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Transfer Pricing in Canada

by Steve Suarez

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In this article, the author provides an overview of Canada's transfer pricing regime, including audit and resolution of transfer pricing cases.

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Transfer pricing is a major growth area in Canadian taxation. The Canada Revenue Agency continues to allocate more and more resources to transfer pricing audit and enforcement, which is likely to continue given Canada's status as a somewhat high-tax jurisdiction (at least in relative terms) following major U.S. corporate tax rate reductions in 2018.

As noted by senior U.S. tax officials (perhaps with reference to Canada, its largest trading partner), it is relatively easy for tax authorities to find a basis for challenging a taxpayer's transfer pricing.[1] The CRA administers Canada's transfer pricing rules assertively, and various aspects of those rules differ significantly from those of other countries and the relevant OECD guidance. Thus, MNEs with Canadian group members should be aware of how Canada's transfer pricing regime operates and how the CRA administers it.

I. Transfer Pricing Legislation

A. ITA Section 247

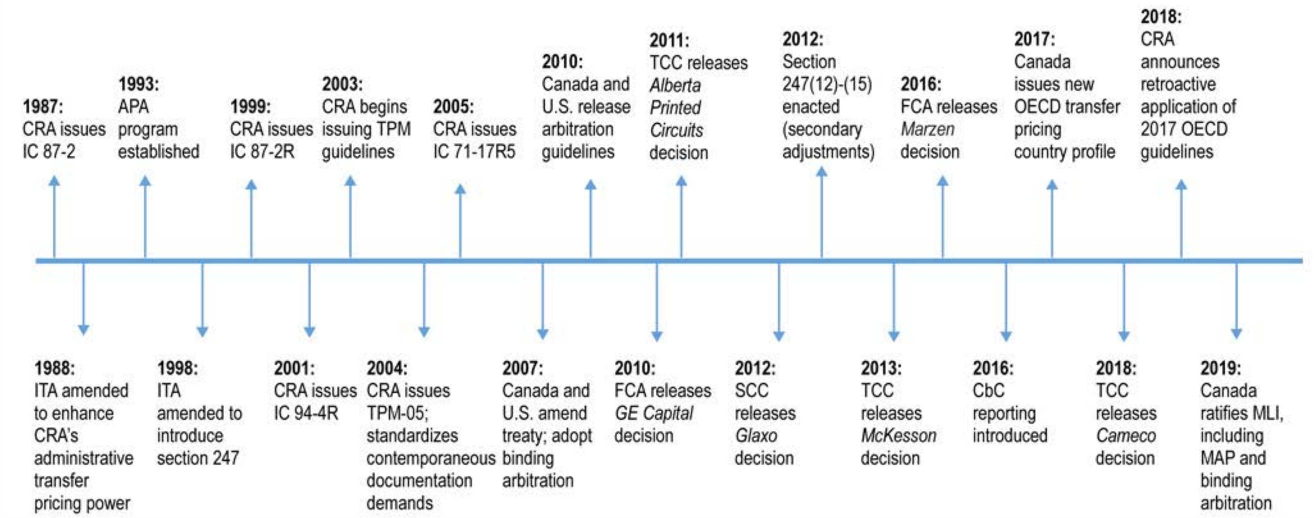
Historically Canadian tax statutes have taken a minimalist approach to transfer pricing, essentially establishing a relevant standard (for example, the arm's-length principle) and not prescribing any particular method for meeting it. The 1985 version of section 69(2) applied when the taxpayer paid to a non-arm's-length nonresident (NALNR) "an amount greater than the amount . . . that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length."[2]

After the OECD issued its revised Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators in 1995, Canada's Department of Finance released new draft transfer pricing legislation, which (after some modifications) was enacted in 1998 as Income Tax Act section 247. The government's stated intention in introducing section 247 was to update Canada's transfer pricing legislation to bring it into line with the OECD's formulation of the arm's-length

[1]"It's relatively easy to challenge any transfer price or expense allocation simply by invoking a different comparable set, applying a different methodology, or pointing to extraneous factual considerations." Prepared remarks of Michael Danilack, IRS Large Business & International Division deputy commissioner (International), Tax Executives Institute 61st midyear meeting in Washington (Apr. 5, 2011).

[2]Subsection 69(3) addressed the opposite situation, in which the NALNR paid the taxpayer less than a reasonable amount.

Figure 1. Canadian Transfer Pricing Timeline



principle. New section 247 also enacted specific transfer pricing penalties and introduced the concept of creating satisfactory contemporaneous documentation. Numerous and more detailed elements have since been added to section 247 to address specific situations, alongside legislative amendments to other provisions to enhance the CRA's information-gathering and administrative powers (including in the transfer pricing sphere).

1. Overview

In contrast to the comprehensive approach taken in legislative regimes such as section 482 of the U.S. tax code and supporting regulations, the Canadian statute is minimalist. The key component is section 247(2), which reads:

> Where a taxpayer or a partnership and a non-resident person with whom the taxpayer or the partnership, or a member of the partnership, does not deal at arm's length (or a partnership of which the non-resident person is a member) are participants in a transaction or a series of transactions and
>
> (a) the terms or conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm's length, or
>
> (b) the transaction or series
>
> (i) would not have been entered into between persons dealing at arm's length, and
>
> (ii) can reasonably be considered not to have been entered into primarily for *bona fide* purposes other than to obtain a tax benefit,
>
> any amounts that, but for this section and section 245, would be determined for the purposes of this Act in respect of the taxpayer or the partnership for a taxation year or fiscal period shall be adjusted (in this section referred to as an "adjustment") to the quantum or nature of the amounts that would have been determined if,
>
> (c) where only paragraph 247(2)(a) applies, the terms and conditions made or imposed, in respect of the transaction or series, between the participants in the transaction or series had been those that would have been made between persons dealing at arm's length, or
>
> (d) where paragraph 247(2)(b) applies, the transaction or series entered into between the participants had been the transaction or series that would have been entered into between persons dealing at arm's length, under terms and conditions that would have been made between persons dealing at arm's length.

As with previous iterations of Canada's transfer pricing legislation, section 247 does not prescribe any particular method for complying with the arm's-length principle.

Section 247(2) requires the identification of a particular transaction or series of transactions (the tested transactions) in which both the Canadian taxpayer[3] and an NALNR are participants.[4] The tested transactions are then measured against the two charging elements in section 247:

- the general transfer pricing rule (GTPR) in section 247(2)(a), which applies when the terms and conditions of the tested transactions between any of the participants differ from those that would have been made between arm's-length persons; and
- the transfer pricing recharacterization rule (TPRR) in section 247(2)(b), which applies when the tested transactions would not have been entered into between arm's-length persons, and can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit.

Defining the tested transactions is often a critical element of the exercise, because section 247 tests whether arm's-length persons would have entered into those transactions (and if so, on what terms).

In *Cameco Corp. v. The Queen*, 2018 TCC 195, the Tax Court of Canada said that because the overarching purpose of section 247(2) is to compare the taxpayer's non-arm's-length transactions against comparable transactions and circumstances involving independent enterprises, the tested transactions should be chosen accordingly (at paragraph 704):

> To allow for a meaningful comparative or substitutive analysis, the transaction or the series identified in the preamble must be susceptible of such an analysis. An overly broad series renders the analysis required by the transfer pricing rules impractical or even impossible by unduly narrowing (possibly to zero) the set of comparable circumstances and substitutable terms and conditions.

