INTERNATIONAL TRANSFER PRICING AND OTHER INTERNATIONAL TRANSACTIONS

87-2 February 27, 1987

Introduction

1. This circular is for the guidance of any Canadian taxpayer related to entities in one or more foreign jurisdictions. It applies to international non-arm's length transactions involving a Canadian taxpayer, and it describes the Department's approach to the tax treatment of international transfer pricing and other issues that have an effect on the income reported in Canada.

2. In basic terms the taxpayer in Canada is expected to report taxable income on the basis of having charged a fair price for goods and services provided to non-resident affiliates, and of having paid no more than a fair price for goods and services received from non-resident affiliates. In this latter connection, it must be emphasized that the taxpayer should not absorb any duplication in the intercompany prices and other charges that are incurred.

3. Although some of the comments that follow are made in the context of the transfer of goods or services into Canada, the principles apply equally to the reverse situation. This circular has been divided into three parts.

PART I - The Law

A summary of the relevant provisions of the Income Tax Act and their scope of application to international, non-arm's length transactions; this summary is not to be construed as a formal interpretation of the law, but rather an explanation of the basis on which the Department considers that the "arm's length principle" is reflected in the Act.

PART II - Pricing Methods and Considerations

A discussion of some of the theories and principles of transfer pricing and some of the practical considerations in the application of the Income Tax Act to the transfer of goods and the various forms of transfer of services, e.g., management services, research and development and the use of intangibles.

PART III - Audit Policy

A summary of the Department's policy on auditing international non-arm's length transactions.

PART I - THE LAW

4. Section 69 of the Income Tax Act applies, in part, to certain non-arm's length transactions, including those with which this circular is mainly concerned, namely, intercompany purchases and sales of goods and all manner of property; transfers of technology, rights, patents, and

intangibles; the rental of property; the use of intellectual property, and the providing of technical assistance. Management fees and other payments for services are covered by these provisions as are payments resulting from research and development, cost-sharing arrangements or expense allocations. Other sections may be applicable in a particular case, including section 67 (which disallows unreasonable expenses) and subsection 245(1) (which deals with undue or artificial reductions of income), subsection 15(1) (shareholder appropriations) and Part XIII (tax on income from Canada of a non-resident).

5. Paragraphs 69(1)(a) and (b) apply to non-arm's length acquisitions and dispositions of "anything" which includes products and other tangibles as well as intangible property, such as a right to use property. Paragraph 69(1)(a) means in effect that for income tax purposes the cost of acquisition may not exceed fair market value, and paragraph 69(1)(b) means that the proceeds of disposition may not be less than fair market value. Although this circular deals with international non-arm's length transactions which are governed by the provisions of subsections 69(2) and 69(3), the Department uses the same theories and principles of transfer pricing to determine fair market value under subsection 69(1) for domestic non-arm's length transactions. This is further elaborated on in 7 below.

6. Subsections 69(2) and (3) override subsection 69(1) and apply if the transaction involves a Canadian taxpayer and a non-resident with whom the taxpayer was not dealing at arm's length. These provisions apply specifically to product prices, royalties, rentals, transportation charges and fees for other services. Subsection 69(2) means in effect that the amount that the taxpayer in Canada has paid or agreed to pay to the non-resident may not, for tax purposes, exceed a reasonable arm's length price, whereas subsection 69(3) effectively means that the amount (including a nil amount) a non-resident not dealing at arm's length has paid or agreed to pay to a Canadian taxpayer may not, for tax purposes, be less than a reasonable arm's length price. It should be noted that these provisions are applied to each transaction.

7. The term "reasonable arm's length price" in this circular means the amount, as described in the legislation, that would have been reasonable in the circumstances if the parties to the transaction had been dealing at arm's length, and may mean fair market value or another amount depending on the circumstances in a particular case. The presumption is that a reasonable arm's length price would be fair market value but, for example, if a particular supplier were attempting to increase market share, the supplier might temporarily establish an arm's length price that was below the current fair market value. Normally the most persuasive evidence of fair market value or reasonable arm's length price is from the market to which the transfer is being made, as opposed to the home market of the supplier (especially in the case of the transfer of goods).

