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## Canada's TPM-15 and TPM-16: Throwing Sand in the BEPS Gears

*The author argues recent transfer pricing memoranda issued by the Canada Revenue Agency on low-value services and the use of multiple-year data ignore relevant guidance developed by the Organization for Economic Cooperation and Development under its project to combat base erosion—and further that the TPM on multiple-year data places the CRA firmly at odds with U.S. regulations.*



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**T**he Canada Revenue Agency Jan. 29 released two memoranda on transfer pricing: TPM-15, on intragroup services and Section 247 of the Canada Income Tax Act, and TPM-16, on the role of multiple-year data in transfer pricing analyses.<sup>1</sup>

In Canada, the Transfer Pricing Memoranda (TPM) series provides supplementary guidance to Information Circular 87-2R on international transfer pricing. As a whole, they define and help deepen the understanding

<sup>1</sup> TPM-15 is available at 23 *Transfer Pricing Report* 1386, 3/5/15; TPM-16 is available at 23 *Transfer Pricing Report* 1394, 3/5/15. Also see 23 *Transfer Pricing Report* 1356, 3/5/15.

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of the administrative position of the CRA on transfer pricing for the application of Section 247 of the Canadian Income Tax Act.

TPM-15 and TPM-16 raised eyebrows with both their content and the timing of their release. This article highlights the most perplexing features of the memoranda.

### TPM-15: Intragroup Services

TPM-15 states in the first paragraph that it is meant to “clarify the CRA’s policy on several audit and tax issues commonly encountered during the audit of intragroup services.” As such, it purportedly provides supplementary guidance on Part 6 of Information Circular IC 87-2R, initially released Sept. 27, 1999.<sup>2</sup>

To set things in context, IC 87-2R, Part 6, basically summarizes the content of Chapter 7 of the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* as drafted in 1995 (and subsequently reprinted in the July 2010 edition). Aside from its general penchant for the comparable uncontrolled price (CUP) method and its explicitly stated preference for the use of a direct approach for the com-

<sup>2</sup> Available at 8 *Transfer Pricing Report* 472, 9/29/99.

putation of a charge where an intragroup service has been rendered, Part 6 of the IC 87-2R is indeed a replica of Chapter 7 of the OECD guidelines.

But those familiar with the OECD guidelines—or transfer pricing in general—must be aware that Chapter 7 has been under heavy fire for some time now, from the OECD itself and from the European Union, among others. The EU Joint Transfer Pricing Forum issued guidelines on low-value intragroup services in a 2010 report.<sup>3</sup>

The final blow to Chapter 7, however, likely was the OECD's public discussion draft on low-value services, issued under Action 10 of its Action Plan on Base Erosion and Profit Shifting (BEPS).<sup>4</sup> The draft, issued Nov. 3, 2014, led to more than 350 pages of comments subsequently issued Jan. 20, 2015.<sup>5</sup> All this is to say that Chapter 7, like most of the OECD transfer pricing guidelines, is feeling the full sway of the BEPS initiative.

Among the common denominators in these key documents is the intent to design and implement some type of safe harbor approach to quantify the transfer pricing value of alleged “low-value adding intra-group services.” In doing so, both the EU and the OECD member countries have signaled their ultimate objective to somehow align the transfer pricing policies on international intragroup services with the U.S. regulations on intercompany services, found in Regs. §1.482-9.

Against this background, TPM-15 seems to come out of nowhere. In the memorandum, the CRA starts by reiterating its fondness for the direct charge method to quantify a charge where an intragroup service has been rendered. To this end, the memo highlights two “main issues surrounding intra-group services”:

- determining whether intragroup services have been provided; and
- valuing intragroup services.

### When Services Provided

On the crucial issue of whether intragroup services have been provided, TPM-15 basically recites the content of Part 6 of IC 87-2R. Nonetheless, the guidance in paragraphs 42-48 pertaining to the types of costs not deductible under the Canadian Income Tax Act is a welcome addition from a Canadian transfer pricing and Canadian income tax compliance standpoint.

Paragraph 42 highlights various Canadian Income Tax Act provisions that may “restrict or disallow certain expense deductions.” Some of the wording in paragraph 44 of the memorandum may, however, create a few concerns. The CRA suggests that “the law”—intended here to include the CRA's interpretation of case law—may supersede Article 9 of a given tax treaty (the article on associated enterprises and the arm's-length principle) if a charge is deemed not deductible under the Canadian Income Tax Act even if it is arm's-length in nature.