Accordingly, a series of transactions that includes several disparate elements unlikely to exist in a purely arm's-length setting is unsuitable for use as the tested transactions.

Section 247(3) provides for penalties if transfer pricing adjustments are made in excess of defined thresholds. Effectively, the penalty excludes transfer pricing adjustments for which the taxpayer made reasonable efforts to determine and use arm's-length prices and allocations.[5]

Section 247(4) sets out the standards for taxpayers to prepare and provide contemporaneous documentation regarding their transactions with NALNRs in the relevant tax year. A taxpayer who fails to meet those requirements is deemed not to have made reasonable efforts to determine and use arm's-length prices and allocations and is potentially liable for section 247(3) penalties if the transfer pricing adjustments exceed the prescribed thresholds. The reverse is not true, however: Meeting the contemporaneous documentation standards does not deem the taxpayer to have made reasonable efforts. Complying with the section 247(4) contemporaneous documentation requirements is a necessary, but not necessarily sufficient, step to avoid transfer pricing penalties if the adjustments exceed the statutory thresholds.

The balance of section 247 includes definitions, provisions regarding partnerships, exceptions for some transactions with controlled foreign affiliates (CFAs) of the Canadian taxpayer, the interaction of section 247 with other ITA provisions, downward (favorable) transfer pricing income or capital adjustments, and secondary adjustments (deemed dividends) arising from transfer pricing adjustments and repatriation alternatives.

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[3]While that term is generally understood to mean a person subject to Canadian income tax, the CRA has asserted the dubious proposition that it could also include a controlled foreign affiliate of a Canadian taxpayer in determining whether the foreign affiliate's passive income is imputed to the taxpayer under Canada's controlled foreign corporation rules. *See* CRA 2017-0691191C6.

[4]While in most cases it will be clear whether the Canadian taxpayer is dealing at arm's length with a nonresident counterparty, see *Alberta Printed Circuits v. The Queen*, 2011 TCC 232, for an example of a transfer pricing case in which the court determined whether two parties factually dealt at arm's length.

[5]Section 247(3) transfer pricing penalties are discussed in Section I.A.6., *infra*.

2. General Principles

Canadian tax law starts with the taxpayer's rights and obligations as established under commercial (nontax) law, and applies the ITA to them.[6] The primacy of the taxpayer's actual legal rights and obligations (other than in limited circumstances enumerated in the ITA)[7] is an essential starting point in interpreting and applying Canada's transfer pricing rules, particularly because that often differs from the approach taken in other countries.

Canada is sometimes described as a "form over substance" jurisdiction for tax purposes. That is a misnomer: A more accurate description of the regime would be "legal substance over economic substance" with tax laws applying based on the commercial law rights and obligations the taxpayer has created, irrespective of whatever name they bear in the documents — that is, form — or their economic similarity to different legal relationships. That is particularly important in a transfer pricing context, because it infers less scope for the CRA to apply the functions, assets, and risks analysis called for in the OECD guidelines in a way that ignores a taxpayer's bona fide legal relationships.

The CRA has tried various extra-statutory doctrines to convince courts to impose tax by ignoring what the taxpayer has done, such as by using a business purpose test,[8] absence of legal reality doctrine,[9] or a search for economic realities.[10] The Supreme Court of Canada (SCC) has consistently rejected those in favor of applying the statute to the actual legal substance of the taxpayer's actions.

It follows that the first step in any analysis is to determine what legal rights and obligations the parties have created under the relevant commercial law. The parties' documentation evidences their intentions and agreement, and is therefore taken as prima facie evidence of their legal relationships.[11] It is of course open to the CRA to challenge the legal effectiveness or sufficiency of the relevant agreements under the governing commercial law as somehow not creating the intended legal rights and obligations.[12] Moreover, the primacy of legal substance does not mean that documents supersede reality. To create bona fide legal relationships, the parties must act in a manner generally consistent with their transaction documents (although the standard is not perfection) and have the capacity to do so (a contract with a shell company that has no ability to perform its terms is at risk of being ignored, both for tax and commercial purposes).

It is also the case in Canada that one is taxed based on what he did, not on what he could have done. That a particular result could have been achieved another way with a less favorable tax result is irrelevant. To the contrary, the SCC has repeatedly stated that "taxpayers have the right to order their affairs to minimize tax payable."[13] Further, whatever transactions a taxpayer undertakes must be assessed from the starting point that the taxpayer has every right to do so, even if tax-motivated:

> This Court has made it clear in more recent decisions that, absent a specific provision to the contrary, it is not the courts' role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way. . . . Unless the Act provides otherwise, a taxpayer is entitled to be taxed based on what it actually did, not

[6] *See, e.g., Jean Coutu Group Inc. v. Canada*, 2016 SCC 55, para. 41; and *Québec (Agence du Revenu) v. Services Environnementaux AES Inc.*, 2013 SCC 65, para. 45.

[7] For example, the general antiavoidance rule in section 245 (an exceptional remedy of last resort) allows the CRA to redetermine the tax consequences of the taxpayer's transactions when they have been undertaken primarily to obtain a tax benefit and constitute the abuse or misuse of the ITA or a tax treaty. The TPRR is another example.

[8] *Stubart Investments Ltd. v. The Queen*, [1984] 1 S.C.R. 536.

[9] *Continental Bank Leasing Corp. v. Canada*, [1998] 2 S.C.R. 298.

[10] *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622.

[11] *See, e.g., Orion Finance Ltd. v. Crown Financial Management Ltd.*, [1996] 2 B.C.L.C. 78 (C.A.), as cited by the SCC in *Continental Bank*, [1998] 2 S.C.R. 298. The same principle cuts both ways: Taxpayers must live with the legal rights and obligations they have created, even when doing so is to their disadvantage or their tax consequences are contrary to their intentions. *See Jean Coutu Group*, 2016 SCC 55, at para. 41.

[12] An example of that is the incomplete transaction approach unsuccessfully advanced by the Crown in *Stubart Investments*, [1984] 1 S.C.R. at 547.

[13] *Jean Coutu Group*, 2016 SCC 55, at para. 41.

> based on what it could have done, and certainly not based on what a less sophisticated taxpayer might have done.[14]

Finally, when interpreting the ITA, the courts apply a textual, contextual, and purposive analysis to determine not merely what the words of any particular provision mean in a literal sense but also how they should be interpreted in a manner harmonious with other ITA provisions.[15] In *Cameco*, for example, the Tax Court's interpretation and application of section 247 was informed in part by how Canada's CFC rules impute some forms of a CFA's income to a Canadian parent company and not others. It is essential to be aware of all these core principles when interpreting and applying section 247, as opposed to merely reading its words.

3. CRA Policies and OECD Guidelines

When reading Canada's transfer pricing rules, taxpayers should understand the limited role of administrative guidelines, including those issued by the OECD. Canadian courts have made clear that what governs is the ITA, which does not incorporate CRA or OECD administrative pronouncements.

The CRA has many administrative policies and procedures relevant to transfer pricing. They are not the law and so are not legally binding on taxpayers but are rather the CRA's interpretation of the law and reflective of how the CRA administers it.

The CRA's transfer pricing site provides access to the most important CRA publications in this area, including Information Circulars IC 87-2R, "International Transfer Pricing," IC 71-17R5, "Guidance on Competent Authority Assistance Under Canada's Tax Conventions," and IC 94-4R, "International Transfer Pricing: Advance Pricing Arrangements." The CRA has also issued a series of consecutively numbered transfer pricing memoranda (TPMs 2 through 17) on various transfer pricing subjects. Canada's transfer pricing country profile on the OECD website (supplied by the Canadian government) also provides a source of administrative guidance.

