NO.: **87-2R** DATE: September 27, 1999

SUBJECT: **International Transfer Pricing**

REFERENCE:

On November 1, 1999, Revenue Canada will begin operations as the Canada Customs and Revenue Agency.

This circular replaces and cancels Information Circular 87-2, dated February 27, 1987.

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Introduction

1. The purpose of this circular is to provide guidance with respect to the application of the transfer pricing rules in section 247 of the *Income Tax Act* (the Act), which received Royal Assent on June 18, 1998.

2. Transfer prices are the prices at which services, tangible property, and intangible property are traded across international borders between related parties.

3. This circular sets out the Department's views on transfer pricing and also provides the Department's position with respect to the application of the 1995 Organisation for Economic Co-operation and Development (OECD), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the OECD Guidelines).

4. The OECD Guidelines should be consulted for a more detailed discussion of the principles contained in Parts 2 to 6 of this circular.

5. Section 247 and this circular relate specifically to transactions or arrangements between a taxpayer and a non-resident person with whom the taxpayer does not deal at arm's length. However, many of the principles and methods outlined in this circular may also provide taxpayers with general guidance on the attribution of income between a permanent establishment and other parts of the same entity.

6. The transfer prices adopted by a group of non-arm's length parties directly affect the profits to be reported by each of those parties in their respective countries.

7. Canada's transfer pricing legislation:

- embodies the arm's length principle; and
- requires that, for tax purposes, the terms and conditions agreed to between non-arm's length parties in their commercial or financial relations be those that one would have expected had the parties been dealing with each other at arm's length.

This ensures that taxpayers, who are non-arm's length members of a group and engage in transactions with other members of the group, report substantially the same amount of income as they would if they had been dealing with each other at arm's length.

8. 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.

9. The arm's length principle:

- treats a group of parties not dealing at arm's length as if they operate as separate entities rather than as inseparable parts of a single unified business; and
- is generally based on a comparison of:
  - prices or margins between non-arm's length parties on cross-border transactions ("controlled transactions"); with
  - prices or margins on similar transactions between arm's length parties ("uncontrolled transactions").

10. Whether a taxpayer has adhered to the arm's length principle is a factual determination to be reviewed on a case-by-case basis.

Definitions

For purposes of this circular, the following terms and expressions, unless otherwise specified, should be read as follows:

"**taxpayer**", "**person**" or "**party**" include a partnership;

"**transaction**" includes a series of transactions, an arrangement or an event;

"**property**" includes both tangible and intangible property;

"intangible property" includes:

- **rights** to use assets such as patents, trademarks, trade names, designs or models; and
- **intellectual property** such as know-how and trade secrets;

"**product**" includes tangible property, intangible property and services;

"**uncontrolled transactions**" will either be transactions:

- between two arm's length parties outside the group; or
- between a non-arm's length party of a group and an arm's length party outside the group;

"controlled transactions" refers to transactions between parties not dealing at arm's length.

Part 1. The Law

11. Section 247 of the Act contains the main provisions relating to transfer pricing. The following is a brief description of the principal subsections of that section.

12. 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; or
- 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).

13. Where the terms or conditions of controlled transactions differ from those that would have been made between persons dealing at arm's length, the following applies:

- Any amount determined under the Act for a taxpayer shall, subject to the provisions of subsection 247(10), be adjusted under subsection 247(2) of the Act. The adjusted amount will reflect those amounts that would have been determined for the taxpayer if the terms and conditions of the transactions were those that would have been made between arm's length persons.
- Subsection 247(2) of the Act permits 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, under the following conditions:
  - if persons enter into a transaction that would not have been entered into between persons dealing at arm's length; and
  - it is reasonable to consider that the transaction was not entered into primarily for *bona fide* purposes other than to obtain a tax benefit.

14. Subsection 247(3) of the Act renders a taxpayer liable to a penalty, if the net result of certain adjustments made under subsection 247(2) of the Act for a taxpayer in a tax year exceeds the lesser of 10% of the taxpayer's gross revenue for the year and $5,000,000.

15. With regard to the net result calculation for purposes of the penalty, the following adjustments apply:

- **upward adjustments** in transactions for which the taxpayer failed to make reasonable efforts to determine and use arm's length transfer prices or allocations; and
- **downward adjustments** in transactions for which the taxpayer has made reasonable efforts to determine and use arm's length transfer prices or allocations (subject to the Minister's discretion under subsection 247(10)).

16. For purposes of subsection 247(3) of the Act:

Upward adjustments are adjustments that result in:

- an increase in a taxpayer's income;
- a decrease in a taxpayer's loss; or
- a decrease in the taxpayer's capital expenditures;

for the year, and

Downward adjustments are adjustments that result in:

- a decrease in a taxpayer's income;
- an increase in a taxpayer's loss; or
- an increase in the taxpayer's capital expenditures;

for the year.

17. The issue of whether a taxpayer has made reasonable efforts to determine and use arm's length transfer prices or allocations for purposes of the penalty under subsection 247(3) of the Act is discussed in Part 7 of this circular.

18. 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 in respect of a transaction for 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. Taxpayers are required to make or obtain certain records or documents on or before the filing date for the tax year, the "documentation due date" (defined in subsection 247(1)), and provide those records and documents to the Minister within 3 months of the receipt of a written request to do so.

19. Subsection 247(2) of the Act applies to tax years that begin after 1997. Generally, subsections 247(3) and (4) of the Act apply to adjustments made under subsection 247(2) of the Act for tax years that begin after 1998. The penalty provisions do not apply to transactions completed before September 11, 1997, which enter into the calculation of taxable income in a subsequent year. Whether the transaction is under an agreement, signed before September 11, 1997, is irrelevant. The determining factor is the date the transaction actually takes place.

For example, a transfer pricing adjustment to the costs of goods sold in 1999 may relate to property transferred before September 11, 1997, and held in inventory until it was sold in 1999. Such an adjustment would not be considered for purposes of the penalty.

20. In addition to affecting the cross-border movement of property and services, section 247 could be applied to financial transactions. In theory, section 247 could be applied to a wide variety of arrangements resulting in foreign accrual property income to Canadian shareholders. In general, the Department considers that subsection 247(2) does not change the existing law as it relates to inter-corporate debt and equity investments. The Department will usually use subsection 245(2) if the arrangement is part of an aggressive tax plan or is potentially abusive (e.g., loss importation), but could also use subsection 247(2) to challenge such an arrangement.

21. As a general rule, the specific provisions of the Act—relating to loans and other indebtedness to or from non-residents, which are contained in sections 17 and 80.4, subsections 15(2) and 18(4)—would be applied before considering the more general provisions of section 247. These specific provisions deal with situations in which a Canadian corporate taxpayer:

- does not charge an adequate rate of interest on a loan or other indebtedness to a non-resident;
- receives an interest-free or low-interest loan from a non-resident; or
- is thinly capitalized.

22. It would usually be inconsistent with the spirit of the Act for the Department to apply the more general provisions of section 247, thereby deeming interest to be received or receivable on the inter-corporate loans, in the following situations:

- where a loan is made by a foreign affiliate of a corporation resident in Canada to the corporation; or
- where a loan is made by one foreign affiliate of a corporation resident in Canada to another foreign affiliate of that resident corporation and subsection 80.4(2) does not apply.

23. Where subsection 80.4(2) does apply, the amount of the benefit is excluded in the calculation of foreign accrual property income of the foreign affiliate under A(*d*) of the definition of "foreign accrual property income" in subsection 95(1). The Department does not plan to change its assessing practices in this regard.

24. Specific provisions in the Act deal with inter-company debt and the associated interest charges. However, the Department recognizes that credit terms and financing arrangements are among the many related factors to be considered in the evaluation of transfer prices.

25. Subsection 247(10) provides the Minister with the authority to make downward adjustments. Downward adjustments are made only if, in the opinion of the Minister, the circumstances indicate the adjustments are appropriate.

26. However, the Minister may decide not to exercise his discretion under 247(10) where:

- the taxpayer's request has been prompted by the actions of a foreign tax authority and the taxpayer has the right to request relief under the Mutual Agreement Procedure article of the applicable treaty; or
- the taxpayer's request can be considered abusive.

27. The Department's general policy regarding taxpayer-initiated adjustments that reduce tax payable is outlined in the current version of Information Circular 75-7 and Information Circular 84-1.

Part 2. The Arm's Length Principle

28. The arm's length principle requires that, for tax purposes, the terms and conditions agreed to between non-arm's length parties in their commercial or financial relations be those that one would have expected had the parties been dealing with each other at arm's length.

29. The arm's length principle is stated in paragraph 1 of Article 9 of the OECD Model Tax Convention:

"Where . . . conditions are made or imposed between . . . two [non-arm's length] enterprises in their commercial or financial relations which differ from those which would be made between [arm's length] enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

30. Paragraph 1.15 of the OECD Guidelines indicates 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 similar transactions.

31. For such price or margin comparisons to be useful, the economically relevant characteristics of the transactions being compared must be at least sufficiently similar so as to permit reasonably accurate adjustments to be made for any differences in such characteristics. Transactions between other non-arm's length parties should not be used for purposes of these comparisons, because the terms and conditions may not be arm's length.

32. 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 characteristics of the property 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.

