Working Party No. 6 on the Taxation of Multinational Enterprises

DRAFT LEGISLATION AND INFORMATION CIRCULAR ON TRANSFER PRICING RELEASED

Note by Canada

The attached note is submitted to the Working Party No. 6 FOR INFORMATION at its meeting on 9-10 December 1997.

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DRAFT LEGISLATION AND INFORMATION CIRCULAR ON TRANSFER PRICING RELEASED

Finance Minister Paul Martin and Revenue Minister Herb Dhaliwal today jointly released draft amendments to the *Income Tax Act* relating to the transfer pricing measures announced in the February 18, 1997 federal budget. Also released is a draft revision of Information Circular 87-2 which describes Revenue Canada’s administrative practices in the area of transfer pricing.

The proposed amendments and the revised information circular are being released in draft form to provide taxpayers and their advisors an opportunity to consider and comment on the proposals. In addition, the release at this time should give taxpayers sufficient opportunity to comply with the new contemporaneous documentation requirements. It is anticipated that these measures will be included in a bill to be introduced later this year. Consequently, only comments received before November 1, 1997 will be considered.

The proposed rules are in conformity with the revised (1995) transfer pricing guidelines of the Organization for Economic Co-operation and Development (the “OECD”), and are generally in keeping with the transfer pricing rules of other OECD member states, such as the U.S. Most notably, the draft amendments to the Act:

- require taxpayers who participate in cross-border transactions with non-arm’s length parties to conduct such transactions on terms and conditions that would have prevailed had the parties been dealing at arm’s length with each other;
- introduce documentation requirements which effectively require taxpayers to contemporaneously document their transfer pricing transactions and the steps taken to ensure that the terms and conditions of such transactions satisfy the arm’s length principle; and
- impose a penalty, in certain circumstances, where a taxpayer fails to make reasonable efforts to determine and use arm’s length transfer prices or arm’s length allocations in respect of transfer pricing transactions.

The draft information circular provides guidance for taxpayers with respect to a number of transfer pricing matters, including:

- the methods endorsed by the OECD to determine arm’s length transfer prices or allocations for transfer pricing transactions and the considerations that enter into the selection of the most appropriate method in the circumstances of a particular transaction;
• special considerations regarding cost contribution arrangements, transfers of intangibles and intra-group services;

• the nature and extent of the documentation required to ensure that the taxpayer will be considered, under the proposed legislation, to have made reasonable efforts to determine arm’s length transfer prices or allocations; and

• the application of the proposed penalty.

Mr. Martin noted that the new transfer pricing provisions would protect the Canadian tax base by encouraging taxpayers to observe the arm’s length principle, which is the internationally recognized standard against which the terms and conditions of transfer pricing transactions are measured. Mr. Dhaliwal indicated that the proposed new provisions were also consistent with Revenue Canada’s intention to devote more resources to the verification of cross-border transactions by multinational enterprises and would make transfer pricing audits more efficient for both taxpayers and Revenue Canada.

Revenue Canada will put in place the necessary administrative procedures to ensure that the proposed penalty is applied in a consistent manner.

The Department of Finance also welcomes comments with respect to the issue of transfer pricing between the permanent establishments or branches of the same entity. This issue is currently being studied by the OECD Committee on Fiscal Affairs and further amendments to the Act may be necessary to address this issue.

References to "Announcement Date" in the draft legislation and explanatory notes should be read as referring to today's date.

Draft Information Circular 87-2R is available on the Internet at http://www.revcan.ca or on Revenue Canada’s E.D.C.S.

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Draft Legislation on Transfer Pricing

1. (1) Subsections 69(2) and (3) of the Income Tax Act are repealed.
   (2) Subsection (1) applies to taxation years that begin after 1997.

2. (1) Section 233.1 of the Act is replaced by the following:

233.1 (1) The definitions in this subsection apply in this section.

“reportable transaction” means

   (a) in the case of

          (i) a reporting person for a taxation year who is not resident in Canada at any time in the year,
          or

          (ii) a reporting partnership for a fiscal period no member of which is resident in Canada in the period,

   a transaction or series of transactions that relate in any manner whatever to a business carried on in Canada by the reporting person or partnership in the year or period or a preceding year or period; and

   (b) in any other case, a transaction or series of transactions that relate in any manner whatever to a business carried on by a reporting person (other than a business carried on by a reporting person as a member of a partnership) or partnership in a taxation year or fiscal period.

“reporting partnership” for a fiscal period means a partnership

   (a) a member of which is resident in Canada in the period, or

   (b) that carries on a business in Canada in the period.

“reporting person” for a taxation year means a person who, at any time in the year,

   (a) is resident in Canada, or

   (b) is non-resident and carries on a business (other than a business carried on as a member of a partnership) in Canada.

“transaction” includes an arrangement or event.

Reporting person’s information return

(2) Subject to subsection (4), a reporting person for a taxation year shall, on or before the reporting person’s filing-due date for the year, file with the Minister, in respect of each non-resident person with whom the reporting person does not deal at arm’s length in the year and each partnership of which such a non-resident person is a member, an information return for the year in prescribed form containing prescribed information in respect of the reportable transactions in which the reporting person and the non-resident person or the partnership, as the case may be, participated in the year.
Reporting partnership’s information return

(3) Subject to subsection (4), a reporting partnership for a fiscal period shall, on or before the day on or before which a return is required by section 229 of the *Income Tax Regulations* to be filed in respect of the period or would be required to be so filed if that section applied to the reporting partnership, file with the Minister, in respect of each non-resident person with whom the reporting partnership, or a member of the reporting partnership, does not deal at arm’s length in the period and each partnership of which such a non-resident person is a member, an information return for the period in prescribed form containing prescribed information in respect of the reportable transactions in which the reporting partnership and the non-resident person or the partnership, as the case may be, participated in the period.

*De minimis* exception

(4) A reporting person or partnership that, but for this subsection, would be required under subsection (2) or (3) to file an information return for a taxation year or fiscal period, is not required to file the return unless the total of all amounts each of which is the total fair market value of the property or services that relate to a reportable transaction in which the reporting person or partnership and a non-resident person with whom the reporting person or partnership, or a member of the reporting partnership, does not deal at arm’s length in the year or period, or a partnership of which such a non-resident person is a member, as the case may be, participated in the year or period, exceeds $1,000,000.

Deemed member of partnership

(5) For the purposes of this section, a person who is a member of a partnership that is a member of another partnership is deemed to be a member of the other partnership.

(2) Subsection (1) applies to taxation years and fiscal periods that begin after 1997.

3. (1) The Act is amended by adding the following after section 246:

**Part XVI.1  
Transfer Pricing**

Definitions

247.(1) The definitions in this subsection apply in this section.

“arm’s length allocation” means, in respect of a transaction, an allocation of profit or loss that would have occurred between the participants in the transaction if they had been dealing at arm’s length with each other.

“arm’s length transfer price” means, in respect of a transaction, an amount that would have been a transfer price in respect of the transaction if the participants in the transaction had been dealing at arm’s length with each other.

“qualifying cost contribution arrangement” means an arrangement under which reasonable efforts are made by the participants in the arrangement to establish a basis for contributing to, and to contribute on that basis to, the cost of producing, developing or acquiring any property, or acquiring or performing any
services, in proportion to the benefits which each participant is reasonably expected to derive from the property or services, as the case may be, as a result of the arrangement.

“transaction” includes an arrangement or event.

“transfer price” means, in respect of a transaction, an amount paid or payable or an amount received or receivable, as the case may be, by a participant in the transaction as a price, a rental, a royalty, a premium or other payment for, or for the use, production or reproduction of, property or as consideration for services (including services provided as an employee and the insurance or reinsurance of risks) as part of the transaction.

“transfer pricing capital adjustment” of a taxpayer for a taxation year means the total of

(a) the total of all amounts each of which is

(i) 3/4 of the amount, if any, by which the adjusted cost base to the taxpayer of a capital property (other than a depreciable property) or an eligible capital expenditure of the taxpayer in respect of a business is reduced in the year because of an adjustment made under subsection (2), or

(ii) the amount, if any, by which the capital cost to the taxpayer of a depreciable property is reduced in the year because of an adjustment made under subsection (2); and

(b) the total of all amounts each of which is that proportion of the total of

(i) 3/4 of the amount, if any, by which the adjusted cost base to a partnership of a capital property (other than a depreciable property) or an eligible capital expenditure of a partnership in respect of a business is reduced in a fiscal period that ends in the year because of an adjustment made under subsection (2), and

(ii) the amount, if any, by which the capital cost to a partnership of a depreciable property is reduced in the period because of an adjustment made under subsection (2),

that

(iii) the taxpayer’s share of the income or loss of the partnership for the period

is of

(iv) the income or loss of the partnership for the period,

and where the income and loss of the partnership are nil for the period, the income of the partnership for the period is deemed to be $1,000,000 for the purpose of determining a taxpayer’s share of the partnership’s income for the purpose of this definition.