The general phrasing of Canada's statutory transfer pricing rules leaves much discretion regarding how the arm's-length principle is to be interpreted and applied. In *Canada v. GlaxoSmithKline Inc.*, 2012 SCC 52, the SCC established that while OECD guidelines may be a helpful interpretative aid for the courts, they "are not controlling as if they were a Canadian statute and the test of any set of transactions or prices ultimately must be determined according to [section 247] rather than any particular methodology or commentary set out in the *Guidelines*."

While Canadian courts have frequently cited the OECD guidelines when applying Canada's transfer pricing rules, they have sometimes been reluctant to follow them. That was perhaps most obvious in *McKesson Canada Corp. v. The Queen*, 2013 TCC 404, in which Justice Patrick J. Boyle said:

> I would add the observation that OECD Commentaries and Guidelines are written not only by persons who are not legislators, but in fact are the tax collection authorities of the world. Their thoughts should be considered accordingly. For tax administrators, it may make sense to identify transactions to be detected for further audit by the use of economists and their models, formulae and algorithms. But none of that is ultimately determinative in an appeal to the Courts. The legal provisions of the *Act* govern and they do not mandate any such tests or approaches. The issue is to be determined through a fact finding and evaluation mission by the Court, as it is in any factually based issue on appeal, having regard to all of the evidence relating to the relevant facts and circumstances.

Canadian courts have rejected important elements of the OECD guidelines as being inconsistent with ITA section 247. For example, the Tax Court's decision in *Cameco* rejected the CRA's suggestion that managing or monitoring risk is equivalent to actually bearing that risk.[16]

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[14] *Shell Canada*, [1999] 3 S.C.R. 622, at paras. 45-46.

[15] See *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54, at para. 10.

[16] For analysis of the decision, see Steve Suarez, "The *Cameco* Transfer Pricing Decision: A Victory for the Rule of Law and the Canadian Taxpayer," *Tax Notes Int'l*, Nov. 26, 2018, p. 877; and Nathan Boidman, "*Cameco* and Cash-Boxes," *Tax Notes Int'l*, Dec. 10, 2018, p. 1055.

As noted below regarding the TPRR, taxpayer disputes often arise because of the CRA's liberal application of the OECD guidelines beyond what section 247 permits. That phenomenon is likely to grow following the release of the 2017 version of the OECD guidelines, which further diverge from the primacy Canada places on a taxpayer's substantive legal relationships. Controversially, the CRA has stated that not only will it prospectively apply the 2017 version of the OECD guidelines, but it will also do so retroactively on the premise that the new rules do not represent a substantive change.[17]

4. The General Transfer Pricing Rule

In *Canada v. General Electric Capital Canada Inc.*, 2010 FCA 344 (*GE Capital*), the Federal Court of Appeal (FCA) characterized the GTPR in section 247(2)(a) as follows:

> The concept underlying subsection 69(2) and paragraphs 247(2)(*a*) and (*c*) is simple. The task in any given case is to ascertain the price that would have been paid in the same circumstances if the parties had been dealing at arm's length. This involves taking into account all the circumstances which bear on the price whether they arise from the relationship or otherwise.
>
> This interpretation flows from the normal use of the words as well as the statutory objective which is to prevent the avoidance of tax resulting from price distortions which can arise in the context of non arm's length relationships by reason of the community of interest shared by related parties. The elimination of these distortions by reference to objective benchmarks is all that is required to achieve the statutory objective. Otherwise all the factors which an arm's length person in the same circumstances as the respondent would consider relevant should be taken into account.

Canadian courts accept the basic concept of a functional analysis among members of a multinational group, taking into account the different functions, resources, and risks of each, as well as the respective interests of separate entities.[18] However, they do not allow that analysis to deviate from the taxpayer's actual transactions or the legal rights and obligations created under commercial law, or permit the CRA — as it attempted in *Cameco* — to reallocate those functions, resources, and risks differently than the taxpayer and its counterparties did. According to the Tax Court, the assumption underlying section 247(2)(a) is that arm's-length parties would enter into the tested transactions but on different terms or conditions.[19] Thus, the GTPR requires the CRA to start with the taxpayer's actual transactions, rather than ones the CRA believes arm's-length parties would have been more likely to enter into.[20]

The CRA frequently applies section 247(2)(a) by reallocating risks and functions differently than the taxpayer's actual transactions did, which courts consistently reject.[21] The CRA's actions often result from a reliance on the OECD guidelines and its focus on economic characteristics beyond what the text of the GTPR supports.

a. Relevant Circumstances

In determining what terms and conditions arm's-length parties would use, the GTPR requires considering all aspects of a Canadian taxpayer's circumstances, including those arising

[17] The CRA said it has the same view concerning any guidance issued since the 2017 update — namely, guidance on profit splits, hard-to-value intangibles, and attribution of profits to permanent establishments. *See* CRA 2018-0779931C6.

[18] *Glaxo*, 2012 SCC 52, at paras. 62 and 63.

[19] *Cameco*, 2018 TCC 195, at para. 686.

[20] *Id.* at para. 751: "The traditional transfer pricing rules must not be used to recast the arrangements actually made among the participants in the transaction or series, except to the limited extent necessary to properly price the transaction or series by reference to objective benchmarks."

[21] *See, e.g.*, *Cameco*, 2018 TCC 195, at para. 759, discussing the CRA's expert witness's failure to replace the prices actually paid under the intercompany contracts with prices that would have been charged between unrelated parties conducting the same transactions under the same or similar circumstances. Instead of using objective benchmarks, he replaced the legal substance of the transactions with notional relationships in which Cameco, the Canadian parent, had essentially all the price risk associated with the purchase and sale of the goods legally and factually purchased and sold by its European subsidiary.

by virtue of being part of an MNE.[22] That is illustrated in *GE Capital*, in which the primary question before the court was whether the guarantee fee the U.S. parent charged its Canadian subsidiary should have been what an arm's-length third-party guarantor with no connection to the Canadian subsidiary would have charged or should have reflected the implicit support the parent company would be expected to provide to that subsidiary without a fee — that is, the notional arm's-length guarantor *in the parent's circumstances*. The court concluded that the parent's implicit support was indeed a circumstance the notional arm's-length parties described in section 247(2)(a) would consider in pricing an explicit parental guarantee of the subsidiary's debt, and that therefore the relevant issue was the incremental value to the taxpayer of that explicit guarantee.

