Transfer Pricing: Overview

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As cross-border transactions have become increasingly commonplace, transfer pricing compliance has emerged as a critical operational issue for many large Canadian businesses. This Practice Note provides a general overview of the structure and administration of the Canadian transfer pricing rules as they apply to both domestic and cross-border transactions. It also discusses the transfer pricing considerations that should be borne in mind when negotiating and drafting commercial agreements.

Canada's transfer pricing laws are complex. No transactions should be based on the contents of this Practice Note alone. Clients should consult a qualified tax professional for guidance on the application of the Canadian transfer pricing rules in light of their own circumstances.

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As cross-border transactions have become increasingly commonplace, transfer pricing compliance has emerged as a critical operational issue for many large Canadian businesses.

The Canada Revenue Agency (CRA) aggressively enforces the transfer pricing rules contained in the Income Tax Act, R.S.C. 1985, c. 1 (5th Supplement) (Tax Act) and has stated that transfer pricing is one of its key areas of focus. CRA auditors are now instructed to request transfer pricing-related documentation at the outset of any audit that involves a multi-national enterprise.

The range of transactions that may fall within the ambit of the Canadian transfer pricing rules is extremely broad. The sale of goods, the provision of services, the licensing of intellectual property, and a host of different types of lending, hedging, insurance, and derivative arrangements are all potentially subject to the transfer pricing rules in the Tax Act.

The consequences of not complying with the Canadian transfer pricing rules can be severe. In addition to being subject to potential tax reassessments, the failure to properly comply with the Canadian transfer pricing rules can attract significant penalties and, in some cases, result in double taxation. Furthermore, the ability of certain taxpayers to avail themselves of interest and penalty relief through a voluntary disclosure of tax deficiencies that relate to transfer pricing matters, is limited as such matters are generally referred to the CRA's Transfer Pricing Review Committee for consideration.

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What Is Transfer Pricing?

In very simple terms, transfer pricing refers to the amounts payable by one party (a Purchaser) in exchange for goods, services, financial products, the assumption of risk, or any other property provided by another party (a Seller).

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From a tax perspective, the price paid for property or services can be of great importance. A Purchaser is often permitted to claim a deduction when computing its income for tax purposes equal to at least a portion of the amounts it pays to acquire property or services that is used in the course of carrying on its business. Conversely, the Seller is generally required to include such amounts in its income for tax purposes.

When a transaction is undertaken by parties that do not deal with one another at arm’s length, a natural incentive may arise to price the transaction in a manner that artificially increases or decreases the price payable. For instance, if a Seller is subject to high income tax rates, or a Purchaser will derive limited benefit from being able to claim a tax deduction in respect of the amount paid for property or services, the parties may collectively seek to minimize the transfer price. By contrast, where a Seller is not subject to a high rate of tax, or a Purchaser is subject to income tax at relatively high rates, the parties may collectively seek to maximize the transfer price.

As a means of counteracting such natural incentives, the Tax Act contains rules (commonly referred to as the transfer pricing rules) that seek to eliminate the tax advantages that might otherwise be enjoyed by multi-national enterprises that adopt intra-group pricing strategies that seek to shift Canadian income to lower tax jurisdictions or artificially increase the deductions that may be claimed by Canadian-resident taxpayers.

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Transfer Pricing and the Arm’s Length Principle

The Canadian transfer pricing rules generally apply to transactions between parties that do not deal with each other at arm’s length.

The Tax Act provides that it is generally a question of fact whether persons not related to each other are, at a particular time, dealing with each other at arm’s length. The CRA has stated that parties to a particular transaction should generally be considered not to be dealing with each other at arm’s length when any of the following circumstances are present:

- There is a common mind which directs the bargaining for both parties to the transaction.
- The parties to the transaction act in concert without separate interests.
- One party enjoys de facto control over the other party.

The Tax Act further provides that related persons are deemed not to deal with each other at arm’s length. Related persons are defined to include:

- Corporations under common control.
- Two corporations where one corporation controls the other.
- Individuals connected by "blood relationship", marriage or common-law partnership, or adoption.

The Tax Act contains other interpretive rules that further guide the determination of arm’s length status under particular circumstances. Details on the CRA’s approach to defining arm’s length relationships may be found in CRA Folio S1-F5-C1 “Related persons and dealing at arm’s length”.

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Example of Transfer Pricing in Practice

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Facts

Canco is a corporation that is resident in Canada. The shares of Canco are wholly owned by Parentco, which is a corporation resident in the Bahamas for tax purposes.

Canco produces hockey sticks that it supplies to unrelated parties, as well as to companies with which it does not deal at "arm's length".

It costs Canco $2 to manufacture a hockey stick. Canco is willing to supply hockey sticks to wholesalers with which it deals at arm's length at a price of $3 per stick.

One of the companies to which Canco supplies hockey sticks is Foreignco. Foreignco is a wholesale distributor of hockey equipment and is resident in the Bahamas for tax purposes. Canco supplies 10,000 hockey sticks to Foreignco each year.

The shares of Foreignco are wholly owned by Parentco. Therefore, Canco and Foreignco are deemed not to deal with each other at arm's length under the Tax Act.

Under the applicable tax rules in Canada and the Bahamas, Canco's income is subject to income tax at a rate of 25%, while Foreignco and Parentco are not subject to any tax on their income.

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Analysis

If Canco were to charge Foreignco the same price for a hockey stick that it charges to customers with which it deals at arm's length, Canco would earn taxable income of $10,000 each year in respect of such sales (($3 - $2) x 10,000).

However, if Canco were to instead only charge $2 for each hockey stick that it supplies to Foreignco, Canco would not earn any taxable income from those sales (($2 - $2) x 10,000). Since Foreignco is not subject to income tax, the fact that it would have reduced costs and, therefore, earn higher income on its subsequent sales of hockey sticks to retailers will be of no consequence to Foreignco.

In the absence of any form of transfer pricing regulation, Parentco and its subsidiaries would collectively be better off if they were to adopt this intercompany pricing strategy, as the group's cumulative after-tax income would increase by $2,500 ($3 [arm's length sale price] - $2 [cost of producing a hockey stick]) x 10,000 [volume of hockey sticks sold to Foreignco] x 25% [Canadian tax rate]).

