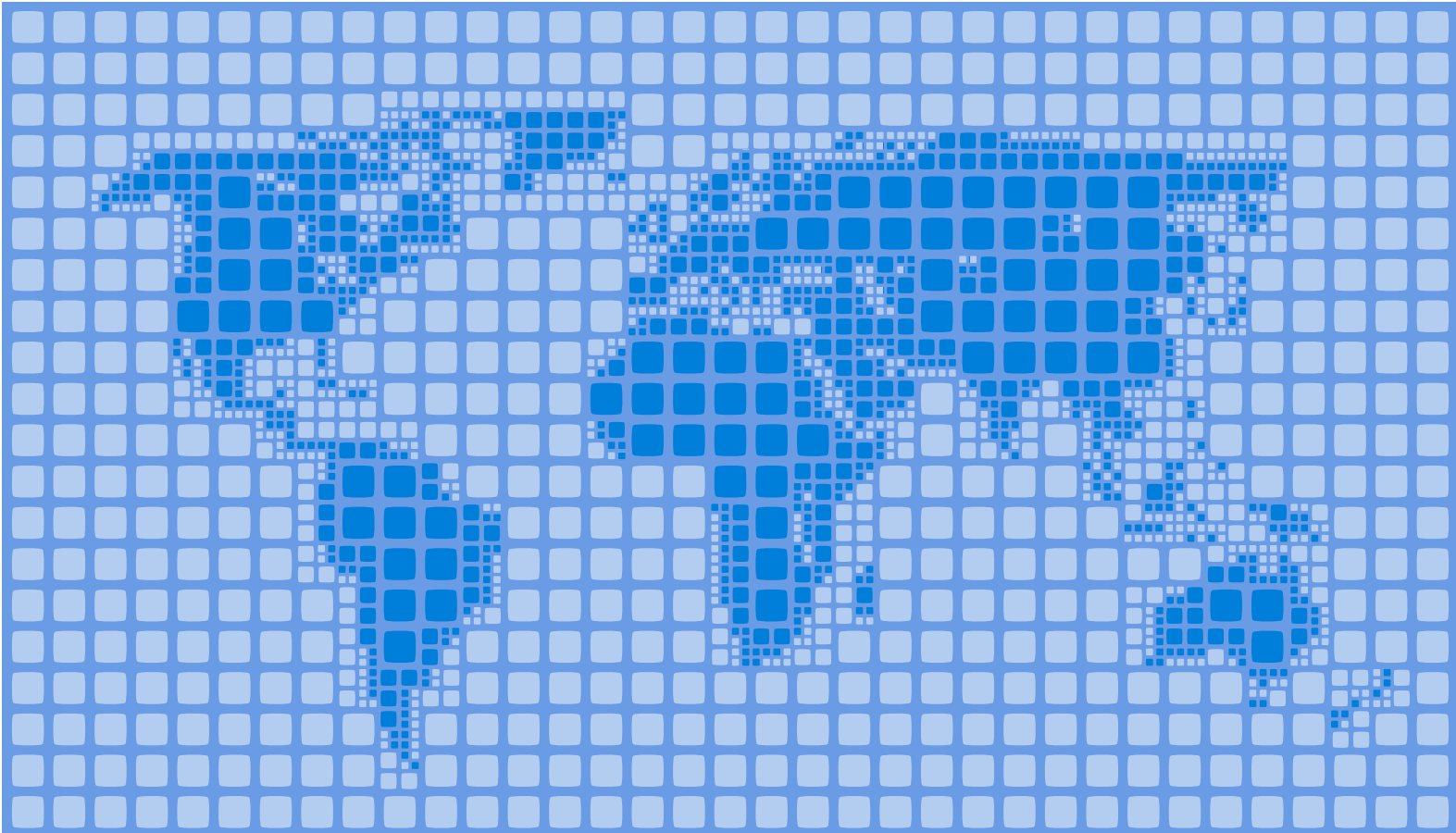


The Administration of Canada's Transfer Pricing Rules: Issues and Recommendations

*Report by the Transfer Pricing Subcommittee
Prepared for the Advisory Panel on Canada's System
of International Taxation*

August 2008



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1. Introduction

1.1 Mandate of the Subcommittee

The mandate of the Subcommittee is to identify and comment on issues commonly arising under the administration of the current transfer pricing provisions of the Income Tax Act (ITA). The Subcommittee recognizes that its comments are not comprehensive. They are targeted at what the Subcommittee believes are among the most significant issues in this area, which if addressed would enhance the application and administration of transfer pricing in Canada in step, nevertheless, with how it is understood the transfer pricing rules of other countries are applied in the broader context of international understandings reflected in the Transfer Pricing Guidelines of the Organisation for Economic Co-operation and Development (OECD). The focus is on the process and administration of transfer pricing rules and not their substantive aspects under the ITA or more generally in relation to the application of international transfer pricing standards or the provisions of Canada's tax treaties. The Subcommittee is to make recommendations on how to improve process and administration, with a particular emphasis on crafting solutions to current issues, that will help both taxpayers and the Canada Revenue Agency (CRA).

1.2 Scope of the report

This report identifies current issues arising from the administration of the transfer pricing rules in section 247 and related provisions of the ITA. It does not address whether the arm's length principle that underlies section 247 is theoretically sound or whether it should be replaced by other principles or approaches. The Subcommittee recognizes the inherent difficulties with the implementation of the arm's length principle domestically and across borders. Its recommendations are intended to be practical and of the sort that can be implemented exclusively through revisions to the ITA, the adoption of guidelines by the CRA, or changes to the CRA's prevailing administrative policies and procedures and related guidelines. None of the recommendations is meant to, or in the Subcommittee's view would, put Canada out of step with the international transfer pricing practices or norms.

This report is not an in-depth study of the issue of transfer pricing or an independent review of the transfer pricing system in Canada. The Subcommittee is grateful for the willingness of officials of the CRA and the Department of Finance to discuss with the Subcommittee issues that arose in the course of the Subcommittee's deliberations and to review and comment on earlier drafts of this report. However, the views expressed in this report are solely those of the members of the Subcommittee.