The principle of implicit parental support is one than can also work in the taxpayer's favor. In *Cameco*, the CRA's experts' analysis of the GTPR asserted that Cameco's European sales subsidiary lacked economic substance commensurate with the value of the purchase and sale contracts it entered into. In dismissing that argument, the court remarked that according to Cameco's expert witness, arm's-length counterparties would have considered the European subsidiary's relationship with and support from its Canadian parent Cameco in assessing whether to enter into substantial contracts with the subsidiary. That parental support, along with its stand-alone position, would have made the subsidiary a credible counterparty able to fulfill its contractual and business obligations. The court said the implicit support the parent provided to the subsidiary would be factored into any financial assessment of that subsidiary (paragraphs 767-768).

b. Transfer Pricing as a Range

Glaxo addressed an earlier iteration of Canada's transfer pricing rules: Section 69(2), which applied when a taxpayer paid an amount greater than would have been reasonable in the circumstances had the parties been dealing at arm's length. The SCC noted the observation in the 1995 OECD transfer pricing guidelines that "transfer pricing is not an exact science," and suggested that a taxpayer need only have used transfer prices "within what the court determines is a reasonable range" to comply with Canada's transfer pricing rules. Subsequent decisions involving section 247 have accepted that principle despite the absence of the word "reasonable" in the GTPR.[23]

When a range of acceptable arm's-length prices or rates has been established and the price or rate used by the taxpayer falls outside that range, applying the GTPR will not result in using the top or bottom of the reasonable range. In *McKesson*, the court concluded that an arm's-length range of discount rates for receivables would be between 0.959 and 1.17 percent, far less than the 2.206 percent rate used by the taxpayer. In dismissing the taxpayer's appeal and leaving undisturbed the rate used in the CRA's reassessment, the court said it would be inappropriate for it to order the government to reassess at the high point of the range. According to the court:

> That would reward overreaching taxpayers who would then count on the court process to ensure they enjoyed the highest permissible transfer price. This would encourage the poor use of public resources and expenditures. In contrast, in transfer pricing disputes which, as here, often involve very large amounts, the taxpayer's costs can be less than the value of even a slight variance in the underlying price of the inputted asset or service. Taxpayers would be economically encouraged to use the Court to ensure they get their maximum transfer price by choosing one that is likely to exceed it.

That result is largely consistent with the CRA's administrative policy expressed in TPM-16:

> When several comparable transactions or results are acceptable, an arm's length

[22] *See, e.g.*, *Alberta Printed Circuits*, 2011 TCC 232, at para. 163: "In short, all circumstances means 'all' the circumstances [a taxpayer] finds himself in before a reasonable businessman steps into his shoes." Personal subjective beliefs would be irrelevant.

[23] *See, e.g.*, *Marzen Artistic Aluminum Ltd. v. Canada*, 2016 FCA 34, at para. 49; and *McKesson*, 2013 TCC 404, at paras. 120 and 143.

range will usually be established by the CRA. In accordance with paragraph 3.60 of the Guidelines, the CRA will not make a transfer pricing adjustment if the price or margin of a transaction is within the arm's length range. If, however, the price or margin falls outside the established range, the CRA will determine the most appropriate point within the range using the most suitable measure of central tendency under the circumstances. Where no further distinction can be made on the basis of comparability, the most appropriate point may usually be determined by using the average. The average gives equal weight to each observation being considered, while the use of the range minimizes the potential impact of any unknown or unquantifiable comparability defects.

c. Adjustments Under the GTPR

The result of applying the GTPR is to allow any amounts determined under the ITA to be adjusted "to the quantum or nature of the amounts that would have been determined if" the terms and conditions of the tested transactions had been those that would have been made by arm's-length persons. Adjustments made under the GTPR are generally limited to pricing. Courts have consistently refused to allow adjustments that effectively amount to a recharacterization of a taxpayer's transactions, saying doing so is permitted only under the strict limitations of the TPRR.[24]

5. The Recharacterization Rule

For the TPRR in section 247(2)(b) to apply, two conditions must be met:

- it must be established that the tested transactions would not have been entered into by arm's-length persons; and
- the tested transactions must reasonably be considered not to have been entered into primarily for bona fide purposes other than obtaining a tax benefit.

Even though section 247(2)(b) is commonly referred to as a recharacterization rule, when it applies, in fact the CRA is not (as the *Cameco* court observed) permitted to recharacterize the tested transactions. Rather, the court said the section authorizes the government to identify an alternative transaction or series that arm's-length parties would enter into in the same circumstances and then make an adjustment that reflects arm's-length terms and conditions for that alternative. In that regard, the TPRR deviates significantly from recharacterization as permitted by the 2017 OECD guidelines.

The only Canadian judicial decision interpreting and applying section 247(2)(b) is *Cameco*.[25] The Tax Court determined that in applying the TPRR, the question before it was not what arm's-length parties would have done in the taxpayer's circumstances, but rather whether the tested transactions "would have been entered into by arm's length persons acting in a commercially rational manner." It thus established a commercial rationality standard for determining whether the TPRR applies:

> If a transaction or series is commercially rational then it is reasonable to assume that arm's length persons would enter into the transaction or series. The fact that the transaction or series is uncommon or even unique does not alter this assumption. If a transaction or series is not commercially rational then it is reasonable to assume that arm's length persons would not enter into the transaction or series.
>
> If a taxpayer and a non-arm's length non-resident enter into a transaction or series that is not commercially rational, then subparagraph 247(2)(b)(ii) comes into play. As recognized in the 1995 Guidelines, non-arm's length persons may enter into transactions or series that arm's length persons would not. Subparagraph 247(2)(b)(ii) ensures that that fact alone does not trigger the Minister's right to substitute an alternative arm's length

[24] *See, e.g.*, *McKesson*, 2013 TCC 404, at para. 125; and *Cameco*, 2018 TCC 195, at para. 688.

[25] *See* Suarez, *supra* note 16.

transaction or series for the actual transaction or series.

The court thereby set a high threshold of "irrationality" for meeting the first element of the TPRR. For example, it concluded that there was nothing commercially irrational about a parent corporation transferring a potential business opportunity to a foreign subsidiary.

To that limited extent, the TPRR's commercial rationality standard is largely consistent with the comparable circumstances set out in the 2017 OECD guidelines.[26] However, Canada's TPRR is clearly narrower — for example, the taxpayer must have a primary tax reduction purpose to trigger it. As the *Cameco* court observed (at paragraph 698), the TPRR is also narrower than article 9 of the OECD model tax convention.

More importantly, Canadian tax jurisprudence does not support the "accurate delineation" of a taxpayer's transactions in accordance with their economically significant characteristics found in the OECD guidelines, whereby the taxpayer's actual transactions may be disregarded in favor of accurately delineated ones. As noted, Canadian tax law applies the ITA to the taxpayer's actual legal rights and obligations without regard to their economically significant characteristics other than in exceptional circumstances when the ITA permits otherwise. It is clear that recharacterization is allowed much less frequently under the TPRR than under the OECD guidelines.[27]

A senior Department of Finance official who drafted the TPRR has written that when the government was contemplating the new transfer pricing rules in 1997, it decided they should not apply to transactions in which the form belies the substance. Those transactions were more appropriately addressed by specific antiavoidance rules or the general antiavoidance rule in section 245, he said. According to the official, the concern was that applying the transfer pricing rules in a "substance versus form" context would usurp the role of the GAAR and render it virtually meaningless when the transaction or series involved an NALNR, which was not the government's intention in enacting section 247(2)(b). The purpose of the TPRR is to ensure that Canada's revised transfer pricing rules can be applied effectively to irrational transactions for which no arm's-length comparables exist and when the parties selected the form of transaction to thwart the effective application of the rules to the tested party.[28]

Traditionally, the CRA has more broadly interpreted when the TPRR may apply than what *Cameco* would permit, and it will be interesting to see what effect the case has on the CRA's audit practice.