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Impact of the OECD Guidelines and Commentary

The Canadian government views the principles and protocols released by the Organisation for Economic Co-operation and Development (OECD) as instructive guidance to the administration of its transfer pricing rules. In particular,

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the assessing practices of the CRA in respect of transfer pricing are materially influenced by the OECD, "Transfer Pricing Guidelines for Multi-National Enterprises and Tax Administrations" (OECD Guidelines). In July 2017, the OECD released updated transfer pricing guidelines (OECD, "Transfer Pricing Guidelines 2017" (Revised OECD Guidelines)) which contained significant revisions to the previously existing OECD Guidelines. These revisions were the result of the OECD's work on the Base Erosion and Profit Shifting project. Notwithstanding the fact that the Revised OECD Guidelines contained significant changes to the OECD Guidelines, the Canadian government's view following the issuance of the Revised OECD Guidelines was that the "clarifications" contained in the Revised OECD Guidelines "generally support the CRA's current interpretation and application of the arm's length principle, as reflected in its audit and assessing practices" and that the "revisions are thus being applied by the CRA as they are consistent with current practices". The CRA generally expressed comparable views concerning many forms of guidance issued since the publication of the Revised OECD Guidelines, namely guidance on profit splits, hard-to-value intangibles and attribution of profits to permanent establishments.

The transfer pricing-related resources produced by the OECD, including the OECD Guidelines, can be accessed on the OECD website.

The Canadian Transfer Pricing Regime

The main statutory elements of Canada's cross-border transfer pricing regime are contained in section 247 of the Tax Act. For a discussion of the Canadian domestic transfer pricing rules, see Domestic Transfer Pricing Considerations.

Transfer Pricing Adjustments

The key provision of the Canadian transfer pricing rules is subsection 247(2) of the Tax Act. Subsection 247(2) applies to transactions between a taxpayer (Canadian taxpayer) and a non-resident person that does not deal at arm's length with the Canadian taxpayer (related non-resident) if either:

- The terms and conditions of the relevant transactions differ from those that persons dealing at arm's length would have agreed to.
- The transactions would not have been entered into by persons dealing with each other at arm's length and can reasonably be considered not to have been entered into primarily for a bona fide purpose other than to obtain a tax benefit.

If section 247(2) applies to a transaction, the CRA can generally make adjustments (transfer price adjustments) in respect of the transaction in computing the tax payable by the Canadian taxpayer to reflect the quantum or nature of the amounts that would have been determined for the purposes of the Tax Act had the terms and conditions of the transaction, or the transaction itself, been consistent with the terms and conditions, or type of transaction, that would have been acceptable to arm's length parties. For more details on the methodologies that are used to determine "arm's length" terms and conditions, see Transfer Pricing Methodologies.

In *Canada v. Cameco Corporation, 2020 CarswellNat 2291 (F.C.A.), leave to appeal refused 2021 CarswellNat 377 (S.C.C.)*, the Federal Court of Appeal confirmed that a transaction can only be recharacterized where no arm's length parties would have entered into the transaction or series of transactions in question under any terms or conditions. In response to this decision, the Canadian federal government announced in Budget 2021 its intention to engage in a consultation process to review Canada's transfer pricing rules and identify potential improvements.

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A transfer price adjustment could have significant income tax implications for a Canadian taxpayer including:

- Increasing an amount included in the revenue of the Canadian taxpayer (increasing its taxable income).
- Reducing an amount deductible by the Canadian taxpayer (also increasing its taxable income).
- Increasing the proceeds of disposition for property sold or otherwise disposed of by the Canadian taxpayer (potentially giving rise to an increased taxable gain or recapture of tax depreciation, referred to as "capital cost allowances" (CCA)).
- Reducing the cost of property acquired by the Canadian taxpayer (potentially reducing the amount of CCA than can be claimed in respect of the property or reducing the cost amount of the property).
- Resulting in the recharacterization of an amount payable to or by the Canadian taxpayer, with corresponding tax results.

Recently, new section 247(2.1) of the Tax Act was enacted to establish an ordering rule that will generally require transfer pricing adjustments to be applied prior to applying other computational provisions of the Tax Act.

Any increase in tax liability arising from a transfer price adjustment will typically give rise to liabilities for interest on the unpaid amount of any additional tax. A transfer price adjustment may also expose the Canadian taxpayer to potential penalties. See Transfer Pricing Penalties.

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Transfer Pricing Penalties

To promote greater compliance with the Canadian transfer pricing rules, subsection 247(3) of the Tax Act imposes a penalty on Canadian taxpayers that are subject to significant transfer price adjustments (TP penalty).

In simplified terms, the TP penalty that may be assessed in a particular instance is generally equal to 10% of the following:

- The relevant transfer price adjustments, minus
- The total of all transfer price adjustments (including negative adjustments) which relate to transactions for which the Canadian taxpayer made reasonable efforts to determine and use arm's length prices (the Net Adjustment).

However, the transfer pricing rules contain a minimum application threshold that provides that a Canadian taxpayer is generally only potentially subject to a TP penalty if the Net Adjustment is greater than the lesser of:

- $5,000,000.
- 10% of the Canadian taxpayer's prescribed gross revenue for the year.

The effect of the TP penalty regime is that a transfer pricing penalty may be imposed if:

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- A transfer price adjustment is significant in either absolute terms (that is, the Net Adjustment is greater than $5,000,000) or in relative terms (that is, the Net Adjustment is greater than 10% of the Canadian taxpayer' s gross revenue).
- The Canadian taxpayer has not made reasonable efforts to determine and use arm' s length prices in transactions with a non-arm's length non-resident.

In determining whether a Canadian taxpayer has made reasonable efforts to determine and use arm' s length prices, the CRA will consider whether the taxpayer took all reasonable steps to ensure that its transfer prices conform with the arm's length principle. A determination of what is reasonable is generally based on what a reasonable business person in the Canadian taxpayer' s circumstances would do having regard to its particular circumstances, the significance of the relevant transaction and the complexity of the relevant transfer pricing issues.

However, a Canadian taxpayer will, despite its actual efforts, be deemed not to have made reasonable efforts to determine and use arm' s length transfer prices if it has not obtained and maintained "contemporaneous documentation". See Contemporaneous Documentation.