8. Interest on loans and other indebtedness to or from non-residents will normally be subject to the specific provisions in paragraph 20(1)(c) and section 17 which provide for the deductibility of reasonable interest expenses and deal with situations whereby a Canadian corporate taxpayer has not charged an adequate rate of interest on a loan to a non-resident. Intercompany interest charges are not dealt with specifically in this circular, but it is recognized that credit terms and financing arrangements are among the many related factors to be considered in the evaluation of

intercompany prices. (See 12 below.)

PART II - PRICING METHODS AND CONSIDERATIONS

9. The "arm's length principle," in the context of transactions between parties that are not in fact dealing at arm's length, means that each such transaction should be carried out under terms and at a price that one could reasonably have expected in similar circumstances (similar product or service, market, credit terms, reliability of supply and other pertinent circumstances) had the parties been dealing at arm's length. In applying the arm's length principle, the Department endorses and follows the methods set out in the 1979 Organization for Economic Co-Operation and Development ("OECD") report, "Transfer Pricing and Multinational Enterprises," with a strong preference for clearly defined and established intercompany arrangements.

10. To the extent possible, taxpayers are encouraged to design their intercompany pricing so that, for example, a product is transferred at a reasonable arm's length price for the product itself, and if there are also benefits or services being transferred, as is common in the operations of a multinational group, each is identified as a separate transfer and is subject to a separate evaluation and intercompany charge. A separate identification and valuation of the various products and services will not only facilitate the audit of international transactions but will also, where an income tax treaty or convention is in force, assist the treaty partners in their negotiations to avoid double taxation.

11. If the above approach is not practical or proves unrealistic in terms of the manner in which the particular industry conducts its business, then the taxpayer should be prepared to provide, in a comprehensive statement of intercompany pricing policy, the basis on which transfer prices are established world-wide. Such a statement should be based on a thorough functional analysis of the activities and contributions of each group member, and should clarify and quantify the various factors which were considered in establishing the transfer prices, e.g., technical assistance, access to technology, reward for economic risk, financing assistance, etc.

12. The quantum of income taxed in Canada should be consistent with the real profit contribution of the Canadian taxpayers involved, based on the economic functions performed and the risks assumed by them. This result is achieved when non-arm's length transactions with non-residents are consistently made at reasonable arm's length prices. The determination of reasonable arm's length prices, while necessarily somewhat subjective, is nevertheless a question of fact, and therefore the situation of each taxpayer must be examined on its own particular circumstances and merits.

TRANSFER OF GOODS

13. This section of the circular deals with intercompany purchases and sales of goods including raw materials, semi-finished products and components and finished goods. The same principles apply to the acquisition or disposition of intangible property, as for example the outright transfer of ownership of a patent.

14. The primary method in the view of the Department, other tax administrations and the OECD, is to base a transfer price on a "comparable, uncontrolled price," i.e., a price established in the same market and circumstances by parties who are dealing at arm's length. If there are obvious "comparables" available, as for example where the supplier sells identical goods to both related and unrelated customers, then ordinarily this method would provide the most persuasive evidence of arm's length prices. Application of the comparable, uncontrolled price method tends to be restricted by the difficulty in establishing that the product involved, the market, the credit terms, reliability of supply and other pertinent circumstances are indeed comparable. The Department believes that if the comparable uncontrolled price method is to be used, variations in the respective circumstances should be minor or capable of quantification on some reasonable basis. In cases where there are major differences in prices among the available comparables, the reasons for such differences should be determined; it is possible that certain of the transactions are not truly comparable or not truly uncontrolled. The use of a comparable, uncontrolled price precludes the allocation of related product development costs, overhead or royalties unless such charges are also made to unrelated parties which have paid the same price.

Comparable, Uncontrolled Price Method Example:

Canco sells product x directly to its United States subsidiary. Canco and others sell product x in the United States to unrelated parties through commission sales agents. By custom, this product is sold FOB the purchaser's plant. An average daily United States transaction price based on sales by commission agents is available from these agents.