A highly unusual July 5, 2019, notice to tax professionals illustrates the CRA's willingness to aggressively apply section 247 to a growing range of intragroup transactions beyond the typical scope of transfer pricing rules. The notice announced the resolution of an audit addressing what appears to be a fairly common inbound double-dip financing structure on the basis that the TPRR and section 247(3) penalties applied. Under the structure, a Canadian subsidiary borrows funds from its U.S. parent while simultaneously entering into a forward subscription agreement with a U.S. sister entity whereby the sister subscribes for shares of the Canadian subsidiary whenever funds are needed to repay interest or principal on the debt owing to the U.S. parent.[29]

The notice states:

> It is the CRA's general view that such transactions are undertaken primarily to obtain a tax benefit and that they would not be undertaken by parties dealing at arm's length. When the CRA finds transactions similar to the example . . . the Transfer Pricing Review Committee will be consulted regarding the application of paragraphs 247(2)(b) and (d). Where these

[26] "Where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances."

[27] For analysis, see Matias Milet and Jennifer Horton, "The Canada Revenue Agency's Interpretation of the 2017 OECD Transfer Pricing Guidelines," 103 *Int'l Tax* 10 (Dec. 2018).

[28] Brian Bloom, "Paragraph 247(2)(b) Demystified," CCH Tax Topics No. 1783 (May 11, 2006).

[29] The U.S. sister entity typically obtains from the U.S. parent the funds required to meet its obligations under the forward subscription agreement. Structured properly, this arrangement results in deductible interest expense for the Canadian debtor and no interest income in the U.S., *viz.*, a hybrid mismatch.

paragraphs apply, related transfer pricing penalties will generally apply on the basis that taxpayers engaging in this type of tax planning did not use reasonable efforts to use arm's length prices, terms and conditions in their transfer pricing.

6. Penalties

Section 247(3) sets out the circumstances in which a transfer pricing adjustment will result in a penalty. It is computed as 10 percent of the taxpayer's adverse transfer pricing adjustments (not the change in taxes owed as a result of an adverse transfer pricing adjustment) for the year, meaning that it can apply even if the taxpayer is in a loss position or is not otherwise paying tax for the year.

From a policy perspective, transfer pricing penalties discourage taxpayers from over-allocating income to other jurisdictions with transfer pricing penalties — for example, the United States — and under-allocating to Canada. The CRA has said, "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."[30]

In theory, a taxpayer subject to transfer pricing adjustments (however large) can avoid a transfer pricing penalty if it satisfies the standard for having made reasonable efforts to determine and use arm's-length prices and allocations. Whether the taxpayer has made reasonable efforts to determine and use arm's-length prices and allocations for a particular transaction is a question of fact. However, when the taxpayer fails to meet the statutory standard in section 247(4) to prepare and provide the CRA with contemporaneous documentation, it is deemed not to have made reasonable efforts. Figure 2 illustrates the penalty determination process.

A transfer pricing penalty applies when the taxpayer's net transfer pricing adjustment for the year exceeds the lesser of $5 million or 10 percent of the taxpayer's gross revenue (not profit) for the year. The taxpayer's net transfer pricing adjustment is computed as:

> the sum of all adverse transfer pricing adjustments for the year, being reductions in the cost of capital property[31] and adjustments that increase the taxpayer's income (or decrease its loss) for the year;
>
> less
>
> (1) all such amounts for which the taxpayer made reasonable efforts to determine and use arm's-length prices and allocations; and (2) the sum of all favorable transfer pricing adjustments for the year, being increases in the cost of capital property[32] and adjustments that decrease the taxpayer's income (or increase its loss) for the year, but only if the taxpayer made reasonable efforts to determine and use arm's-length prices and allocations for such transactions.

When the taxpayer's net transfer pricing adjustment for the year exceeds the lesser of the two specified thresholds, the taxpayer is assessed a penalty of 10 percent of that net adjustment. Because Canadian transfer pricing penalties are computed as percentages of transfer pricing adjustments rather than any resulting increases in actual taxes owed, they are relatively onerous by international standards. Moreover, penalties are not deductible for Canadian income tax purposes, will not be negotiated in the mutual agreement procedure process, and are generally ineligible for foreign tax credit relief in other countries.

a. Contemporaneous Documentation

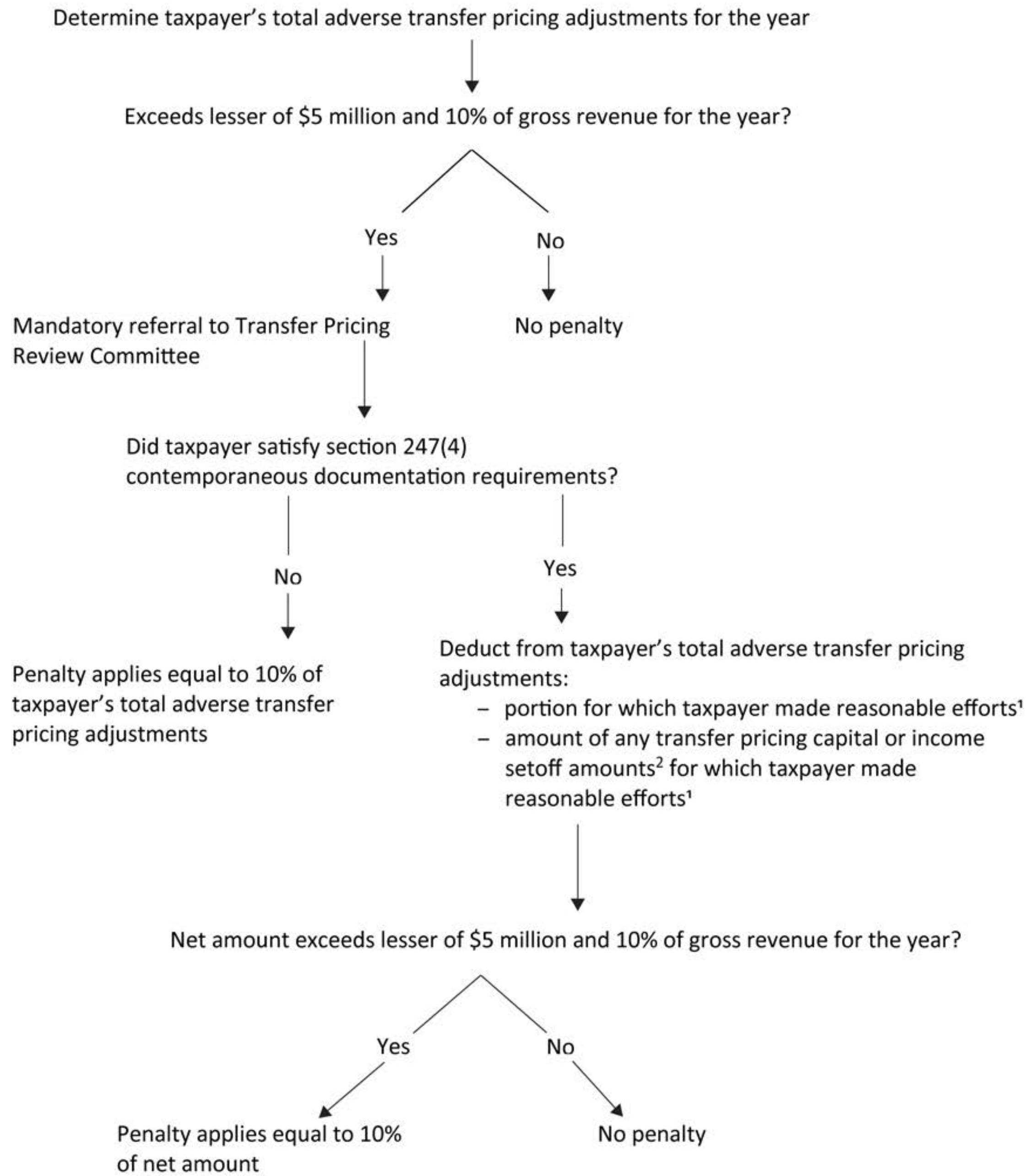
The preparation of contemporaneous documentation is legally essential to a reasonable efforts defense against penalties. The process involved in meeting the contemporaneous documentation standard implies a level of analysis that makes it more likely a taxpayer's transfer prices will comply with the arm's-length principle, reducing the likelihood that year-end adjustments will be needed. Moreover, the quality of such documentation will affect a CRA audit

[30] IC 87-2R, "International Transfer Pricing," at para. 177.