For more information on the CRA' s policies with respect to reasonable efforts, see CRA Transfer Pricing Memorandum TPM-09 "Reasonable efforts under section 247 of the Income Tax Act".

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Contemporaneous Documentation

Subsection 247(4) of the Tax Act deems a Canadian taxpayer not to have made reasonable efforts to determine and use arm's length transfer prices in respect of a transaction unless it has made or obtained contemporaneous documentation on or before the documentation-due date for the taxation year in which the relevant transaction occurred. The "documentation-due date" is typically the date on which the Canadian taxpayer is required to file its income tax return, or, in the case of a partnership, its partnership information return.

Contemporaneous documentation is required to be updated, as needed, in subsequent taxation years to reflect material changes that may affect the terms and conditions of the relevant transaction.

Proper contemporaneous documentation must contain an accurate description of each of the following:

- Property or services to which the relevant transaction relates.
- Terms and conditions of the transaction and their relationship (if any) to the terms and conditions of other transactions between the relevant parties.
- Identity of the parties to the transaction and their relationship to each other at the time the transaction was entered into.
- Functions performed, the property used or contributed, and the risks assumed by the parties in respect of the transaction.
- Data and methods considered and the analysis performed to determine the appropriate transfer price (Data and Analysis).
- Assumptions, strategies and policies, if any, that influenced the determination of the appropriate transfer price (Assumptions and Policies).

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As a step in preparing acceptable contemporaneous documentation, transactions between a Canadian taxpayer and a non-arm's length non-resident should be documented with an appropriate intercompany agreement. However, the Data and Analysis and the Assumptions and Policies on which the terms and conditions of a particular transaction were based, and which are required to support a conclusion that they are arm's length terms and conditions, typically go beyond what would be contained in an intercompany agreement and should be separately documented.

The CRA generally expects that contemporaneous documentation will show:

- The general organization and description of the relevant business of the Canadian taxpayer.
- The selection of a particular transfer pricing methodology and, where appropriate, an explanation as to why a particular methodology was chosen over a more highly ranked methodology. For more information on transfer pricing methodologies, see Transfer Pricing Methodologies.
- Especially with respect to transfers of intangible property, a projection of the expected benefits of acquiring the property.
- The scope of the search and criteria used to identify comparable transactions.
- An analysis of the factors considered in assessing the comparability of benchmark transactions.
- The assumptions, strategies and policies of the parties as they relate to the goods and services being purchased or sold.
- A description of any business strategies associated with the particular terms and conditions of a given transaction (for example, where a supplier may make initial sales at a lower price to encourage increased future sales), and a projection of the expected future benefits of these strategies, where appropriate.

Because of the potential scope of what constitutes an acceptable package of contemporaneous documentation, a Canadian taxpayer will need to make a conscious effort to assemble the information and documentation, and may need to seek expert advice in order to meet the conditions set out in the Tax Act. Care should be taken in preparing (and, as appropriate, updating) contemporaneous documentation, as both the CRA and the courts are becoming increasingly strict in determining what constitutes acceptable contemporaneous documentation for the purposes of avoiding a transfer pricing penalty (see Box, The Marzen and Agracity Decisions).

When requested in writing by the CRA, a Canadian taxpayer must provide its contemporaneous documentation for the relevant taxation years within three months of receiving the request. No extensions are provided.

If the Canadian taxpayer fails to provide its contemporaneous documentation within this period, it will be deemed not to have made reasonable efforts to determine and use arm's length transfer prices for the purposes of the TP penalty in respect of the taxation years under review.

For more information on the CRA's policies with respect to requests for contemporaneous documentation, see CRA Transfer Pricing Memorandum TPM-05R "Requests for Contemporaneous Documentation".

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The Marzen and Agracity Decisions

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Marzen Artistic Aluminum Ltd v. R., 2014 CarswellNat 1919 (T.C.C. [General Procedure]) (Marzen) illustrates the importance of assembling and maintaining sufficient contemporaneous documentation. In simple terms, the case involved what appeared to be an attempt by a Canadian corporation to shift income from Canada to its Barbadian subsidiary. The CRA (successfully) reassessed the taxpayer to impose a transfer price adjustment and levied a TP penalty of approximately $500,000 on the basis that the taxpayer had failed to prepare (and provide) contemporaneous documentation.

At trial, the taxpayer argued that it had provided sufficient contemporaneous documentation in the form of:

- Relevant intercompany agreements.
- Certain correspondence between the parties relating to elements of the transaction.
- A business study prepared by one of the promoters of the business structure.

However, the court rejected the taxpayer's arguments, noting that the taxpayer failed to provide records or documentation that fulfil the requirements of paragraph 247(4)(a) of the Tax Act and specifically that the documents and records submitted by the taxpayer are "not sufficient to satisfy [subparagraphs 247(4)(a)(v) and (vi)]" (namely the Data and Analysis and Assumptions and Policies supporting the terms and conditions of the impugned transactions). The court upheld the CRA's position that the taxpayer was subject to a TP penalty (although due to the transfer-pricing adjustment being reduced to below $5 million, no penalty was actually payable by the taxpayer). The *Marzen* decision was upheld at the Federal Court of Appeal (see *Marzen Artistic Aluminum Ltd. v. R., 2016 CarswellNat 150 (F.C.A.)*).

In *Agracity Ltd. v. The Queen, 2020 CarswellNat 3418 (T.C.C. [General Procedure])* (Agracity), the taxpayer was reassessed pursuant to section 247(2) of the Tax Act and was assessed transfer pricing penalties under section 247(3). The taxpayer had entered into a services agreement with a non-arm's length Barbados corporation (Barbados Co). Barbados Co had an exclusive supply agreement with a herbicide manufacturer. Under a services agreement between the taxpayer and Barbados Co, the taxpayer agreed to sell the herbicide to Canadian consumers and was responsible for invoicing Canadian consumers as well as logistics relating to the importation and delivery of the product. Agracity was paid a fee per litre of herbicide sold, which amounted to approximately $2 million during the years in question.