1.3 Technical context

This brief overview aims at providing a general background for the issues and recommendations discussed in this report. Transfer pricing is one of the most important international tax issues in Canada and other countries. Transfer prices are the prices at which goods, services, and intangibles are traded across international borders between related parties. Because transactions between related parties occur in circumstances that are not subject to the same constraints as dealings between unrelated parties, transfer prices may diverge from “market prices.” In some cases, there are no market prices, or at least market prices that reflect sufficiently comparable circumstances to those being tested, because the transactions involve unique goods, intangibles or services, or otherwise the circumstances of the tested taxpayers are sufficiently complex that references to unrelated parties cannot be counted on to yield reliable comparisons. As a result, the possibility exists that the taxable income of related parties may also differ from what would have arisen if they had conducted the same transactions with unrelated or arm’s-length parties.

As well, it is important to note that transfer pricing invokes two levels of analysis, and that they should not be conflated. At one level is the usual taxpayer encounter with its tax authority concerning the correct interpretation and administration of the tax law. However, beyond that is the encounter between two states when each is able, in the first instance, to assert a sustainable legitimate claim to apply its tax laws to circumstances common to them both. At this level, the relative shares of a common tax base are the subject of a “government-to-government” determination; the taxpayer and its group are, simply, the ground on which the governments settle their competing claims.

Inherently, transfer pricing raises the second level of analysis in every case. In the opinion of the Subcommittee, it is important that the administration of the ITA (and other countries’ administrative and procedural rules also) be sensitive to this. In cases where there is dispute about genuinely held objectively sustainable views among taxpayers and tax authorities and there are no serious concerns about “tax jeopardy,” tax administrations should, in the Subcommittee’s view, be encouraged to exercise their administrative discretion broadly, and confidently, to avoid compounding tax disputes by requiring conceivably onerous and costly provisional tax compliance accountable to the period in which governments sort out their relative interests in a taxpayer and its group’s collective tax liability. This sentiment underlies several of the Subcommittee’s comments, which are not meant to be a challenge to the way in which the CRA administers the ITA but a recognition that suitable statutory or other support to the CRA may be warranted to allow the CRA to exercise its discretion with reference to more clearly articulated limits.

Canada’s current transfer pricing legislation is section 247 of the ITA. Like other OECD countries, Canada adopts the arm’s length principle as the basic rule governing the tax treatment of related party cross-border transactions. The arm’s length principle requires that, for tax purposes, the terms and conditions agreed to between related parties in their commercial or financial relations be those that one would have expected had the parties been dealing with each other at arm’s length.

Subsection 247(2) is expressed to apply where a taxpayer or a partnership and a non-resident person with whom the taxpayer or partnership does not deal at arm's length (or a partnership of which the non-resident person is a member) participate in a transaction or a series of transactions and

- (a) the terms or conditions of the transaction or series of transactions differ from arm's-length terms and conditions, or
- (b) the transaction or series of transactions would not have been entered into between arm's-length parties and they can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit.

Subsection 247(2) permits the CRA to adjust the quantum or nature of amounts that would have been agreed to between arm's-length parties. An adjustment to the nature of the affected transactions (commonly referred to as "recharacterization") is only exercisable when the transaction falls within paragraph 247(2)(b) and then only if there is demonstrable purposive tax avoidance.

A CRA-initiated adjustment often results in an increase in the taxpayer's income (or decrease in the taxpayer's loss or capital expenditures) as a result of an increase in the amount received from, or decrease in the amount paid to, a related non-resident person. In addition to the increased tax liability of the taxpayer, the adjustment may affect the tax liability of the non-resident related party under Part XIII of the ITA, which is known as a "secondary adjustment."

A taxpayer may request the CRA to make a transfer pricing adjustment in order to reduce the taxpayer's income. Such taxpayer-initiated downward adjustments are subject to the Minister's discretion under subsection 247(10).

Subsection 247(3) imposes a penalty equal to 10 percent of the transfer pricing adjustment. It is intended to be a compliance penalty focusing on the efforts that a taxpayer makes to determine an arm's length-price and not solely on the ultimate accuracy of the transfer prices. It does not apply if a taxpayer makes reasonable efforts to determine and use arm's-length prices or allocations. Subsection 247(4) deems a taxpayer not to have made reasonable efforts to determine and use arm's-length transfer prices or allocations unless the taxpayer has prepared or obtained and updated contemporaneous documentation and provided the documents to the CRA within three months of the receipt of a written request.

Section 247 is silent on many aspects of the implementation of the arm's length principle. The CRA supplements the specific statutory requirements to some extent by publishing its policies in the form of information circulars (e.g., *Information Circular 87-2R*; *Information Circular 94-4R*, *Information Circular 71-17R5*) and transfer pricing memoranda.¹ The CRA also encourages taxpayers to enter into advance pricing arrangements (APAs) to manage the uncertainty inherent in applying the arm's length principle in proposed or actual cross-border transactions.

1 www.cra-arc.gc.ca/tx/nrrsdnts/cmmn/trns/menu-eng.html

Transfer pricing disagreements between a taxpayer and the CRA are resolved through the domestic dispute resolution process (i.e., the Notice of Objection filed with the CRA Appeals Branch and the Notice of Appeal filed with the Tax Court of Canada) as well as the mutual agreement procedure (MAP) under Canada's tax conventions. The MAP article requires a taxpayer to request the Canadian competent authority negotiate with its counterpart of a treaty country. In the area of transfer pricing, the relevant Canadian competent authority is the Competent Authority Service Division (CASD) within the International and Large Business Directorate of the CRA.

The ITA provides no special procedural rules for resolving transfer pricing disputes. Section 115.1 does provide, however, that any agreement reached under MAP has the force of law in Canada.

2. Summary

The main issues identified in this report are as follows:

(a) MAP and competent authority process

There is a need for more guidance on the treatment by the Canadian competent authority of determinations by the CRA's Appeals Branch and on the Accelerated Competent Authority Procedure (ACAP).

(b) Alignment of procedural rules

There are discontinuities between the general rules on waivers in the context of domestic dispute resolution procedures and those that concern or are implicated in transfer pricing and MAP.

(c) Relief due to the nature of the MAP

Taxpayers are required to make tax pre-payments or post security when a transfer pricing issue is being negotiated between two competent authorities (i.e., and therefore is out of a taxpayer's control). Deficiency interest levied in respect of tax unpaid during this period or as a consequence of a MAP proceeding determined to be unpaid is a significant penalty as the taxpayer is required to pay interest on an unpaid tax liability that the taxpayer did not know it had and may have been incapable of reasonably estimating or expecting.