[31] The full amount of reductions in the cost of depreciable property, and 50 percent of the amount of reductions in the cost of all other capital property.

[32] The full amount of increases in the cost of depreciable property, and 50 percent of the amount of increases in the cost of all other capital property.

Figure 2. Transfer Pricing Penalties



[1]"Reasonable efforts" means reasonable efforts to determine and use arm's-length prices and allocations in respect of relevant transactions.
[2]That is, downward adjustments.

and whether an in-depth review will occur, because those materials are often among the first things reviewed by an auditor, and first impressions are important.[33]

Section 247(4) refers to records or documents describing completely and accurately in all material respects the following aspects of a taxpayer's transactions:

- 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 every other transaction entered into between the parties to the transaction;
- the identity of the parties to the transaction and their relationship to each other when the transaction was entered into;
- the parties' functions performed, property used or contributed, and risks assumed for the transaction;
- 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 for the transaction;[34] and
- any assumptions, strategies, and policies that influenced the determination of the transfer prices or the allocations of profits or losses or contributions to costs for the transaction.[35]

Effective contemporaneous documentation specifically addresses each of those statutory requirements – that is, transfer pricing studies prepared by an MNE should be "Canadianized" to identify and respond to those six items. That documentation (which may include items such as legal documents, transfer pricing studies, and internal correspondence) need not be filed with the taxpayer's tax return for the year but must be created or obtained by the tax return filing deadline (six months after year-end for corporations). Because the TPRR requires a primary tax-reduction purpose to apply, it is helpful to document a transaction's business purpose. Contemporaneous documentation must be delivered to the CRA within three months of a written request for it to avoid penalties (no extension of that deadline will be given).

There is no significant case law on what is sufficient to meet the statutory minimums described above. The CRA has stated that deficiencies most often occur in the last three of the six items. It also expects contemporaneous documentation to include:

- the general organization and description of the business;
- the selection of a particular transfer pricing method, 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.[36]

From a penalty perspective, the results of a taxpayer's contemporaneous documentation are binary: It either meets the standards of section 247(4) or not. Thus, there is little benefit in spending resources to produce a substandard transfer pricing study that will be of no practical assistance in protecting the taxpayer from penalties.

b. Reasonable Efforts

If the taxpayer has timely provided satisfactory contemporaneous documentation, penalties otherwise arising from an adverse

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[33] *See, e.g.*, IC 87-2R, para. 186: "A taxpayer's documentation is a major factor in determining whether the Department will review a particular transfer pricing issue in more detail."

[34] The CRA interprets that requirement as including a description of the comparable transactions considered and of those used in applying the pricing method, an assessment of the degree of comparability of those transactions with the taxpayer's transactions, and a description of any adjustments made to enhance the degree of comparability. *See* IC 87-2R, para. 182.

[35] The CRA considers that requirement to include 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. *See* IC 87-2R, para. 182.

[36] *See* IC 87-2R, para. 187.

transfer pricing adjustment can be reduced or avoided if the taxpayer made reasonable efforts to determine and use arm's-length prices and allocations.[37] There are no significant Canadian court decisions regarding what constitutes reasonable efforts to determine and use arm's-length prices and allocations under section 247.

Generally, the tax jurisprudence addressing what constitutes reasonableness as used in other provisions looks to an objective determination of what similarly situated businesspersons might have done. In one transfer pricing case, the Tax Court held open the possibility — without deciding — that one consideration of reasonableness of efforts may be the taxpayer's long-standing and unchallenged practice.[38] The CRA's non-challenge of a taxpayer's transfer pricing efforts over several years (particularly when those years have been audited) would certainly seem a fair measure of whether those efforts were at least reasonable — that is, sufficient to avoid a penalty — as opposed to the higher standard of correct — that is, whether they met the arm's-length standard necessary to avoid a transfer pricing adjustment.

It is clear that determining whether reasonable efforts were used involves weighing the costs and benefits of a particular course of action: What may be reasonable for one taxpayer might be unreasonable for another. It is likely that if asked to determine whether reasonable efforts had been made, a court would consider:

- that by definition a taxpayer engaging in a reasonable efforts determination would have already satisfied the specific statutory contemporaneous documentation standard of section 247(4);
- the relative vagueness of the arm's-length principle and the articulation of it in section 247, and that "transfer pricing is not an exact science" (as the CRA notes in TPM-09);
- whether the advice of experts had been sought, the qualifications of those experts, and data and independence given to them to arrive at their conclusions; and
- industry practice.

The primary CRA statement on what constitutes reasonable efforts for transfer pricing purposes is set out in TPM-09:

> A reasonable effort means the degree of effort that an independent and competent person engaged in the same line of business or endeavour would exercise under similar circumstances. What is reasonable is based on what a reasonable business person in the taxpayer's circumstances would do, having regard to the complexity and importance of the transfer pricing issues that arise in the taxpayer's case.

TPM-09 says the taxpayer must at least consider applying a recommended transfer pricing method "in accordance with the natural hierarchy of recommended methods referred to in IC 87-2R." Another factor is whether a reasonable search for comparable data was made, with an acknowledgement that relatively less effort would be reasonable to find comparables for smaller controlled transactions. The CRA states penalties will be considered where taxpayers are using non-arm's-length transactions as comparables, not following the natural hierarchy of transfer pricing methods, or relying on multiyear data, or where the TPRR is applied.

7. Secondary Adjustments

Transfer pricing adjustments are typically based on a finding that a Canadian taxpayer has received too little or paid too much in a transaction with an NALNR. That finding effectively means the Canadian taxpayer conferred a benefit on the NALNR. When the Canadian taxpayer is a corporation, section 247(12) deems that amount a dividend paid by the corporation to the NALNR (unless the NALNR is a CFA of the Canadian corporation).[39] Nonresident dividend withholding tax of 25 percent applies on that amount (subject to reduction under any applicable tax treaty).

The amount of any deemed dividend may be reduced if the NALNR reimburses the Canadian corporation by repaying the deficiency of value, if

[37] Those may be different than the arm's-length terms and conditions referred to in the GTPR.

[38] *HSBC Bank Canada v. The Queen*, 2007 TCC 307.

[39] The precise amount is determined net of downward adjustments between the same parties.

the CRA agrees.[40] The CRA generally will not defer reassessing withholding tax arising from a transfer pricing adjustment while the adjustment itself is being objected to or appealed by the taxpayer. The taxpayer may post acceptable security in lieu of full payment in appropriate circumstances.