The Minister of National Revenue (the Minister)'s primary position was that the transactions between the taxpayer and Barbados Co were a sham. In the alternative, the Minister argued that the transaction should be recharacterized pursuant to subparagraphs 247(2)(b) and (d) of the Tax Act or that the agreement should be repriced pursuant to subparagraphs 247(2)(a) and (c).

The Tax Court dismissed the argument that the transaction was a sham. The Minister was also unsuccessful in arguing that paragraphs 247(2)(b) and 247(2)(d) of the Tax Act were applicable as the Court did not accept the Minister's position that the transaction was not one which arm's length parties would enter into. The Minister was also unsuccessful in arguing paragraphs 247(2)(a) and 247(2)(c) applied as the Minister did not lead evidence to show that the fees paid to the taxpayer were outside of the range which arm's length parties would have agreed to.

The Court found that the transfer pricing penalties were inapplicable based on the Court's conclusion that section 247(2) did not apply. However, at the outset, the taxpayer conceded that it was unable

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to raise a due diligence defense as it had failed to satisfy the contemporaneous documentation requirements. Had the Minister been successful in arguing section 247(2) applied, the transfer pricing penalties assessed would likely have been upheld. The *Agracity* decision is currently on appeal to the Federal Court of Appeal.

Canadian Part XIII Withholding Tax Implications of a Transfer Price Adjustment

Where a Canadian taxpayer that is a corporation enters into a transaction with a shareholder that is a non-arm's length non-resident, and the transaction is subject to a transfer price adjustment, the non-arm's length non-resident may be deemed to have received a dividend from the Canadian taxpayer in an amount equal to the adverse transfer price adjustment (that is, an amount equal to the benefit conferred by the Canadian taxpayer on the non-arm's length non-resident) (a TP Deemed Dividend).

For example, where a Canadian taxpayer purchases goods from a non-arm's length non-resident shareholder at a price that exceeds the fair market value of such goods, a dividend may be deemed to have been paid by the Canadian taxpayer to the non-arm's length non-resident in an amount equal to the difference between the amount paid for the goods and their fair market value.

The Tax Act provides that the amount of a TP Deemed Dividend may be reduced, with the concurrence of the Minister of National Revenue, to the extent that amounts in respect of the benefit conferred on the non-arm's length non-resident are repaid by the non-arm's length non-resident to the Canadian taxpayer.

Any TP Deemed Dividend will be subject to withholding tax levied under Part XIII of the Tax Act at a rate of 25% (although the rate may be subject to reduction under an applicable tax treaty).

Although Part XIII withholding tax is a tax that is formally imposed on the non-arm's length non-resident, the Canadian taxpayer is required to withhold and remit the Part XIII tax in respect of any TP Deemed Dividend, and is jointly and severally liable for any unremitted Part XIII tax.

In addition to the potential liability for Part XIII withholding tax, both the non-arm's length non-resident and the Canadian taxpayer are potentially liable for interest in respect of any unremitted Part XIII tax. The directors of the Canadian taxpayer may also potentially be held liable for any failure of the Canadian taxpayer to remit appropriate Part XIII withholding tax (together with related interest payable by the Canadian taxpayer).

Voluntary Disclosure

Canada's Voluntary Disclosures Program (VDP) is one process through which the CRA administers the Minister of National Revenue's discretion to grant relief from interest and penalties arising from non-compliance with the Tax Act. As of March 1, 2018, voluntary disclosure applications relating to transfer pricing adjustments or transfer pricing penalties are now required to be referred to the CRA's Transfer Pricing Review Committee. One of the stated reasons for this change in administrative policy is the complexity of transfer pricing issues inherent to such applications. However, it still remains to be determined how extensive the availability of relief for taxpayers with VDP applications relating to transfer pricing adjustments or transfer pricing penalties will be under the new

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administrative policies. Finally, VDP applications relating to advance pricing arrangements are not eligible for relief under the VDP.

Advance Pricing Arrangements

The CRA has an Advance Pricing Arrangement (APA) program to help taxpayers determine appropriate transfer pricing methods for transactions or arrangements they have with non-arm's length non-resident persons. The APA program provides a cooperative process for resolving transfer pricing issues prospectively. There is no legal requirement to enter into an APA; the CRA provides this as an administrative service. The main objective of the program is to provide increased certainty regarding future transfer pricing issues in a manner consistent with the Tax Act and guidance delivered through the CRA's information circulars and by the OECD.

Dispute Resolution

The normal dispute resolution provisions of the Tax Act apply if the CRA assesses or reassesses a taxpayer to reflect an adjustment made pursuant to subsection 247(2) of the Tax Act. Section 165 of the Tax Act provides that a taxpayer may object to a (re)assessment by serving on the Minister of National Revenue (Minister) a notice of objection within the applicable time limitations set out in paragraphs 165(1)(a) and (b) of the Tax Act. Generally, a notice of objection must be served on the Minister, in the manner set out in subsection 165(2) of the Tax Act, on or before the day that is 90 days after the day of sending of the notice of (re)assessment being objected to. If the 90 day deadline is missed, a one year extension may be available pursuant to sections 166.1 or 166.2 of the Tax Act. Once a notice of objection is served on the Minister, subsection 165(3) of the Tax Act provides that the Minister shall, with all due dispatch, reconsider the (re)assessment and vacate, confirm or vary it. Large corporations, as defined in subsection 225.1(8) of the Tax Act, should be mindful of the requirements applicable to notices of objection for large corporations set out in subsection 165(1.11) of the Tax Act.

Competent Authority

Since transfer prices necessarily involve more than one tax jurisdiction, if there is disagreement between the relevant tax authorities as to what is an acceptable transfer price in the circumstances, a reassessment by a tax authority of the transfer price of a taxpayer would likely result in a situation of double taxation. However, where the other tax jurisdiction involved is a country with which Canada has entered into a tax treaty, the taxpayer may be entitled to use the mutual agreement procedure (MAP) generally provided for in such treaties.

