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TaxNewsFlash

Canada

Finance Unveils Consultation on Canadian Transfer Pricing Rules

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Multinational enterprises should review new Finance consultations and proposals that could affect their transfer pricing policies. Finance recently released a consultation paper and accompanying legislative proposals that include potentially significant changes to the Canadian transfer pricing rules, including amendments to the transfer pricing adjustment rule and possible revisions to certain administrative practices. The consultation paper, which includes a series of questions for public comment, notes that these proposals are intended to provide more clarity on technical aspects of the application of the arm's length principle, and to better align the Canadian transfer pricing rules with international standards and transfer pricing guidance published by the Organization for Economic Co-operation and Development (OECD Guidelines). Finance is accepting comments on these proposed changes until July 28, 2023. Although it is not yet clear when these proposed measures could be enacted, Finance notes that they are expected to apply on a prospective basis.

As a result of these proposed changes, affected taxpayers should review the consultation document, assess the potential future impact of the proposed changes on their transfer pricing policies, and consider whether the taxpayer should submit comments on the proposed changes.

Background
Finance announced that it would launch a consultation on planned changes to Canada's transfer pricing rules in the 2021 federal budget. At that time, Finance indicated that the changes were intended to discourage the inappropriate shifting of income out of Canada, which could artificially reduce taxes owed in Canada.

Generally, where one entity within a multinational group agrees to buy or sell goods or services with another group entity, an appropriate amount of profit on these transactions must be reported in Canada under the transfer pricing rules in section 247. Where prices or cost allocations do not reflect arm's length terms and conditions, the current rules provide that the CRA can adjust a Canadian taxpayer's transfer prices or cost allocations. In general, applying the arm's length principle is based on a comparison of the non-arm's length parties' prices or profit margins with the prices, or profit margins of arm's length parties engaged in similar transactions.

Draft legislative measures

In the consultation paper, Finance proposes amendments that would rely on two elements for the transfer pricing analysis:

- A rule that sets the starting point of the comparison to arm's length transactions with reference to the economically relevant characteristics, and
- A rule related to the hypothetical comparison of the conditions the parties would include at arm's length in comparable circumstances.

Finance also proposes to broaden the rules to ensure that all conditions are scrutinized, as opposed to only price or other conditions stemming from intra-group contracts.

Non-recognition and replacement of controlled transactions

Finance's proposals also replace the current recharacterization provisions with a non-recognition test, which Finance notes is in line with transfer pricing regimes in other jurisdictions. In particular, Finance advises that, where a "delineated transaction or series" meets certain conditions, taking into consideration the participants' respective perspectives and realistically available options, a proposed non-recognition and replacement rule would apply. In particular, this rule would apply where both:

- The transaction differs from a transaction that would have been entered into by the participants had they been dealing at arm's length in a commercially rational manner in comparable circumstances, and
- The transaction prevents the determination of a transfer price that would have been acceptable to the participants had they been dealing at arm's length in a commercially rational manner in comparable circumstances.

The non-recognition and replacement rule would deem that certain conditions that are inconsistent with arm's length conditions would be disregarded in favour of certain other conditions. Specifically, these conditions should, as closely as possible, reflect the delineated transaction, have a commercially rational expected result, and can be priced from the perspective of arm's length parties.

KPMG observations
Finance also asks for feedback on how Canada's transfer pricing rules can achieve more consistency with the OECD Guidelines. Finance notes that it is currently proposing to adopt a consistency rule with a static approach, so that future revisions to the OECD Guidelines would be incorporated into Canadian law only after passing specific legislative amendments (or promulgating regulations).

In addition, the consultation paper provides several examples of how the proposed changes to the arm's length comparison would apply. Finance further advises that certain consequential amendments would result from these proposals, which it says will be released at a later stage of the consultation.

Administrative measures

Finance also proposes changes intended to streamline Canada's transfer pricing documentation requirements and transfer pricing penalty provisions in accordance with the OECD Guidelines.

Master File transfer pricing documentation

Finance proposes to amend the rules so that only taxpayers that are members of larger MNE groups (i.e., groups that are also subject to country-by-country reporting requirements) would be required to prepare a Master File in prescribed form. The Master File would only be required to be submitted upon request by the CRA.

Documentation requirements

Finance says that it is also considering changes intended to streamline documentation requirements for lower-risk transactions or taxpayers. In particular, Finance indicates that these potential changes could allow a taxpayer to satisfy transfer pricing documentation requirements for certain controlled transactions through an annual reporting schedule. Finance notes that the CRA would establish the criteria for taxpayers to use this simplified approach.

Penalties

Finance also states that it is considering raising the threshold for the application of transfer pricing penalties by increasing the threshold to net adjustments that are greater than $10 million (increased from $5 million) or 10% of the taxpayer's revenue, whichever is less.

Streamlined pricing approaches

Finance is considering introducing streamlined pricing approaches intended to reduce the burden of benchmarking arm's length returns, including to:

- Adopt the approach for pricing low value-adding intra-group services introduced in the 2017 OECD Guidelines (under which a 5% return for all qualifying services and a 5% return on the costs of an inbound service charge would be accepted as arm's length).

- Introduce a safe harbour return for relatively routine distribution activities, while also noting that Canada remains an active participant in discussions on "baseline marketing and distribution activities" in relation to Amount B of Pillar One of the Inclusive Framework on Base Erosion and Profit Shifting.

- Limit the acceptable range of certain loan conditions when identifying the arm's length transactions to be used as a comparable, including limiting the terms of intra-group loans (to five years), using the credit rating of the MNE group as a whole and removing subordination features and embedded options.

KPMG observations
Finance's proposed Master File documentation requirement for larger multinational enterprises will bring Canada in line with many other OECD countries that have adopted the Master File documentation requirement.

Finance's streamlined pricing proposals may simplify transfer pricing for some routine transactions. However, it will be important that taxpayers are not required to use these simplifications where they create a non-arm's length result. For example, it is not clear that the proposals for intra-group loans will always result in pricing that is materially consistent with the economically relevant characteristics that exist between comparable arm's length and non-arm's length transactions. Material differences could result in more disputes, and it is not clear how Competent Authorities would eliminate double taxation under the relevant tax treaties.

We can help

Your KPMG adviser can help you assess the effect of these new developments. For more details, contact a KPMG Transfer Pricing professional in Canada.

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