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

Average transaction price for the day	$467
DEDUCT:	
Adjustment for saving the 3% agent's commission	14
Freight adjustment (amount reflected in average daily transaction price less actual cost)	31
Total deductions	45
Transfer price	$422

15. Where appropriate comparables are not available and the taxpayer must use one of the other methods discussed in the following paragraphs, it is recommended that a thorough functional analysis of the activities of the group members be carried out (as mentioned in 11 above). A functional analysis will identify and evaluate, with respect to a given product or product line, the role and contribution of each member, including the economic risk assumed and the degree of responsibility for engineering and production, continuing research, management and administration, marketing and customer services. A functional analysis will facilitate informed

decisions as to what constitutes an "appropriate" mark-up or a "reasonable" profit contribution, and it will help to identify severe distortions in the margins of related parties.

16. Secondary methods of determining a reasonable arm's length price are the "cost-plus" and "resale price" methods. Cost-plus calculations start with the transferor's cost of the goods and add thereto an appropriate mark-up. Resale price calculations work backwards from the transferee's eventual resale price, subtracting therefrom an appropriate margin or gross profit. See 15 above and 17 below for comments on the word "appropriate" in this context.

17. When using the "cost-plus" method, cost must be computed in accordance with generally accepted accounting principles or normal commercial accounting practices in the industry in Canada, even though some other computation of cost may be acceptable in the foreign country. In determining the cost of a product, the Department does not recognize depreciation based on the replacement or current market value of capital property used in the manufacturing process. When considering the reasonableness of a mark-up, the method used to determine the cost of the product will be considered. If the cost includes only direct production costs, an appropriate mark-up would be an amount that is sufficient to cover normal indirect overhead and general and administrative expenses plus a reasonable profit contribution, whereas if a full absorption costing method is used, a lower mark-up would be indicated.

Cost Plus Method Example:

Canco produces a high-value liquid product in bulk for itself and three foreign subsidiaries of its Australian parent. Canco also does custom formulations for unrelated parties using active ingredients supplied by them. Canco realizes its standard cost plus 22 per cent on these custom formulations.

The transfer price per litre for a particular shipment to a related foreign company is calculated as follows:

Canco standard cost (excluding active ingredient costs)		.35
ADD:		
22% of	$.35	.07
Cost of active ingredients		.98
Transfer price		1.40

18. The resale price method is most appropriate in those cases where no comparables are available and the purchaser adds relatively little value to the product. The greater the value of the functions performed by the purchaser, the more difficult the determination of an appropriate resale margin for purposes of the resale price method.

Resale Price Method Example:

Canco is the Canadian distributor for its United States parent's established line of home computers. The parent sells these computers in its home market to six independent distributors at retail price less a discount based on volume purchased during the year.

The transfer price to Canco for a particular computer is calculated as follows:

Resale price (in Canada)	$2,600
DEDUCT:	
Discount to Canco (at the percentage allowed to a United States distributor with same purchase volume)	900
Allowance for expenses borne by Canco not borne by the United States distributors (Canco's parent bears these costs for that country)	
- advertising	70
- warranty work	30
Total deductions	1,000
Transfer price	1,600

19. Other methods may be employed in support of one of the three aforementioned methods or in circumstances where none of these methods is appropriate. This is consistent with the recommendations of the OECD. The method utilized should reflect an attempt to present the particular transaction in terms of what would have transpired in an arm's length relationship.

20. One example of an "other method" would measure a proposed transfer price against a number of "check-points." A particular component might have four of these check-points:

- cost of direct materials of the component,
- full cost of production of the component,
- value of the component as a replacement part, and
- value as a fraction of the market value of the entire product.

In this example the transfer price might be required to satisfy, within reasonable limits, criteria based on the four check-points.

21. It has been suggested that the Department should accept the "value for duty," established for imported goods in accordance with the Customs Act, as representing a reasonable arm's length price for purposes of the Income Tax Act. This is not always possible for a number of reasons, including the obviously different contexts in which valuation of goods is required by the respective Acts.

22. The methods for determining value for duty under the current provisions of the Customs Act resemble those outlined in this circular. Value for duty may now be closer to transfer prices acceptable for income tax purposes; however, differences do remain and the Department is under no obligation to accept the established or reported value for duty when considering the income tax implications of a non-arm's length importation.