The CRA indicates that double tax relief may not be available in such cases unless a specific treaty provision

applies. To some extent, that position may be considered at odds with the general acceptance that tax treaties are meant to eliminate double taxation, whether the arm's-length principle is at the crux of the matter or not. But this specific question shall remain open for today's discussion on TPM-15.

### Valuation

As for the transfer pricing valuation of intragroup services, the timing of TPM-15 is unfortunate. One might have expected that such recent guidance would have taken into account obvious changes in international tax policy regarding the comparability analysis and valuation of intragroup services for transfer pricing purposes. After all, Canada is a member country of the OECD and still possesses a leadership role in Working Party No. 6 on the taxation of multinational enterprises.

In fact, TPM-15 contains not a single reference to the BEPS initiative, whether considered as a whole or in relation to any upcoming revision of Chapter 7 of the OECD transfer pricing guidelines. Instead, TPM-15 contains over a dozen direct references to the dying version of Chapter 7.

Moreover, this awkward unawareness of the BEPS initiative on the comparability analysis and valuation of intragroup services is magnified by paragraphs 74-77 of the memorandum. Paragraph 74 of TPM-15 states that if the group service provider merely acts as an agent, thereby not actually providing the services itself but facilitating the provision of the services as an intermediary, the arm's-length compensation would be limited to a fee for its agency role.

Paragraph 75 advocates applying this approach in to acquisition of goods—that is, for central purchasing functions—and, in more general terms, the author would submit, for any consignment-based transfer pricing transaction. The issue therefore is clearly stated from the CRA viewpoint.

Undeniably, in the last 15 years, the value of so-called agency role functions has been a sensitive transfer pricing issue in Canada. Any additional guidance on the matter therefore must be applauded. As pointed out in paragraph 76, “careful consideration should be given to the appropriate base for calculation of such fees or mark-ups.”

But, surprisingly, this is the end of the road. TPM-15 provides no worthwhile guidance whatsoever on that key issue. Instead, paragraph 76 of the memorandum makes broad proclamations, such as “the base should make sense in relation to the nature and quantum of the benefits provided by the service” and “in determining the most appropriate base for calculating a fee or mark-up, consideration should be given to the specific facts and circumstances of the case as well as industry practice.”

These statements, which merely refer to what already is being carried out through the OECD comparability analysis, leave small, medium and large businesses holding the bag.

### TPM-16: Role of Multiple-Year Data

The stated purpose of TPM-16, on the role of multiple-year data in transfer pricing analyses, is “to provide guidance and direction on the use of multiple year data in determining the arm's length price in transfer pricing cases.”

<sup>3</sup> Available at [http://op.bna.com/tpif.nsf/id/thjn-8bxlt4/\\$File/Korde-LeidenLLMpaper.pdf](http://op.bna.com/tpif.nsf/id/thjn-8bxlt4/$File/Korde-LeidenLLMpaper.pdf).

<sup>4</sup> Available at 23 *Transfer Pricing Report* 929, 11/13/14.

<sup>5</sup> Available at <http://www.oecd.org/ctp/transfer-pricing/public-comments-action-10-low-value-adding-intra-group-services.pdf>.

The CRA has had a fairly contentious relationship with multiple-year data and statistical tools in general since at least 2003, when it released a paper on that topic by Ronald Simkover, the chief economist in its International Tax Operations Department.<sup>6</sup>

At the time, the CRA, as stated in the paper, already was claiming that “statistical tools do not improve the comparability of any of the selected comparable independent transaction.” As for multiple-year data, the CRA denied any potential use of that information to establish the arm’s-length nature of a transaction. Arm’s-length parties should in fact “set their prices on an ongoing basis” for transfer pricing purposes, according to the CRA. The compliance costs involved, it would seem, are irrelevant.

TPM-16 provides additional guidance on paragraph 51 of IC 87-2R stating that “taxpayers, in applying the recommended methods and taking into account the effects on profits due to product life cycles and short-term economic conditions, should consider multiple year data for the taxpayer; and the arm’s length party as a comparable.” The memo also reminisces on Simkover’s paper abundantly, although never mentioning it by name.

TPM-16 establishes a clear distinction between the use of multiple-year data to account for the degree of comparability of the economic characteristics of a transaction and its use to identify an arm’s-length price or range. TPM-16 somewhat brings into line the administrative policy of the CRA pertaining to the use of multiple-year data with the guidance found in Chapter 3 of the OECD transfer pricing guidelines.

From that perspective, the update is a welcome addition to TPM-14,<sup>7</sup> which discussed significant changes made to the OECD guidelines in 2010.