33. Taxpayers must exercise judgement in determining the degree of comparability of transactions. Selecting the most appropriate pricing method depends largely on the assessment of the comparability of transactions. The availability of quality information on the factors present in the controlled transactions will influence this determination.

34. The Department recognizes that transfer pricing is not an exact science. The application of the most appropriate transfer pricing methodology may produce a range of results. The Department relies on the facts and circumstances of the case to determine a range, or the point in a range, that is the most reliable estimate of an arm's length price or allocation. Taxpayers should exercise care in assessing the reliability of each comparable transaction used to establish a range. The Department's view is that the use of statistical measures, such as an interquartile range, does not necessarily enhance the reliability of the comparable data considered in producing a range.

35. Business strategies are factors that can affect comparability because they influence the price that arm's length parties would charge for a product.

For example, where an arm's length party attempts to introduce a product into a new market or increase its market share, 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 or market share. This assumes that an arm's length party would have estimated the potential long-term benefits of such a strategy. It is unlikely, however, that an arm's length party would maintain such a strategy for an extended period of time.

36. Subsection 247(2) of the Act applies the arm's length principle through a review of the terms and conditions attached to transactions or series of transactions entered into between parties not dealing at arm's length. In addition, to arrive at the most precise approximation of an arm's length price or allocation, the arm's length principle should ideally be applied on a transaction-by-transaction basis. Therefore, in establishing transfer prices, taxpayers should set prices separately for each transaction they enter into with a non-arm's length party. This separate determination usually provides the most reliable estimation of an arm's length price.

37. In some situations, transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. In these situations, it may be necessary to bundle transactions.

38. Paragraph 1.42 of the OECD Guidelines provides the following examples:

- some long-term contracts for the supply of commodities or services;
- rights to use intangible property;
- the pricing of a range of closely-linked products (e.g., in a product line) when it is impractical to determine pricing for each individual product or transaction.

39. When determining whether transactions should be priced separately or on some aggregate basis, taxpayers should consider a number of factors, including:

- intangibles associated with the various transactions;
- availability of quality information on comparable transactions;
- functional comparability of transactions; and
- additional costs associated with valuing transactions separately.

40. Whether the price for a bundle of transactions is set separately for each transaction or on an aggregate basis will not change the underlying nature of the individual transactions. The Department does not view the bundling or unbundling of transactions for purposes of the determination of an arm's length price as a recharacterization of the underlying transactions.

41. In addition to the fact that evaluating transactions on a separate basis generally provides the most reliable estimation of an arm's length price, taxpayers should also consider separating transactions for two reasons:

- payments on some transactions to a non-resident are subject to Part XIII withholding tax, while others are not; and
- tax treaties may subject different types of payments to different rates of withholding tax.

42. However, where the normal industry practice is to set one price for a combination of transactions (e.g., goods and the associated intangible property) it may not be reasonable to expect to find quality data available to set the price for separate transactions. Therefore, the total amount may be taxed under either Part I or Part XIII of the Act, as the case may be, on an aggregate basis.

43. The Department generally accepts business transactions as they are structured by the parties. The fact that a taxpayer has entered into a transaction with a non-arm's length non-resident party in a form that would not exist between arm's length parties does not necessarily imply that the transaction is inconsistent with the arm's length principle. This may reflect the fact that parties not dealing at arm's length operate under different commercial circumstances than do parties transacting at arm's length.

44. There are instances where it is necessary to recharacterize a transaction for tax purposes; however, as indicated in the OECD Guidelines, those instances are limited. The OECD Guidelines identify two exceptional situations where the recharacterization of a transaction would be considered (see paragraph 1.37 of the OECD Guidelines).

45. Paragraph 247(2)(*b*) of the Act, which provides the authority to recharacterize a transaction, states that a transaction can be recharacterized only after meeting the following two conditions:

- the transaction or series must be one that would not have been entered into between persons dealing at arm's length; and
- it can be reasonable to consider that the transaction or series of transactions was not entered into primarily for *bona fide* purposes other than to obtain a tax benefit.

46. All proposed assessments to recharacterize a transaction under paragraph 247(2)(*b*) will be referred to the Transfer Pricing Review Committee **before** the assessment is issued, to ensure fair and consistent application.

Part 3. Methods – Application of the Arm's Length Principle

47. Section 247 is intended to reflect the arm's length principle expressed in the OECD Guidelines.

48. The OECD Guidelines recommend a number of transfer pricing methods (known as "the recommended methods") that, when applied correctly, result in an arm's length price or allocation. These methods are divided into two groups:

- **traditional transaction methods:**
  - the comparable uncontrolled price (CUP) method;
  - the resale price method; and
  - the cost plus method;

and

- **transactional profit methods:**
  - the profit split method; and
  - the transactional net margin method (TNMM).

49. The Act does not impose an explicit hierarchy of transfer pricing methodologies, nor does it specifically mandate methods in order to meet the arm's length principle. However, the Department's view is that there is a natural hierarchy in the methods. Certain methods provide more reliable results than others, depending on the degree of comparability between controlled and uncontrolled transactions.

50. 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. For controlled and uncontrolled transactions to be considered comparable, one must be able to confirm **either**:

- that there are no differences between the transactions which would materially affect the price in the open market;

  or, if there are material differences,
- that reliable adjustments can be made to eliminate the material effects of such differences.

51. 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.

52. The OECD Guidelines, at Chapter II and III, paragraphs 2.49, 3.49 and 3.50, state that:

- the traditional transaction methods are preferable to the transactional profit methods; and

- the transactional profit methods are used as methods of last resort, when the use of traditional transaction methods cannot be reliably applied or cannot be applied at all.

The Department endorses this view.

53. The CUP method, if applicable, clearly provides the highest degree of comparability for the traditional transaction methods because it:

- focuses directly on the price of a transaction; and
- requires both functional and product comparability.

54. Although the CUP method provides the most direct and reliable means of establishing an arm's length price, other traditional transaction methods may have to be used where:

- there is not enough quality information available with respect to uncontrolled transactions; or
- it is not possible to reliably quantify the differences between controlled and uncontrolled transactions.

55. At some point, differences become so significant that the CUP method will no longer produce the most reliable measure of an arm's length price.

For example, it may not be possible to make appropriate adjustments due to material market differences.

56. The difference between the CUP method and the cost plus or resale price methods is as follows:

- the CUP method compares prices of comparable property or services; and
- the cost plus and resale price methods establish the margin that a taxpayer might expect as a reward for the functions performed, assets used, and risks assumed.

57. Because the cost plus and resale price methods operate at the gross margin level, product differences have a less significant impact on the reliability of the results than in the CUP method; however, the closer the comparability of products, the more reliable the result will be.

58. The choice between the resale price method or the cost plus method depends on the comparability of quality data available for each of the parties to the transaction. Quality comparable information is generally more readily available for the least complex party.

For example, the resale price method may be the most appropriate choice if the least complex party is a distributor.

59. Taxpayers will have to consider the transactional profit methods if:

- no quality data are available to apply the cost plus or resale price methods; or
- the available data to apply the cost plus or resale price methods have material differences that cannot reliably be adjusted.

60. The OECD Guidelines do not express a clear preference for one transactional profit method over the other. In fact, they discourage the use of both methods.

However, the profit split method will generally provide a more reliable estimate of an arm's length result than the TNMM unless a high degree of comparability, including the comparability of intangible assets, can be established. This is suggested by:

- the OECD's evaluation of each of the transactional profit methods; and
- the Department's experience with the use of these methods.

61. The most appropriate method in a given set of circumstances will be the one that provides the highest degree of comparability between transactions. Once a taxpayer establishes comparability at a particular level within the hierarchy of methods, the taxpayer is not required to consider or apply a lower-ranking method. On the other hand, if the taxpayer cannot establish comparability at any level, other methods should be considered in order to determine the most appropriate method.

62. In certain cases, taxpayers may have some doubts about the reliability of the results produced by a particular method. Because the results produced by each of the recommended methods should have some consistency, taxpayers may wish to confirm their results by applying another method.

63. The Department will examine the application of the method selected by a taxpayer to ensure that the selected method produces the most reliable measure of an arm's length result.

For example, if a taxpayer used the TNMM to establish its transfer price and the Department obtains comparable information at the CUP level, the Department is of the view that the CUP method will provide better evidence of an arm's length transfer price.

A. Traditional Transaction Methods

Comparable uncontrolled price (CUP) method

64. The CUP method provides the best evidence of an arm's length price. A CUP may arise where:

- the taxpayer or another member of the group **sells** the particular product, in similar quantities and under similar terms to arm's length parties in similar markets (an internal comparable);
- an arm's length party **sells** the particular product, in similar quantities and under similar terms to another arm's length party in similar markets (an external comparable);
- the taxpayer or another member of the group **buys** the particular product, in similar quantities and under similar terms from arm's length parties in similar markets (an internal comparable); or

- an arm's length party **buys** the particular product, in similar quantities and under similar terms from another arm's length party in similar markets (an external comparable).

65. Incidental sales of a product by a taxpayer to arm's length parties may not be indicative of an arm's length price for the same product transferred between non-arm's length parties, unless the non-arm's length sales are also incidental.