“transfer pricing income adjustment” of a taxpayer for a taxation year means the total of all amounts each of which is the amount, if any, by which an adjustment made under subsection (2) (other than a transfer pricing capital adjustment of the taxpayer for a taxation year) would result in an increase in the taxpayer’s income for the year or a decrease in a loss of the taxpayer for the year from a source if that adjustment were the only adjustment made under subsection (2).
Transfer pricing adjustment

(2) Where a taxpayer or a partnership and a non-resident person with whom the taxpayer or the partnership, or a member of the partnership, does not deal at arm’s length (or a partnership of which the non-resident person is a member) are participants in a transaction or a series of transactions, and

(a) the terms or conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm’s length, or

(b) the transaction or series would not have been entered into between persons dealing at arm’s length,

any amounts that, but for this section and section 245, would be determined for the purposes of this Act in respect of the taxpayer or the partnership for a taxation year or fiscal period and the nature of such amounts shall be adjusted or recharacterized (in this section referred to as an “adjustment”) to the quantum or nature of the amounts that would have been determined if

(c) where paragraph (a) applies, the terms and conditions made or imposed, in respect of the transaction or series, between the participants in the transaction or series had been those that would have been made between persons dealing at arm’s length, or

(d) where paragraph (b) applies, the transaction or series entered into between the participants had been the transaction or series that would have been entered into between persons dealing at arm’s length, under terms and conditions that would have been made between persons dealing at arm’s length.

Penalty

(3) A taxpayer (other than a taxpayer all of whose taxable income for the year is exempt from tax under Part I) is liable to a penalty for a taxation year equal to 10% of the amount determined under paragraph (a) in respect of the taxpayer for the year, where

(a) the amount, if any, by which

(i) the total of

(A) the taxpayer’s transfer pricing capital adjustment for the year, and

(B) the taxpayer’s transfer pricing income adjustment for the year

exceeds

(ii) the total of all amounts, each of which is the portion of the taxpayer’s transfer pricing capital adjustment or transfer pricing income adjustment for the year that can reasonably be considered to relate to a particular transaction, where

(A) the transaction is a qualifying cost contribution arrangement in which the taxpayer or a partnership of which the taxpayer is a member is a participant, or
(B) in any other case, the taxpayer or a partnership of which the taxpayer is a member made reasonable efforts to determine arm’s length transfer prices or arm’s length allocations in respect of the transaction, and to use those prices or allocations for the purposes of this Act, is greater than

(b) the lesser of

(i) 10% of the amount that would be the taxpayer’s gross revenue for the year if the Act were read without reference to subsection (2), subsections 69(1) and (1.2) and section 245, and

(ii) $5,000,000.

Contemporaneous documentation

(4) For the purposes of subsection (3) and the definition of qualifying cost contribution arrangement, a taxpayer or a partnership is deemed not to have made reasonable efforts to determine and use arm’s length transfer prices or arm’s length allocations in respect of a transaction or not to have participated in a transaction that is a qualifying cost contribution arrangement, unless the taxpayer or the partnership, as the case may be,

(a) makes or obtains, within 60 days after the end of the taxation year or fiscal period of the taxpayer or the partnership, as the case may be, in which the transaction is entered into, records or documents which provide a complete and accurate description of

(i) the property or services to which the transaction relates,

(ii) 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,

(iii) the identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into,

(iv) the functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction,

(v) 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, as the case may be, in respect of the transaction, and

(vi) 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;

(b) for each subsequent taxation year or fiscal period, if any, in which the transaction continues, makes or obtains, within 60 days after the end of the year or period, records or documents that completely and accurately describe any material changes in the year or period to the matters referred to in any of subparagraphs (a)(i) to (vi) in respect of the transaction; and
Partner’s gross revenue

5 For the purpose of subparagraph (3)(b)(i), where a taxpayer is a member of a partnership in a taxation year, the taxpayer’s gross revenue for the year as a member of the partnership from any activities carried on by means of the partnership is deemed to be that proportion of the amount that would be the partnership’s gross revenue from the activities if it were a taxpayer (to the extent that that amount does not include amounts received or receivable from other partnerships of which the taxpayer is a member in the year), for a fiscal period of the partnership that ends in the year, that

(a) the taxpayer’s share of the income or loss of the partnership from its activities for the period

is of

(b) the income or loss of the partnership from its activities for the period,

and where the income and loss of the partnership from its activities are nil for the period, the income of the partnership from its activities for the period is deemed to be $1,000,000 for the purpose of determining a taxpayer’s share of the partnership’s income from its activities for the purpose of this subsection.

Deemed member of partnership

6 For the purposes of this section, where a person is a member of a partnership that is a member of another partnership

(a) the person is deemed to be a member of the other partnership; and

(b) the person’s share of the income or loss of the other partnership is deemed to be equal to the amount of that income or loss to which the person is directly or indirectly entitled.

Exclusion for loans to subsidiary

7 Subsection (2) does not apply to a transaction that is a loan referred to in subsection 17(3).

Provisions not applicable

8 Where subsection (2) would, if this Act were read without reference to section 67 and subsections 69(1) and (1.2), apply to adjust the quantum of an amount under this Act, section 67 and subsections 69(1) and (1.2) shall not apply to determine the quantum of the amount, if subsection (2) was applied to adjust or recharacterize the quantum or nature of the amount.

Anti-avoidance

9 For the purposes of determining a taxpayer’s gross revenue under subparagraph (3)(b)(i) and subsection (5), a transaction or series of transactions is deemed not to have occurred, if one of the purposes of the transaction or series was to increase the taxpayer’s gross revenue for the purpose of subsection (3).
No adjustment unless appropriate

(10) Notwithstanding subsection (2), 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) shall not be made under that subsection unless, in the opinion of the Minister, the circumstances are such that it would be appropriate that such an adjustment be made.

Payment of penalty

247.1. (1) Every taxpayer shall on or before the last day of the second month after the end of a taxation year pay to the Receiver General any penalty to which the taxpayer is liable under this Part for the year.

Interest

(2) Where a taxpayer has failed to pay all or any part of a penalty payable under this Part by the taxpayer, the taxpayer shall pay to the Receiver General interest at the prescribed rate on the amount the taxpayer has failed to pay computed from the day on or before which the penalty was required to be paid to the day of payment.

Provisions applicable to Part

(3) Sections 152, 158, 159, 162 to 167 and Division J of Part I apply to this Part with such modifications as the circumstances require.

(2) Subsections 247(1), (2), (6), (7), (8) and (10) and subsection 247.1(3) of the Act, as enacted by subsection (1), apply to taxation years and fiscal periods that begin after 1997.

(3) Subsections 247(3), (4), (5) and (9) and subsections 247.1(1) and (2) of the Act, as enacted by subsection (1), apply with respect to adjustments made under subsection 247(2) of the Act, as enacted by subsection (1), for taxation years or fiscal periods that begin after 1998, except that

(a) subsections 247(3) to (5) and (9) of the Act, as enacted by subsection (1), do not apply with respect to a transaction completed before Announcement Date, and

(b) a record or document made or obtained or provided to the Minister of National Revenue by a taxpayer or a partnership before the day that is 60 days after the end of the taxpayer’s first taxation year or the partnership’s first fiscal period, as the case may be, that begins after 1998 is deemed for the purpose of subsection 247(4), as enacted by subsection (1), to have been so made, obtained or provided on a timely basis.
Draft Explanatory Notes

ITA
69(2) and (3)

Subsections 69(2) and (3) of the Act are, respectively, designed to prevent the overstatement of deductions and the understatement of revenues in computing the income of a taxpayer as a result of the misstatement of the prices charged (commonly known as “transfer prices”) in transactions with a non-resident person with whom the taxpayer does not deal at arm’s length. This is accomplished by re-stating the transfer prices for tax purposes so that they reflect the prices that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm’s length.

Subsections 69(2) and (3) are repealed effective for taxation years that begin after 1997, as a consequence of the introduction of proposed new subsection 247(2) of the Act.

ITA
233.1

Section 233.1 of the Act provides that every corporation resident in Canada or carrying on business in Canada at any time in a taxation year shall, within six months from the end of the year, file an information return for the year containing prescribed information regarding transactions with non-resident non-arm’s length persons. A separate information return is required to be filed in respect of each such non-resident person.

Section 233.1 is amended in order to extend the filing requirements contained therein to partnerships and individuals (including trusts).

ITA
233.1(1)

Proposed new subsection 233.1(1) of the Act sets out a number of definitions for the purposes of the filing requirements in proposed new subsections 233.1(2) to (4).

A “reportable transaction” generally means a transaction or series of transactions that relate to a business carried on by a “reporting person” or a “reporting partnership”. However, in the case of

- a reporting person who is a non-resident throughout a taxation year, or
- a reporting partnership all the members of which are non-resident throughout a fiscal period of the partnership,

a reportable transaction refers to a transaction or series of transactions that relates to a business carried on in Canada by the reporting person or partnership in the year or period or a preceding year or period.

A “reporting partnership” for a fiscal period means a partnership that either carries on business in Canada in the period or a member of which is resident in Canada in the period.