INTRA-GROUP SERVICES

23. The intra-group services that present problems are not usually those performed in the ordinary course of business for which there are arm's length comparisons available. The services that most frequently require

attention are those which pertain to the special interdependence of the members of a multinational group, and these services can be dealt with in three categories, i.e.

(i) management or administration services,
(ii) research and development, and
(iii) the use of intangibles.

MANAGEMENT OR ADMINISTRATION SERVICES

24. The Department's interpretation of the law as it applies to "Management or Administration Fees Paid to Non-Residents" is contained in IT-468 and reference should be made to that bulletin. The following remarks on management services are more general in nature and are intended to advise taxpayers regarding acceptable methods of measuring and charging for management services.

25. The transfer of management or administration services is occasioned by a centralization of administration and other common services, usually in the parent company itself but occasionally in a separate entity established for that purpose. Central management or administration expenses should first be categorized as follows:

(a) expenses that are incurred by the parent company in its "custodial" capacity, i.e., as a shareholder managing its investments in subsidiaries rather than in the provision of services to its subsidiaries (these expenses should be borne by the parent and applied against its income from investments);
(b) expenses such as the costs of training workers for a new plant that are clearly incurred for the benefit of a single company in the group and are associated with the provision of specific identifiable services to that company; and
(c) expenses that are incurred for the benefit of a number of companies or the group as a whole and are for shared services and facilities, such as a centralized world-wide insurance department, that are usually centralized for convenience or economy.

26. An allocation of central management expenses to a Canadian taxpayer is acceptable only if the taxpayer is in a position to derive a real benefit from the related services. Where a resident taxpayer is staffed by a management team normally associated with a self-sufficient business, the allocation should be limited to expenses that can clearly be identified with the taxpayer and which do not represent a duplication of services already provided by Canadian personnel.

27. The only category of central management or administration expenses that presents an allocation problem is that described in 25(c) above. The basis for allocating these expenses may be more or less complex depending on the structure of the group and the extent to which various costs are common to the group as a whole or pertain to certain members only. In any event, for purposes of such an allocation to a Canadian taxpayer, the basis of allocation should be based on a comprehensive review of the central expenses carried out in advance of the allocation. The basis used must be available for examination by the Department before the allocation will be accepted. The basis of allocation should result in costs being shared in proportion to the benefits received, for example, the allocation of costs

of a centralized department based on an estimate of time spent on duties performed for each entity.

28. In a large multinational enterprise having numerous subsidiaries and/or branches in several jurisdictions, the basis of allocation may not always be reviewed each year by the taxpayer, but in such a situation the taxpayer is expected to provide an analysis of any relevant changes from the year under audit back to the taxpayer's most recent comprehensive review, which should not be older than two or three years.

29. As described in IT-468, there are income tax implications related to an allocation of management expenses to a Canadian taxpayer under both Part I and Part XIII of the Act.

30. The deductibility under Part I of the "management or administration fee or charge" will be evaluated by reference to the nature and the quantum of the benefits derived. The amount charged by the non-resident should not exceed the expenses that may be allocated to the Canadian taxpayer as set out in 25(b) and (c) above, i.e., the expenses incurred solely for the benefit of the Canadian taxpayer and a reasonable share of expenses that are incurred for the benefit of a number of companies or the group as a whole. As mentioned in 26 above, no portion of the amount charged should be in respect of services already provided by Canadian personnel.

Generally, there is no profit element in shared costs charged to Canadian branches and subsidiaries. However, the Department has seen examples where a reasonable mark-up on charges for services from a non-resident related company which is in the business of providing such services has been made and the total charge has been allowed as a deduction under Part I.

31. Under the provisions of Part XIII, a payment to a non-resident in respect of a "management or administration fee or charge" is subject to a 25 per cent withholding tax. It has historically been important, particularly for the numerous payments to U.S. parent companies, to identify "management fees" (as opposed to expense reimbursements or other charges) and ensure that this tax has been withheld and remitted.

32. Most modern income tax treaties and conventions do not require that management fees be treated as anything other than a component of industrial, commercial or business profits. Such profits are furthermore taxable only in the home jurisdiction of the enterprise earning the profits (except in the particular situation where profits can reasonably be attributed to a permanent establishment of that enterprise in the other jurisdiction). The 25 per cent tax on management fees is therefore not normally exigible where such treaties are in force.