(d) Transfer pricing penalties

The current penalty provision sometimes causes harsh results for taxpayers, in particular small start-up companies. Taxpayers whose conduct does not amount to gross negligence can be liable for significant penalties that are excessive in light of the intent and purpose of the penalty provision.

(e) Downward adjustments

There is a need for procedural recourse with respect to the Minister's discretion in respect of requests for downward adjustments pursuant to subsection 247(10) of the ITA. Another question is why these adjustments would not be permitted as a matter of course on notice to the CRA, since they would be subject to review during the course of an eventual audit which, necessarily, benefits from the extended limitation period for non-arm's length transactions.

(f) Secondary adjustments

The basis on and relationships in respect of which withholding tax is imposed in respect of secondary adjustments treated as constructive dividends would benefit from clearer legislative authority. There is uncertainty as to which entities are the recipients of constructive dividends arising from secondary adjustments, how this is determined under the ITA and consequently how the applicable withholding tax rate taking account of relevant income tax conventions should be determined.

(g) Branches/permanent establishments

Section 247 currently does not apply in respect of branches (or permanent establishments) of foreign companies or for that matter in respect of foreign branches (or permanent establishments) of Canadian companies. This is difficult to reconcile with any treaty provision that requires the attribution of income to permanent establishments in accordance with the arm's length principle as well as with evolving international standards in this connection reflected in the OECD's continuing study of the attribution of profits to permanent establishments. It may also raise concerns about obtaining information from foreign enterprises carrying on business in Canada through a branch as opposed to a subsidiary. On the other hand, amending section 247 to apply to branches is extremely difficult and complex at the moment.

(h) More concentration of the experience and expertise of the CRA

It is desirable to increase the centralization of the experience and expertise of the CRA in the transfer pricing area and to reflect the application of that experience and expertise in the exercise of authority by the International Tax Division (ITD) and the CASD at the CRA's head office to determine the course of and not merely to act as consultants to the tax services offices about transfer pricing matters.

(i) APA and arbitration

It is the view of the Subcommittee that APAs should also be eligible for arbitration pursuant to the fifth protocol to the Canada-U.S. tax treaty as APAs are simply particular applications of the MAP.

(j) MAP and recharacterization

As recharacterization is considered by the OECD as part of the tax actions available to tax authorities pursuant to Article 9 of the OECD Model Tax Convention, cases where the CRA bases the reassessment of a taxpayer on paragraphs 247(2)(b) and (d) should be eligible for negotiation pursuant to the MAP.

(k) Exchanges and secondments

It is suggested that CRA and the private sector look into setting up an exchange or secondment program. It is felt that this would benefit both sides.

The Subcommittee proposes ways to address these issues. Where a consensus is reached, the Subcommittee recommends specific solutions (Section 3 below). In other cases, the Subcommittee suggests further study of the issue (Section 4 below).

3. Issues and Recommendations

3.1 MAP and competent authority process

3.1.1 Domestic appeals and the competent authority process

Issue

Where a taxpayer files a Notice of Objection with the Appeals Branch of the CRA on a matter that is under competent authority consideration, an issue arises as to whether the competent authority is bound by the findings of the Appeals Branch. The current CRA position is stated in paragraph 41 of *Information Circular 71-17R5*:

However, if the Appeals Branch decision has the concurrence of the taxpayer, the Canadian competent authority will only present the case to the other competent authority and will not negotiate the issue. If the taxpayer does not concur with the Appeals Branch decision, the Canadian competent authority will negotiate the issue. The Canadian competent authority will give due consideration to the findings made by the Appeals Branch with regard to the application of Canadian law.

There is some confusion about the interpretation of the last sentence.

Recommendation 1

It is highly desirable to clarify that the Canadian competent authority, in its search for resolution of cases under the MAP, should in no way be restricted by findings made by the Appeals Branch.

In particular, paragraph 41 of *Information Circular 71-17* should clearly state that the Canadian competent authority may and should deviate from the Appeals findings where this is necessary to avoid double taxation, regardless of whether or not the taxpayer concurred in a reassessment to resolve a transfer pricing disagreement with the CRA domestically at the Appeals level.

3.1.2 Accelerated Competent Authority Procedure (ACAP)

Issue

An ACAP program was announced in 2005 and described in paragraphs 21–23 of *Information Circular 71-17R5*. However, the CRA has since declined to entertain ACAP requests in various circumstances that seem, to the Subcommittee, to be common situations in which the ACAP tool could usefully be applied. In some cases the CRA has limited the application of the ACAP to cover only taxation years for which a transfer pricing audit has been substantially completed. In other cases the CRA indicated that a substantially completed audit did not meet the prevailing criteria because the request was not made before the audit was substantially completed. This may severely limit the

effectiveness of the “accelerated” feature as well as, possibly, the general utility of the program itself. It does not fully realize the potential of programs of this nature in line with the OECD position on ACAPs.²

It would be useful to establish and publish the ACAP guidelines in order to realize their full potential to assist in resolving, prospectively, tax controversies that involve recurring or continuous circumstances. This would be consistent with prevailing guidelines of the OECD and other countries. The accelerated resolution of prospective tax disputes would, among other things, reduce the cost to taxpayers and tax authorities of protracted tax controversies. It should also have the effect of reducing the relative significance of other issues identified in the report concerning the provisional payment of disputed tax and deficiency interest on unpaid tax and in relation to secondary adjustments.

Recommendation 2

The Subcommittee recommends that the ACAP program should clearly cover “yet to be audited” taxation years.

Additional Considerations

To be included in ACAP (the “ACAP years”), it would not be necessary for an audit of a taxation year to have been undertaken nor for Canada or any other relevant treaty partner to have raised an adjustment with respect to that year. In this connection the Subcommittee discussed the considerations that might apply to give effect to this kind of an extension of ACAP. For example, the time to make an ACAP request could be any time before notification in writing to the taxpayer that a competent authority agreement has been reached in respect of the taxation years preceding the ACAP years. However, substantive and procedural limitations would need to apply to ensure as much as possible that any commitment by the competent authority, even a provisional or qualified commitment of this nature, would be based on objectively reliable, auditable information and that the relevant circumstances were not only consistent with but materially the same as those evaluated in completed or substantially advanced competent authority proceedings. All that would be necessary for the application of ACAP is that any covered taxation year(s) be subsequent to those for which a competent authority agreement has been reached pursuant to a relevant MAP provision, the relevant facts and circumstances surrounding the transactions at issue have not materially changed, and the income tax return(s) in respect of the ACAP years have been filed at the time the originating competent authority agreement is reached.