A “reporting person” for a taxation year means a person, specifically, a corporation, trust or natural person, who, at any time in the year, is either resident in Canada or is non-resident and carries on business in Canada.
For the purposes of the above definitions and proposed new subsections 233.1(2) to (4) of the Act, a “transaction” includes an arrangement or an event, such as the payment of a dividend.

**ITA 233.1(2)**

Proposed new subsection 233.1(2) of the Act provides that a reporting person (see the definition in proposed new subsection 233.1(1)) is required to file an information return for a taxation year in prescribed form and containing prescribed information in respect of the reportable transactions (see the definition in proposed new subsection 233.1(1)) in which the reporting person and a non-resident non-arm’s length person (or a partnership of which that non-resident person is a member) participated in the year.

The information return must be filed by the reporting person’s filing-due date for the year. A separate return must be filed for each such non-resident person (or partnership).

Proposed new subsection 233.1(2) applies to taxation years and fiscal periods that begin after 1997.

**ITA 233.1(3)**

Proposed new subsection 233.1(3) of the Act provides that a reporting partnership (see the definition in proposed new subsection 233.1(1)) is required to file an information return for a fiscal period in prescribed form and containing prescribed information in respect of the reportable transactions (see the definition in proposed new subsection 233.1(1)) in which the reporting partnership and a non-resident non-arm’s length person (or a partnership of which the non-resident person is a member) participated in the period. An information return must also be filed by a reporting partnership under this subsection if a member of the reporting partnership does not deal at arm’s length with the above-mentioned non-resident person.

The deadline for filing the return is the same as the deadline for filing a partnership information return under section 229 of the Income Tax Regulations. If no section 229 return is required to be filed, the reporting partnership’s information return under proposed new subsection 233.1(3) must be filed by the day by which the section 229 return would be required to be filed if section 229 did apply to the reporting partnership.

Proposed new subsection 233.1(3) applies to taxation years and fiscal periods that begin after 1997.

**ITA 233.1(4)**

Proposed new subsection 233.1(4) of the Act provides an exception to the reporting requirements in proposed new subsections 233.1(2) and (3). More specifically, it provides that a reporting person or partnership is not required to file an information return for a taxation year or fiscal period, unless the total fair market value of the property or services that relate to reportable transactions in which the reporting person or partnership and a non-resident non-arm’s length person (or a partnership of which the non-resident person is a member) participated in the year or period, exceeds $1,000,000. Also included in determining whether a reporting partnership has exceeded the $1,000,000 threshold, is the value of property or services that relate to reportable transactions in which the reporting partnership and a non-resident person (or a partnership of which the non-resident person is a member) participated, where a
member of the reporting partnership does not deal at arm’s length with the non-resident person (or the partnership).

Proposed new subsection 233.1(4) applies to taxation years and fiscal periods that begin after 1997.

ITA 233.1(5)

Proposed new subsection 233.1(5) of the Act provides that, for the purpose of proposed new subsection 233.1, a person who is a member of a partnership which in turn is a member of another partnership is considered to be a member of that other partnership.

Proposed new subsection 233.1(5) applies to taxation years and fiscal periods that begin after 1997.

ITA 247

Proposed new section 247 in proposed new Part XVI.1 of the Act is related to the issue of transfer pricing for property or services purchased and sold in cross-border transactions and the determination of amounts for tax purposes.

ITA 247(1)

Proposed new subsection 247(1) of the Act defines a number of terms for the purpose of proposed new section 247 dealing with transfer pricing.

An “arm’s length allocation” means an allocation of profit or loss that would have occurred between the participants in a transaction assuming they had been dealing at arm’s length with each other. Similarly, an “arm’s length transfer price” means an amount that would have been a transfer price in respect of a transaction assuming the participants in the transaction had been dealing at arm’s length with each other.

The term “transfer price” is used in the definition “arm’s length transfer price”. It is defined as an amount paid or payable or received or receivable by a participant in a transaction as a price, a rental, a royalty, a premium or other payment for, or for the use, production or reproduction of, property or as consideration for services, as part of the transaction. For greater certainty, the term services includes the services of an employee and the insurance or reinsurance of risks.

The term “qualifying cost contribution arrangement” refers to an arrangement under which the participants collectively make reasonable efforts to establish a basis for contributing to, and to contribute on that basis to, the cost of producing, developing or acquiring any property, or acquiring or performing any services, in proportion to the benefits which each participant is reasonably expected to derive from the property or services as a result of the arrangement.
The terms “arm’s length allocation”, “arm’s length transfer price” and “qualifying cost contribution arrangement” are relevant for the purposes of the penalty provision in proposed new subsection 247(3) of the Act for certain transfer pricing adjustments made pursuant to proposed new subsection 247(2) of the Act.

A “transfer pricing capital adjustment” of a taxpayer for a taxation year consists of two amounts. The first amount is the total of

- 3/4 of all reductions made under proposed new subsection 247(2) to the adjusted cost base of a non-depreciable capital property of the taxpayer or an eligible capital expenditure of the taxpayer and
- all reductions made under proposed new subsection 247(2) to the capital cost of a depreciable property of the taxpayer.

The second amount is relevant only if the taxpayer is a member of a partnership. It is equal to the total of all amounts each of which is that proportion of the total of

- 3/4 of all reductions made under proposed new subsection 247(2) to the adjusted cost base of a non-depreciable capital property of the partnership or an eligible capital expenditure of the partnership, and
- all reductions made under proposed new subsection 247(2) to the capital cost of a depreciable property of the partnership,

that the taxpayer’s share of the income or loss of the partnership for the period is of the total income or loss of the partnership for the period.

If the income and loss of the partnership for the period are nil, the partnership is deemed to have income in the amount of $1,000,000 for the purpose of determining the taxpayer’s share of the partnership’s income for the purpose of this definition.

A “transfer pricing income adjustment” of a taxpayer for a taxation year means the total of all amounts by which the taxpayer’s income for the year would increase or the taxpayer’s loss for the year from a source would decrease because of an adjustment made under proposed new subsection 247(2), assuming that that were the only adjustment made under that subsection.

The definitions “transfer pricing capital adjustment” and “transfer pricing income adjustment” are relevant for the purpose of the penalty in proposed new subsection 247(3).

ITA 247(2)

In general terms, proposed new subsection 247(2) of the Act requires that, for tax purposes, non-arm’s length parties conduct their transactions under terms and conditions that would have prevailed if the parties had been dealing at arm’s length with each other. Therefore, proposed new subsection 247(2) embodies the arm’s length principle.

More specifically, proposed new subsection 247(2) applies in situations where a taxpayer or a partnership and a non-resident person with whom the taxpayer, the partnership or a member of the partnership does
not deal at arm’s length (or a partnership of which the non-resident person is a member) are participants in a transaction or a series of transactions and

- that would have been made between persons dealing at arm’s length, or
- the transaction or series would not have been entered into between persons dealing at arm’s length.

Where these conditions are met, proposed new subsection 247(2) may adjust or recharacterize any amounts that, but for that subsection and the general anti-avoidance rule in section 245, would have been determined for the purposes of the Act in respect of the taxpayer or the partnership. Such amounts may be adjusted or recharacterized to reflect the quantum or nature of the amounts that would have been determined if the participants had been dealing at arm’s length with each other.

Proposed new subsection 247(2) applies to taxation years and fiscal periods that begin after 1997.

ITA 247(3)

In general terms, proposed new subsection 247(3) of the Act provides that a taxpayer is liable to a penalty for a taxation year if the total amount of the taxpayer’s “reduced” transfer pricing income and capital adjustments for the year exceeds the lesser of 10% of the taxpayer’s gross revenue for the year and $5,000,000. A taxpayer’s transfer pricing income and capital adjustments are reduced to the extent that they can reasonably be considered to relate to

- a transaction that is a qualifying cost contribution arrangement (see proposed new subsection 247(1)) and in which the taxpayer (or a partnership of which the taxpayer is a member) is a participant, or
- a transaction in respect of which the taxpayer (or a partnership of which the taxpayer is a member) made reasonable efforts to determine arm’s length transfer prices or arm’s length allocations (see proposed new subsection 247(1)), and to use those prices or allocations for tax purposes.

It should be noted, however, that no reduction may be made to a taxpayer’s transfer pricing income and capital adjustments if the taxpayer (or a partnership of which the taxpayer is a member) has failed to document its transactions in accordance with the provisions of proposed new subsection 247(4). Briefly, that subsection requires a taxpayer (or a partnership of which the taxpayer is a member) to contemporaneously document the transactions that are governed by proposed new subsection 247(2) and to provide such documentation to the Minister of National Revenue within 60 days of a request therefor. If the taxpayer fails to comply with these requirements, proposed new subsection 247(4) deems the taxpayer not to have made reasonable efforts to determine arm’s length transfer prices or arm’s length allocations in respect of a transaction or not to have participated in a qualifying cost contribution arrangement.