The MAP is a mechanism involving essentially government-to-government negotiations that is often used to resolve issues of double taxation. When a taxpayer is faced with a situation of double taxation, the taxpayer may formally request the assistance of the relevant competent authorities in accordance with the applicable double taxation treaty. The competent authorities of each jurisdiction will, if all other requirements are met, work together to attempt to resolve the double taxation situation by agreeing on which jurisdiction will be entitled to tax what share of the income of the multinational enterprise of which the taxpayer is a member. The relevant income tax treaty may also impose specific time limitations for seeking relief under the competent authority procedures in order to avoid double taxation. After a taxpayer's request is submitted, the Canadian competent authority will issue an acknowledgement letter to the taxpayer. The request is then reviewed to determine whether it is justified under the applicable income tax treaty. If the request is rejected, the Canadian competent authority will advise the taxpayer and the other competent authority in writing, citing reasons. The file is then referred back to the tax services office (TSO) where the taxpayer may pursue other domestic recourses, if available. If the request is accepted, the

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Canadian competent authority will issue a letter to the taxpayer and the other jurisdiction's competent authority of its agreement to pursue the case.

Certain treaties provide for binding arbitration where the competent authorities are unable to reach an agreement. The Canadian competent authority will be bound by the procedures and timelines for arbitration contained in the relevant treaty should arbitration be invoked.

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Transfer Pricing Methodologies

As discussed under Transfer Pricing and the Arm's Length Principle, the Canadian transfer pricing rules are founded on the arm's length principle: when parties that do not deal with each other at arm's length enter into a transaction, the terms and conditions of the transaction should be consistent with those that would have been acceptable to parties acting at arm's length.

While seemingly straightforward in concept, the determination of an "arm's length price" in the context of a related-party transaction can be an extremely complicated undertaking. Frequently, there are no concrete external benchmarks that transacting parties can cite to support the arm's length character of a chosen transfer price.

Both the CRA and the OECD have stated that the application of the arm's length principle generally requires that the transfer prices adopted by parties that do not deal with each other at arm's length should be consistent with the prices, or margins, used or obtained by arm's length parties engaged in similar transactions. Various transfer pricing methodologies have been developed to determine transfer prices that are consistent with the arm's length principle.

The CRA has endorsed the potential use of five different transfer pricing methodologies (all of which are described in greater detail in the OECD Guidelines) that taxpayers may apply to determine appropriate arm's length prices in the context of a non-arm's length transaction.

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Traditional Transaction Methods

The first set of transfer pricing methodologies endorsed by the CRA, commonly referred to as "traditional transaction methods", consist of the following:

- Comparable uncontrolled price (CUP) methodology. The CUP methodology seeks to determine arm's length transfer prices by basing the price of the product or service that is the subject of the non-arm's length transaction on the prices charged by arm's length parties that have entered into transactions involving:
    - comparable products or services;
    - provided in similar quantities, under similar terms, and in similar markets.

  The CUP methodology is especially effective and easy to apply when one of the parties to the non-arm's length transaction has also entered into comparable transactions with arm's length parties.
- Resale price methodology. The resale price methodology is frequently utilized in a distributorship context and seeks to determine arm's length transfer prices based on the price at which the party that acquired property in the non-arm's length transaction subsequently resells such property to an arm's length party

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(outside sale price). To determine the appropriate transfer price of the property between the non-arm's length parties, the outside sale price is reduced by a reasonable gross margin to:

- account for the reselling party's operating costs; and
- allow for the earning of an arm's length profit.

The resale price methodology is most effective when the reselling party adds little or no value to the products.

- Cost plus methodology. The cost plus methodology seeks to determine arm's length transfer prices by taking the cost of producing a particular product or service and adding a reasonable gross mark-up. The applicable mark-up is generally based on the mark-up that is earned in comparable uncontrolled transactions by persons performing similar functions and preferably selling similar products or services to arm's length persons. In determining the cost of a product or service under the cost plus methodology, direct and indirect costs of production, but not operating expenses, are typically taken into account.

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Transactional Profit Methods

The second set of transfer pricing methodologies endorsed by the CRA, commonly referred to as "transactional profit methods", consist of the following:

- Profit split methodology. The profit split methodology represents an alternative means of determining arm's length transfer prices if the relevant non-arm's length parties have intertwined operations and the products involved are unique (for example, certain intangibles) so that it is impossible to identify proper arm's length comparables in the broader marketplace. The profit split methodology is typically applied by:
  - ascertaining the total profit earned by the non-arm's length parties in respect of a specific transaction; and
  - dividing the profit between the parties on the basis of the relative value of each party's contribution to the non-arm's length transaction.

- Transactional net margin methodology (TNMM). Under TNMM, arm's length prices are determined by comparing the net profit margin of a party to the non-arm's length transaction to the net profit margins earned by arm's length parties in the context of comparable transactions, relative to an appropriate base such as costs, sales or assets. As a one-sided transfer pricing methodology, the TNMM is generally applied in respect of the least complex party to a transaction (being a party that, among other things, does not contribute to the generation of valuable or unique intangible assets). Unlike the cost plus and resale price methodologies, the TNMM compares parties based on net, rather than gross, profit margins.

In considering the application of a transfer pricing methodology, reference should be made to the current administrative positions of the CRA (see the CRA website). Information Circular 87-2R "International Transfer Pricing", which had historically represented the CRA's views on transfer pricing, was cancelled by the CRA effective December 30, 2019 as aspects of the circular no longer necessarily reflected the CRA's current views. While the CRA has expressly commented that the circular's description of the recharacterization provisions being

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a tool of last resort no longer reflects their views, other views expressed by the CRA in the circular may continue to reflect the CRA's interpretive positions.

Selecting a Transfer Pricing Methodology

Canadian courts have held that the arm's length price used in a particular transaction must be determined according to the relevant provisions of the Tax Act rather than any particular methodology or commentary set out in the OECD Guidelines.

The OECD Guidelines require taxpayers to select the most appropriate transfer pricing method for a particular case. The CRA has endorsed this position, stating that:

- The methodology selected should be the one that will provide the most direct view of arm's length behaviour and pricing.
- What is relevant is the degree of comparability available under each of the methods and the availability and reliability of the data.

However, the CRA also suggests that there remains a natural hierarchy of transfer pricing methodologies.

The CRA generally prefers the traditional transaction methodologies to the transactional profit methodologies, which it has suggested are to be used as a last resort when the traditional transaction methods cannot be applied reliably. The CUP methodology is the CRA's most preferred method for determining arm's length transfer prices.

