes.

In conclusion, it is important to remember that when preparing a company's transfer pricing documentation for tax purposes, the valuation for duty purposes must be taken into consideration. The fact that the CBSA has accepted the majority of valuations reported on the Customs sheet, a large proportion of which include related party transactions, suggests that the CBSA has implicitly accepted transfer pricing valuation for customs purposes.

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The Gowlings Transfer Pricing and Competent Authority Team

During the past decade, multinational organizations have been expanding into global markets at an unprecedented rate and governments around the world are taking notice of the increased risk of fiscal erosion. Due to increased awareness and enforcement activities related to transfer pricing, companies need to comply with the requirements of multiple tax administrations. The complexity of the transfer pricing rules and the level of documentation required may overwhelm an organization's tax department.

Proper planning can position an organization to optimize its tax situation by properly placing the correct combination of functions, assets and risks in the desired jurisdiction. With our extensive knowledge of the transfer pricing rules and current government policies, we can help your company establish favourable and defensible transfer pricing policies in advance of an audit, defend your company's current transfer pricing structure, or develop prospective plans through an Advance Pricing Agreement.

The Gowlings Transfer Pricing and Competent Authority Team has over 25 years of transfer pricing and competent authority experience. Our professionals include former Canadian government transfer pricing specialists who have been involved, first hand, in the analysis and negotiations of hundreds of competent authority requests and advance pricing agreements with competent authorities around the world. Since 2005, the Gowlings Transfer Pricing Team has represented clients from small entrepreneurs to Fortune 500 companies before the Canada Revenue Agency and other governments around the world.