If the taxpayer’s “reduced” transfer pricing income and capital adjustments for the year exceed the lesser of $5,000,000 and 10% of the taxpayer’s gross revenue for the year, determined without reference to proposed new subsection 247(2), subsections 69(1) and (1.2) and section 245, the taxpayer is liable to a penalty for the year equal to 10% of the amount of the “reduced” transfer pricing income and capital adjustments.
The penalty in proposed new subsection 247(3) applies to adjustments made under proposed new subsection 247(2) for taxation years or fiscal periods that begin after 1998; however, adjustments made in respect of transactions completed before Announcement Date are not subject to the penalty.

**ITA 247(4)**

In broad terms, proposed new subsection 247(4) of the Act requires a taxpayer to document its transactions that are governed by proposed new subsection 247(2), failing which the taxpayer will be liable to the penalty (assuming the taxpayer’s transfer pricing income and capital adjustments exceed the penalty threshold) in proposed new subsection 247(3).

More specifically, proposed new subsection 247(4) deems a taxpayer not to have made reasonable efforts to determine arm’s length transfer prices or allocations in respect of a transaction nor to have participated in a transaction that is a qualifying cost contribution arrangement, unless the taxpayer (or the partnership) makes or obtains certain records or documents within 60 days of the end of the taxation year (or fiscal period) in which the transaction is entered into. Put another way, the taxpayer’s transfer pricing income and capital adjustments otherwise determined for the year will not be able to be reduced for purposes of calculating the penalty in proposed new subsection 247(3) unless certain documentation requirements have first been satisfied.

The records or documents which are required to be made or obtained must provide a complete and accurate description of

- the property or services to which the transaction relates,
- the terms and conditions of the transaction and how they relate to the terms and conditions of other transactions entered into between the participants,
- the identity of the participants and their relationship at the time the transaction was entered into,
- the functions performed, the property used or contributed and the risks assumed by the participants,
- the data and transfer pricing methods (for example, the comparable uncontrolled price method) considered and the analysis performed to determine the transfer prices or allocations of profits or losses or contributions to costs in respect of the transaction, and
- 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 in respect of the transaction.

Where the transaction that is being documented spans more than one taxation year or fiscal period, the taxpayer or partnership must completely and accurately document any material changes occurring in the subsequent year or period to the matters listed above. Such documentation is required to be made or obtained by the taxpayer or partnership within 60 days after the end of the subsequent year or period.
All the documentation that must be prepared under this subsection is required to be provided to the Minister of National Revenue within 60 days of service, made personally or by registered or certified mail, of a written request therefor.

Proposed new subsection 247(4) applies to adjustments made under proposed new subsection 247(2) for taxation years that begin after 1998. It should be noted, however, that a record or document made or obtained or provided to the Minister within 60 days of the end of the taxpayer’s first taxation year (or the partnership’s first fiscal period) that begins after 1998 is deemed to have been made, obtained or provided on a timely basis.

ITA
247(5)

Proposed new subsection 247(5) of the Act provides a rule to determine a taxpayer’s gross revenue from membership in a partnership for the purpose of the penalty provision in proposed new subsection 247(3). Under proposed new subsection 247(3), a taxpayer is not liable to a penalty for a taxation year unless the total of the taxpayer’s “reduced” transfer pricing income and capital adjustments for the year exceeds the lesser of $5,000,000 and 10% of the taxpayer’s gross revenue for the year, determined without reference to proposed new subsection 247(2), subsections 69(1) and (1.2) and section 245.

Under proposed new subsection 247(5), the taxpayer’s gross revenue for a taxation year as a member of a partnership is that proportion of the partnership’s gross revenue for a fiscal period ending in the year (computed as though the partnership were a taxpayer and without reference to any amounts received or receivable from other partnerships of which the taxpayer is a member in the year), that the taxpayer’s share of the income or loss of the partnership from its activities for the period is of the total income or loss of the partnership from its activities for the period. If the income or loss of the partnership for the period are nil, the partnership is deemed to have income in the amount of $1,000,000 for the purpose of determining the taxpayer’s share of the partnership’s income for the purpose of this subsection.

Proposed new subsection 247(5) applies with respect to adjustments made under proposed new subsection 247(2) for taxation years and fiscal periods that begin after 1998; however, proposed new subsection 247(5) does not apply with respect to transactions completed before Announcement Date.

ITA
247(6)

Proposed new subsection 247(6) of the Act provides that, for the purpose of proposed new section 247, a person who is a member of a partnership which in turn is a member of another partnership is considered to be a member of that other partnership. It also provides that a member’s share of the income or loss of the other partnership is deemed to be the amount to which it is directly or indirectly entitled.

Proposed new subsection 247(6) applies to taxation years and fiscal periods that begin after 1997.

ITA
247(7)

Proposed new subsection 247(7) of the Act effectively exempts interest-free and low interest loans made by a corporation resident in Canada to a non-resident subsidiary it controls from the application of proposed new subsection 247(2).
Proposed new subsection 247(7) applies to taxation years and fiscal periods that begin after 1997.

ITA

247(8)

Proposed new subsection 247(8) of the Act ensures that where

− proposed new subsection 247(2) would apply to adjust the quantum of an amount under the Act, assuming the Act were read without reference to section 67 and subsections 69(1) and (1.2), and

− subsection 247(2) is, in fact, applied to adjust the quantum or recharacterize the nature of that amount,

then section 67 and subsections 69(1) and (1.2) shall not apply to determine the quantum of that amount.

Proposed new subsection 247(8) applies to taxation years and fiscal periods that begin after 1997.

ITA

247(9)

Proposed new subsection 247(9) of the Act is an anti-avoidance rule intended to prevent taxpayers from artificially increasing their gross revenue for the purpose of the penalty in proposed new subsection 247(3). It provides that, for the purpose of the gross revenue penalty threshold in proposed new subparagraph 247(3)(b)(i) and the determination of a partner’s gross revenue under proposed new subsection 247(5), a transaction or a series of transactions is deemed not to have occurred where a purpose of the transaction or series was to increase a taxpayer’s gross revenue for the purpose of the penalty.

Proposed new subsection 247(9) applies with respect to adjustments made under proposed new subsection 247(2) for taxation years and fiscal periods that begin after 1998; however, proposed new subsection 247(9) does not apply with respect to transactions completed before Announcement Date.

ITA

247(10)

Proposed new subsection 247(10) of the Act provides that adjustments (other than adjustments that result in or increase a transfer pricing capital or income adjustment of a taxpayer for a taxation year) shall not be made under proposed new subsection 247(2) unless the Minister considers that such adjustments would be appropriate in the circumstances.

Proposed new subsection 247(10) applies to taxation years and fiscal periods that begin after 1997.

ITA

247.1(1)

Proposed new subsection 247.1(1) of the Act provides that where a taxpayer is liable to a penalty under proposed new subsection 247(3) for a taxation year, the taxpayer must pay that penalty to the Receiver General for Canada before the end of the second month of the following taxation year.
Proposed new subsection 247.1(1) applies to adjustments made under proposed new subsection 247(2) for taxation years and fiscal periods that begin after 1998.

**ITA**

247.1(2)

Proposed new subsection 247.1(2) of the Act levies an interest charge on the portion of a penalty which a taxpayer has failed to pay to the Receiver General in accordance with the terms of proposed new subsection 247.1(1).

Proposed new subsection 247.1(2) applies to adjustments made under proposed new subsection 247(2) for taxation years and fiscal periods that begin after 1998.

**ITA**

247.1(3)

Proposed new subsection 247.1(3) of the Act ensures that the provisions of Part I of the Act relating to assessments, payments, penalties, refunds, objections and appeals apply to proposed new Part XVI.1 of the Act.

Proposed new subsection 247.1(3) applies to taxation years and fiscal periods that begin after 1997.
Introduction

1. Information Circular 87-2 has been updated to reflect changes to the *Income Tax Act* (the Act) proposed in 1997 dealing with transfer pricing and the 1995 revision by the Organisation for Economic Co-operation and Development (OECD) of its transfer pricing guidelines.

2. This circular sets out the Department’s views on transfer pricing. It provides guidance for taxpayers who participate in transactions or arrangements with non-resident persons with whom they do not deal at arm’s length. Unless otherwise specified, the expression *taxpayer, person or party* includes a partnership.

3. The OECD and Canada continue to endorse the arm’s length principle as the basic rule governing the tax treatment of non-arm’s length cross-border transactions. This principle requires that, for tax purposes, taxpayers conduct their transactions with non-arm’s length parties on the same terms and conditions that would have prevailed if the parties had been dealing at arm’s length. The application of this principle ensures that a taxpayer that is a member of a multinational group and that engages in transactions with members of the group, pays substantially the same amount of tax as it would have paid had the members of the group been dealing with each other at arm’s length. The determination of whether a taxpayer has adhered to the arm’s length principle is a question of fact.

4. In July 1995, the OECD issued the first part of its *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the OECD Guidelines). The first chapter provides a background discussion of the arm’s length principle. The next two chapters discuss acceptable transfer pricing methods. Chapter IV deals with a number of administrative issues. Chapter V provides guidance on the documentation of transfer prices.