66. Transactions may serve as comparables despite the existence of differences between those transactions and non-arm's length transactions, if:

- the differences can be measured on a reasonable basis; and
- appropriate adjustments can be made to eliminate the effects of those differences.

67. Where differences exist between controlled and uncontrolled transactions, it may be difficult to determine the adjustments necessary to eliminate the effect on transfer prices. However, the difficulties that arise in making adjustments should not routinely preclude the potential application of the CUP method. Therefore, taxpayers should make reasonable efforts to adjust for differences.

68. The use of the CUP method precludes an additional allocation of related product development costs or overhead unless such charges are also made to arm's length parties. This prevents the double deduction of those costs—once as an element of the transfer price and once as an allocation.

69. **CUP method example:**

Note: The examples in this circular are strictly for the purpose of illustrating the application of the various methods. They are simplified hypothetical examples and the numerical amounts, reported as prices, mark-ups, margins, adjustments, etc., have no factual basis, and should not be taken as establishing a benchmark or standard.

Canco, a Canadian company, sells commodity X directly to its German subsidiary, Germanco, for its own consumption. Commodity X is actively traded in Germany and an average daily German transaction price is readily available. The average daily German transaction price represents a delivered price and includes any freight and duties. On the other hand, under the agreement between Canco and Germanco, Germanco takes possession of the product at Canco's plant.

The transfer price per ton for a particular shipment is calculated as follows:

Average daily German transaction price per ton		$ 576
Deduct		
Adjustment for freight	$ 32	
Adjustment for duties	28	

Total adjustments		60

Transfer price per ton		$ 516
		===

Resale price method

70. The resale price method begins with the resale price to arm's length parties (of a product purchased from an non-arm's length enterprise), reduced by a comparable gross margin. This comparable gross margin is determined by reference to either:

- the resale price margin earned by a member of the group in comparable uncontrolled transactions (internal comparable); or
- the resale price margin earned by an arm's length enterprise in comparable uncontrolled transactions (external comparable).

71. Under this method, the arm's length price of goods acquired by a taxpayer in a non-arm's length transaction is determined by reducing the price realized on the resale of the goods by the taxpayer to an arm's length party, by an appropriate gross margin. This gross margin, the resale margin, should allow the seller to:

- recover its operating costs; and
- earn an arm's length profit based on the functions performed, assets used, and the risks assumed.

72. Where the transactions are not comparable in all ways and the differences have a material effect on price, the taxpayer must make adjustments to eliminate the effect of those differences. The more comparable the functions, risks and assets, the more likely that the resale price method will produce an appropriate estimate of an arm's length result.

73. An exclusive right to resell goods will usually be reflected in the resale margin.

74. The resale price method is most appropriate in a situation where the seller adds relatively little value to the goods. The greater the value-added to the goods by the functions performed by the seller, the more difficult it will be to determine an appropriate resale margin. This is especially true in a situation where the seller contributes to the creation or maintenance of an intangible property, such as a marketing intangible, in its activities.

75. **Resale price method example:**

Canco distributes widgets in Canada for its United States parent, Usco. Salesco, a Canadian company operating at arm's length to Usco, distributes gadgets, a product similar to widgets, in Canada for Usco. The key functional differences, other than the minor differences in product, between the controlled transactions and the uncontrolled transactions are:

- Usco bears the warranty risk in the uncontrolled transaction and Canco bears the warranty risk in the case of the controlled transaction; and
- Usco provides samples and promotional materials to Salesco free of cost while Canco produces its own samples and promotional materials and bears the related costs.

The widget and gadget markets are similar in Canada. Salesco earns a commission of 15% of gadget sales net of discounts and allowances.

Calculation of sales commission:

Canco's net sales of widgets to arm's length parties		$4,000
Arm's length sales commission rate based on Usco agreement		15%

Arm's length sales commission based on Usco agreement		$ 600
Adjustments for functional and risk differences:		
Promotional costs	$ 10	
Warranty costs	22	

Total adjustments		32

Adjusted sales commission		$ 632
		====

Calculation of transfer

Canco's net sales of widgets to arm's length parties	$4,000
Less adjusted sales commission	632

Transfer price	$3,368
	====

Cost plus method

76. The cost plus method begins with the costs incurred by a supplier of a product or service provided to an non-arm's length enterprise, and a comparable gross mark-up is then added to those costs. This comparable gross mark-up is determined in two ways, by reference to:

- the cost plus mark-up earned by a member of the group in comparable uncontrolled transactions (internal comparable); or
- the cost plus mark-up earned by an arm's length enterprise in comparable uncontrolled transactions (external comparable).

77. In either case, the returns used to determine an arm's length mark-up must be those earned by persons performing similar functions and preferably selling similar goods to arm's length parties.

78. Where the transactions are not comparable in all ways and the differences have a material effect on price, taxpayers must make adjustments to eliminate the effect of those differences, such as differences in:

- the relative efficiency of the supplier; and
- any advantage that the activity creates for the group.

79. The more comparable the functions, risks and assets, the more likely it is that the cost plus method will produce an appropriate estimate of an arm's length result.

80. In general, for purposes of applying a cost-based method, costs are divided into three categories:

(1) **direct costs** such as raw materials;

(2) **indirect costs** such as repair and maintenance which may be allocated among several products; and

(3) **operating expenses** such as selling, general, and administrative expenses.

81. The cost plus method uses margins calculated after direct and indirect costs of production. In comparison, net margin methods—such as the transactional net margin method (TNMM) discussed in Section B of this Part—use margins calculated after direct, indirect, and operating expenses. For purposes of calculating the cost base for the net margin methods, operating expenses usually exclude interest expense and taxes.

82. Properly determining cost under the cost plus method is important. Cost is usually calculated in accordance with accounting principles that are generally accepted for that particular industry in the country where the goods are produced.

83. However, it is most important that the cost base of the transaction of the tested party to which a mark-up is to be applied be calculated in the same manner as—and reflects similar functions, risks, and assets as—the cost base of the comparable transactions. Where cost is not accurately determined in the same manner, 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.

For example, if the comparable party includes a particular item as an operating expense, while the tested party includes the item in its cost of goods sold, the cost base of the comparable must be adjusted to include the item.

84. **Cost plus method example:**

Canco, a Canadian company, manufactures specialized stamping equipment for arm's length parties in the manufacturing industry using designs supplied to them by the arm's length parties. Canco realizes its costs plus a mark-up of 10% on this custom manufacturing. Under the arm's length agreements, **costs** are defined as the sum of direct costs (i.e., labour and materials) plus 50% of the direct costs. The additional 50% of direct costs is intended to approximate indirect costs, including overhead. Canco also manufactures stamping machines for its United States subsidiary, Usco, using designs supplied by Usco. Under the Usco agreement, **costs** are defined as the sum of the direct costs plus the actual indirect costs, including overhead.

The objective of this example is to illustrate that the cost base of the tested party and the comparable transaction must be expressed in equivalent terms. Therefore, for purposes of the example, it is assumed that the transactions between Canco and the arm's length parties are functionally comparable to the transactions between Canco and Usco. Normally there would be functional differences, such as differences in marketing activities, which should be given

consideration in the determination of an arm's length mark-up.

Canco has calculated its indirect costs and has allocated those costs to the various projects based on the direct labour hours charged to each project. Based on Canco's calculations, the actual indirect costs, including overhead, to be charged to each project equal 45% of the direct costs. The cost base of the comparable transactions must be restated to determine the appropriate mark-up.

The transfer price is calculated as follows:

Calculation of mark-up under the arm's length agreements:

Direct costs	$ 1,000
Indirect costs (50% × $1,000)	500

Total costs	$ 1,500
	====
Mark-up 10%	$ 150
	====
Price	$ 1,650
	====

Calculation of mark-up under the arm's length agreements using restated costs:

Direct costs	$ 1,000
Indirect costs (45% × $1,000)	450

Total costs	$ 1,450
	====
Price established above	$ 1,650
	====
Mark-up based on restated costs ($1,650 – $1,450)	$ 200
	====
Gross mark-up based on restated costs ($200/$1,450)	13.8%
	====

Calculation of the arm's length transfer price:

Canco's direct costs related to Usco contract	$ 900
Add:	
Indirect costs (45% × $900)	405
Mark-up (13.8% × ($900 + 405))	180

Transfer price	$ 1,485
	====

85. The OECD Guidelines provide another example, in paragraph 2.37, where the comparable arm's length party leases its business assets while the tested party owns its business assets. The example highlights that the cost base may not be comparable without the appropriate adjustment to the cost base.

86. The application of the cost plus method also requires careful consideration of the relative efficiencies of the parties being compared. An analysis of efficiencies includes a consideration of the differences in:

- cost structures (such as the age of the plant and equipment);
- business experience (such as start-up versus mature businesses); and
- management efficiency.

87. Where material differences are identified, the reliability of the comparables may be affected. Material differences between the capital intensity of the tested party and an arm's length party often indicate material differences in the transactions for which adjustments cannot be made.

88. For purposes of applying the cost-based transfer pricing methods, items such as depreciation and other indirect charges are usually calculated in accordance with accounting principles that are generally accepted for that particular industry. Therefore, amounts such as depreciation or financial reporting purposes—and not amounts such as capital cost allowance, determined solely for calculating a taxpayer's taxable income—are, in general, relevant for purposes of establishing the appropriate cost base under the cost plus method.

