

Contacts:

Robert Robillard
514-742-8086
robertrobillard@drtp.ca

Stéphane Dupuis
514-952-1965
stephanedupuis@drtp.ca

Transfer Pricing in Canada: The Transfer Pricing Methods

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Legislation

Since 1997, Canada's transfer pricing rules have been included in section 247 of the Canadian *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 and for the selection of a transfer pricing method. Complete compliance is deemed necessary by the Canadian *Income Tax Act* 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) 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 transfer pricing methods

The *OECD Transfer Pricing Guidelines* recognize 5 transfer pricing methods.

The 3 traditional transaction methods:

- Comparable uncontrolled price method (CUP);
- Resale price method; and
- Cost plus method.

The 2 transactional profit methods:

- Transactional net margin method (TNMM); and
- Transactional profit split method (contribution analysis and residual analysis).

Each transfer pricing method possesses its strengths and weaknesses for the determination of an arm’s length price. The *OECD Transfer Pricing Guidelines* indicate at paragraph 2.2 that “the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case.”

However, the OECD member countries have demonstrated a general inclination for the traditional transaction methods (the CUP method in particular) over the transactional profit methods.

In every case, to ensure that the best method is indeed selected, the selection process should aim at applying the results derived from the comparability analysis.

The correct application of a transfer pricing method may encompass the need for transfer pricing adjustments in order to accommodate for differences between the controlled transaction and the arm’s length comparable transaction.

Numerous technical considerations should be accurately addressed to ensure that the application of the transfer pricing method meets the requirements of Chapter III of the *OECD Transfer Pricing Guidelines*, including:

- the choice of the tested party;
- the availability of internal comparables;
- the inherent limitations of commercial databases;
- the relevance and sensitivity of financial comparability adjustments;
- the arm's length range;
- the timing issues related to comparability;
- the relevance and use of multiple or single year data;
- the relevance and use of other statistical tools.

In Canada, paragraph 49-50 of Information Circular *IC 87-2R* explains that:

“[...] Certain methods provide more reliable results than others, depending on the degree of comparability between controlled and uncontrolled transactions. The reliability of any method is also affected by the availability of data and the degree of accuracy with which any necessary adjustments can be made to achieve comparability. [...]”

In other words, “reasonable efforts” must be made in the selection and application of a transfer pricing method. In doing so, the Canadian taxpayer is very likely to meet the legal requirements prescribed in subparagraph 247(4)(a)(v) ITA.

Canadian tax courts

The Supreme Court of Canada (SCC), the Federal Court of Appeal (FCA), and the Tax Court of Canada (TCC) have all demonstrated a clear preference for the CUP method over any other transfer pricing method. See for more detail:

- *Canada v. GlaxoSmithKline*, 2012 SCC 52;
- *Canada v. General Electric Capital Canada*, 2010 FCA 344;
- *Alberta Printed Circuits Ltd. v. The Queen*, 2011 TCC 232;
- *McKesson Canada Corporation v. The Queen* 2013 TCC 404 (appeal filed at the FCA); and
- *Marzen Artistic Aluminum Ltd. v. The Queen*, 2014 TCC 194 (appeal filed at the FCA).

Transfer pricing methods 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 comprised of the Country-by-country (CbC) template, Master file; and Local file.

All the transfer pricing information contained in the Master file, Local file, and the Model template of country-by-country reporting, will facilitate the selection and application of a transfer pricing method by tax administrations around the world.

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 application of the selected transfer pricing method to determine an arm’s length price of a controlled transaction between parties not dealing at arm’s length. The information provided through the Master file, Local file, and the Model template of country-by-country reporting could create unnecessary transfer pricing controversies and double taxation for your company if misinterpreted by tax administrations.

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.

DRTP Consulting can assist you

DRTP Consulting's solutions go beyond transfer pricing and international tax solutions. DRTP's economics consulting and research practice provides analysis and research services that encompass a wide range of economic and evaluation applications. Our work helps clients make strategic planning decisions, evaluate business alternatives and models and determine economic and financial contributions and profitability.

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.

For more information contact us.



Robert Robillard
CPA, CGA, MBA, M.Sc. Econ.
Senior Partner
514-742-8086
robertrobillard@drtp.ca



Stéphane Dupuis
M.Sc. Econ., M.Sc. Int'l Business
Senior Partner
514-952-1965
stephanedupuis@drtp.ca

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