The CRA has stated that, for a taxpayer to justify the efforts it made to determine an arm's length price, the taxpayer should consider applying the Transfer Pricing Methodologies and explain how it chose the particular method it applied. In determining whether a taxpayer reasonably chose a particular transfer pricing method, the CRA will consider whether the taxpayer undertook a search to locate appropriate data in respect of comparables that was reasonable in the circumstances.

Unique Situations

If, in a particular situation, a taxpayer is unable to establish sufficient comparability to reliably apply any of the Transfer Pricing Methodologies, the CRA has acknowledged that other methodologies may be considered. However, the CRA has warned that any alternative transfer pricing methodology should be carefully calibrated to ensure that, when applied, it generates results that reflect the arm's length principle.

Domestic Transfer Pricing Considerations

Special statutory provisions, under both the Tax Act and the *Excise Tax Act*, R.S.C. 1985, c. E-15 (HST Act) (which governs the goods and services (GST) and harmonized sales tax (HST) regime), also apply to transactions between Canadian resident taxpayers that do not deal with one another at arm's length.

Domestic Transfer Pricing Provisions Contained in the Tax Act

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Although the Tax Act does not contain a complete set of domestic transfer pricing rules, certain provisions of the Tax Act can apply to adjust the tax results of domestic transactions executed between non-arm's length parties.

For example, section 69 of the Tax Act has several provisions that apply to non-arm's length transactions to deem these transactions to have occurred (at least for some purposes) at fair market value. In particular, a taxpayer that disposes of property to a non-arm's length person for no proceeds, or for proceeds that are less than the fair market value of the property, is deemed to have disposed of the property for an amount equal to its fair market value. Similarly, a taxpayer that acquires property from a non-arm's length person for proceeds that are greater than the fair market value of the property is deemed to have acquired the property for an amount equal only to its fair market value.

The adjustments required by section 69 of the Tax Act are not reciprocal and, therefore, may potentially give rise to double taxation. For instance, while section 69 may deem a Seller to have disposed of property for an amount equal to its fair market value, it does not provide a corresponding step-up in the cost amount of the property to the non-arm's length Purchaser. Similarly, while section 69 may deem a Purchaser to acquire property at an amount only equal to its fair market value, it does not reduce the value of the consideration actually received by the non-arm's length Seller for such property.

For this reason, even in the context of domestic transactions, it is important that non-arm's length transactions be effected at arm's length prices.

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Domestic Transfer Pricing Provisions Contained in the HST Act

The HST Act includes a transfer pricing rule to prevent parties from using non-arm's length prices to artificially reduce or avoid GST/HST liabilities in respect of taxable supplies of goods and services.

Generally, under the HST Act, a person engaged in a commercial activity (which includes sales of most goods and services, other than certain exempt supplies, such as financial services) that is registered for GST/HST purposes can claim an input tax credit (ITC) to recover any GST/HST it pays in respect of inputs used in the course of that commercial activity. As a result, that person has no incentive to avoid the imposition of GST/HST (since they can typically recover any GST/HST they pay).

However, where a person is not a GST/HST registrant, or is not using goods and services exclusively in the course of a commercial activity for which it can recover the GST/HST on inputs by claiming an ITC, it has an incentive to purchase those goods and services from non-arm's length suppliers at less than fair market value to reduce its liability for GST/HST.

To counteract such schemes, the HST Act contains an anti-avoidance rule that generally applies to non-arm's length supplies of goods and services if the recipient is not acquiring the goods and services exclusively for use or supply in the course of a commercial activity. Where the anti-avoidance rule applies:

- Supplies of goods and services, which were otherwise made at an amount less than their fair market value, are deemed to have been made at fair market value.
- The supplier of the goods and services is required to collect and remit GST/HST to the CRA on the fair market value of those goods and services, regardless of what it actually received from the recipient.

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The supplier can be held liable for the unremitted GST/HST and related interest. Where a corporation fails to remit GST/HST that it was required to collect, its directors can also be held liable for such tax (as well as any related interest).

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Transfer Pricing Considerations in Negotiating and Drafting Commercial Agreements Between Parties Not Dealing at Arm’s Length

In drafting a commercial agreement, care must be taken to ensure that the transfer pricing risks that might otherwise be borne by a contracting party as a result of the agreement are properly mitigated. The Canadian transfer pricing-related risks that will be of greatest concern will often depend on whether the parties to the agreement deal with each other at arm’s length or not at arm’s length.

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Pricing Support

Parties that do not deal with each other at arm’s length are frequently presumed by the CRA not to have engaged in hard bargaining when negotiating the terms of their commercial agreements, as each party may be considered to have been acting under the guidance of a common mind. In these circumstances, the CRA will show little deference to the pricing reflected in the relevant agreement and may seek to challenge the operative pricing if it does not accord with what the CRA believes would have been mutually acceptable to contracting parties that dealt with each other at arm’s length.

To best mitigate the transfer pricing risks that may arise in the context of an agreement between non-arm’s length parties, the contracting parties must be able to establish that the consideration payable under the agreement is consistent with that which would have been acceptable to similarly situated parties that dealt with each other at arm’s length.

As a result, evidence should be gathered, contemporaneous with the negotiation and execution of the agreement, that substantiates the arm’s length character of the pricing reflected in the agreement. Evidence of the arm’s length character of a transfer price may include:

- Copies of comparable agreements executed with third parties.
- Past transfer pricing studies.
- Proposals previously made to arm's length third parties.
- Pricing guides.
- Industry or trade publications.
- Government economic studies.
- Annual reports and other securities filings of competitors.
- Analysts’ reports.

In documenting the basis for a chosen transfer price, the elements of the consideration payable under the agreement should be viewed broadly and should include:

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- Non-monetary consideration.
- Assumptions of risks.
- Limitations on recourse.
- Interest rates charged on overdue accounts (relative to market rates).
- Term and extension rights.
- Termination and default rights and obligations.

To the extent that there are any special commercial considerations that motivated a particular pricing strategy, internal records should be kept documenting such strategies, and the terms of the operative agreements should be consistent with the relevant organizational strategy.