89. The cost plus and resale price methods are applied to only one party (the tested party) of the group participating in the transaction. Generally, the more complex the functions performed, the assets used and the risks assumed, the more difficult it is to find comparable data to apply these methods. Therefore, the cost plus and resale price methods generally produce the most reliable results where:

- the functions performed by the tested party are the least complex; and
- the tested party does not contribute valuable or unique intangible assets.

For example, Foreign Co. conducts research and development, and manufactures and sells, a particular computer product into its home market. Canco, a Canadian foreign affiliate of Foreign Co., on the other hand, manufactures only one component of the computer product and sells all the components it produces to Foreign Co. The component is developed by Foreign Co. Because Foreign Co. develops and owns both the manufacturing and marketing intangibles, it will generally be more difficult to find comparable data to apply the cost plus and resale price methods to Foreign Co.'s manufacturing and sales activities than it would be to find comparable data to apply the cost plus method to Canco's manufacturing activities. Canco would generally be the tested party in this scenario.

B. Transactional Profit Methods

90. Traditional transaction methods are the most reliable means of establishing arm's length prices or allocations. However, the complexity of modern business situations may make it difficult to apply these methods. Where the information available on comparable transactions is not detailed enough to allow for adjustments necessary to achieve comparability in the application of a traditional

transaction method, taxpayers may have to consider transactional profit methods.

91. However, the transactional profit methods should not be applied simply because of the difficulties in obtaining or adjusting information on comparable transactions, for purposes of applying the traditional transaction methods. The same factors that led to the conclusion that it is not possible to apply a traditional transaction method must be considered when evaluating the reliability of a transactional profit method.

92. The OECD Guidelines endorse the use of two transactional profit methods:

- the profit split method; and
- transactional net margin method (TNMM).

93. The key difference between the profit split method and the TNMM is that the profit split method is applied to all members involved in the controlled transaction, whereas the TNMM is applied to only one member.

94. The more uncertainty associated with the comparability analysis, the more likely it is that a one-sided analysis, such as the TNMM, will produce an inappropriate result. As with the cost plus and resale price methods, the TNMM is less likely to produce reliable results where the tested party contributes to valuable or unique intangible assets. Where uncertainty exists with comparability, it may be appropriate to use a profit split method to confirm the results obtained.

95. In the Department's experience, it is difficult to find exact comparables for valuable or unique intangible assets. Furthermore, by their nature, these intangibles are often difficult to value, making it a challenge to calculate adjustments to account for the impact of the intangible. Therefore, the Department's view is that the TNMM is seldom the recommended approach for controlled transactions involving valuable or unique intangible assets.

Profit split method

96. Under the profit split method:

- The **first step** is to **determine the total profit** earned by the parties from a controlled transaction. The profit split method allocates the total integrated profits related to a controlled transaction, not the total profits of the group as a whole. The profit to be split is generally the operating profit, before the deduction of interest and taxes. In some cases, it may be appropriate to split the gross profit.
- The **second step** is to **split the profit 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 non-arm's length party, in relation to what arm's length parties would have received.

97. The profit split method may be applied where:

- the operations of two or more non-arm's length parties are highly integrated, making it difficult to evaluate their transactions on an individual basis; and
- the existence of valuable and unique intangibles makes it impossible to establish the proper level of comparability with uncontrolled transactions to apply a one-sided method.

98. Due to the complexity of multinational operations, one member of the multinational group is seldom entitled to the total return attributable to the valuable or unique assets, such as intangibles.

For example, although one member of a multinational group often develops a product intangible, another member of the group may expend considerable effort in developing a marketing intangible in a specific geographic location.

99. Also, arm's length parties would not usually incur additional costs and risks to obtain the rights to use intangible properties unless they expected to share in the potential profits. When intangibles are present and no quality comparable data are available to apply the one-sided methods (i.e., cost plus method, resale price method, the TNMM), taxpayers should consider the use of a profit split method.

100. The second step of the profit split method can be applied in numerous ways, including:

- splitting profits based on a residual analysis; and
- relying entirely on a contribution analysis.

101. Following the determination of the total profit to be split in the first step of the profit split, a residual profit split is performed in two stages. The stages can be applied in numerous ways, for example:

- **Stage 1**: The allocation of a return to each party for the readily identifiable functions (e.g., manufacturing or distribution) is based on routine returns established from comparable data. The returns to these functions will, generally, not account for the return attributable to valuable or unique intangible property used or developed by the parties. The calculation of these routine returns is usually calculated by applying the traditional transaction methods, although it may also involve the application of the TNMM.
- **Stage 2**: The return attributable to the intangible property is established by allocating the residual profit (or loss) between the parties based on the relative contributions of the parties, giving consideration to any information available that indicates how arm's length parties would divide the profit or loss in similar circumstances.

102. **Residual profit split method example:**

Canco, a Canadian company, has developed and manufactures a unique computer chip. The chip is considered to be an innovative technological advance. Usco, a United States subsidiary of Canco, has developed and manufactures a computer which incorporates the new chip and technology

developed by Usco itself. The success of the computer is attributable to both companies for the design of the computer and the computer chip.

Canco supplies Usco with the computer chips for assembly in the computers. Usco manufactures the computers and sells the computers to an arm's length distributor.

In light of the innovative nature of the chip and computer, the group was unable to find comparables with similar intangible assets. Because they were unable to establish a reliable degree of comparability, the group was unable to apply the traditional transaction methods or the TNMM. However, reliable data are available on chip and computer manufacturers without innovative intangible property, and they earn a return of 10% on their manufacturing costs (excluding purchases).

The total profits attributable to computer and chips are calculated as follows:

Sales to the arm's length distributor		$ 1,000
Deduct		
Canco's manufacturing costs	$ 200	
Usco's manufacturing costs	300	

Total manufacturing costs for the group		500

Gross margin		$ 500
Deduct		
Canco's development costs	$ 100	
Usco's development costs	50	
Canco's operating costs	50	
Usco's operating costs	100	

Subtotal		300

Net profit		$ 200
Canco's return to manufacturing (200 × 10%)	$ 20	
Usco's return to manufacturing (300 × 10%)	30	

Subtotal		50

Residual profit attributable to development		$ 150
		====

To simplify this example, it is assumed that the current chip and computer development costs accurately reflect each of the participants relative contribution to the computer's technological advantage. The split of the residual profit should consider the benefits over the entire expected life of the technology, which would usually go beyond the current year. However, given the foregoing assumption, the residual profit in this example would be split as follows:

Based on proportionate development costs:

Canco's share of residual profit [100/(100 + 50)] × $150	$ 100
	====
Usco's share of residual profit [50/(100 + 50)] × $150	$ 50
	====

Canco's transfer price is calculated as follows:

Manufacturing costs	$ 200
Development costs	100
Operating costs	50
Routine 10% return on manufacturing costs	20
Share of residual profit	100

Transfer price	$ 470
	====

103. Where the profit is split based on the relative assets of the parties, merely providing each party with the same return on its respective assets is usually not acceptable. The methodology used should recognize that different types of assets have different expected rates of return, based on their liquidity and risk.

For example, working capital would usually expect to earn a short-term financing rate of return. However, fixed assets—such as property (real estate), plant and equipment would usually expect to earn a long-term rate commensurate with the risks assumed.

104. An alternative way to apply the profit split method, also suggested by the OECD, is to rely entirely on a contribution analysis. The total profit earned by the parties from a controlled transaction is divided, based on the relative contributions of the parties.

105. In the Department's experience, the relative contributions are often difficult to quantify. Therefore, the Department recommends the use of the residual profit split in most cases where the profit split method is appropriate. The use of comparable data to allocate a portion of the total profit in Stage 1 of the second step of the residual profit split will generally improve the reliability of the profit split.

Transactional net margin method (TNMM)

106. The 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; and
- examines the net profit margin relative to an appropriate base such as costs, sales or assets.

107. This differs from the cost plus and resale price methods that compare gross profit margins. However, the TNMM requires a level of comparability similar to that required for the application of the cost plus and resale price methods. Where the relevant information exists at the gross

margin level, taxpayers should apply the cost plus or resale price method.

108. Because the TNMM is a one-sided method, it is usually applied to the least complex party that does not contribute to valuable or unique intangible assets. Since TNMM measures the relationship between net profit and an appropriate base such as sales, costs, or assets employed, it is important to choose the appropriate base taking into account the nature of the business activity. The appropriate base that profits should be measured against will depend on the facts and circumstances of each case.

For example:

Canco, a Canadian company, produces a liquid product for itself and three foreign subsidiaries of its Swiss parent. Canco and the foreign subsidiaries own the rights to the liquid product formulae for sales to their respective countries. Although Canco has no internal comparable transactions, it has been able to locate data relating to an arm's length party who performs custom formulations for arm's length purchasers using formulae supplied to them by those purchasers. Given the absence of valuable or unique intangibles, Canco has been able, after the appropriate functional analysis, to verify that the custom formulator is comparable. However, Canco cannot obtain the relevant information at the gross margin level. Therefore, it is unable to apply the cost plus method. The arm's length formulator realizes a net mark-up of 10% on the custom formulations.