5. Chapters VI and VII of the OECD Guidelines were published in March 1996. Chapter VI is entitled "Special Considerations for Intangible Property" and Chapter VII is entitled "Special Consideration for Intra-group Services."

6. The Department supports and proposes to follow the OECD Guidelines. The contents of this circular reflect the guidance provided by the OECD Guidelines. Readers should consult the OECD Guidelines for a more detailed discussion of the principles contained in Parts 2 to 6 of this circular.

Part 1. The Law – Overview

7. Section 247 of the Act contains the law relating to transfer pricing. The following is a brief description of the three principle subsections of that section.

8. Subsection 247(2) of the Act applies to a transaction between a taxpayer and a non-resident person with whom the taxpayer does not deal at arm’s length. Subsection 247(2) of the Act also applies to a transaction between a partnership or a member of a partnership and a non-resident person with whom the partnership or member does not deal at arm’s length (or a partnership of which such a non-resident is a member). A *transaction* includes a series of transactions, an arrangement or an event.
9. Where the terms or conditions of such transactions differ from those that would have been made between persons dealing at arm’s length, any amount determined under the Act in respect of a taxpayer may be adjusted under subsection 247(2) of the Act to reflect those amounts that would have been determined in respect of the taxpayer if the terms and conditions of the transactions were the same as those made between arm’s length persons. In addition, if persons enter into a transaction that would not have been entered into between persons dealing at arm’s length, subsection 247(2) of the Act may permit the recharacterization of the transaction to determine the amounts that would have been determined if the transaction had been one that would have been entered into by persons dealing at arm’s length. Subsection 247(2) of the Act applies to taxation years that begin after 1997.

10. If the adjustments made under subsection 247(2) of the Act in respect of a taxpayer for a taxation year exceed a certain threshold, the taxpayer may be liable to a penalty under subsection 247(3) of the Act. The penalty will be imposed if the taxpayer fails to make reasonable efforts to determine and use arm’s length transfer prices or allocations for the transactions for which the adjustments were made. The issue of whether a taxpayer has made reasonable efforts to determine and use arm’s length transfer prices or allocations is discussed in Part 7 of this circular.

11. Subsection 247(4) of the Act deems a taxpayer not to have made reasonable efforts to determine and use arm’s length transfer prices or allocations for the purposes of the penalty under subsection 247(3) of the Act, unless the taxpayer satisfies the conditions set out in subsection 247(4) of the Act. The taxpayer has to make or obtain certain records or documents within 60 days of the end of the taxation year and provide those records and documents to the Minister within 60 days of a written request to do so.

12. Subsections 247(3) and (4) of the Act generally apply to adjustments made under subsection 247(2) of the Act for taxation years that begin after 1998.

Part 2. The Arm’s length Principle

13. The arm’s length principle requires that, for tax purposes, each transaction between parties that are not dealing with each other at arm’s length be carried out under terms and conditions that one would have expected had the parties been dealing with each other at arm’s length.

14. Paragraph 1.15 of the OECD Guidelines states that the application of the arm’s length principle is generally based on a comparison of the prices or margins used or obtained by non-arm’s length parties with those used or obtained by arm’s length parties engaged in the same or similar transactions. In order for such price or margin comparisons to be useful, the economically relevant characteristics of the transactions being compared must be identical or at least sufficiently similar so as to permit reasonably accurate adjustments to be made for any differences in such characteristics.

15. Paragraphs 1.19 through 1.35 of the OECD Guidelines indicate that a number of factors may influence the degree of comparability of transactions. These factors include the following: the characteristics of the goods or services being purchased or sold, the functions performed by the parties to the transactions (taking into account assets used and risks assumed), the terms and conditions of the contract, the economic circumstances of the parties and the business strategies pursued by the parties. The importance of each of these factors in establishing comparability will depend upon the nature of the transaction and the pricing method adopted. In turn, the pricing method adopted will depend largely on the comparability of these factors.

16. Business strategies are factors that can affect comparability, as they influence the price that arm’s length parties would charge for a product. For example, where an independent party attempts to introduce a
product into a new market, it may be reasonable for that party to temporarily charge a price lower than it would otherwise charge, in an attempt to establish that market. This assumes that an independent party would have estimated the potential long-term benefits of such a strategy. It is unlikely that an independent party would maintain such a strategy for an extended period of time.

17. In establishing transfer prices, taxpayers should set prices separately for each transaction they enter into with a non-arm’s length party. For example, where a transfer encompasses the sale of a good as well as the provision of a related service (as is common in the operations of multinational groups), a price for the good and a price for the service should be separately determined and identified. This separate determination is required in order to arrive at the most accurate estimation of an arm’s length price. It is also required because some payments by a resident of Canada to a non-resident are subject to Part XIII withholding tax, while others are not. Moreover, if a tax treaty is applicable, payments for different types of services may be subject to withholding tax at different rates. However, the Department recognizes that, in some cases, it may not be possible to segregate bundled transactions. For example, where the normal industry practice is to set a fee for a combination of intangible property and services, there may be insufficient data available to allocate the fee between the intangible property and the services.

18. The Department generally accepts business transactions as they are structured by the parties. However, as indicated in the OECD Guidelines, there may be limited instances where it is necessary to recharacterize a transaction for tax purposes. The OECD Guidelines identify two types of situations where the recharacterization of a transaction would be considered.

19. In the first situation, the substance of a transaction differs from its form. The example provided in the OECD Guidelines involves an investment in a related enterprise in the form of interest-bearing debt where arm’s length parties would have structured their investment as a subscription of capital. However, where the thin capitalization rules in subsections 18(4) through 18(8) of the Act could apply to such a transaction, the transaction is unlikely to be recharacterized.

20. In the second situation, the transaction differs from that which independent enterprises behaving in a commercially rational manner would have entered into and the structure of the transaction makes it nearly impossible to determine an appropriate transfer price. In the example provided in the OECD Guidelines, a taxpayer performing research sells, for a lump sum payment, unlimited entitlement to intellectual property it is developing. Arm’s length parties would not have structured the transaction in this manner. In such cases, the Department might seek to recharacterize the transaction, for tax purposes, as a form of continuing research agreement.

Part 3. Arm’s length Methods

21. The OECD Guidelines recommend a number of transfer pricing methods (the recommended methods) that, when applied correctly, result in an arm’s length price or allocation. The Department will rely on these methods to determine if the terms and conditions of a taxpayer’s cross-border transactions with non-arm’s length parties are consistent with the arm’s length principle.

22. These methods are divided into two groups:

(a) the traditional transaction methods, i.e., the comparable uncontrolled price (CUP) method; the resale price method; and the cost plus method; and

(b) the transactional profit methods, i.e., the profit split and transactional net margin methods.
23. The OECD Guidelines, at paragraph 3.49, state that the traditional methods are preferable to the transactional profit methods and that the transactional profit methods should only be used as methods of last resort, namely when the use of traditional methods would not produce a reliable arm’s length price. The Department endorses this view.

24. The OECD Guidelines do not express a clear preference for one transactional profit method over the other. In fact, they discourage the use of such methods. However, the OECD’s evaluation of each of the transactional profit methods, as well as the Department’s experience with the use of profit methods, suggest that the profit split method will generally provide a more reliable estimate of an arm’s length result than the transactional net margin method. The Department, therefore, considers the transactional net margin method to be the method of last resort.

25. In terms of the traditional methods, it is clear that the comparable uncontrolled price method, if applicable, will provide a higher degree of comparability than any of the other methods.

26. While the ordering of the recommended methods is clear in theory, the lack of reliable information necessary to apply a particular method may require the application of a lower-ranking recommended method for which adequate information is available. A taxpayer should select the recommended method that is the most appropriate to its particular facts and circumstances. The most appropriate method will be the one that provides the highest degree of comparability between transactions. Once a taxpayer selects a particular method, the taxpayer is not required to make determinations under a lower-ranking method.

27. The Department is under no obligation to accept a particular method used by a taxpayer unless, on an objective analysis of its application, it produces the most reliable measure of an arm’s length result.

A. Traditional Transaction Methods

Comparable uncontrolled price

28. The comparable uncontrolled price (CUP) method provides the best evidence of an arm’s length price. There are two possible sources of a CUP. First, the taxpayer may sell the particular product in the same quantities, under the same terms and in the same markets to parties with whom it deals at arm’s length (an internal comparable). Second, other taxpayers may sell the same product, in the same quantities, under the same terms and in the same markets, to arm’s length parties (an exact comparable uncontrolled price).

29. However, care must be taken in using an internal comparable as the basis for a transfer price between non-arm’s length parties. For example, incidental sales of a product to third parties may not be indicative of an arm’s length price for the product.

30. Transactions may serve as comparables despite the existence of differences between those transactions and non-arm’s length transactions, provided the differences can be measured on a reasonable basis and an appropriate adjustment can be made to eliminate the effects of those differences.