33. Whereas the previous (1941) convention between Canada and the U.S. did not interfere with the Part XIII tax on management fees (except to reduce the tax rate to 15 per cent), the new (1980) convention is a "modern" treaty as described in 32 above. As a consequence of applying the terms of the 1980 convention to payments after 1984, the previous importance of the management fee issue has been greatly reduced.

RESEARCH AND DEVELOPMENT

34. The following comments pertain to the intercompany transfer of

research and development (R & D) in the situation where the R & D is performed centrally or in specified companies and made available for the benefit or potential benefit of the group. If, on the other hand, a company engaged in R & D retains the benefits therefrom for its own account and makes this knowledge available to other members by way of licensing agreements, the transfer comprises the "use of intangibles" which is discussed in 40 to 48 below. Of course, a company may handle one division of its research by cost-sharing and another by licensing agreements.

35. In determining the deductibility under Part I of payments for R & D expenses, the Department will look to the nature and quantum of the benefits received, and will ensure that there is no double-charge involved (as for example when R & D is also a component in establishing transfer prices). The Canadian taxpayer obviously must be in a position to benefit from the R & D, if not immediately at least potentially, by having a genuine and substantial interest in the results which the research might produce.

36. Where R & D is performed centrally or in specified companies for the benefit or potential benefit of the entire group, there are essentially two issues to be addressed:

(i) the reasonableness of the basis for allocating these expenses to the various members of the group, and

(ii) the entitlement to any mark-up or profit on the activities of the member conducting the R & D function.

37. It is not possible to specify any basis of allocating expenses as being preferable; the method utilized should be appropriate to the particular circumstances in each case. One possible approach would be to categorize the R & D by line of business and product group, then to allocate the current expenses among those companies who currently deal in the particular product group.

38. Although the Department considers that R & D is more appropriately treated as a cost centre, the entitlement to a mark-up or profit on the activities of the member conducting the R & D function will be considered in relation to the arrangement amongst the corporate group at the time the R & D activity is undertaken. If this arrangement is in the nature of a cost-sharing arrangement where resources are pooled for convenience or economy, each participant would bear its fair share of the net costs in return for a fair share of the usable results of the R & D. There would be no mark-up or profit on the R & D activities in this type of situation. By contrast, if it is other than a cost-sharing arrangement, and the R & D facility is treated as a profit centre, the amount charged to the Canadian taxpayer would be based on a reasonable arm’s length price, which normally should not exceed its fair share of those R & D expenses that are (at least potentially) of benefit to Canadian operations, marked up at a reasonable rate.

39. As regards the application of Part XIII, payments for the use of R & D usually attract withholding tax. The main exception is the allocation based on a "bona fide cost-sharing arrangement," which is fully discussed in IT-303 and IT-303 Special Release. It should be noted that such a cost-sharing arrangement precludes a profit element for the R & D function and if a profit element is present, the total amount of the payments under

the arrangement will attract Part XIII tax.

USE OF INTANGIBLES

40. When R & D is conducted in a particular company and that company retains control of the resultant body of knowledge, other members of the group usually gain access to the knowledge through a licensing agreement or equivalent. Scientific and industrial information and expertise, sometimes referred to as "know-how," may be disseminated in a similar fashion. Intercompany payments under such arrangements usually take the form of royalties or similar payments, and such payments usually attract Part XIII withholding tax. Refer to IT-303 and IT-303 Special Release for the Department's views on the application of Part XIII to payments for the use of intangibles.

41. The "intangibles" that are dealt with hereunder include patents, inventions, formulae, processes, designs, patterns and similar types of intellectual property, trade-marks, trade names, brand names, franchises, licences, special commercial or industrial information and expertise, copyrights and exclusivity rights.

42. Deductibility under Part I of payments for the use of intangibles is essentially a matter of two issues:

(i) is the payment in fact for the use of the intangible for the year - as opposed to a payment for its outright acquisition or other capital outlay; and

(ii) does the amount of the payment represent a reasonable arm's length price for the value received?

43. Normally a payment for the acquisition of an intangible constitutes a capital outlay and is non-deductible on that basis, subject to possible amortization available under the Act. The more difficult question is the determination of the price for use of an intangible. The following comments will address this question in terms of a royalty rate, since that is the most common form of payment.

