

CANADA

RECENT DEVELOPMENTS

As tax authorities around the world, the Finance Ministers of the G-20 countries, the Organisation for Economic Cooperation and Development ("OECD"), the public and the press focus on Transfer Pricing and international taxation, we highlight some recent developments in Canada.

Transfer pricing – a recap

Transfer pricing refers to the prices charged between related parties in different tax jurisdictions for goods, services, assets, the right to use intangibles, interest, guarantee fees and factoring fees.

Transfer prices must be determined following the arm's length principle which requires that all transfer prices, and the related terms and conditions, must be established on the same basis as if the parties were not related, i.e., the prices, terms and conditions should reflect what two unrelated parties would agree to in similar circumstances.

The Canadian penalty

In Canada, failing to follow the arm's length principle exposes the Canadian entity to a 10% penalty on any transfer pricing adjustment made by the Canada Revenue Agency ("CRA"). The CRA may not impose that 10% penalty when the entity has made reasonable efforts to determine and use arm's length prices, as evidenced by preparing and maintaining Contemporaneous Transfer Pricing Documentation ("Documentation").

A company's Documentation is its first line of defence in any transfer pricing audit and should be prepared from that perspective.

Recent Canadian developments

The CRA issued three Transfer Pricing Memorandums ("TPM") to provide its guidance with respect to certain transfer pricing issues: [revised TPM-05R, Requests for Contemporaneous Documentation](#); [TPM-15, Intra-Group Services and Section 247 of the Income Tax Act](#); and, [TPM-16, Role of Multiple Year Data in Transfer Pricing Analyses](#).

TPM-05R, requests for contemporaneous documentation²

TPM-05R clarifies the CRA's expectations regarding a company's response to a CRA request to provide its Documentation to the Agency. The main point is that the CRA expects some level of documentation will be prepared and maintained for each taxation year. For example, even if a company has a Study for its 2014 taxation year the CRA will expect some form of documentation for 2015, i.e., the preparation of a Memo that confirms there have been no material changes in 2015 to all of the factual information in the 2014 Study, and testing the 2015 results against any benchmarks or other relevant economic analyses used in the Study.

The CRA expects that a company will have Canadian-specific Documentation for each taxation year that is available to be provided to the Agency within 3 months of a written request to provide it.

TPM-15, Intra-Group Services and section 247 of the Income Tax Act³

TPM-15 elaborates on certain requirements for the analysis of intra-group service charges as set out in the [Information Circular⁴ on transfer pricing](#). The two main issues that must be addressed during the analyses and documentation of intra-group services are:

- Whether a service has, in fact, been provided; and
- What amount would represent an arm's length charge for such a service.

The TPM goes on to discuss, in greater detail, the direct versus indirect charge method and the need to link the services being provided by the providing entity to the users of those services. There is also a more detailed discussion about which Transfer Pricing Methodologies may be considered to determine an arm's length value for a service, and the use of mark-ups to reflect how arm's length parties would charge fees for a given service to recover their costs plus an element of profit. The CRA confirms that the approach and principles applied to intra-group services fees must be applied consistently for both inbound and outbound charges.

Companies are expected to perform detailed analyses relating to any intra-group services transactions; in terms of the precise services being rendered in a given taxation year, the benefits received by the entity paying for those services, the appropriate transfer pricing methodology used to charge for those services, and support for a conclusion that the resulting services fee is an arm's length amount.

TPM-16, Role of multiple year data in transfer pricing analyses⁵

TPM-16 confirms the CRA's long held position that when a company is setting its transfer prices, and later testing and documenting them, the CRA expects it to use the results of a single year of data from comparable company information, as opposed to averaging multiple years of data.

The TPM includes an appendix that provides a full discussion of the CRA's views as to the appropriate and inappropriate uses of statistical tools in transfer pricing analyses, distinguishing between descriptive statistical tools, those used to describe a set of numerical data, and inferential statistical tools – those used to infer or predict the value of observations within a set of data.

The CRA also confirms that when a company's prices or margin falls outside the arm's length range, the Agency will adjust the company's results (transfer prices) using the average from the arm's length range for that year to reassess the company.

As a result, it is imperative to have strong comparables and operating results that fall within the arm's length range established by those comparables.

Proactive planning and annual documentation is recommended

Given the increasing focus on transfer pricing, in Canada and globally, now is the time for companies to revisit how they set their transfer prices for all of their intercompany transactions, and what support they have on file to support a conclusion that they made "reasonable efforts" to determine and use arm's length prices or allocations.

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¹ The transfer pricing adjustment will apply to those adjustments that exceed the lesser of:
(a) CAD 5 million; and,
(b) 10% of the Canadian company's gross revenues for the taxation year in question.

² TPM-05R was issued on 28 March 2014.

³ TPM-15 was issued on 29 January 2015.

⁴ Information Circular IC 87-2R, International Transfer Pricing, issued 27 September 1999.

⁵ TPM-16 was issued on 29 January 2015.