The transfer price of the liquid product is calculated as follows:

Canco's cost of goods sold	$ 1,000
Canco's operating expenses	300

Total costs	$ 1,300
Add:	
Net mark-up (10% × $1,300)	130

Transfer price	$ 1,430
	====

109. The TNMM relies on a comparison of net margins. Therefore, a standard of comparability similar to that needed for the cost plus and resale price methods must be met if the TNMM is to produce a reliable estimate of an arm's length result. Application of the TNMM, like the cost plus and resale methods, requires a careful evaluation of the functional differences.

110. Where differences between the taxpayer's situation and that of one or more comparable entities exist and can be determined, taxpayers must make appropriate adjustments to ensure a high standard of comparability.

111. Some differences 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). The failure to account for these differences or to make satisfactory adjustments may preclude the method from producing a reliable estimate of an arm's length result. Aggregated data compiled with respect to the profits within a particular industry rarely satisfy the standards of comparability required to implement the TNMM.

112. Typically, the TNMM is applied to only one of the parties involved in the transaction. However, the TNMM can be applied to more than one member of a group where it is used to establish routine returns in Stage 1 of the second step of the residual profit split.

113. Where the TNMM is applied to only one member of a group, it may fail to consider the relative contributions of all the members to the profits of the group. It can produce results that do not accord with the arm's length principle, where the tested party contributes to valuable or unique intangible assets. The result may be that a level of profit is attributed to one member of the group, leaving the other members of the group with unrealistic shares of the group's total profits.

114. The TNMM is a net margin method. The Department acknowledges that the TNMM and the comparable profits method (CPM), put forward by other tax authorities as a transfer pricing methodology, both base the establishment of arm's length conditions on an analysis of net margin ratios. However, the Department is also aware that, in many cases, the practical application of the CPM does not meet the degree of comparability required by the OECD Guidelines for the application of the TNMM.

115. CPM will be acceptable in Canada, subject to the natural hierarchy of methods (discussed in Part 3 of this circular), and to the extent that its application conforms to the comparability standards set forth for the TNMM in the OECD Guidelines.

116. Some tax jurisdictions promote the use of statistical measures to enhance the reliability of the comparable data considered in producing a range. As previously mentioned in paragraph 34 of this circular, the Department does not endorse the use of statistical measures which are commonly used in the application of the TNMM. Instead, the Department relies on the facts and circumstances of the case to determine a range, or the particular point in a range, that is the most reliable estimate of an arm's length price or allocation.

117. The Department recommends that taxpayers follow a four-step approach in their search for external comparable transactions under the TNMM. The steps are as follows:

- **Step 1**: Select entities with similar industry classifications to the tested party, taking into consideration that closer comparability of products and functions produces more reliable results.
- **Step 2**: Screen the entities identified in a similar industry classification to determine if the entities have basically comparable transactions as the tested party, based on the

financial information available. **For example,** where the tested party is a manufacturer with limited intangibles, the ratio of research and development expenses to sales may highlight functional differences between the tested party and the entities selected.

- **Step 3**: Review all the detailed information (financial and textual) available on the entities selected in Step 1 and not screened out by the testing in Step 2. Do this to determine if the information indicates that they could be considered to have comparable transactions. Although entities are reported in a similar industry code, the narrative descriptions will often reveal that the selected entities' transactions are not comparable to those of the tested party.
- **Step 4**: Material differences may affect the comparability of any of the entities' transactions selected in Step 1 and not screened out by the testing in Step 2 or Step 3. In these situations, make the appropriate adjustments where possible and eliminate any entities for which necessary adjustments cannot reasonably be made.

118. Taxpayers should apply the TNMM on a transactional basis and not on a company-wide basis. However, transactions may be combined after considering the factors described in paragraph 39 of this circular.

119. There may be situations where a taxpayer has followed the hierarchy of methods and is unable to establish an appropriate degree of comparability based on the facts and circumstances. In such a situation, the taxpayer may have to consider using a method, other than a recommended method, that will satisfy the arm's length principle. Where another method is used, it should reflect an attempt to present the particular transaction in terms of what would have transpired in an arm's length relationship.

Part 4. Qualifying Cost Contribution Arrangements (QCCA)

120. Subsection 247(1) of the Act defines a qualifying cost contribution arrangement (QCCA). In general terms, a QCCA is an 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.

121. Each participant's expected benefit from a QCCA, for the purposes of apportioning the costs, consists of the benefits that the participant will derive from exploiting the results of the QCCA, and not from the actual activities of the QCCA. If the QCCA develops property such as an intangible, each participant in a QCCA is not required to be a legal owner of the property, but each participant must enjoy substantially similar rights, benefits, and privileges as a legal owner (effective or beneficial ownership).

122. Frequently, a QCCA is concluded for the joint development of intangible property, with each participant being assigned an interest 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).

123. For a QCCA to satisfy the arm's length principle, each participant's contribution must be consistent with that which an arm's length party would have agreed to contribute under comparable circumstances given the benefit it would have reasonably expected to derive from the arrangement. Therefore, only persons who can reasonably be expected to derive a benefit from the results of a QCCA can be considered participants in that QCCA. The requirement of an expected benefit does not impose a condition that the subject activity in fact be successful.

124. Under the arm's length principle, the value of each participant's contribution to a QCCA should be consistent with the value that arm's length parties would have assigned to that contribution in comparable circumstances. The application of the arm's length principle would take into account, among other things, the contractual terms and economic circumstances particular to the QCCA.

125. Where a participant to a QCCA, or a non-arm's length party to a participant to a QCCA, performs all or part of the QCCA activities, it would expect to be compensated on an arm's length basis. The arm's length compensation would be determined under the general principles discussed in this circular, including consideration of functions performed, assets used, and risks assumed. This compensation can include expected benefits from the QCCA.

126. The arm's length principle also applies to capital contributions of tangible or intangible assets to a QCCA.

For example, where two parties intend to be equal participants in a QCCA, 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.

127. Under a QCCA, a participant's share of the overall contributions to the QCCA must be in proportion to the share of the overall benefits it expects to derive from the arrangement.

128. **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 as a result of its participation in the arrangement; or
- the anticipated cost savings they expect to gain as a result of its participation in the arrangement.

129. **In practice,** to indirectly estimate the additional income to be derived from the arrangement, the participants may use allocation keys such as:

- sales;
- units used, produced or sold;
- gross or operating profit;
- number of employees; or
- capital invested.

130. A taxpayer should choose allocation keys, taking into account:

- the nature of the QCCA; and
- the relationship between the allocation key and the expected benefits.

For example, projected sales of the end-products may not be an appropriate allocation key where:

- a particular component is developed within a QCCA; and
- the component is used by the participants in a variety of end-products that differ significantly in price.

The differences in the prices of the end-products will distort the relationship between the cost to the participants and their expected benefits. In this case, the number of components used by each participant may be a better measure of the expected benefits to the participants.

131. For tax purposes, the contributions by a participant to a QCCA will be treated as though they were made outside the scope of the QCCA to carry on the activities that are the subject of the QCCA (e.g., to perform scientific research and experimental development (SR&ED) or purchase a capital asset). 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.

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

133. For tax purposes, the balancing payment should be treated as an addition to the cost of the payer and as a reimbursement of costs to the recipient. Where the balancing payment is more than the recipient's expenditures or costs, the excess will be treated as a taxable amount.

134. The costs subject to allocation would be net of other QCCA receipts, (i.e., royalties from licenses or proceeds from the sale of research assets). Costs subject to allocation for SR&ED carried out in Canada under a QCCA will be calculated before deducting any tax incentives (i.e., SR&ED tax credits) earned with respect to the SR&ED, but after deducting subsidies granted by a government, unless there is evidence that arm's length parties would have done otherwise.

135. Under the arm's length principle, participants in a QCCA that transfer a part or all of their interests in the results of prior QCCA activities (such as intangible property, work in-progress, or the knowledge obtained from past QCCA 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 on the price an arm's length party would have paid for the rights obtained by the new participant. This determination would take into account the proportionate share of the overall expected benefit to be received from the QCCA.

136. For tax purposes, a buy-in payment will be treated as if the payment was made outside the QCCA for acquiring the interest in the rights being obtained (e.g., an interest in intangible property already developed by the QCCA, work in progress, or the knowledge obtained from past QCCA activities).

137. Similar issues arise when a participant to a QCCA disposes of part or all of its interest in a QCCA. The effective transfer of property interests should be compensated according to the arm's length principle (a buy-out payment). However, taxpayers should exercise care in the event of either a buy-in or buy-out because the very nature of any intangibles in a QCCA may often make the buy-in or buy-out valuation difficult. This valuation is particularly difficult where the intangibles developed by a QCCA are valuable or unique.

138. For tax purposes, a buy-out payment will be treated as if the payment was made outside the QCCA for the disposal of pre-existing interests (e.g., an interest in intangible property already developed by the QCCA, work in progress, or the knowledge obtained from past QCCA activities).

Part 5. Intangible Property

139. Applying 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. In most cases, both the supplier and the recipient share the risks and the benefits associated with using an intangible.