2 The ACAP is defined by the OECD in the *Manual for Effective Mutual Agreement Procedure (“MEMAP”)* (Annex 3) as the following (emphasis added):

In addition to an ongoing request for competent authority assistance, a taxpayer may request assistance for subsequent filed, *but yet to be audited*, taxation years on the same issue. The inclusion of these subsequent “ACAP” years in the MAP discussions not only prospectively resolves double taxation but also alleviates the burden of a separate audit and MAP process.

3.2 Alignment of procedural rules

3.2.1 *Waivers*

Issue

The time period within which to file a waiver pursuant to subparagraph 152(4)(a)(ii) and subsection 152(3.1) of the ITA (generally four years) does not interact properly with the time limitation period applicable to reassessing transfer pricing transactions as found at subparagraph 152(4)(b)(iii) (seven years). As a result, if a transfer pricing audit begins four or more years after the mailing of the original notice of assessment with respect to the relevant taxation year, then it will not be possible for the taxpayer to file waivers and keep the year open rather than face the “drop-dead” date of assessment and ensuring objection and appeal proceedings to accomplish this result indirectly and in various respects imperfectly. Taxpayers may lose the opportunity to seek relief from MAP. Valid waivers permit the CRA to reassess a return to provide relief as a result of competent authority negotiations for years that would otherwise be legally barred from being adjusted.

Recommendation 3

Subparagraph 152(4)(a)(ii) should be amended in order to harmonize its time limitation with that of subparagraph 152(4)(b)(iii).

The amended rule may look like the following:

- (4) Assessment and reassessment [limitation period] — The Minister may at any time make an assessment, reassessment or additional assessment of tax for a taxation year, interest or penalties, if any, payable under this Part by a taxpayer or notify in writing any person by whom a return of income for a taxation year has been filed that no tax is payable for the year, except that an assessment, reassessment or additional assessment may be made after the taxpayer's normal reassessment period in respect of the year only if
- (a) the taxpayer or person filing the return
 - (i) has made any misrepresentation that is attributable to neglect, carelessness or wilful default or has committed any fraud in filing the return or in supplying any information under this Act, or
 - (ii) has filed with the Minister a waiver in prescribed form within the time period stipulated at subparagraph 152(4)(b)(iii) for transactions to which section 247 may apply and within the normal reassessment period for the taxpayer for any other transactions or situations in respect of the year; ...

3.2.2 *Segregation of MAP issues from other issues*

Issue

Transfer pricing assessments often involve or arise in the context of many issues, not all of which require recourse to procedures, including MAP, commonly associated with the resolution of a transfer pricing controversy. A taxpayer may wish to make a competent authority request regarding one issue pertaining to a menu of adjustments, and wish independently to pursue other issues according to exclusively domestic recourses with a view to having those issues resolved finally as soon as possible and in any event before the end of an extended period of competent authority deliberations. Because the MAP process is time consuming and involves government-to-government negotiations, it often slows down the domestic process for those other issues.

Recommendation 4

Consideration should be given to facilitating through legislative change or otherwise the segregation of issues covered by a MAP from other issues so that the separated processes can proceed separately. More specifically, these other issues would include not only domestic issues, but also ancillary transfer pricing issues, such as penalties and interest if the competent authorities would not deal with them. By way of an example, section 173 of the ITA can be amended so that a taxpayer is allowed to file more than one objection and each objection can proceed separately.

3.2.3 *Alignment of appeals process and competent authority process*

Issue

The Appeals Branch sometimes issues its decision while the taxpayer is still pursuing competent authority relief. This forces the taxpayer to file a Notice of Appeal before the Tax Court of Canada in order to protect its rights in the event the tax authorities fail to provide relief from double taxation at the competent authority level. Although it is possible for the taxpayer to request that its appeal be held in abeyance pending competent authority resolution, the taxpayer currently has no formal right to have its appeal suspended. As was noted earlier, a competent authority proceeding is not concerned only with the relationship between taxpayers and tax authorities, but also between the tax authorities themselves as they determine their relative entitlement to a shared tax base. Where it can be determined that there is a genuine element of potential double taxation to resolve, shown by the acceptance of a case by the competent authorities for determination, then taxpayers should be relieved of the obligation to navigate the procedural rules that otherwise would apply until, and then without detriment, the competent authorities have determined the relative interests of the countries concerned.

Recommendation 5

The Appeals Branch should consider holding its formal decision on all objections in abeyance pending resolution of the case at the competent authority level. In cases where Appeals has issued its decision and the taxpayer is pursuing competent authority relief, it is recommended that a rule be adopted so as to enable a taxpayer to have a formal right, upon request, that its appeal be held in abeyance pending competent authority resolution.

3.3 Relief due to the nature of MAP

3.3.1 Tax prepayment and security

Issue

Taxpayers are required to make tax pre-payments or post security when a transfer pricing issue is being negotiated between two competent authorities. At present, large corporations are required to pay one-half of the amount assessed under Part I and all of the amount assessed under Part XIII, as well as all of the amount of the related penalties and interest within 90 days of the date of assessment. If the large corporation does not file a protective appeal or objection, the remaining balance of 50 percent of the Part I tax must be paid. If the corporation seeks competent authority assistance and files a protective appeal or objection, security for 50 percent of the tax will be required. If the corporation seeks the competent authority process without filing a protective appeal or objection or in respect of disputed tax under Part XIII, security for 100 percent of the tax will be required (*Information Circular 71-17R5*, para. 47–78). Such policy is inconsistent with the OECD guidelines.³

In practice, under the authority of section 220 of the ITA, the CRA has adopted a policy to allow taxpayers to post security for Part I tax. We have been told that the CRA has also extended its security policy to Part XIII tax assessments that are the subject of competent authority negotiations. The condition is that 100 percent of the assessment must be secured.