Cost plus

31. Under the cost-plus method, the costs incurred for supplying a product or service are known. An arm’s length mark-up on the costs is determined either from the taxpayer’s sales of the product or a similar product to third parties in comparable transactions, or from the mark-up realized by unrelated
taxpayers in comparable transactions with third parties. Where the transactions are not comparable in all respects and the differences have a material effect on price, adjustments should be made to eliminate the effect of those differences. The more comparable the products and/or functions, the more likely it is that the cost-plus method will produce an appropriate estimate of an arm’s length result. The principles of this paragraph apply equally to the rendering of services.

32. It is important to properly determine cost under this method. Where cost is not accurately determined, both the mark-up (which is a percentage of cost) and the transfer price (which is the total of the cost and the mark-up) will be misstated. Cost must be calculated in accordance with accounting principles that are generally accepted in Canada and that are appropriate to the industry, whether or not some other calculation of cost is used in the relevant foreign country. In determining the cost of a product, the Department does not recognize depreciation based on the replacement or current market value of capital property.

33. It is also important to ensure that the cost base to which the markup is applied is comparable to the cost base of the third party transactions which serve as comparables. For example, as noted in paragraph 2.37 of the OECD Guidelines, it may be necessary to make an adjustment to cost where one person leases its business assets while another owns its business assets.

Resale price method

34. The resale price method is similar in concept to the cost-plus method, in that it relies on comparisons of gross margins. Under the resale price method, the selling price to third parties is known and an expected return for the functions performed by the seller is established by reference to third party sales by the seller, or by reference to the return earned by persons performing the same or similar functions and selling the same or similar goods as the seller, to arm’s length parties.

35. Under this method, the arm’s length price of a property acquired by a taxpayer in a non-arm’s length transaction is determined by reducing the price realized on the resale of the property by the taxpayer to an arm’s length party, by an appropriate gross margin. This resale margin represents an arm’s length return for the functions performed and the risks assumed by the taxpayer.

36. This method is most appropriate in a situation where the seller adds relatively little value to the product. The greater the value-added to the product by the functions performed by the seller, the more difficult it will be to determine an appropriate resale margin. This is especially true in situations where the seller employs an intangible property, such as a marketing intangible, in its activities.

B. Profit Methods

Profit split method

37. The profit split method may be applied where the operations of two or more non-arm’s length parties are highly integrated, making it very difficult to evaluate their transactions on an individual basis and, therefore, precluding the application of one of the traditional methods.

38. Under the profit split method, the first step is to determine the total profit earned by the parties from their integrated operations. The profit to be split is generally the operating profit. It may, in some cases, be appropriate to split the gross profit. This profit is then split between the parties based on the relative value of their contributions to the non-arm’s length transactions, considering the functions performed, the assets used and the risks assumed by each related party.
39. In all cases where the profit split method is applied, a detailed analysis of the functions performed by the parties to the transactions should be completed and well documented. It is not acceptable to merely provide each party with the same return on its respective assets.

40. Where the return on the functions performed by the parties can be established from comparable data, the Department prefers the residual profit split method over other types of profit split methods. A residual profit split is performed in two stages following the determination of the total profit to be split. The first stage is the allocation of a return to each party for the readily identifiable functions (e.g., manufacturing or distribution), based on standard returns established from comparable data. The returns to these functions will, therefore, not account for the return attributable to intangible property used by the parties. In the second stage, the return attributable to the intangible property is established by allocating the residual profit (or loss) between the parties. This is based on an analysis of the facts and circumstances indicating how this residual would have been divided between arm’s length parties.

Transactional net margin method

41. The transactional net margin method (TNMM) compares the net profit margin of a taxpayer arising from a non-arm’s length transaction with the net profit margins realized by arm’s length parties from similar transactions. The TNMM is a method of last resort. Its application can be considered only when the other recommended methods cannot be used or do not produce a reasonable estimate of an arm’s length price or allocation.

42. The TNMM should only be applied to determine the taxpayer’s net return derived from its transactions with non-arm’s length-parties. In addition, where the comparable party transacts with both arm’s length and non-arm’s length parties, care should be taken to isolate the net return attributable to the arm’s length transactions.

43. As the TNMM relies on a comparison of net margins, a high standard of comparability must be met in order for the TNMM to produce a reasonable estimate of an arm’s length result. It should be noted that several factors other than transfer prices may account for differences in net margins. Where differences between the taxpayer’s situation and that of one or more comparable entities exist and can be ascertained, appropriate adjustments must be made in order to ensure a high standard of comparability. The failure to account for these differences or to make satisfactory adjustments may preclude the method from producing a reasonable estimate of an arm’s length result.

44. In some cases, reliable adjustments can be made for differences between the situations of comparable persons and the taxpayer, such as differences in financing strategies or in the cost of financing. Other differences which directly affect net margins may not lend themselves to simple or reliable adjustments (e.g., differences in the age and productivity of plant and equipment, management abilities or philosophies and the business experience of the respective entities). It should be noted that industry profit data drawn from broad sources rarely satisfies the standards of comparability required to implement the TNMM.

45. If a sufficient degree of comparability exists between products and functions, a taxpayer should be able to use one of the traditional transactional methods, instead of the TNMM.

46. Typically, the TNMM is applied to only one of the members of a multinational group. Because the TNMM fails to consider the relative contributions of all the members to the profits of the group, it may produce absurd results. This could occur where attributing a level of profit to the one member leaves the other members of the group with unrealistic shares of the total profits of the group.
Part 4. Cost Contribution Arrangement

47. In general terms, a cost contribution arrangement (CCA) is a written arrangement whereby two or more parties share the costs and risks of producing, developing, or acquiring any property, or acquiring or performing any services, in proportion to the benefits which each participant is reasonably expected to derive from the property or services as a result of the arrangement. Each participant’s benefit or compensation for its respective contribution to a CCA is to be derived from exploiting the results of the CCA individually, and not from the actual activities of the CCA.

48. Frequently, a CCA is concluded for the joint development of intangible property, with each participant receiving a share of the rights in the developed property. However, participants may also pool their resources to acquire any type of centralized services, e.g., accounting, computer technical support, human resources, or the development of an advertising campaign common to the participants’ markets.

49. In order for a CCA to satisfy the arm’s length principle, each participant’s contribution must be consistent with that which an independent party would have agreed to contribute under comparable circumstances given the benefit it would have reasonably expected to derive from the arrangement. The expectation of mutual benefit is fundamental to the acceptance by independent parties of an arrangement for pooling resources and skills without separate and immediate compensation. Therefore, only persons who can reasonably be expected to derive a benefit from the results of a CCA can be considered participants in that CCA.

50. Under the arm’s length principle, the value of each participant’s contribution to a CCA should be consistent with the value that arm’s length parties would have assigned to that contribution in comparable circumstances. In the Department’s experience, the arm’s length value of contributions in the form of services and associated operating costs is the cost to the provider. However, where participants to a CCA make long-term contributions of tangible or intangible assets to the CCA, it is unlikely that the cost of the assets would be used by arm’s length persons as the basis for determining their respective entitlements to future benefits. For example, where two parties intend to be equal participants in a CCA, with the first party contributing property with a fair market value well in excess of its cost, and the other contributing cash, cost would not be an appropriate measure of the first party’s contribution.

51. Where the participants to a CCA perform all or part of the CCA activities in a separate company that is not a participant in the CCA (whether or not it is an affiliate of a participant), an arm’s length charge would be appropriate compensation for the separate company. It must be remembered that where a separate company performs CCA activities on behalf of the participants, it does not bear the major risks associated with those activities. The arm’s length charge for such a company would be determined under the general principles discussed in this circular, including consideration of functions performed, assets used and risks assumed. In general, any mark-up included in an arm’s length charge would reward only the agency role performed by such a company.

52. Under a CCA, a participant’s share of the overall contributions to the CCA must be in proportion to the share of the overall benefits it expects to derive from the arrangement. In theory, each participant’s share of the benefits may be determined by directly estimating the anticipated additional income that each participant is expected to generate, or its estimated cost saving, as a result of its participation in the arrangement. In practice, the participants may use an allocation key or basis such as sales, units used, produced or sold, gross or operating profit, the number of employees or capital invested, to indirectly estimate the additional income to be derived from the arrangement.
53. An allocation key should be chosen taking into account the nature of the CCA and the relationship between the allocation key and the expected benefits. For example, where a particular component is developed within a CCA and the component is used by the participants in a variety of end products which differ significantly in price, projected sales of the end-products would not be an appropriate allocation key. The differences in the prices of the end-products will distort the relationship between the cost to the participants and their expected benefits. A better measure of the expected benefits to the participants would be the extent to which the component is used by each participant.

54. Where a participant’s contribution to a CCA is not consistent with its share of the expected benefit, a balancing payment may be required between the participants to adjust their respective contributions.

55. Under the arm’s length principle, participants to a CCA that transfer a part or all of their interests in the results of prior CCA activities (such as intangible property, work in-progress or the knowledge obtained from past CCA activities) to a new participant should receive arm’s length compensation from the new participant for that property (a buy-in payment). The amount of a buy-in payment should be determined based upon the price an arm’s length party would have paid for the rights obtained by the new participant, which determination would take into account the proportionate share of the overall expected benefit to be received from the CCA. These principles also apply to determine the value of a buy-out payment when a participant disposes of part or all of its interest in a CCA.