8. Special Situations

a. Controlled Foreign Affiliates

A specific exception to the transfer pricing rules exists for some financial transactions between a Canadian parent corporation and its CFAs. Essentially, when the foreign subsidiary owes an amount to the Canadian corporation that arose (1) as a loan that the subsidiary has used to earn active business income (under Canada's CFC regime), or (2) in the course of an active business carried on by the subsidiary, section 247(7) excludes the debt from Canada's transfer pricing rules. That exception facilitates interest-free loans from a Canadian parent to a foreign subsidiary.[41] A similar exception in section 247(7.1) applies to a Canadian parent's guarantee of debt incurred by its CFAs.

b. Priority of Section 247

In the 2019 federal budget, the Department of Finance proposed a new rule that would establish the primacy of the section 247 transfer pricing rules over other ITA provisions when both could potentially apply.[42] An example would be if a Canadian loaned money to an NALNR at less than an arm's-length rate of interest, a situation addressed by other ITA provisions. The tax community raised various concerns regarding potentially unintended or inappropriate results the draft rule might produce. A revised version of this proposal was released as draft section 247(2.1) on July 30, 2019, and remains problematic.

If that new rule were to proceed, it would reverse CRA administrative policy of generally applying more specific provisions before section 247.[43] It would also likely result in more penalties under section 247(3), thereby necessitating greater analysis of and contemporaneous documentation for financial transactions to meet the reasonable efforts standard. On the other hand, a reassessment made under section 247 rather than a more specific ITA provision may be more likely to be accepted by foreign tax authorities as deserving of correlative relief.

B. Other Relevant Provisions

Other ITA provisions affect transfer pricing situations, both in potentially applying in place of or in addition to, and informing the interpretation and application of, section 247.

1. Canadian Nexus

In general terms, a nonresident of Canada will be subject to mainstream Canadian income tax only if it carries on business in Canada, disposes of taxable Canadian property,[44] or is a natural person employed in Canada. Otherwise, nonresidents will typically be subject to Canadian income tax only when a Canadian resident pays them various forms of passive income, which is subject to nonresident withholding tax of 25 percent, subject to reduction under any applicable tax treaty.

The CRA actively investigates whether nonresidents' Canadian activities meet the nexus required to impose mainstream income tax. For a nonresident corporation, that prima facie equates to whether it has carried on business in Canada during the year, a relatively low bar that creates an obligation to file a Canadian income tax return.[45] However, for most nonresidents, Canada's extensive tax treaty network imposes

[40] Section 247(13) ((14) for interest). The rules essentially give the CRA the ability to define acceptable terms of reimbursement, which are generally reflected in CRA administrative practice in IC 87-2R, para. 212; IC 71-17R5, paras. 56-58; and TPM-02. The CRA typically requires a taxpayer to accept the proposed transfer pricing adjustment as a condition of allowing reimbursement to replace the deemed dividend.

[41] That kind of interest-free loan will trigger the foreign affiliate dumping rules described in Section I.B.5.b, *infra*, if the Canadian parent is itself controlled by a nonresident shareholder.

[42] The existing rule (section 247(8)) establishes the precedence of section 247 over rules in sections 67-69 addressing unreasonable outlays and expenses and non-value-for-value transactions; thus, the arm's-length standard prevails over fair market value when they differ. *See* CRA 2014-0538201C6.

[43] *See* IC 87-2R, para. 21.

[44] Essentially, property with some Canadian-situs element, such as real property in Canada, shares of a corporation deriving its value primarily from such property, or the assets of a business carried on in Canada. *See* Suarez and Marie-Eve Gosselin, "Canada's Section 116 System for Nonresident Vendors of Taxable Canadian Property," *Tax Notes Int'l*, Apr. 9, 2012, p. 175.

[45] Section 150(1)(a)(i)(B). While merely transacting with Canadians does not meet the threshold, the presence in Canada of employees — or, in some cases, agents — engaged in the nonresident's business activities can suffice.

the higher threshold of having a permanent establishment in Canada for Canada to be able to impose mainstream corporate income tax on business income.

MNEs should be aware that an audit of a Canadian group member could lead to questions of whether the activities of nonresident group members have created a Canadian nexus for taxing their Canadian-source business income.

Those rules are supported by a withholding regime that requires anyone paying a fee or commission to a nonresident of Canada in respect of services rendered in Canada to withhold and remit 15 percent of the payment.[46]

2. Benefits for Nonresident Shareholders

When a Canadian resident corporation (Canco) confers a benefit on a shareholder or person connected with a shareholder,[47] the amount of the benefit is generally imputed (and added) to the shareholder's income. The amount of a benefit received by a nonresident is treated as a dividend paid to that nonresident, triggering Canadian dividend withholding tax. Before the introduction of section 247(12), the shareholder benefit provision was frequently used as the statutory basis for a secondary transfer pricing adjustment.

3. Debts Owing by Nonresidents

a. Nonresident Shareholders: Loans

Loans made by a corporation to its shareholders (or persons connected to its shareholders) are included in the debtor's income unless repaid within one calendar year after the end of the lender's tax year in which the loan arose.[48] Nonresident debtors are deemed to have received a dividend, triggering Canadian dividend withholding tax (25 percent, subject to reduction by any applicable tax treaty). Alternatively, the parties may instead generally choose to elect into the interest imputation regime in section 17.1 that ensures the Canadian lender realizes a sufficiently high amount of actual or deemed interest income on the debt each year.

b. Nonresident Shareholders: Interest

If a shareholder of a Canco (or a person connected to such a shareholder) has incurred a debt to Canco (or a related corporation) and the interest rate on that debt is less than an arm's-length rate, the debtor must actually pay (not merely accrue) at least a minimum amount of interest on the debt each year, or be deemed to have received a taxable benefit that is included in income.[49] An interest benefit will be included in the debtor's income for a tax year if the interest on the loan or debt computed at a prescribed rate exceeds interest on the loan or debt for the period actually paid to Canco within 30 days after the end of the year. When a debtor is a nonresident person, any such interest benefit is deemed to be a dividend received by the nonresident and is subject to Canadian nonresident withholding tax at a 25 percent rate (unless reduced under an applicable tax treaty).

c. Other Debts Owed by Nonresidents

A residual rule requires a Canco to include at least a prescribed amount of interest income on debts owing to it by nonresident persons, (1) that are outstanding for more than one year, and (2) on which interest at less than a "reasonable" rate is charged. The following debts are excluded from this rule:

- debt described above with reference to section 15(2) that has either been deemed to be a dividend subjected to nonresident withholding tax or the subject of an election into the section 17.1 alternative interest imputation regime;
- amounts owed by an unrelated nonresident that arose in connection with goods sold or services provided by Canco in the ordinary course of its business and on arm's-length terms and conditions; and

[46] For more on that topic, see Natasha Miklaucic, "Canadian Tax Considerations of Nonresidents Providing Services in Canada," *Tax Notes Int'l*, Mar. 9, 2015, p. 899.

[47] A connected person is generally a person not dealing at arm's-length with the shareholder, other than a foreign subsidiary of (1) a Canadian corporation or (2) non-arm's-length Canadian corporation.

[48] Section 15(2). For example, for a debt owing to Canco incurred during its tax year ending December 31, 2019, the deadline for repayment is December 31, 2020. To qualify for the exception, the repayment cannot be part of a series of loans or other transactions and repayments.

[49] That rule does not apply to debtors that are Cancos or if the amount of the loan or indebtedness has been included in income under the rules in section 15(2).