44. Ideally, the intra-group royalty rate should be determinable by reference to an arm's length comparable royalty. If a company has issued a licence to an independent manufacturer, in respect of a particular patent, one would expect that the royalty rate so established would represent a reasonable arm's length price for use in intra-group licences covering the same patent.

45. Many multinational groups market their products entirely through branches and subsidiaries, with the result that no arm's length comparable royalty exists. The best that can be expected is to draw comparisons with royalty rates in the same industry or a similar industry involving relatively similar products, similar market conditions, and similar licensing arrangements.

46. The following items might be expected to have a bearing on the determination of a royalty rate:

(a) prevailing rates in the industry;

(b) terms of the licence, including geographic limitations and exclusivity rights;

(c) singularity of the invention and the period for which it is likely to remain unique;

(d) technical assistance, trade-marks and "know-how" provided along with access to the patent;

(e) profits anticipated by the licensee; and

(f) benefits to the licensor arising from sharing information on the experience of the licensee.

47. In the same way that a taxpayer is expected to explain the basis for the intercompany pricing policy when questioned by the Department, the taxpayer should also be prepared to demonstrate the reasonableness of intercompany royalties, having regard to all the pertinent facts and circumstances.

CONFIDENTIALITY OF THIRD PARTY INFORMATION

48. In the context of an income tax audit where the Department has obtained information on comparable prices from third parties that forms the basis of an assessment, the Department will seek written permission from the third parties to disclose the information to the taxpayer involved. If permission is not granted, disclosure of the information is prohibited by subsection 241(1) until legal proceedings have commenced with respect to the assessment issued or, in other words, until the taxpayer has filed a Notice of Claim with the Tax Court of Canada or a Statement of Claim with the Federal Court of Canada. At this point subsection 241(3) applies to permit the Department to release the details on the comparables to the taxpayer assessed.

PART XIII WITHHOLDING TAX

49. Where, as a result of the audit of international transactions, it has been determined that Part I adjustments are required to the Canadian taxpayer, a further consideration is required to determine whether Part XIII tax is exigible on the appropriation and whether or not any relief will be provided if the monies are returned to the Canadian taxpayer.

TAX TREATIES AND COMPETENT AUTHORITY PROCEDURES

50. Canada has entered into a number of bilateral international tax agreements with other countries for the purpose of avoiding double taxation.

51. Many of these International Tax Agreements contain provisions concerning income allocation in accordance with arm’s length principles. Generally, these provisions are found in Article 9 of the relevant treaty and are often modelled after Article 9 of the OECD Model Convention concerning the taxation of associated enterprises. These provisions attempt

to provide a framework in which an adjustment to profits in one country may be offset by a corresponding adjustment in the other country.

52. Where the treaty provisions concerning the taxation of associated enterprises are not sufficient to resolve a dispute between interested parties, a taxpayer may request competent authority consideration as provided under the Mutual Agreement article of most of Canada's international tax agreements. Refer to Information Circular 71-17R2 for a more detailed discussion of the procedures and acceptability of requests for competent authority consideration.

PART III - AUDIT POLICY

53. In auditing transfer pricing and related international transactions, the Department's objective is to ensure that Canadian taxpayers have reported their appropriate share of income by paying no more than or receiving no less than, reasonable arm's length prices in their international non-arm's length transactions.

54. If in a particular case the Department decides to review a taxpayer's intercompany transactions, experienced auditors will examine each component in the package, i.e., transfer prices, royalties, intercompany financing, service fees, etc. This will prevent, for example, the double deduction for a foreign parent's research and development costs - once by way of an intercompany royalty or cost-sharing arrangement, and again as an element of the transfer pricing.

55. The Department will take into account any foreign exchange gain or loss, where applicable, when calculating a transfer price adjustment.

56. In carrying out an international audit, the Department will, to the extent practicable, analyze intercompany transactions by applying the arm's length principle on a transaction-by-transaction basis. This approach is necessary because the Income Tax Act applies to each transaction between the various related parties and not to the Canadian taxable income, return on sales, return on equity or any other measurement of general profitability.