3 The OECD states in its MEMAP:

There are several reasons why suspension of the collection of tax pending resolution of MAP can be a desirable policy. Any requirement to pay a tax assessment specifically as a condition of obtaining access to MAP in order to get relief from that very tax would generally be inconsistent with the policy of making MAP broadly available to resolve such disputes. Even if a MAP agreement ultimately eliminates any double taxation or other taxation not in accordance with the Convention, the requirement to pay tax prior to the conclusion of the MAP may permanently cost the taxpayer the time value of the money represented by the amount inappropriately imposed for the period prior to the MAP resolution, at least in the fairly common case where the respective interest policies of the relevant Contracting States do not fully compensate the taxpayer for that cost. Thus, this means that in such cases the MAP would not achieve the goal of fully eliminating, as an economic matter, the burden of the double taxation. ... Moreover, even if that economic burden is ultimately removed, a requirement on the taxpayer to pay taxes on the same income to two Contracting States can impose cash flow burdens that are inconsistent with the Convention's goals of eliminating barriers to cross-border trade and investment. Finally, another unfortunate complication may be delays in the resolution of cases if a country is less willing to enter into good faith MAP discussions when a probable result could be the refunding of taxes already collected. If the tax in question is in jeopardy of being lost due to bankruptcy or due to the taxpayer becoming a flight risk, then collection practices allowing for immediate recovery seem appropriate.

Recommendations 6, 7 and 8

- (6) The above CRA practice with respect to accepting security for Part I tax and Part XIII tax should be clarified in writing through amending *Information Circular 71-17R5*.
- (7) Broader relief through legislative changes should be considered in appropriate circumstances. This is to recognize an inherent characteristic of MAP proceedings as involving the determination of government's relative interests, for their own account, in a common tax base and a taxpayer's indifference, in many cases, to the outcome of that determination. The ITA can be amended to permit a taxpayer not to pay a disputed tax liability, in the absence of jeopardy, to the extent that competent authority proceedings are reasonably expected or ongoing.
- (8) In the alternative, it is recommended that the same policy apply to both Part I and Part XIII taxes related to a MAP proceeding and that taxpayers be allowed to post security covering only half of the amounts in dispute.

3.3.2 Deficiency interest

Issue

Deficiency interest is imposed in respect of disputed tax liabilities relating to the period of competent authority process as well as in respect of adjustments occasioned by the determination of that process, even though the outcome of that process, and consequently how and to what degree a taxpayer is taxable is unknown and unknowable until the end of that process after the Canadian competent authority and its non-Canadian counterpart have determined how and on what basis the ITA is to apply taking account of considerations, it is expected, that have as much to do with their relative taxation interests as the taxpayer's adherence to any particular domestic tax regime. This interest is a severe penalty as it is not deductible. As the OECD has observed, "(it) is widely acknowledged that a taxpayer may suffer the economic equivalent of double taxation, even where underlying double taxation is eliminated through a MAP agreement, if there is considerable asymmetry between two countries' treatment of interest that may accrue on tax liabilities and refunds."⁴ The OECD suggests that "the relief of interest for the period of time a taxpayer is in the MAP process, especially if that period is beyond a reasonable period, may seem warranted given that the taxpayer is not in control of large segments of the MAP process, such as the competent authority-to-competent authority discussions."⁵

4 OECD MEMAP, para. 4.5.2.

5 Ibid.

Because there may be doubt about whether the issue of deficiency interest, at least indirectly, is covered by a MAP, relief can only be provided reliably on a unilateral basis in Canada. The CRA's policy is to grant relief on a case-by-case basis, taking into account factors such as taxpayer cooperation and reciprocity with the foreign jurisdiction.⁶ The process of requesting for and granting relief is largely discretionary, involving generally taxpayer-initiated and CRA self-imposed assertions of "blame" or responsibility for delay in the proceedings. The Subcommittee thinks, generally, that conditioning the exercise of the CRA's discretion on the CRA somehow being blameworthy is not the only or most sound, or reliable, way to ground assertion of interest liability and is generally unfair to the CRA. More specifically the circumstances implicated in a MAP proceeding are often complex and frequently involve the settlement between governments of their relative interests in a shared tax base where a taxpayer is indifferent as to the outcome.

Recommendation 9

The availability of deficiency interest relief could be addressed on a basis more sensitive to the nature of MAP proceedings and the complexity of international tax controversies, and the reference to the parallel taxpayer-to-government and government-to-government interests through amending the ITA so that deficiency interest is not charged with respect to adjustments occasioned by a MAP, APA or other like proceeding provided that any resulting tax liability or required "repatriation" occurred within a reasonable period after the conclusion of the proceeding, say 90 days (or the period beginning with the commencement of the proceedings subject to the taxpayer's timely compliance with requests by the competent authorities for information and other support to enable the proceeding to advance effectively toward a resolution).

In the alternative, the deficiency interest in these circumstances should be deductible in computing the income of a taxpayer assessed for unpaid tax.

An example of legislative change is to amend sections 223.1 and 115.1 to provide the necessary relief. The existing section 115.1 is an example of how, generally, the CRA is meant to be unimpeded by the rest of the ITA in giving effect to a competent authority determination — bilateral or unilateral.

⁶ *Information Circular 71-17R5*, para. 52.

3.4 Transfer Pricing Penalties

Issue

The penalty under subsection 247(3) is imposed if a transfer pricing adjustment exceeds the threshold, which is the lesser of: 10 percent of the taxpayer's gross revenue for the year or \$5,000,000. Taxpayers will not be subject to the subsection 247(3) penalty if they made reasonable efforts to determine, use, and document arm's-length prices. Documentation must be complete and accurate in all material respects and must be prepared contemporaneously with the filing due date for the tax year in question and provided to the CRA within three months of a written request.

For many small companies this is an imposing and expensive standard to meet. However, given the structure of the penalty threshold, companies with lower revenues can easily be subject to the penalty. Indeed, a start-up company with no or minimal revenue could be subject to a penalty if any transfer pricing adjustment was made. CRA audits of such businesses may be time consuming and costly for small businesses.