140. Arm's length pricing for the transfer of intangible property must take into account the perspective of both the transferor of the property and the transferee. A transferor attempts to recover the costs associated with developing an intangible and to earn a reasonable return. However, to the recipient, the value of an intangible is based solely on the expected benefits (additional profits) that the intangible would generate. The overall expected benefit to the recipient is usually a key consideration in determining the transfer price of an intangible to both parties.

For example, in most cases, an arm's length exclusive distributor of a product would only agree to pay a higher

royalty for the use of a highly valuable brand name if the use of such brand-name is expected to generate profits, for the distributor, which are higher than those that the distributor would have expected if it had distributed a similar product without the brand-name intangible.

141. The very nature of intangible property may often make its valuation difficult. The inherent risk often associated with intangible property may produce significant fluctuations in their value. In addition, intangible property may be of significant value even though it has no or little book-value in the taxpayer's balance sheet.

142. It may be very difficult to find intangibles which are comparable. In applying the arm's length principle to transactions involving intangibles, the most appropriate transfer pricing method will be the one that provides the highest degree of comparability between transactions.

143. Where comparable data on an intangible exists, the most appropriate transaction method is a traditional one (i.e., CUP or resale price). 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, a trademark, or know-how) where the same or a comparable intangible property has been sold or licensed to arm's length parties.

144. Genuine offers from arm's length parties for the intangible may also be taken into account. However, where such an offer does not result in an agreement between the parties, taxpayers should also consider the factors leading to the rejection of the offer. An offer made by a potential purchaser may be representative of a price that the particular purchaser was prepared to pay. However, it may not be representative of the price that a vendor is prepared to accept.

145. Traditional transaction methods or the TNMM would probably not be appropriate where an intangible property is highly valuable or unique, such as a patent resulting from risky and costly research and development because of the difficulty in finding comparable information.

Furthermore, to the extent that excess profits are generated by a highly valuable or unique intangible, it would be unusual that all the excess profits would accrue to either the supplier or the user of the intangible. In such cases, the residual profit split method may often be the most appropriate method.

146. In determining a transfer price for an intangible, whether for sale or for use, a taxpayer must consider the terms and conditions that arm's length parties would insist on to protect their respective positions.

For example, where the value of an intangible is uncertain, one needs to consider whether an arm's length transferor would permit the long-term exploitation of the intangible by an arm's length party.

As protection, an arm's length transferor may insist on an agreement that:

- has a relatively short term;
- includes a price adjustment clause; or
- sets variable royalty rates tied to profits.

If the exploitation of the intangible proves highly profitable, the transferor would enjoy a reasonable share of that financial success.

Similarly, an arm's length transferee, wishing to exploit an intangible property, may not agree to pay large amounts for the exclusive use of the property for a long period of time, if the value of the intangible is uncertain. In such circumstances, transferees may negotiate a short-term contract, a price adjustment clause, or variable royalty rates tied to profits.

147. Where a royalty rate is being established, a taxpayer should consider:

- prevailing industry rates;
- terms of the agreement, including geographic limitations, time 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 any patent;
- profits anticipated by the licensee; and
- benefits to the licensor arising from sharing information on the experience of the licensee.

148. Taxpayers who do not own trademarks or trade names sometimes undertake marketing activities. In these instances, the issue arises as to whether they should share in any return attributable to the marketing intangibles. Distributors who bear the costs of marketing activities would usually expect to share in the return from the marketing intangibles. As well, distributors who bear marketing costs in excess of those that an arm's length distributor with similar rights to exploit the intangible would incur, would expect an additional return from the owner of the trademark or trade name. The actual marketing activities of the distributor over a number of years should be given significant weight in evaluating the return attributable to marketing activities.

149. Despite the difficulty in determining a transfer price for intangibles, using hindsight to determine their value is not appropriate. Under the arm's length principle, an agreement that is, in substance, the same as one into which arm's length parties would have entered, would not usually 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 factors that a reasonable person with some knowledge of the

industry would have taken into account at the time the valuation was projected.

150. As outlined in paragraph 43 of this circular, the Department generally accepts business transactions as they are structured by the parties. However, the OECD Guidelines identify two types of situations where the recharacterization of a transaction would be considered. One situation identified by the OECD is a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to intangible property arising as a result of future research.

151. The Department will review any long-term agreements between non-arm's length parties for the right to use intangibles to ensure that they are consistent with the arm's length principle. Paragraph 247(2)(*b*) provides for an adjustment where the Department determines that:

- a long-term sale of intangible property would not have been entered into between persons dealing at arm's length; and
- the sale was not entered into primarily for *bona fide* purposes other than to obtain a tax benefit.

For example, it may be appropriate in such a situation for the Department to modify the amounts for purposes of the Act on the basis of an alternative transaction whose form, nature, terms, and conditions correspond to what arm's length parties would have agreed to—to reflect an ongoing research agreement.

Part 6. Intra-Group Services

152. A wide variety of services are often provided by one member of a multinational group to other members within the group. These intra-group services may be of an administrative, technical, financial, or commercial nature.

153. The OECD Guidelines on providing intra-group services include a framework to determine:

- whether a charge for a particular service is justified; and, if so,
- how to determine the amount of the charge.

154. Therefore, in applying the arm's length principle to intra-group services, a taxpayer must first 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 arm's length 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.

155. The test to determine if a charge for an activity is justified, would involve the following question: Would the entity for whom the activity is being performed **either** have been willing to pay for the activity if performed by an arm's length entity **or** have performed the activity itself?

Where it would not have been reasonable to expect the entity to **either** pay an arm's length entity for the activity **or** to perform it itself, it is unlikely that any charge for the activity would be justified.

156. 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 arm's length corporation would not bear the costs of a shareholders meeting of another corporation; therefore, a subsidiary would not bear any costs of a parent's shareholders meeting.

157. Costs relating to the legal structure or the general financial 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 paragraph 7.10 of 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 group member.

158. 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 an arm's length party on the member's behalf. In some cases, however, there may be a valid business reason for duplicating a service.

For example, an arm's length party may:

- continue to operate an existing computer system, for a brief period, concurrently with a new one to deal with unforeseen difficulties which may arise during the implementation of the new system; or,
- obtain a second legal opinion to supplement an internal legal review and opinion in order to reduce the risk of error on a particular issue (see the OECD Guidelines, paragraph 7.11).

In either of these two cases, there is a valid business reason for duplicating the function.

159. 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. Therefore, the determination of an arm's length charge must take into consideration the amount that an arm's length entity is prepared to pay for such a service in comparable circumstances.

160. Where a service is rendered by arm's length parties or the service supplier, as part of its ordinary and recurring activities, renders the service for arm's length parties, the price charged in those circumstances is a good indication of the arm's length price. Thus, the CUP method should be

used, assuming sufficient quality data for its application is available.

161. This presumes that:

- the services are substantially the same in terms of their nature and quality as well as the quantity or extent to which these services are provided;
- the markets are similar; and
- the services are provided on comparable terms.

162. Where the CUP method cannot be applied, the taxpayer should consider the cost plus method. The cost plus method is appropriate where, after the appropriate functional analysis, the taxpayer can verify comparability (including the functions performed, the assets used, and the risks assumed) with uncontrolled transactions. The taxpayer must ensure that the costs incurred by the service supplier are substantially the same as those incurred in the comparable transactions. If not, appropriate adjustments must be made.

163. Arm's length service suppliers would usually expect to recover their costs plus an element of profit. However, in determining an arm's length charge for service, one must also take into account the economic alternatives available to the recipient of the service. Often, the price the recipient is willing to pay for the service does not exceed the cost of supply to the service supplier.

For example, in many cases, the services provided through intra-group arrangements are administrative or ancillary in nature, and the participants would only have been prepared to centralize the activity if they could share in the cost savings. Cost may represent an arm's length charge in such situations.

164. Determining whether a mark-up is appropriate and, where applicable, the quantum of the mark-up, requires careful consideration of factors such as:

- the nature of the activity;
- the significance of the activity to the group;
- the relative efficiency of the service supplier; and
- any advantage that the activity creates for the group.

For example, the relative efficiency of arm's length service suppliers may not be comparable to the intra-group services where the intra-group services are offered as a convenience to the group and not as an ordinary and recurrent activity.

165. As discussed in paragraph 7.36 of the OECD Guidelines, it is important to distinguish between the situation of:

- a taxpayer who renders services for the other members of a group; and
- a taxpayer who acts solely as an agent on behalf of the group to acquire services from an arm's length party.

In the latter situation, the arm's length compensation would be limited to rewarding the agency role. In such a case, it would not be appropriate to determine an arm's length charge by referring to a mark-up on the cost of the services acquired from an arm's length party. Whether a taxpayer is providing a service or merely acting as an agent on behalf of the group is a question of fact.

166. A charge for services can be determined by two methods:

- the **direct charge** method; and
- the **indirect charge** method.

167. Under the **direct charge** method, a specific charge is established for each identifiable service.

168. Under the **indirect charge** method, an allocation, to a particular entity, of the cost of a service provided to more than one entity is made by referring to a basis or allocation key that indicates the share of the total value of the service attributable to the particular entity.

169. The Department prefers the direct charge method over the indirect charge method. In cases where the services rendered by the taxpayer to other members of the group:

- are the same or similar as those rendered to arm's length parties, or
- can be reasonably identified and quantified,

the direct charge method should be used.