56. The contributions by a taxpayer to a CCA will be treated, for tax purposes, as though they were made outside the scope of the CCA to carry on the activities that are the subject of the CCA (e.g., to perform research and development or purchase a capital asset).

57. A contribution to a CCA does not constitute a royalty for the use of intangible property to the extent that the contribution is for the acquisition of a beneficial interest in the property.

Part 5. Intangible property

58. The application of the arm’s length principle to transfers of intangible property raises specific issues associated with the difficulty and uncertainty sometimes encountered with attributing an arm’s length value to such transfers.

59. It may be possible to use the CUP method to determine an arm’s length price for the sale or license of an intangible property (such as a patent, trademark, or know-how) where the same or a comparable intangible property has been sold or licensed to arm’s length parties, or where there have been genuine offers from third parties for the intangible.

60. Where an intangible property is highly valuable or unique, it may be difficult if not impossible to find a comparable property. As costs incurred do not necessarily bear any relationship to the successful development of an intangible, it is highly improbable that the cost plus method would be acceptable in the circumstances. Accordingly, it may not be possible to apply any of the traditional pricing methods, or the TNMM. In such cases, the profit split method may be the most reliable.

61. Where a royalty rate is being established, the following items should generally be considered:

- prevailing rates in the industry;
- terms of the license, including geographic limitations and exclusivity rights;
• singularity of the invention and the period for which it is likely to remain unique;
• technical assistance, trademarks and know-how provided along with access to the patent;
• profits anticipated by the licensee; and
• benefits to the licensor arising from sharing information on the experience of the licensee.

62. Despite the difficulty in valuing intangibles, it is not appropriate to use hindsight in determining their value. Under the arm’s length principle, an agreement that is, in substance, the same as one into which independent parties would have entered, would not normally be subject to adjustment by a tax administration as a result of subsequent events. Therefore, it would be inconsistent with the arm’s length principle for a tax administration to require, or accept, an adjustment solely on the basis that income streams or cost savings differ from those initially estimated by the parties. However, the Department may consider a factor or factors that a reasonable person with some knowledge of the industry would have taken into account at the time the valuation was made.

63. In valuing an intangible, it is important to consider the terms and conditions that arm’s length parties would insist upon to protect their respective positions. For example, where the value of an intangible is uncertain, it is unlikely that an arm’s length party would permit the long-term exploitation of the intangible by a third party for consideration that might prove to be grossly inadequate. As protection against parting with the right to exploit the intangible for inadequate consideration, the transferor would normally insist on an agreement for a relatively short term or one that includes a price adjustment clause. The transferor could also insist on an agreement that sets a variable royalty scale so that, if the exploitation of the intangible proves highly profitable, the transferor would enjoy a reasonable share of that financial success. Similarly, an independent entity wishing to exploit an intangible property would be unlikely to agree to unconditionally pay large amounts for the exclusive use of the property, particularly for a long period of time.

Part 6. Intra-Group Services

64. The OECD Guidelines regarding the provision of intra-group services provide a framework to determine: (i) whether a charge for a particular service is justified; and (ii) if so, what the amount of the charge should be and how it should be determined.

65. In applying the arm’s length principle to intra-group services, it is first necessary to determine whether a specific activity performed by a member of the group for another member is a service for which a charge is justified. An independent entity would be willing to pay for an activity only to the extent that the activity confers on it a benefit of economic or commercial value. Therefore, a simple and generally appropriate test to determine if a charge for an activity is justified, is whether the entity for whom the activity is being performed would either have been willing to pay for the activity if performed by an independent entity or perform the activity itself. Where it would not have been reasonable to expect the entity to either pay an independent entity for the activity or to perform it itself, it is unlikely that a charge for the activity would be justified.

66. Certain costs are incurred for the sole benefit of shareholders and therefore should not be charged to other members of the group. For example, an independent entity would not bear the costs of a shareholders’ meeting of an arm’s length corporation. Also, costs which relate to the legal structure or the reporting requirements of a particular group member should not be charged to another member. Certain other costs, such as those involved in raising funds for the acquisition of an interest in a business, would
generally not be attributable to another member of the group. However, as suggested in the OECD Guidelines, if the funds were raised on behalf of another member of the group that used them to acquire a new company, it may be appropriate to attribute the costs to that other member.

67. It would be unusual for a group member to incur a charge for a service performed by another member of the group if that activity is performed by the member itself or by a third party on the member’s behalf. In some cases, there may be a valid business reason for duplicating a service. For example, an existing computer system may continue, for a brief period, to be operated concurrently with a new one to deal with unforeseen difficulties which may arise from the new system. The OECD Guidelines note another instance, namely where a second legal opinion is obtained in order to reduce the risk of error on a particular issue. In either case, there is a _bona fide_ business reason for duplicating the function.

68. Where a charge for a service is justified, the amount charged should be determined in accordance with the arm’s length principle. The OECD Guidelines state that the issue must be considered from the point of view of both the supplier and the recipient of the service. The arm’s length charge is not only a function of the price at which a supplier is prepared to perform the service (or the cost of providing the service), but also a function of the value to the recipient of the service and, therefore, of the amount that an independent entity is prepared to pay for such a service in comparable circumstances.

69. Where a service is rendered by arm’s length parties or the service provider renders the service for arm’s length parties, the price charged in those circumstances is a good indication of the arm’s length price; that is, the CUP method should be used, assuming sufficient data for its application is available. This presumes that the services are identical both in terms of type and quantity or extent to which they are provided, that the markets are similar and that the services are provided on comparable terms. Where the service provider renders the services for arm’s length parties and those services are ordinary and recurrent activities of the service provider, the fee charged to arm’s length parties for such services may constitute a CUP.

70. Where the CUP method cannot be applied, the cost plus method should be considered. The cost plus method would be appropriate where the functions involved (including the assets used and the risks assumed in the context of those functions) are comparable to those performed by the independent entities used in the comparison. In particular, it is important to ensure that the costs incurred by the service provider are the same as those incurred in the comparable transactions and, if not, that appropriate adjustments are made.

71. An arm’s length charge does not necessarily include a profit element. As previously mentioned, the amount of the arm’s length charge and, if applicable, the profit element included in such a charge depend on two factors: the costs incurred by the service provider in supplying the services and the value that the recipient assigns to the services. There may be circumstances where the value of the service to the recipient, that is, the amount that it would be willing to pay for the service, does not exceed the cost of supply to the service provider. It would therefore be inappropriate, under the cost plus method, to include a profit element in a charge for such a service. Consequently, the application of the cost plus method requires careful consideration of the relative efficiency of the service providers being compared.

72. In determining the profit element to which a service provider is entitled, one must first ascertain the nature of the service being provided. In particular, it is important to distinguish the situation of a taxpayer who renders services for the other members of a group from that of a taxpayer who acts solely as an agent on behalf of the group to acquire services from a third party (see paragraph 7.36 of the OECD Guidelines). In the latter situation, the arm’s length compensation would be limited to rewarding the agency role of the taxpayer, that is, it would not be appropriate to determine an arm’s length charge by
reference to a mark-up on the cost of the services. Whether a taxpayer is providing a service or merely acting as an agent on behalf of the group is a question of fact.

73. It should be noted that the deductibility of the costs allocated to a particular taxpayer is determined in accordance with the Act. The fact that a charge for the costs is itself justified does not automatically make the costs deductible under the Act.

Direct charge and indirect charge

74. There are two methods for determining a charge for services: the direct charge method and the indirect charge method. Under the direct charge method, a specific price is established for each identifiable service. Under the indirect charge method, an allocation, to a particular entity, of the value of a service provided to more than one entity is made by reference to a basis or allocation key that indicates the share of the total value of the service attributable to the particular entity.

75. The Department prefers the direct charge method over the indirect charge method. Where services rendered by the taxpayer to other members of the group are the same as those rendered to arm’s length parties, the taxpayer should use the direct charge method. In other cases, where the service provided to the members can be reasonably identified and quantified, the direct charge method should also be used.

76. There are, however, situations where a service has been provided to a number of non-arm’s length parties and the portion of the value of the service directly attributable to each of the parties cannot be determined (e.g., where global market research is intended to benefit all the related entities). In this case, the indirect charge method must be used. Where an indirect allocation is used, it should result in a charge that is comparable to that which independent enterprises would accept. The choice of an allocation key (e.g., sales, units used, produced or sold, or the number of employees) should be made giving consideration to the nature and use made of the service.

Part 7. Penalty – Reasonable Efforts

77. Subsection 247(3) of the Act imposes a penalty equal to 10% of the total of the transfer pricing income and capital adjustments that relate to transactions for which a taxpayer has failed to make reasonable efforts to determine and use arm’s length transfer prices or arm’s length allocations. A penalty can also be imposed if the adjustments relate to transactions that are not qualifying cost contribution arrangements.