Recommendations 10, 11 and 12

- (10) The CRA should provide more guidelines on what constitutes "reasonable efforts" and its standards for risk assessments.
- (11) The threshold for imposing the penalty should be raised so that small start-up businesses are not caught by the penalties.
- (12) The CRA should exercise its discretion to provide relief from penalties, or in the first instance not to impose penalties and not to refer taxpayers' circumstances for penalty review, except in cases where there is clear disregard by taxpayers of their obligations to provide a reasonable explanation of the transfer pricing implications of their reported income and the absence of any meaningful documentation in the categories contemplated in subsection 247(4) of the ITA even if the existence and content of such documentation is available only in the course of a normal audit. In other words, penalties under subsection 247(3) of the ITA should be an extreme measure to punish and deter flagrant disregard by taxpayers of their reporting responsibilities and should not arise, and should not be expected to arise, in usual cases. Nevertheless, the CRA should retain its discretion to exercise such penalties, based on consistent standards as the CRA determines most workable, in order to mitigate the possibility that taxpayers disregard their enhanced reporting and documentation responsibilities attendant on the existence of non-arm's-length transactions.

3.5 Downward adjustments

Issues

Currently, there is a need for procedural recourse for taxpayers who disagree with the determinations of (or lack of a determination by) the Minister in respect of determinations pursuant to subsection 247(10).

There is also an issue whether the existence of the discretion is necessary at all. Subject to all of the normal assessment tools that the CRA has within an extended limitation period and taking account of the necessary visibility of this kind of request, it can be argued that the downward adjustment should not be discretionary. Presumably the concern for the CRA is a “whipsaw” where Canada concedes its tax base, but it is not picked up elsewhere.

Recommendations 13 and 14

(13) Subsection 247(10) should be amended to provide recourse when a request for downward adjustment is either not acted upon or refused.⁷

(14) It should be considered whether to remove the discretion from subsection 247(10).

3.6 Secondary adjustments

Issue

There is some confusion about the legal basis for levying Part XIII tax on secondary adjustments treated as dividends. Should subsections 15(1), 214(3) and 212(2) apply alone? Or subsection 56(2) does and should apply as well? Assessments grounded in subsection 15(1) arguably most commonly arise with respect to direct, and in the present context often wholly-owned direct, holdings of shares, for example in a subsidiary. More complex direct and indirect share ownership affects whether and how such assessments would be framed and whether subsection 56(2) would be applicable.

⁷ An amended subsection 247(10) may look like the following:

- (a) Where, subsequent to the filing of a tax return for the relevant taxation year, a taxpayer considers that an adjustment (other than an adjustment that results in or increases a transfer pricing capital adjustment or a transfer pricing income adjustment of a taxpayer for a taxation year) is required pursuant to subsection (2) with respect to the relevant taxation year, the Minister shall, on written application made within the time period specified at subparagraph 152(4)(b)(iii), determine, with all due dispatch, all amounts which must be adjusted pursuant to subsection (2) as a result of the application and issue such notice of reassessment or of loss determination and refund such amounts, if any, as appropriate under this Act.
- (b) Where, on application under paragraph (a) by a taxpayer to the Minister in respect of an adjustment (other than an adjustment that results in or increases a transfer pricing capital adjustment or a transfer pricing income adjustment of a taxpayer for a taxation year), the Minister is not satisfied that the adjustment requested was appropriate, the Minister shall assess any amount payable under this Act by the person and send a notice of assessment to the person, or make such loss determination as is necessary in the circumstances and sections 150 to 163, subsections 164(1) and (1.4) to (7), sections 164.1 to 167 and Division J of Part I apply with any modifications that the circumstances require.

Recommendation 15

Legislative changes should be made to clarify the treatment of constructive dividends. For example, paragraph 214(3)(a) can be replaced by the following:

214(3) Deemed payments — For the purposes of this Part,

- (a) where a transfer pricing income adjustment or a transfer pricing capital adjustment is made pursuant to section 247 and that adjustment requires an amount to be included in computing a taxpayer's income, that amount shall be deemed to have been paid by the taxpayer as a dividend to its non-resident shareholder(s).

3.7 Part XIII interest refund

Issue

Overpayments of Part XIII taxes occur when the amount of payments subject to Part XIII taxes (typically dividends, interest, rent and royalties) is reduced as a result of a competent authority process or transfer pricing assessments under section 247. An example for the latter scenario is the case where a Canadian corporation's payments of royalties to its U.S. sister corporation were found to be excessive (i.e., exceeding the arm's-length prices). Upon reassessment, the taxpayer is denied the deduction under Part I of the ITA of the portion of the royalty in excess of the arm's-length amount. The excess royalty is deemed to be a dividend paid to the U.S. resident company and assessable under Part XIII at a rate of 5 percent pursuant to Article X of the Canada-U.S. tax treaty. There is an overpayment of Part XIII tax because tax on the original royalty payments was withheld at 10 percent.

The issue of refund of Part XIII taxes is clearly authorized by subsection 227(10.1) and subsection 164(1) of the ITA. However, the ITA is unclear as to the refund interest on Part XIII taxes. In general the CRA policy is not to provide refund interest on refunds of Part XIII tax that arise out of the competent authority process. The technical reason for the CRA position seems to be that the CRA considered the competent authority request to be akin to a Part XIII refund request under subsection 227(6) — from which, if the Minister agrees to the refund, no assessment arises, and there is no application of subsection 164(3) such as exists in subsections 227(10) and (10.1).

Subsection 227(10.1) includes in its post-amble subsection 164(3), which authorizes the refund interest. In general, a reasonable interpretation can be made that the ITA intends to provide refund interest on refunds of Part XIII tax.

Recommendation 16

There should be a mechanism for allowing Part XIII interest refunds. Legislative clarification can be provided by amending paragraph 164(3)(c) to include “notice of assessment” in respect of Part XIII tax and “notice of assessment” can be deemed to arise out of the competent authority process. Subsection 164(7) can be amended so that “overpayment” includes the total of all amounts paid on account of the corporation’s liability under Part XIII.

3.8 More concentration of transfer pricing experience and expertise of the CRA

Issue

Several divisions of the CRA are currently involved in the administration of transfer pricing rules, and each has its own expertise. Although there is already a manner of centralization, increasing concentration of the CRA’s relevant experience and expertise at the ITD and the CASD, with the authority to allow it to be deployed broadly in transfer pricing matters would have several advantages. It would contribute to consistency and substantive analysis on a number of fronts, including establishing expectations of taxpayers as to compliance and mutual expectations by the CRA and taxpayers as to how particular transfer pricing issues will be approached on audit and likely will be addressed in controversy or competent authority proceedings. It should help address internal prioritization issues concerning the kinds of transfer pricing cases that are of interest, why they are of interest, and how they will be addressed according to underlying themes or principles, without having to deal specifically with a menu of items. Finally, a more systematic concentration of experience and expertise, as well as related authority, would contribute to ensuring that the CRA is seen to speak institutionally with a single force in the international area — on substantive, penalty, interest, exercise of discretion and other issues — albeit with support from the field. Among other things, this would avoid the need for divisions within the CRA and taxpayers to navigate multiple processes as if those processes were autonomous.