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Price Adjustment Clauses

To guard against adverse transfer pricing reassessments, consideration should be given to including price adjustment clauses in commercial agreements between parties that do not deal at arm's length. Price adjustment clauses generally stipulate that the pricing under the agreement is intended to reflect an arm's length price and that it will automatically be adjusted to the extent that a revenue authority successfully asserts, or a court of law concludes, that the fair market value of the transferred property is a different amount.

Before including a price adjustment clause in an agreement, reference should be made to the prevailing policy of the CRA on price adjustment clauses, as currently reflected in CRA Folio S4-F3-C1 "Price Adjustment Clauses".

The CRA will generally respect the operation of a price adjustment clause in an agreement if it satisfies the following conditions:

- The agreement reflects a bona fide intention of the parties to transfer the subject property at fair market value.
- The parties sought to determine the fair market value of the transferred property by a fair and reasonable method.
- The parties agree that, if the fair market value of the transferred property determined by the CRA or a court of law differs from the pricing reflected in the agreement, the pricing determined by the CRA or the court will govern.
- Any excess or shortfall in price is actually refunded or paid, or any existing legal liability in relation to the price is adjusted.

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Term and Termination Provisions

Special consideration should be given to the term of any non-arm's length agreement and the circumstances under which either party may terminate the agreement. The term of, as well as the termination provisions in, an agreement between non-arm's length parties should be consistent with prevailing market practice. It is helpful if there is

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a rational connection between the term of the agreement and the initial fixed costs incurred by each party in discharging its obligations under the agreement.

Long-term agreements with fixed consideration provisions are generally more vulnerable to challenge by a revenue authority in the absence of clear, external pricing benchmarks.

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Transfer Pricing Considerations in Negotiating and Drafting Commercial Agreements Between Parties Dealing at Arm’s Length

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Typical Representations and Warranties

Important transfer pricing considerations can also arise in the context of business transacted between arm’s length parties. Most notably, when a business entity is being acquired, the Purchaser will wish to ensure that there are no historical transfer pricing deficiencies that may encumber the target entity and potentially become the subject of a future transfer pricing dispute.

In the context of a share acquisition, transfer pricing representations and warranties are generally included in the share purchase agreement. The vendor will generally provide several representations and warranties that confirm each of the following:

- All tax returns, including T106 Information Return of Non-Arm’s Length Transactions with Non-Residents (transfer pricing information returns), have been filed by the target corporation on a timely basis and are complete and accurate in all material respects.
- All taxes owing by the target corporation have been fully paid and remitted on a timely basis to the appropriate revenue authority.
- Contemporaneous documentation has been prepared by the target corporation, on a complete and timely basis, in a manner that complies with paragraphs 247(4)(a) and (b) of the Tax Act.
- The target corporation has not received notification that a revenue authority has commenced, or is about to commence, an audit, inquiry or other investigation, or has, or will, issue a reassessment of the target corporation in respect of taxes.
- No waiver of applicable limitation periods has been signed or is operative in respect of the target corporation.
- The target corporation is not aware that any party with which it does not deal at arm’s length is the subject of a transfer pricing audit or reassessment.

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Due Diligence Considerations

Before agreeing to purchase the shares of a target corporation, a prospective Purchaser should review a broad range of tax-related documents in the course of its due diligence program, including:

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- All income tax returns, including all transfer pricing information returns, for at least the past three taxation years.
- All correspondence received from revenue authorities.
- All internal memoranda and advice from any tax advisors of the target corporation relating to tax matters.
- All contemporaneous documentation assembled in support of the transfer prices adopted by the target corporation, including any external transfer pricing reports.
- All intercompany invoices, agreements, and correspondence relating to transactions with non-arm's length parties.
- All business plans and organizational charts showing the relationship between related parties to transactions to which the target corporation was a party.
- All functional risk analyses performed in respect of transactions to which the target corporation was a party.
- All financial analyses performed in respect of transactions undertaken by the target corporation with non-arm's length parties.
- Foreign tax filings of each counterparty to a transaction with which the target corporation does not deal at arm's length.
- Financial statements of the target corporation for at least the past three fiscal periods.

When acting for a Seller, consideration should be given to the general tax orientation of the Purchaser, particularly where the Seller will be responsible for pre-closing period tax reassessments. Under these circumstances, consideration might be given to the inclusion of special governance provisions that will regulate the pricing of post-closing intercompany transactions undertaken by the target entity.

It may also be prudent, in certain circumstances, to insert select representations and warranties in an asset purchase agreement comparable to those found in a typical share purchase agreement. While the Purchaser may not be liable for any historical transfer pricing liabilities of the Seller in an asset purchase transaction, transfer pricing reassessments of the Seller in respect of past taxation years may prompt increased revenue authority scrutiny of the continuing operation of the acquired business now being conducted by the Purchaser.

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The International Tax Community and Transfer Pricing

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The Multilateral Instrument

Canada and 93 other jurisdictions are current signatories of the OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), the purpose of which is to implement a number of international tax measures recommended by the OECD in the course of its project on reducing base erosion and profit shifting (BEPS) by amending thousands of bilateral tax treaties worldwide without the need for jurisdictions to renegotiate any of their existing tax treaties on a bilateral basis.

From a transfer pricing perspective, the most relevant measures contained in the MLI are those dealing with the implementation of the minimum standard for resolving treaty-related disputes and the optional mandatory binding

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treaty arbitration provisions. With respect to the former, signatory jurisdictions must agree to fully implement a mutual agreement procedure requiring the competent authorities of each jurisdiction to attempt to resolve certain disputes within three years of notification to the competent authorities.

With respect to the mandatory binding arbitration provisions, the MLI provides for two different arbitration mechanisms:

- The default mechanism, which is a "final offer" mechanism, where if the competent authorities of two jurisdictions cannot come to an agreement within a specified period of time, each competent authority presents its own proposed resolutions and the arbitrators choose their preferred outcome between the two proposals that were submitted.
- An "independent opinion" mechanism, under which a decision is rendered by the arbitrators on the basis of their own analysis of the information provided to them.

Upon signing, Canada registered provisional reservations on most of the measures contained in the MLI, with various exceptions, including the above-noted measures related to mandatory binding treaty arbitration. On May 28, 2018, Canada introduced legislation in the House of Commons to implement the MLI, while the Department of Finance announced the intention to adopt further terms of the MLI upon ratification.

