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GLOBAL TRANSFER PRICING SERVICES

Global Transfer Pricing Review

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TAX



Canada



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The Canada Revenue Agency continues to focus significant resources on transfer pricing audits, including addressing business restructuring situations. Canada's first Supreme Court decision in a transfer pricing case was delivered during 2012, marking a significant milestone in the judicial interpretation of transfer pricing.

Basic information

Tax authority name

Canada Revenue Agency (CRA).

Citation for transfer pricing rules

Section 247 of the Income Tax Act of Canada, RSC 1985, and Chapter 1 and 2 (Fifth Supplement), as amended.

Effective date of transfer pricing rules

In general, section 247 is applicable for taxation years beginning after 1997. However, the transfer pricing penalties (pursuant to subsection 247(3)) are applicable for taxation years beginning after 1998.

For taxation years prior to 1998, there were different transfer pricing provisions of the Income Tax Act that were applicable.

What is the relationship threshold for transfer pricing rules to apply between parties?

Ownership of more than 50 percent; however, parties may still be found to be non-arm's length even where there is less than 50 percent ownership (de facto control or the absence of independent interests).

What is the statute of limitations on assessment of transfer pricing adjustments?

Generally, 7 years (6 years in specific cases) from the date of issuance of the notice of original assessment. The

notice of original assessment is generally received 3 to 6 months after the filing of the tax return.

Transfer pricing disclosure overview

Are disclosures related to transfer pricing required to be prepared or submitted to the revenue authority on an annual basis (e.g. with the tax return)?

Yes, as long as related party transactions are above a certain dollar threshold.

What types of transfer pricing information must be disclosed?

A form called the T106 must be completed. The T106 requires detailed information about transactions with non-arm's length non-resident entities, including types and quantum of transactions, transfer pricing methodologies used, whether there has been a change in methodology, whether the methodology is based on an Advance Pricing Agreement (APA) with another tax authority and whether contemporaneous documentation exists with respect to such transactions. A T106 is required if the amount of the total reportable transactions for all the non-residents combined is more than one million Canadian dollars (CAD). Where a reporting person's total amount of transactions with a particular non-resident during the taxation year is below CAD25,000, certain information is not required.

What are the consequences of failure to prepare or submit disclosures?

A late filing penalty or multiple late filing penalties for more than one T106 form may be assessed if the T106 is filed after the due date. The penalty is equal to the greater of CAD100 and CAD25 per day, up to a maximum of 100 days.

A failure-to-file penalty may be assessed where the reporting persons knowingly fail to file T106 documentation. The minimum penalty is CAD500 per month, to a maximum of CAD12,000 for each failure to comply. The failure-to-file penalty is reduced by any late filing penalties assessed.

Transfer pricing study overview

Is preparation of a transfer pricing study required – i.e. can the taxpayer be penalized for mere failure to prepare a study?

No. Technically, the preparation of transfer pricing studies is not required per se. However, failure to prepare transfer pricing studies on a contemporaneous basis can automatically trigger the application of a transfer pricing penalty if the CRA levies adjustments above certain thresholds.

Other than complying with a requirement per the previous question, describe the benefits, if any, of preparing and maintaining a transfer pricing study?

Benefits include:

- penalty protection
- reduce the risk of adjustment
- proactively manage the facts and analysis
- shift the burden of proof to the tax authority.

To satisfy the requirement and/or obtain the benefits, are there any requirements on when the transfer pricing study must be prepared and submitted?

In order to be contemporaneous, the transfer pricing analysis and documentation must be prepared by the taxpayer's filing due date (i.e. within 6 months after fiscal year-end) and must be provided to the CRA within 3 months of a written request.

When a transfer pricing study is prepared, should its content follow Chapter V of the OECD Guidelines?

No. While it uses the Organisation for Economic Co-operation and Development (OECD) Guidelines as the basis for the information required, section 247(4) (a) sets out six required elements:

1. the property or services to which the transaction relates
2. the terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the participants in the transaction
3. the identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into
4. the functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction
5. the data and methods considered and the analysis performed to determine the transfer prices or the allocations of profits or losses or contributions to costs, and the case may be, in respect of the transaction

6. the assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction.

Does the tax authority require an advisor/tax practitioner to have specific designation in order to prepare or submit a transfer pricing study?

No.

Transfer pricing methods

Are transfer pricing methods outlined in Chapter II of the OECD Guidelines acceptable?

Yes.

Is there a priority among the acceptable methods?

Canada follows the OECD Guidelines regarding the use of the most appropriate method. However, there remains somewhat of a preference for traditional transaction methods and Canadian courts have shown a general preference for the comparable uncontrolled price (CUP) method. In competent authority or APA proceedings, transactional profit methods are often used.

If there is no priority of methods, is there a "best method" rule?

No.

Transfer pricing audit and penalties

When the tax authority requests a taxpayer's transfer pricing documentation, how long does the taxpayer have to submit its documentation?

Three months.

If an adjustment is proposed by the tax authority, are dispute resolution options available to the taxpayer outside of competent authority?

Aside from requesting competent authority assistance, taxpayers can also file a notice of objection with the Appeals division of the CRA and, if necessary, can pursue an appeal before the Tax Court of Canada.

If an adjustment is sustained, can penalties be assessed? If so, what rates are applied and under what conditions?

Yes. The legislation provides for the imposition of a penalty equal to 10 percent of the total transfer pricing adjustment, in certain cases. The penalty is intended to be compliance-related, focusing on the efforts that a taxpayer makes to determine and use arm's length pricing. The penalty equals 10 percent of the net amount of adjustments made in a tax year, but only where the net adjustments exceed the lesser of 10 percent of the taxpayer's gross revenue for the year or CAD5 million. The net amount of the adjustment is based on:

- upward adjustments relating to transactions for which the taxpayer does not have adequate documentation
- downward adjustments relating to transactions for which the taxpayer has adequate documentation.