Recommendation 17

The Subcommittee recommends more increased concentration and centralization of experience and expertise in the transfer pricing area at the CRA, in both the ITD and the CASD, and the application of that experience and expertise through the centralized authority of the ITD and the CASD in audits conducted by tax services offices and not merely contribution on a consultative basis to these offices.

3.9 APA and arbitration

Issue

Pursuant to paragraph 6 of Article XXVI of the fifth protocol to the Canada-U.S. tax treaty, a transfer pricing issue that cannot be resolved through MAP is eligible for arbitration. It is unclear whether APAs will be subject to arbitration. The uncertainty arises from the asymmetrical reference to APAs in paragraph 16 of Annex A to the protocol, which stipulates:

For purposes of paragraphs 6 and 7 of Article XXVI and this note, each competent authority shall confirm in writing to the other competent authority and to the concerned person(s) the date of its receipt of the information necessary to undertake substantive consideration for a mutual agreement. Such information shall be:

- a) in the United States, the information required to be submitted to the U.S. competent authority under Revenue Procedure 2006-54, section 4.05 (or any applicable analogous provisions) and, for cases initially submitted as a request for an Advance Pricing Agreement, the information required to be submitted to the Internal Revenue Service under Revenue Procedure 2006-9, section 4 (or any applicable analogous provisions), and
- b) in Canada, the information required to be submitted to Canadian competent authority under *Information Circular 71-17* (or any applicable successor publication).

Recommendation 18

Bilateral and multilateral APAs are in essence extensions of the MAP and concluded under its auspices.⁸ It would be helpful to clarify the application of arbitration in respect of APAs as an element of the MAP process. This can be done by confirming that the competent authorities can determine that, as extensions of the MAP, APAs or the issues and outcomes that are the subject of APAs may also be subject to the arbitration process, to the extent available, with the time expended in the APA process and the materials and analysis prepared for that process being credited toward full satisfaction of the time period and materials submission requirements of an arbitration.

There should be some clarification about how arbitration would be expected to deal with the subject of an APA. For instance, in an APA context, after the expiry of two years from the time a full APA submission has been filed with the relevant competent authorities without resolution, each competent authority would have to submit its position paper as contemplated by the arbitration procedural rules and the role of the arbitration panel would be to pick one of the two positions in accordance with the arbitration procedure.

8 See OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, paragraph 4.140.

3.10 MAP and recharacterization

Issue

Pursuant to paragraphs 27 and 28 of *Information Circular 71-17R5*, where the CRA relies on the recharacterization provisions of the ITA in a reassessment, the affected taxpayer's right to relief of double taxation via the MAP is then limited as described below:

27. In general, the Canadian competent authority will not negotiate cases where the (re)assessment relies on section 245 of the *Act* or other specific anti-avoidance provisions of the *Act* including the *Income Tax Act Regulations*. This means, generally, that the Canadian competent authority will consider requests for assistance in such cases, but, if the request is accepted, will limit itself to forwarding the case to the other competent authority for any relief that the foreign competent authority may provide at the latter's discretion.

28. In a situation where an anti-avoidance provision is cited in a (re)assessment, and the taxpayer succeeds in getting that portion of the (re)assessment vacated, either through the Appeals Branch or a court, so that avoidance is no longer an issue, the taxpayer may then request the Canadian competent authority for assistance if taxation not in accordance with the tax convention is still an issue. (Note, however, that for those situations involving a court decision the Canadian competent authority cannot vary the court decision and any assistance would be limited to presenting the case to the other competent authority. See paragraph 43.)

Thus, as paragraphs 247(2)(b) and (d) are considered as a specific anti-avoidance provision of the ITA, the Canadian competent authority effectively will not negotiate cases where the reassessment is based on those paragraphs. However, if taxpayers proceed to the Tax Court of Canada in order to overturn the reliance by the CRA on paragraphs 247(2)(b) and (d), such taxpayers run the risk that the Canadian competent authority will then not negotiate their cases as a result of the court decisions. Consequently, as soon as the CRA invokes paragraphs 247(2)(b) and (d) in a reassessment, affected taxpayers are, for all practical purposes, denied relief under the MAP.

Recharacterization is an action or event considered by the OECD to fall within the ambit of Article 9 of the Model Convention. Paragraph 1.38 of the OECD Guidelines stipulates that "Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm's length." The CRA, in *Information Circular 87-2R*, generally adopts the OECD's Transfer Pricing Guidelines, and more generally subject to specific reservation, Canada adopts the OECD's Model Tax Convention and its Commentaries. Accordingly, adjustments pursuant to Article 9 should be subject to MAP if taxation not in accordance with the relevant convention occurs. In short, the "characterization" of transactions and other arrangements that take place within a commonly controlled (non-arm's length) group is a normative aspect of transfer pricing, and may, by the nature of such transactions and arrangements in a multinational setting, need to be evaluated often without guidance by arm's-length analogues. Moreover, as the OECD stipulates in the OECD Guidelines

and as paragraphs 247(2)(b) and (d) of the ITA and the *Information Circular 87-2R* specifically contemplate, a taxpayer's transactions as implemented generally should be accepted as the basis for the computation of its income including as affected by transfer pricing rules and practices (despite the possibility of the economic equivalence of alternate forms of transactions and arrangements with different tax consequences) in the absence of demonstrable, and we believe, purposive tax avoidance. In our view, purposive tax avoidance should not be presumed simply because a taxpayer has selected one among several possible forms to achieve a particular economic outcome, and as a result of its choice achieves comparatively more beneficial tax treatment.

Recommendation 19

Therefore, it is recommended that the Canadian competent authority amend *Information Circular 71-17* and accept to fully negotiate all adjustments pursuant to section 247 of the ITA, in accordance with OECD guidance.