On June 21, 2019, Bill C-82, An Act to implement a multilateral convention to implement tax treaty related measures to prevent base erosion and profit shifting, received Royal Assent enacting the MLI into law in Canada. The Governor in Council authorized the Minister of Foreign Affairs to begin bringing the MLI into force on August 7, 2019.

Canada deposited its Instrument of Ratification of the MLI on August 29, 2019 and the MLI subsequently entered into force on December 1, 2019.

The provisions of the MLI which concern withholding taxes paid or credited to non-residents came into effect on January 1, 2020. The provisions respecting all other taxes came into effect on June 1, 2020. The provisions of the MLI in respect of a treaty between Canada and a foreign country will only be applicable to the extent that the foreign country has also ratified the MLI. (The status of the ratification of the MLI by a foreign country can be accessed through the MLI Matching Database.)

Country-by-Country Reporting

In the course of its BEPS project, the OECD proposed that the development of coherent international rules regarding transfer pricing documentation would enhance the administration of OECD members' domestic tax rules, while taking into consideration taxpayers' compliance costs. The aim of such rules, according to the OECD, would be to provide tax authorities with information as to taxpayers' global allocation of income, economic activity and taxes paid.

On October 5, 2015, the OECD released its final report on this topic, in which the OECD identified three main objectives that should be considered when designing appropriate transfer pricing documentation requirements for multinational enterprises (MNE), including: (i) ensuring that taxpayers consider transfer pricing requirements in creating their related-party pricing models, and (ii) providing tax authorities with sufficient information to conduct informed transfer pricing risk assessments and audits.

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In particular, Action 13 of the final report requires companies meeting certain thresholds to adopt the OECD recommended a three-tiered standardized approach to transfer pricing documentation, which has come to be referred to as "country-by-country" (CbC) reporting. The three tiers are:

- A master file.
- A local file.
- A CbC report.

The master file is intended to provide tax authorities with high-level information regarding the global business operations and transfer pricing policies of the MNE group. The local files, specific to each jurisdiction in which the MNE group has business operations, is generally intended to contain a detailed analysis of the transfer pricing determinations made in respect of each of the MNE's related-party transactions in the jurisdiction. Finally, the CbC report is intended to provide information relating to the global allocation of the MNE's income and taxes paid, along with a global breakdown of economic activity among the various tax jurisdictions in which the MNE group operates.

The obligations imposed under section 233.8 of the Tax Act do not include a requirement to produce a master file or a local file; rather, "ultimate parent entities" and certain "constituent entities" in an MNE Group that are resident in Canada are required to file only a prescribed form of CbC report (Form RC4649) with the CRA. This report requires, in respect of each jurisdiction in which the MNE group has operations, information with respect to:

- Revenues (including revenues from unrelated parties).
- Profit or loss before income tax.
- Income tax paid.
- Income tax accrued.
- Stated capital.
- Accumulated earnings.
- Number of employees.
- Value of tangible assets (other than cash or cash equivalents).

In addition, this report requires the identification of each entity within the MNE group carrying on a business in a particular jurisdiction and the nature of that entity's main business activity or activities.

The CRA considers the contemporaneous documentation requirements under the existing Canadian transfer pricing rules to be akin to the maintenance of a local file.

For Canadian purposes, an MNE group consists of two or more business entities, if they meet three conditions:

- The business entities are either required to prepare consolidated financial statements for financial reporting purposes under applicable accounting principles or would be so required if equity interests in any of the business entities were traded on a public securities exchange.
- One of the business entities is resident in a particular jurisdiction, and another business entity resides in a different jurisdiction, or is subject to tax in a different jurisdiction with respect to a business it

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carries on in that other jurisdiction through a permanent establishment, if a separate financial statement for the business is prepared for financial reporting, regulatory, tax reporting or internal management control purposes.

- The business entities are not members of an "excluded MNE group".

An "excluded MNE group" for Canadian purposes is a group that would otherwise meet the above conditions, but that has total consolidated group revenue of less than EUR750 million during the fiscal year immediately preceding the particular fiscal year. It is worth stressing that the "excluded MNE group" definition does not refer to the Canadian dollar equivalent of EUR750 million, but actually to EUR750 million.

The Tax Act imposes a penalty of $100 for each failure to provide information required to be included in a CbC report, and a penalty of $25 per day (subject to a $100 minimum and a $2,500 maximum) for each failure to:

- File a CbC report as and when required by the Tax Act.
- Comply with a duty or obligation imposed under the Tax Act or related regulations.

The Tax Act also imposes a penalty where a person or partnership, either knowingly or under circumstances amounting to gross negligence, fails to file a CbC report as and when required. The amount of this additional penalty is determined by reference to whether the CRA has issued a demand for such CbC report to be filed. Where no such demand has been issued, the penalty is equal to $500 per month (or any part thereof), during which the failure to file is continuing, beginning with the month in which the return was required to be filed, up to a maximum of 24 months. If a demand was issued by the CRA, and not complied with, the penalty is $1,000 per month (or any part thereof) beginning with the month in which the demand was served, up to a maximum of 24 months.

Finally, CbC reports filed with the CRA will generally be exchanged automatically with the other jurisdictions in which members of the MNE group have business operations, provided that:

- The other jurisdiction has implemented CbC reporting.
- A legal framework for automatic exchange of information is in place (such as the Multilateral Convention on Mutual Administrative Assistance in Tax Matters or a bilateral tax treaty).
- Canada has entered into a competent authority agreement related to CbC reporting with the particular jurisdiction.

Where the CRA cannot obtain a CbC report from the jurisdiction of the MNE group's ultimate parent entity, a constituent entity of the MNE group may be required to file a CbC report in Canada.

In Budget 2019, the Canadian federal government confirmed that Canada would participate in the review by the OECD of the CbC reports to ensure that they provide tax administrators with the information necessary to allow for proper assessment of transfer pricing and other BEPS risks. The OECD published its final report on October 17, 2020. The report found that Canada's implementation of BEPS Action 13 minimum standard met all of the applicable terms of reference.

END OF DOCUMENT

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