170. However, in some situations, 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 non-arm's length entities). In this case, the taxpayer can use the indirect charge method. Where an indirect allocation is used, it should result in a charge that is comparable to that which arm's length parties would accept.

171. When choosing an allocation key (e.g., sales, gross or operating profits, units used/produced/sold, number of employees, or capital invested), the taxpayer should consider the nature and use made of the service.

For example, if the services relate to human resource activities, such as administering a global employee benefit plan, the proportionate number of employees may be the best measure of the benefit to each group member.

Part 7. Penalty – Reasonable Efforts

172. Subsection 247(3) of the Act imposes a penalty equal to 10% of the net result of certain adjustments made under subsection 247(2) of the Act calculated as follows:

- The total of the transfer pricing income and capital adjustments (upward adjustments, whether there are reasonable efforts or not);

  minus:

- the total of transfer pricing income and capital adjustments for which a taxpayer has made reasonable efforts to determine and use arm's length transfer prices

or arm's length allocations (upward adjustments for which there are reasonable efforts); and

- the total of transfer pricing income and capital setoff adjustments for which a taxpayer has made reasonable efforts to determine and use arm's length transfer prices or arm's length allocations (downward adjustments for which there are reasonable efforts).

173. If the taxpayer has not made reasonable efforts to determine and use arm's length prices or allocations, subsection 247(3) does not permit a reduction of the amount subject to the penalty.

174. The concept of reasonable efforts is also contained in the definition of QCCA found in subsection 247(1) of the Act. A cost-sharing arrangement will not be defined to be a QCCA, if the taxpayer does not make reasonable efforts to match the contributions of the participants to their respective expected benefits. Transfer pricing adjustments made to cost contribution arrangements are aggregated with other transfer pricing adjustments for purposes of the penalty calculation.

175. The penalty will only apply where the net amount calculated above exceeds the lesser of $5,000,000 and 10% of the taxpayer's gross revenue for the year.

176. To illustrate:

- **UT** is defined as the total of all upward adjustments (whether on account of income or capital) under subsection 247(2), whether or not the taxpayer has made reasonable efforts to comply with the arm's length principle.
- **UR** is defined as the total of all upward adjustments (whether on account of income or capital) under subsection 247(2), which relate to transactions for which the taxpayer has made reasonable efforts to determine and use arm's length prices or allocations.
- **DR** is defined as the total of all downward adjustments (whether on account of income or capital) under subsection 247(2) on transactions for which the taxpayer has made reasonable efforts to determine and use arm's length prices or allocations.

Penalty Threshold Calculation:

The penalty under subsection 247(3) applies if, for a particular taxation year:

- (**UT minus UR minus DR**) is **greater** than (the lesser of $5,000,000 and 10% of the taxpayer's gross revenue for that particular tax year).

If not, there is no penalty under subsection 247(3).

If so, the amount of the penalty is calculated separately and the amount of the penalty is not reduced by the threshold.

Penalty Calculation:

- **10% × (UT minus UR minus DR).**

177. Subsection 247(3) of the Act precludes applying the penalty unless the net amount of adjustments exceeds the specific threshold as described above. The penalty is intended to be a compliance penalty focusing on the efforts that a taxpayer makes to determine an arm's length price and not solely on the ultimate accuracy of the transfer prices. Therefore, provided a taxpayer makes reasonable efforts to determine and use arm's length prices or allocations, the transfer pricing penalty does not apply.

178. Tax services offices are responsible for identifying taxpayers who may have failed to make reasonable efforts to determine and use arm's length prices as part of the normal audit review. However, the Department recognizes the importance of applying the transfer pricing penalty provisions in a fair and consistent manner. Thus, **before** a penalty is assessed, tax services offices will refer all cases to the Transfer Pricing Review Committee for review.

179. The general determination of whether a taxpayer has made reasonable efforts to determine and use arm's length transfer prices or allocations is a question of fact. The Department will consider that taxpayers have made reasonable efforts if they have taken all reasonable steps to ensure that their transfer prices or allocations conform with the arm's length principle. However, in addition to the general determination, taxpayers must also consider the provisions of subsection 247(4) which may deem that they have not made reasonable efforts to determine and use arm's length transfer prices or allocations.

180. 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 unless the taxpayer has prepared or obtained records or documents which provide a description that is complete and accurate in all material respects of the items listed in subparagraphs 247(4)(*a*)(i) through (vi) of the Act. This documentation must be prepared or obtained on or before the taxpayer's documentation-due date for the tax year or fiscal period in which a transaction is entered into. Where a transaction spans more than one tax year or fiscal period, the documentation must also be updated to reflect any material changes on or before the documentation-due date for that year or period in which the material change occurs.

181. The taxpayer must provide the records or documents specified in subsection 247(4) to the Department within 3 months of the receipt of a written request to do so. If the taxpayer does not provide the documents within the 3 months, 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.

182. Subsection 247(4) requires that a taxpayer must have records or documents that provide a complete and accurate description, in all material respects, of the following items:

- The property or services 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 (i.e., a transaction whereby a parent company manufactures components that are assembled into a finished product by a foreign subsidiary, and the finished product is sold to the parent for distribution), taxpayers must 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, 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 persons or partnerships involved in the transaction. Paragraphs 1.20 through 1.27 of the OECD Guidelines describe the functional analysis process, and 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

  – a 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 each of those 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.

183. The list of documents in subsection 247(4) of the Act is not intended to be an exhaustive list of the documents necessary to substantiate that:

- a taxpayer's transfer pricing is in accordance with the arm's length principle; or
- a taxpayer has made reasonable efforts to determine arm's length transfer prices or allocations.

The documentation required depends on the facts and circumstances of the particular transaction. In other words, there is no one set of documents that, if made or obtained, would constitute a "safe harbour" from the application of the penalty in subsection 247(3).

184. 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.

185. In addition to meeting the basic requirements of subsection 247(4), a taxpayer's documentation should explain the rationale supporting the taxpayer's transfer prices or allocations. Use of proper documentation is the most effective way that taxpayers can demonstrate to the Department that:

- their transfer prices comply with the arm's length principle; and
- they have made reasonable efforts to comply with the arm's length principle.

186. The efficient administration of the transfer pricing rules in Canada requires co-operation between taxpayers and the Department in resolving transfer pricing issues. Taxpayers are in the best position to understand their businesses and to explain their approach to transfer pricing. Also, a taxpayer's documentation is a major factor in determining whether the Department will review a particular transfer pricing issue in more detail.

187. The Department expects the taxpayer's documentation to include:

- the general organization and description of the business;
- the selection of a particular transfer pricing methodology, including an explanation of why the selected method is more appropriate than any higher-ranking methods;
- the projection of the expected benefits as they relate to the valuation of an intangible;
- the scope of the search and criteria used to select comparables;
- an analysis of the factors determining comparability, including a review of the differences and attempts made to make adjustments; and
- the assumptions, strategies, and policies as they relate to the tangible property, intangible property, and services being transferred.

188. In preparing documentation, taxpayers should attempt to weigh the significance of the transactions in terms of their business with the additional administrative costs required to prepare or obtain such documentation.

The obligation to find comparable transactions for applying the arm's length principle is not an absolute one. The cost and likelihood of finding such comparables relative to the significance of the transactions to the taxpayer should be taken into account.

189. 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.

For example, the application of the residual profit split method would usually require an explanation of why higher-ranked methods were not appropriate, as well as details of the various searches for comparables that were conducted. On the other hand, the application of the CUP method would not require the same information.

190. In light of the obligations set out in subsection 247(4), taxpayers will generally produce or obtain the required documentation at the time the transaction is entered into.

191. Taxpayers may, after a transaction has occurred but before the filing due date, recognize that the transfer price recorded for that particular transaction does not represent an arm's length price.

For example, this could occur if a taxpayer overlooked information that was available at the time the transfer price was set, or detects a computational error in the calculation of the price. In these instances, taxpayers should make a compensating adjustment to the transfer price before filing their tax return. For tax purposes, the adjustment should accrue in the year in which the transaction occurred and taxpayers should ensure that the adjustment is fully documented.

192. Where a taxpayer recognizes that a transfer price is not arm's length only after the filing due date, taxable income as reported on their tax return should be adjusted. Readers are referred to paragraphs 25 through 27 of this circular for further guidance regarding downward adjustments.

193. On the other hand, where the adjustment produces an upward adjustment, taxpayers may be concerned that the transfer pricing penalty could apply to the adjustment. The Department's voluntary disclosure policy, as outlined in Information Circular 85-1R2, *Voluntary disclosures*, applies to penalties assessed under subsection 247(3).

194. The documentation pertaining to a QCCA will generally address:

- the identity of participants in the QCCA;
- the scope of the activities covered by the arrangement;
- the nature and extent of each participant's effective ownership interest in the results of the QCCA activities;
- the manner or basis on which proportionate shares of expected benefits are to be measured;
- the rationale and any assumptions underlying the projections of expected benefits;
- the form and valuation of each participant's contributions;
- the rationale and any assumptions underlying the valuation of each participant's contributions;
- the duration of the arrangement;
- 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.