- debt owed by a closely held CFA of Canco that relates to an active business carried on by the CFA (or another CFA of Canco).

4. Interest Expense Deduction and Thin Cap

Interest expense is generally deductible only when linked to an income-earning purpose and up to a reasonable amount. The case law has generally treated an arm's-length rate of interest as meeting the reasonableness standard.[50]

To limit the potential for cross-border intragroup interest stripping, Canada's thin capitalization rules restrict the amount of interest-deductible debt a Canadian corporation can owe to specified nonresidents.[51] Those rules prevent Canco from deducting interest on outstanding debt owed to specified nonresidents to the extent that debt exceeds 150 percent of Canco's equity.

For example, if Canco owes $100 million to its foreign parent and has only $50 million of equity for thin capitalization purposes, it will be able to deduct interest expense on only $75 million of that debt. Interest on the remaining $25 million will be nondeductible for Canadian tax purposes and will be recharacterized as a dividend to which Canadian nonresident dividend withholding tax will apply. Those rules are supported by a strong antiavoidance regime targeted at back-to-back loans and similar arrangements.[52]

5. Interests in Foreign Corporations

a. Canada's Foreign Affiliate Regime

The Canadian tax system imputes two forms of income earned by a Canadian taxpayer's CFAs back to that taxpayer: passive income and some forms of business income considered sufficiently connected to Canada as to erode the Canadian tax base unless imputed back to the Canadian taxpayer (for example, income from the sale of property or provision of services to the Canadian taxpayer). Conversely, active business income earned by a foreign affiliate is not imputed to the Canadian taxpayer, and when repatriated to Canada as a dividend is received free of Canadian tax if earned in a country with which Canada has a tax treaty or tax information exchange agreement. The Tax Court's conclusions in *Cameco* on how section 247 should apply to the Canadian taxpayer's use of a foreign sales subsidiary were based in large part on an analysis of how Canada's CFC rules impute only some forms of a CFA's income to a Canadian taxpayer.[53]

b. Foreign Affiliate Dumping Rules

In the 2012 federal budget, the government introduced new foreign affiliate dumping (FAD) rules to prevent base erosion in Cancos that are members of MNEs via investments in foreign subsidiaries. The FAD rules generally apply whenever a Canco controlled by a foreign parent makes an investment in a non-Canadian corporation (Foreignco) in which Canco has at least a 10 percent direct or indirect equity interest. When applicable, the rules will either reduce the paid-up capital of Canco's shares, which harms Canco in various ways,[54] or deem Canco to have paid a dividend to the parent (triggering Canadian dividend withholding tax).

An "investment" includes subscribing for shares of, extending credit to, making a capital contribution in, or conferring a benefit on Foreignco. One of the few exceptions to an investment that would otherwise trigger the FAD rules is a debt owed by Foreignco to Canco arising in the ordinary course of Canco's business (for example, trade payables) if Foreignco pays that debt within 180 days other than as part of a series of loans and repayments. Further, if Canco's investment is a loan to Foreignco, Canco and the parent can file an election to cause that debt not to be subject to the FAD rules and to instead be subject to the section 17.1 interest imputation regime.

[50] *See, e.g.*, *Shell Canada*, [1999] 3 S.C.R. 622, at para. 34.

[51] A specified nonresident of Canco is defined as a nonresident person who either owns at least 25 percent of Canco's shares (by votes or value, and including any shares held by non-arm's-length persons), or does not deal at arm's length with shareholders holding at least 25 percent of Canco's shares.

[52] *See* Suarez, "Canada Releases Revised Back-to-Back Loan Rules," *Tax Notes Int'l*, Oct. 27, 2014, p. 357.

[53] *See* Suarez, *supra* note 16.

[54] Paid-up capital reflects amounts received by a corporation in exchange for issuing its shares, and it is a valuable tax attribute (particularly in a cross-border context). In particular, a corporation can make distributions on its shares as a return of paid-up capital (instead of as a dividend) without dividend withholding tax applying, and paid-up capital is included in a corporation's equity for thin capitalization purposes. *See* Suarez, "An Analysis of Canada's Latest International Tax Proposals," *Tax Notes Int'l*, Sept. 29, 2014, p. 1131.

6. Non-Arm's-Length Transactions

When a taxpayer acquires anything from a non-arm's-length person for an amount above its fair market value, it is deemed to have acquired it at FMV. That will limit the amount of the taxpayer's expense or cost basis below what was actually paid. Similarly, when a taxpayer disposes of anything to a non-arm's-length person in exchange for less than FMV, it is deemed to have received proceeds equal to the FMV. That ensures that a taxpayer's taxable income reflects the full FMV of whatever it conveyed to the non-arm's-length recipient. Subject to the pending amendments discussed in Section I.A.8.b, these provisions are generally displaced in a transfer pricing context by section 247(8).

II. The Arm's-Length Principle in Canada

A. Comparables and Transfer Pricing Methods

Because section 247 simply establishes the arm's-length principle without specifying any particular methodology, Canadian transfer pricing cases involve quite a bit of effort in identifying comparables and selecting the most appropriate transfer pricing methodology.

Determining what the tested transactions are is the starting point of the analysis. As noted earlier, in *Cameco* the court cautioned that the broader the series of transactions being examined, the harder it is to find usable comparables, which in turn affects the choice of transfer pricing method. Disagreement over comparables is often the crux of disputes, with the CRA frequently (and generally unsuccessfully) seeking to apply profit-split methods based on alleged deficiencies in the comparables used by the taxpayer. In *Cameco* and *Alberta Printed Circuits*, the taxpayer successfully applied the comparable uncontrolled price method based on comparables that the CRA's experts dismissed as being inadequate for use. Similarly in *Glaxo*, the Tax Court's use of the raw product as the relevant comparable unbundled from the intangibles arising in the linked licensing agreement resulted in choosing comparable transactions (raw material purchases by generic manufacturers) that were not in fact comparable to the taxpayer's transactions.[55]

[55]*See* Section II.B.4, *infra*.

Canadian courts have accepted the OECD's view that "the selection of the most appropriate pricing method depends largely on the assessment of the comparability of transactions."[56] The selection of suitable comparables is clearly a question of judgment. The CRA accepts that:

> 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.[57]

Canadian courts have generally accepted the primacy of the CUP method if satisfied of the adequacy of the comparables. For example, in *Alberta Printed Circuits* the court said:

> The CUP method provides the highest degree of comparability of all methods because it focuses directly on the price of a transaction and requires both functional and product comparability, but other traditional transaction methods may have to be used where there is not enough quality information available with respect to uncontrolled transactions or where it is not possible to reliably qualify the differences between controlled and uncontrolled transactions.

That is borne out by the results in the case law (summarized in Table 1), with CUP being the most frequently applied.[58]

The CRA long took the position that a natural hierarchy of transfer pricing methods existed, with traditional transaction methods (particularly the CUP method) being preferable to transactional profit methods. With the release of the 2010 update to the OECD guidelines, the CRA retreated somewhat from that view:

[56]*Alberta Printed Circuits*, 2011 TCC 232, at para. 167.

[57]IC 87-2R, para. 188. When selecting comparables, the CRA uses various sources, including the Standard & Poor's Capital IQ database. It prefers local comparables as benchmarks but will accept North American ones.

[58]The residual profit-split method has been used in two prominent nontax cases: *Nortel Networks Corp.*, 2014 ONSC 6973 (Ont. