Transfer Pricing in Canada:
The Comparability Analysis

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Legislation

Since 1997, Canada’s transfer pricing rules have been included in section 247 of the Canadian \textit{Income Tax Act} (ITA).

The Canadian transfer pricing rules are managed by the Canada Revenue Agency (CRA). In the province of Quebec, the Agence du revenu du Quebec also does transfer pricing compliance audits.

Subsection 247(4) ITA describes the “documents and records” required in response to a request for contemporaneous documentation issued by the CRA. Paragraph 247(4)(a) ITA indicates that records or documents must provide a “description that is complete and accurate in all material respects” of:

- the property or services to which the transaction relates,
- the terms and conditions of the transaction;
- the identity of the participants in the transaction;
- the functions performed, the property used and the risks assumed;
- the data and methods considered and the analysis performed to determine the transfer prices;
- the assumptions, strategies and policies that influenced the determination of the transfer prices.

Paragraph 247(4)(a) ITA is the Canadian legal approach to the OECD’s comparability analysis necessary to determine the transfer price of a controlled transaction between parties not dealing at arm’s length.
Administrative position

Paragraph 4 of Information Circular IC 87-2R International Transfer Pricing indicates that the “OECD (Transfer Pricing) Guidelines should be consulted for a more detailed discussion of the principles contained in Parts 2 to 6 of this circular.”

In fact, Information Circular IC 87-2R contains over 25 direct references the OECD Transfer Pricing Guidelines.

The Canadian tax courts have also acknowledged the relevance of the OECD Transfer Pricing Guidelines in their decisions related to transfer pricing cases.

The OECD comparability analysis

The OECD comparability analysis is comprised of 5 categories of factors:

- the characteristics of the property or service;
- the functions performed by the parties taking into account the assets used and risks assumed;
- the contractual terms;
- the economic circumstances of the parties and which surround the transaction; and
- the business strategies used by the parties.

Paragraph 1.33 of the OECD Transfer Pricing Guidelines explains that:

“1.33 Application of the arm’s length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. […]”

The comparison of these 5 categories of factors between the controlled transaction and an arm’s length transaction ensure that the controlled transaction will ultimately be concluded at an arm’s length price.

In other words, similar products or services should obviously facilitate a higher degree of comparability between a controlled transaction and an arm’s length transaction and ultimately comparison of their respective prices.

With regard to the functional analysis, corresponding functions performed with a similar level of capital intensity and fairly identical commercial and economic risks assumed will result in a higher
degree of comparability between a controlled transaction and an arm’s length transaction. Functions such as manufacturing, distribution, marketing, financing and management will be compared through the functional analysis.

Contractual terms and conditions of the controlled transaction should show a high degree of similarity to the terms and conditions found in a comparable arm’s length transaction. The same conceptual logic will apply to the comparison of the economic circumstances and the business strategies used by the parties or surrounding the controlled transaction.

In short, a thorough OECD comparability analysis should enable the Canadian taxpayer to meet the legal requirements prescribed in subparagraphs 247(4)(a)(i)-(iv) and (vi) ITA and paragraph 247(4)(b) ITA as applicable for the same controlled transaction.

As for subparagraphs 247(4)(a)(v) ITA, more detail on the transfer pricing method selected would be required.

**Comparability analysis and the Base Erosion and Profit Shifting initiative (BEPS)**

As an OECD member country, Canada has been deeply involved in the Base Erosion and Profit Shifting initiative (BEPS).

The rules included in the *Discussion Draft on Transfer Pricing Documentation and CbC Reporting*, released on January 30, 2014 for public consultation, would implement significant reporting obligations, for each entity resident in each country (*Annex III to Chapter V: A Model Template of Country-by-Country Reporting*) related to:

- Revenues;
- Earnings before income tax;
- Income tax paid;
- Total withholding tax paid;
- Stated capital and accumulated earnings;
- Number of employees;
- Total employee expense;
- Tangible assets other than cash and cash equivalents;
- Royalties paid and received;
- Interest paid and received;
- Service fees paid and received.

Following the issuance of that draft, over 1 400 pages of comments were received by the OECD. In the second OECD webcast (April 2, 2014), the Working Party No. 6 tentatively elected to eliminate the transactional reporting component in the Country-by-country report for each entity.
Transactional reporting would hence be limited to the Local file. However on a country-by-country basis, numerous metrics would still be reported on a consolidated basis including the number of employees, tangible assets, capital and retained earnings.

Financial data would also be required for each countries where the EMN group operates but on a consolidated basis instead of an entity-by-entity basis.

In the third OECD webcast (May 26, 2014), it was confirmed that the OECD will move forward with a “three tier approach” for transfer pricing documentation purposes:

- Country-by-country (CbC) template;
- Master file; and
- Local file.

It was also indicated during the webcast that within the Working Party No. 6 there is “broad recognition” that:

“structured and careful implementation is necessary to guarantee

- consistency in the approaches by governments
- that the relevant information is available to governments for which it is relevant on a timely basis
- that commercially sensitive information is treated confidentially
- that the costs for both taxpayers and tax administrations are balanced
- to secure that the information is used as intended.”

It should be noted that these reporting obligations are part of the OECD comparability analysis.

The transfer pricing documentation contained in the Master file will deepen the understanding of the economic circumstances of the parties and which also surround the controlled transaction.

In the case of the Local file, the transfer pricing documentation required significantly broadens the analysis of:

- the characteristics of the property or service;
- the functions performed by the parties taking into account the assets used and risks assumed;
- the contractual terms; and
- the business strategies used by the parties.

As for the Model template of country-by-country reporting, it will provide tax administrations around the world with numerous metrics relevant to the 5 categories of factors of the OECD comparability analysis.
**Conclusion**

The new transfer pricing documentation rules of the BEPS initiative may significantly increase the burden of the transfer pricing documentation requirements of Canadian taxpayers in the near future.

There will be direct impacts on the comparability analysis compulsory to ensure the proper determination of an arm’s length price of a controlled transaction between parties not dealing at arm’s length.

To ensure that you are fully compliant with the Canadian documentation transfer pricing rules and get ready for the upcoming changes, it may be time to re-examine the transfer pricing policies and procedures of your company.

Other business processes may also need to be reconsidered, revised or modified to ensure strong operational transfer pricing processes in the MNE group and to facilitate the comparability analysis.

**DRTP Consulting can assist you**

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DRTP Consulting’s solutions also pertain to transfer pricing, tax treaties and other international tax matters. DRTP’s services include transfer pricing documentation (transfer pricing policies and procedures, BEPS and C-doc), transfer pricing dispute resolution, tax treaty matters including double tax relief, tax treaty-based returns and waivers, advanced pricing agreement (APA), value chain management and operational transfer pricing planning.

DRTP Consulting’s services are relevant to any business involved in international commerce. DRTP’s services are also relevant to accounting, legal and other types of firms which provide value to their clients.

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