In the alternative, if the Canadian competent authority is not prepared to agree to negotiate recharacterization cases under the MAP, then it is recommended that a procedure be added to the ITA allowing taxpayers to challenge the applicability of paragraphs 247(2)(b) and (d) while retaining all rights to full relief from double taxation through the MAP. This could be achieved via a referral similar to those covered under section 173 of the ITA but which would be at the sole discretion of the taxpayer.

3.11 Exchanges and secondments

Issue

During the discussions of the Subcommittee, it was found that it may be desirable to have personnel exchanges or secondments between the private sector and the ITD and the CASD. Indeed, it was felt that taxpayers and their advisors may benefit from approaching and analyzing problems and issues from the CRA's perspective and viewpoint. For instance, it would be beneficial for private sector practitioners to gain a better understanding of the issues encountered by CRA professionals during transfer pricing audits and of the strategies, challenges and solutions encountered during the negotiation of double tax cases under the MAP and of APAs. Similarly, the Subcommittee anticipates that it may be beneficial for CRA professionals to be involved in the establishment and documentation of transfer pricing practices within a multinational enterprise and to gain a more direct experience with the issues involved at a formative stage of balancing competing considerations in the formation of transfer pricing policies and preparing documentation, and then in defending transfer prices as well as attempting to resolve double taxation cases from the private sector's perspective.

Recommendation 20

Therefore, it is recommended that the CRA and the private sector consider establishing a secondment program to favour exchanges between them. The guidelines of such a program could cover such topics as length of time of secondments, minimum experience required of the candidates and conflict of interest during and after secondments.

4. Issues for Further Study

4.1 Application of transfer pricing rules to branches

Issue

The current section 247 does not deal with branches or permanent establishments (PEs). This is difficult to reconcile with the treaty provision and evolving international standards that require or anticipate the attribution of income to PEs in accordance with the arm's length principle. It also foreshadows possible concerns associated with obtaining information from foreign enterprises carrying on business in Canada through a branch as opposed to a subsidiary.

Applying the arm's length principle to branches is a very complex issue, practically and theoretically. It is very difficult for the Subcommittee to make any specific recommendations at present because of ongoing development at the OECD and the concern that Canada should not be out of step with other countries. The Subcommittee identifies the need for the matter to be studied quickly and guidance to be formulated.

Comments

In principle, transfer pricing (or like) considerations are relevant to determinations concerning the allocation of income resulting from related party transactions as well as "internal dealings" within an entity (i.e., between a PE and its head-office). The general objective of transfer pricing analysis is to provide an objective framework for testing and assuring that the amount of Canadian taxable income is consistent with the Canadian circumstances in which it is earned. At least, transfer pricing analysis provides a framework for identifying and measuring functions and risks that, inevitably in any exercise engaged with computing and attributing income, have to be analyzed. This has been recognized by the OECD in its recently proposed changes to Article 7 of the OECD Model Convention⁹ as well as by Canada and the United States in Annex B to the fifth protocol to the Canada-U.S. tax treaty and technical explanation to that protocol.¹⁰

On the other hand, amending section 247 legislatively to apply to branches or PEs of non-resident taxpayers (or of resident taxpayers carrying on business outside Canada) poses a number of issues in line with those identified in the OECD and Canada-U.S. treaty initiatives. These include how to assimilate "dealings" within an entity to transactions between entities, how to measure and accommodate internal accounting expenses for transfers that do not have a legal existence, and whether to treat internal "dealings" as having exactly the same implications as equivalent transfers between entities with respect to whether an establishment should be attributed profit from such "dealing". Other more fundamental issues concern whether the present

⁹ See OECD, *Revised Commentary on Article 7 of the OECD Model Tax Convention*, 10 April 2007, and *Discussion draft on a new Article 7 (Business Profits) of the OECD Model Tax Convention*, 7 July to 31 December 2008.

¹⁰ The Technical Explanation was released by the U.S. Department of the Treasury on July 10, 2008 with the concurrence of the Government of Canada expressed in a contemporaneous release by the Minister of Finance.

approach taken by the OECD, including the proposed complete restatement of Article 7, can or will have any immediate effect with respect to the application of most of Canada's treaties that do not have any semblance of the proposed new Article 7.

Accordingly, the Subcommittee recommends that the CRA and the Department of Finance be requested to form a working group to further study these issues. The working group might involve members of the private sector.

4.2 Court decisions and MAP

Issue

Pursuant to paragraph 43 of *Information Circular 71-17R5*, the Canadian competent authority considers that it is not authorized to depart from a Canadian court decision in its pursuit of relief from double taxation under the MAP. The Subcommittee questioned whether this restriction is correct in law and appropriate from tax policy and administration perspectives, recognizing that judicial decisions first of all become a part of the law when decided, and further are primarily concerned with the relationship between a tax authority and a taxpayer contrasted with the second aspect of multilateral tax administration implicated in the MAP which is the rationalization of the application of competing tax systems and the interests of their respective governments.

Comments

The Subcommittee considered that it would be helpful to further consider whether the Canadian competent authority can, from a legal perspective, depart from a Canadian court decision regarding the same taxpayer and the same transactions during the same taxation years. In addition, if there is no legal restriction applicable, the Subcommittee suggests that the policy considerations underlying this position be reviewed. Some of the questions that should be considered may include:

- whether relief from double taxation should have primacy over the finality of court decisions;
- whether section 115.1 of the ITA provides the type of support needed for the Canadian competent authority to overrule or disregard a Tax Court of Canada decision and if not how it might be modified to provide the necessary authority; and
- whether time limitation provisions and reassessment provisions currently can accommodate a reassessment pursuant to a MAP subsequent to a Tax Court of Canada decision.

4.3 Domestic arbitration

Comments

The Subcommittee discussed the need for, appropriateness, and relevance of a domestic arbitration process as an alternative dispute resolution mechanism to assist both the Canadian competent authority and Appeals Branch in the expeditious resolution of certain transfer pricing cases. The Subcommittee feels that this avenue may be worth revisiting.

5. Concluding Remarks

In this Report, the Subcommittee identifies a number of important transfer pricing issues and makes realistic recommendations. The Subcommittee also identifies and briefly comments on some emerging issues that require attention in the near future. Members of the Subcommittee enjoyed working on this project and hope the report is helpful to the Panel in its deliberations.