TPM-14, issued in 2012, stated simply that “the CRA endorses the application of the arm’s length principle and the 2010 version of the Guidelines for the administration of the Income Tax Act regarding transfer pricing matters.”

Paragraph 5 of TPM-16, meanwhile, explicitly states that “the use of multiple years of data may be appropriate and beneficial during the comparability analysis stage of a transfer pricing analysis.” Things get a little more blurry from that point on. Paragraph 9 of TPM-16 states forcefully that “the determination of arm’s length prices used in related party transactions for Canadian taxpayers should be established for each individual tax year using the results obtained from comparable transactions in the relevant tax year.” As such, the CRA maintains its long-standing position that “since comparability cannot be expressed in numbers, it is not possible to apply a statistical tool to arm’s length data to improve the comparability of the underlying transactions or to improve our understanding of the comparability,” as stated in paragraph 20.

Paragraph 22 of TPM-16 goes further, stating that “the proper use of multiple year data and the application of statistical tools are different issues.”

In paragraph 16 of TPM-16, the CRA interprets the term “data” as found in paragraphs 3.75 through 3.79 of the OECD guidelines as “more than the observed financial outcomes as reflected in the income statements or selected profit level indicators.” In a nutshell, “data”

encompasses the whole OECD comparability analysis, not the simple use of financial information.

According to paragraph 22 of the memorandum, “it is clear that statistical tools do not meet the necessary criteria to be able to improve a comparability analysis.”

This indicates that the conceptual rift between the unsubstantiated CRA administrative policy and the guidance found in Regs. §1.482-1(e)(2)(B) and (C) of the U.S. transfer pricing regulations remains largely unchanged. Under the U.S. rules, the “reliability” of the transfer pricing analysis is indeed increased through the proper use of statistical methods.

Paragraphs 23-27 of TPM-16 thus expand on the CRA views regarding the use and distinction of statistical tools and multiple-year data for transfer pricing purposes. Paragraph 23 on the use of the average or the median has the hallmarks of Simkover’s paper. The former refers to averages and medians as providing “a single-point descriptor,” while the latter terms them “measures of central tendencies.” Both statements add strictly nothing to the matter at hand.

Paragraph 24 of the memorandum states that “a single point description may be necessary when determining the price that is most appropriate to be used.” The author dares to suggest that a single point is, in fact, absolutely mandatory for the actual and practical pricing of any cross-border transaction at any time—whether it is the average, median or any other statistical measure. In fact, a single point also will find its relevance for any notice of assessment or reassessment issued by the CRA.

Elsewhere, the memorandum appears to open the door, at least slightly, to using the interquartile range. Paragraph 26, while not referring directly to the interquartile range, suggests that its use is conceivable, although on a year-by-year basis. On the actual relevance of the arm’s-length range for transfer pricing compliance purposes in Canada, paragraph 28 of TPM-16 may give renewed comfort with the statement that “the CRA will not make a transfer pricing adjustment if the price or margin of a transaction is within the arm’s length range”—that is, in accordance with paragraph 3.60 of the July 2010 OECD guidelines. Paragraph 29 then reiterates that multiple-year data is valuable in the context of the comparability analysis, although it states that “taxpayers should not average results over multiple years for the purpose of substantiating their transfer prices in an audit context.”

The last sentence of TPM-16 states that multiple-year averages may, however, play a role in the context of an advance pricing agreement. Appendix A then embarks on a short theoretical quest in which, once again, a distinction between the use of “multiple year data” and the use of “statistical tools” pushes the envelope pointlessly. The “distinction” made in Appendix A between “descriptive statistical tools” and “inferential statistical tools” is unsettling; this recurrent policy statement on the alleged inadequacies and potential misuses of the interquartile range, the author contends, illustrates the ever-enduring inability of the CRA to properly reconcile the practical realities of transfer pricing with its conceptual limitations and theoretical shortcomings, especially in the particular setting of a transfer pricing audit or litigation.

<sup>6</sup> Available at 12 *Transfer Pricing Report* 271, 8/6/03.

<sup>7</sup> Available at 21 *Transfer Pricing Report* 831, 12/13/12.

## **Conclusion**

Now more than ever, proper transfer pricing documentation is becoming critical in Canada. If nothing else, TPM-15 on intragroup services and Section 247 of the Income Tax Act, given its lack of reference to any type of safe harbor, is a harsh reminder of that fact.

The guidance on multiple-year data found in TPM-16, meanwhile, will require those documenting cross-border transactions between Canada and the U.S. to keep dealing with the CRA's eccentricities relating to the use of statistical tools in transfer pricing.