78. Subject to the rule in subsection 247(4) of the Act, whether a taxpayer has made reasonable efforts to determine and use arm’s length transfer prices or allocations is a question of fact. A taxpayer will be considered to have made reasonable efforts if it has taken all reasonable steps to ensure that its transfer prices or allocations are in conformity with the arm’s length principle.

79. In general, the Department considers that the making of reasonable efforts requires the application of a recommended method by the taxpayer.

80. The documentation required in order for the taxpayer to be considered to have made reasonable efforts to determine an arm’s length transfer price or allocation in respect of a transaction, is that which the taxpayer would have prepared or obtained, in respect of the transaction, pursuant to principles of prudent business management. A prudent businessperson would attempt to weigh the significance of the transactions in terms of its business with the additional administrative costs required to prepare or obtain
such documentation. Therefore, the obligation to find comparable transactions for purposes of applying
the arm’s length principle is not an absolute one, but may take into account the cost and likelihood of
finding such comparables relative to the significance of the transactions to the taxpayer. On the other
hand, the obligation to comply with the arm’s length principle and the documentation requirements should
be taken into account by a taxpayer when establishing internal procedures and policies to document its
transactions.

81. The application of one transfer pricing method as opposed to another may require significantly
different internal and external information, which, in turn, will produce a different set of supporting
documents.

82. Subsection 247(4) of the Act deems a taxpayer not to have made reasonable efforts to determine
and use arm’s length transfer prices unless the taxpayer has prepared or obtained records or documents
which provide a complete and accurate description of the items listed in subparagraphs 247(4)(a)(i)
through (vi) of the Act. This documentation must be prepared or obtained within 60 days of the end of the
taxation year or fiscal period in which a transaction is entered into. Where a transaction spans more than
one taxation year, the documentation must also be updated to reflect any material changes within 60 days
of the end of the taxation year or fiscal period in which the material change occurs. In order to comply
with subsection 247(4) of the Act, taxpayers must, in effect, produce or obtain the required documentation
at the time the transaction is entered into.

83. The taxpayer must provide these documents to the Department within 60 days of a written
request to do so. If the taxpayer does not provide the documents within the 60 days, the taxpayer is
deemed not to have made reasonable efforts to determine and use arm’s length transfer prices or
allocations for purposes of the penalty in subsection 247(3) of the Act.

84. Subsection 247(4) of the Act is not intended to be an exhaustive list of the documents necessary
to substantiate that the taxpayer’s transfer pricing is in accordance with the arm’s length principle or that a
taxpayer has made reasonable efforts to determine and use arm’s length transfer prices or allocations. Depending
on the facts and circumstances of the transaction under examination, the taxpayer may have to prepare or
obtain documentation in addition to that required by subsection 247(4) of the Act.

85. Subsection 247(4) specifies that a taxpayer must have records or documents which provide a
complete and accurate description of the following items:

- The property or service to which the transaction relates.

- 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 persons or partnerships
  involved in the transaction. For example, in a round-trip transaction (that is, a transaction
  whereby a parent company manufactures components which are assembled into a finished
  product by a foreign subsidiary and the finished product sold to the parent for distribution), it
  is important to document how the terms and conditions of each of the transfers relate to each
  other.

- The identity of the persons or partnerships involved in the transaction or arrangement and
  their relationship at the time the transaction or arrangement was entered into.

- The functions performed, the property used or contributed and the risks assumed by the
  persons or partnerships involved in the transaction. The reader can refer to paragraphs 1.20
through 1.27 of the OECD Guidelines for a description of the functional analysis process. In addition, paragraphs 5.23 and 5.24 of the OECD Guidelines give an overview of the documentation required to support such an analysis.

- 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, as the case may be, for the transaction. This includes a description of the comparable transactions considered and of those used in applying the pricing method, an assessment of the degree of comparability of such transactions with the taxpayer’s transactions, and the description of any adjustments made to enhance the degree of comparability. Where the taxpayer considers more than one method, this also includes the analysis performed using the other methods as well as the analysis that led to the selection of the chosen method.

- 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, for the transaction. This includes all the factors that materially affect the determination of the transfer prices, such as market penetration strategies or any economic assumptions that were relied on to determine the transfer prices.

86. The documentation requirements also apply to CCAs. The documentation pertaining to a CCA should address the following:

- the identification of participants in the CCA and non-arm’s length parties;
- the scope of the activities covered by the agreement;
- the duration of the agreement;
- the nature and extent of each participant’s beneficial interest in the results of the CCA activities;
- the manner or basis upon which proportionate shares of expected benefits are to be measured;
- the form and valuation of each participant’s contributions;
- the allocation of tasks and responsibilities;
- the procedures for entering or withdrawing from the arrangement and the consequences thereof; and
- the policies and procedures governing balancing payments.

87. All material changes to the arrangement are required to be documented. In addition, comparisons of projected and actual benefits must be made to ensure that each participant’s share of the actual benefits derived from the CCA, corresponds to the participant’s contribution to the CCA.

88. Paragraph 5.16 of the OECD Guidelines states that because of the variety of business scenarios encountered in practice, it is not possible to produce an exhaustive list of the documentation required to support a particular pricing method. Instead, only general guidance can be given to assist taxpayers in
identifying documentation that provides evidence that their pricing satisfies the arm’s length principle. Readers should consult the OECD Guidelines for a more detailed discussion of this issue.

89. The documentation required by subsection 247(4) of the Act may include foreign-based documents and information. The general principles developed in this section also apply to such documentation, which means that foreign-based documents should be obtained by the taxpayer to the extent that they are relevant in the determination of arm’s length prices.

90. If any of the documentation submitted to the Department is not in English or in French, the taxpayer must provide an official translation within 30 days of a request by the Department. Any information provided to the Department is subject to the normal confidentiality rules under the Act and income tax conventions.

Part 8. Customs valuations

91. The methods for determining value for duty under the current provisions of the Customs Act resemble those outlined in this circular. However, differences do remain and the Department is under no obligation to accept the value reported for duty when considering the income tax implications of a non-arm’s length importation.

Part 9. Confidentiality of Third Party Information

92. Where, in the context of an income tax audit, the Department has obtained information on comparable prices from third parties that forms the basis of an assessment, the Department may seek written permission from the third parties to disclose the information to the taxpayer under review. If permission is not granted, subsection 241(1) of the Act prohibits disclosure of the information. One exception to this rule is where legal proceedings have commenced with respect to the assessment issued, namely where the taxpayer has filed a Notice of Appeal with the Tax Court of Canada. At this point, subsection 241(3) of the Act applies to permit the Department to release the details on the comparables to the taxpayer assessed.

Part 10. Part XIII Withholding Tax

93. Where adjustments are made under subsection 247(2) of the Act, tax under Part XIII of the Act may also be payable.

Part 11. Competent Authority Procedures

94. Canada has entered into over 60 bilateral income tax treaties with other countries—one of the purposes of which is the elimination of double taxation.

95. Many of these treaties contain rules concerning the allocation of income in accordance with the arm’s length principle. These rules are generally found in Article 9 of the relevant treaty and are often modeled after Article 9 of the OECD Model Convention. They provide a framework in which adjustments to profits by one country’s tax administration may be offset by a corresponding adjustment by the tax administration of another country.

96. One circumstance where the Minister may not find it appropriate to exercise his discretion, under subsection 247(10) of the Act, to make an adjustment under subsection 247(2) of the Act in respect of the taxpayer, is where a taxpayer is entitled to request or has requested relief from double taxation under the mutual agreements procedures of a tax treaty.
97. Where a transfer pricing adjustment results in double taxation, a taxpayer may request competent authority consideration as provided under the Mutual Agreement Article of Canada's tax treaties. The reader may refer to Information Circular 71-17, Requests for Competent Authority Consideration Under the Mutual Agreement Procedures in Income Tax Conventions, for a more detailed discussion of the procedures and acceptability of requests for competent authority consideration.

98. Under the Act and the laws of most of Canada’s treaty partners, taxpayers have a responsibility to clearly document their transactions with related non-residents, or face disallowances or adjustments. Without proper documentation, competent authorities may be unable to resolve disputes and double taxation can result.

Part 12. Advance Pricing Arrangements

99. The Department has introduced an Advance Pricing Arrangement (APA) program to assist taxpayers in determining transfer prices acceptable for the purposes of the Act. An APA is an agreement or arrangement between the taxpayer and the Department which stipulates a mutually acceptable pricing method to be used on specified international transactions for a future period (usually 3 years), with provision to renew. In most cases, the taxpayer chooses a bilateral APA under which a treaty partner also agrees to the terms. For further details, the reader may refer to Information Circular 94-4, International Transfer Pricing: Advance Pricing Agreements (APA).

100. In concluding an APA, a taxpayer and the Department establish an acceptable transfer pricing methodology for specified transactions. As long as the APA remains in effect and the taxpayer complies with its terms and conditions, no transfer pricing adjustments under subsection 247(2) of the Act should arise with respect to the transactions covered by the APA. Without any transfer pricing adjustments, the penalty in subsection 247(3) of the Act would not be applicable.