To what extent are transfer pricing penalties enforced?

Transfer pricing penalties are enforced aggressively.

What defences are available with respect to penalties?

Penalties may be avoided where a taxpayer has made 'reasonable efforts' to comply with the dual obligation to determine and use arm's length prices pursuant to subsection 247(4) of the Income Tax Act and CRA's TPM-09 (reasonable efforts under section 247 of the Income Tax Act). To demonstrate that a reasonable effort has been made, complete and accurate documentation must be prepared and updated on an annual basis. Penalties may be reduced or eliminated based on subsequent competent authority settlements.

What trends are being observed currently?

Canada continues to be a jurisdiction where transfer pricing enforcement is a high priority. The probability of a transfer pricing audit and adjustment remain higher than in many other jurisdictions. In recent years, the CRA has started to apply a risk-based approach to evaluating and selecting taxpayers for transfer pricing audits. This approach is based on a

number of factors including the type and amount of non arm's length transactions, prior audit history, continuing losses as well as the existence of restructuring transactions.

Special considerations

Are secret comparables used by tax authorities?

Yes, but very rarely.

Is there a preference, or requirement, by the tax authorities for local comparables in a benchmarking set?

Yes. Generally the CRA prefers the use of local comparables, but accepts the use of North American comparables.

Do tax authorities have requirements or preferences regarding databases for comparables?

Taxpayers are free to use a database of their choice. The CRA uses the Standard and Poor's Capital IQ database.

What level of interaction do tax authorities have with customs authorities?

Low.

Are management fees deductible?

Yes.

Are management fees subject to withholding?

Yes. However, this is generally nullified by the relevant income tax convention if the payee does not have a permanent establishment in the payer's country.

Are year-end transfer pricing adjustments permitted?

Yes, year-end adjustments may be made. Taxpayers are, however, encouraged to minimize or avoid year-end adjustments where possible, for example by reviewing and trueing-up pricing on a periodic basis during the year.

To the extent that such adjustments are required, they may be made as follows:

- before the books are closed for the year, by making an adjustment in the books
- after the books are closed, but before the financial statements are finalized, by making an adjusting journal entry to the financial statements
- after the financial statements have been finalized, by making an adjustment on Schedule 1 of the corporate tax return.

To the extent that year-end adjustments relate to tangible products imported into Canada, such adjustments will have Customs implications:

- for upward price adjustments, Customs will generally require the importer to declare such higher amount and pay GST and duty on the difference
- downward adjustments are generally disregarded by Customs. Consequently, the importer will not be able to claim back refunds of duty, in those cases where the goods were dutiable.

Other unique attributes?

Generally, the CRA does not support the use of multi-year averaging. In an audit setting, results are evaluated on a year-by-year basis.

Use of the inter quartile range is not supported by the CRA.

Other recent developments

The 2012 Federal Budget confirmed that secondary adjustments are treated as deemed dividends, subject to relevant withholding taxes. In certain cases, the withholding tax will not be eligible for foreign tax credits in the other jurisdiction, as it is based on a deemed, rather than actual, dividend.

During 2012, the Supreme Court of Canada rendered its first decision in a transfer pricing case. This decision addressed a number of fundamental issues, including:

- the necessity to take into consideration all economically relevant circumstances that a party acting at arm's length would likely consider relevant
- the validity of various asserted comparables
- the extent of the taxpayer's onus to support the pricing actually used
- the true role and function of both parties to the transactions.

In terms of administrative guidance, the CRA issued two new Transfer Pricing Memoranda: TPM-13 and TPM-14. TPM-13 deals with referrals to the Transfer Pricing Review Committee and replaces TPM-07, with relatively minor changes. TPM-14 is the CRA's official announcement on adopting the 2010 version of the OECD Guidelines.

As noted, transfer pricing enforcement continues to be a focus area for the CRA, particularly in regard to intellectual property, business restructuring and financial transactions.

Tax treaty/double tax resolution

What is the extent of the double tax treaty network?

Extensive. There are currently 89 treaties in force.

If extensive, is the competent authority effective in obtaining double tax relief?

Almost always: in more than 90 percent of cases.

When may a taxpayer submit an adjustment to competent authority?

After receipt of a notice of reassessment from the CRA.

May a taxpayer go to competent authority before paying tax?

Yes. However, in most cases, the taxpayer will have to either post security or pay half the amount of the tax payable once a reassessment is issued.

Advance pricing agreements

What APA options are available, if any?

Unilateral, bilateral, and multilateral.

Is there a filing fee for APAs?

Yes, out-of-pocket expenses for the CRA in negotiating the APA.

Does the tax authority publish APA data either in the form of an annual report or through the disclosure of data in public forums?

Yes. The CRA issues an APA program Report which provides statistics for that year and a summary of key findings.

Please provide some information on how successful the APA program is and whether there are any known difficulties?

While currently experiencing resourcing constraints, Canada has a long established and generally well functioning APA program. Increased early stage due diligence on proposed APAs by the CRA has created some delays. In total, since the inception of the APA program, there have only been four instances in which the CRA has been unable to conclude an agreement with a taxpayer and/or a foreign tax administration. The current average time to conclude a bilateral APA is approximately 49 months. The CRA will not negotiate APAs concerning business restructuring transactions.

Language

In which language or languages can documentation be filed?

English or French.

KPMG in Canada

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