195. Taxpayers are required to document all material changes to the arrangement. Generally, the Department expects taxpayers to compare the benefits projected to the actual benefits realized. The Department acknowledges that projected benefits will rarely be the same as the benefits ultimately realized.

196. However, material differences between the benefits projected and the benefits realized may suggest that the assumptions made to project future benefits are no longer valid and may need to be amended for future years. Also, where a taxpayer is continually unable to predict benefits with any degree of accuracy, it may be appropriate to consider an adjustment clause for the future. Such a clause would ensure that each participant's share of the actual benefits derived from a QCCA corresponds to the participant's contribution to a QCCA.

197. The documentation pertaining to intangible property will generally address:

- a description of the intangible property, potential market application, and advantages the intangible property provided in the particular market;
- the prevailing industry royalty rates;
- the terms of the license, including geographic limitations, time limitations, and exclusivity rights;
- the 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.

198. In general, the Department considers that the making of reasonable efforts to determine and use arm's length transfer prices or allocations requires the taxpayer to consider applying a recommended method in accordance with the natural hierarchy of recommended methods referred to in Part 3 of this circular. A taxpayer's documentation should explain the choice of the particular method adopted. The taxpayer should also document the consideration given, if any, to any higher-ranking methods and the ultimate reason they were rejected.

199. Evidence of hard bargaining between entities within a non-arm's length group is not, on its own, sufficient to establish that dealings between parties in a non-arm's length group are at arm's length.

200. Some business strategies involve a reduction in current profits in anticipation of an increase in future profits. The important issue is whether an arm's length party would have been prepared to trade off current profits for the expectation of an increase in future profits under similar conditions. Where a taxpayer implements such a strategy, its documentation would usually include:

- projections of the future benefits, including profits; and
- a summary of the assumptions which form the basis of the strategy.

201. Business strategies, including market penetration schemes, can have a significant impact on the determination of transfer prices. Therefore, the Department will closely scrutinize a taxpayer's explanation of business strategies.

202. The documentation required by subsection 247(4) of the Act may include foreign-based documents and information. The general principles developed in subsection 247(4) also apply to foreign-based documentation, which means that the taxpayer's documentation should include foreign-based documents to the extent that they are relevant in determining arm's length prices.

203. If any of the documentation submitted to the Department is not in English or French, the taxpayer must provide an official translation within 30 days of a request by the Department.

204. In addition to the documentation required by subsection 247(4) of the Act, section 233.1 of the Act requires residents of Canada, and non-residents who carry on business in Canada, to provide prescribed information concerning non-arm's length transactions with non-residents.

205. Form T106, *Information Return of Non-Arm's Length Transactions with Non-Residents*, is an annual information return filed by reporting persons, including corporations, trusts, and individuals, and reporting partnerships. The Department uses the information provided on Form T106 to screen non-arm's length transactions for review and audit.

206. The penalties applicable to Form T106 include:

- late filing penalties;
- failure to file penalties; and
- false statement or omissions penalties.

207. Form T106 is available at our tax services offices or on the Internet at **www.rc.gc.ca.**

Part 8. Confidentiality of Third-Party Information

208. In the context of an income tax audit, the Department may, and does in isolated cases, use third-party comparable information gathered by the Minister in accordance with the Act as the basis of an assessment. However, the Department treats third-party information as confidential and considers itself prohibited from disclosure unless the discretionary disclosure provisions of the Act provide for an exception. The Department takes a strict interpretation of the disclosure provisions contained in the Act and makes every effort to maintain the secrecy of third-party information gathered under the Act.

209. Where third-party comparable information forms the basis of an assessment, the taxpayer under review will be so advised. Third-party information may be provided to the taxpayer under review to the extent that the provision of the information is consistent with the Department's commitment to protect confidential data. Where the taxpayer seeks disclosure of any information of a confidential nature, the Department will seek written consent from the third-party to disclose the information to the taxpayer under review. If consent is not granted, the Department makes every effort to maintain the secrecy of that information.

210. When the taxpayer has filed a Notice of Appeal with the Tax Court of Canada, subsection 241(3) of the Act permits the Department to release the third-party comparable information. Nevertheless, if the information is to be released, the Department will first contact the third-party to allow them to take whatever steps are appropriate to protect their information from disclosure.

For example, the Department could suggest that the third-party seek a confidentiality order from the Court.

Part 9. Part XIII Withholding Tax

211. Where adjustments are made under subsection 247(2) of the Act, withholding tax under Part XIII of the Act may also be payable on the amount of the adjustment, as a deemed dividend, by virtue of the deeming provisions of paragraph 214(3)(*a*) of the Act.

For example, if a taxpayer purchased property from its foreign parent at a price in excess of what arm's length parties would have paid, the price would be reduced in accordance with subsection 247(2). The excess amounts paid to the parent, which would be taxable under subsection 15(1) if the parent was a resident of Canada, are deemed to be a dividend to the foreign parent under paragraph 214(3)(*a*) of the Act. The deemed dividend is subject to Part XIII withholding tax under subsection 212(2).

212. The Department may grant relief from Part XIII tax if, as a result of an audit, it has been determined that transfer pricing adjustments are required and the following conditions are met:

- the Canadian taxpayer agrees in writing to the proposed transfer pricing adjustments (such an agreement does not restrict the Canadian taxpayer or the non-arm's length party from seeking relief under the Mutual Agreement Procedure article of Canada's tax treaties);
- the adjustments did not arise from a transaction that may be considered abusive; and

- the foreign corporation repatriates the funds equivalent to the gross amount arising from the transfer pricing adjustment immediately **or** agrees in writing to repatriate such amount within a reasonable time.

213. Repayment is generally made in the same currency as the original payment to which the adjustment relates. Repatriation, which will be subject to audit verification, may be carried out through the use of inter-company loan accounts.

Part 10. Competent Authority Procedures

214. Canada has signed more than 60 bilateral income tax treaties with other countries. One of the reasons for signing such treaties is to eliminate the double taxation that often results from the allocation of tax revenues from international transactions.

215. 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 IX of the relevant treaty;
- are often modelled after Article 9 of the OECD Model Tax Convention on Income and on Capital; and
- 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.

216. Most tax treaties contain specific time limitations for seeking relief. Therefore, taxpayers must consult the appropriate tax treaty to establish the specific time limitations. Failure to notify the appropriate competent authorities within the applicable time limitations may result in double tax.

217. 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**,** when a foreign revenue authority has initiated or proposes a transfer pricing adjustment. In such cases, the Minister expects the taxpayer, under review by the foreign tax authority, to seek assistance from the Canadian Competent Authority to claim corresponding adjustments or deductions.

218. Canadian taxpayers have a responsibility to seek the assistance of the Canadian Competent Authority **before**:

- making claims for corresponding adjustments or deductions in either their current Canadian income tax returns; or
- filing amending income tax returns.

219. Where a transfer pricing adjustment results in double taxation, a taxpayer may request competent authority consideration as provided under the Mutual Agreement Procedure Article of Canada's tax treaties. The reader may refer to the most recent version of Information Circular 71-17, *Requests for Competent Authority Consideration Under the Mutual Agreement Procedures in Income Tax Conventions*. That circular gives a more detailed discussion of the procedures and acceptability of requests for competent authority consideration.

220. One of the purposes of competent authority negotiations is to address the transfer pricing adjustments or allocations that result in double taxation. The application of the Canadian transfer pricing penalty is a compliance issue not covered by the mutual agreement procedures. Therefore, the Canadian Competent Authority will not:

- negotiate with foreign revenue authorities the Department's right to apply the Canadian transfer pricing penalty; or
- challenge the position of foreign revenue authorities on the application of their transfer pricing penalties.

However, the Department will adjust the amount of the Canadian transfer pricing penalty accordingly where the competent authorities negotiations result in a change to the amount of the transfer pricing income or capital adjustments.

221. The Department will not enter into competent authority negotiations nor apply the treaty provisions to eliminate double tax in the event of:

- fraud;
- wilful default; or
- gross negligence by a taxpayer.

222. Under the Act and the laws of most of Canada's treaty partners, taxpayers have a responsibility to appropriately document their transactions with non-arm's length non-residents. Without the proper documentation, competent authorities may be unable to resolve disputes expeditiously and double taxation can result, in extreme circumstances.

Part 11. Advance Pricing Arrangements

223. The Department's Advance Pricing Arrangement (APA) program assists taxpayers in determining transfer prices acceptable for the Act. An APA is an agreement or arrangement between the taxpayer and the Department. An APA stipulates a mutually acceptable transfer pricing method to be used on specified international transactions for a future period, with provision to renew. A bilateral APA under which a treaty partner also agrees to the same transfer pricing methodology provides assurance that potential double taxation will be avoided. For further details, the reader may refer to the most recent version of Information Circular 94-4, *International Transfer Pricing: Advance Pricing Arrangements (APA).*

224. No transfer pricing adjustments under subsection 247(2) of the Act should arise regarding the transactions covered by the APA as long as:

- the APA remains in effect; and
- the taxpayer complies with its terms and conditions.

Without any transfer pricing adjustments, the penalty in subsection 247(3) of the Act would not be applicable.

Part 12. Customs Valuations

225. 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. The Department is not obliged to accept the value reported for duty when considering the income tax implications of a non-arm's length importation.

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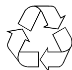

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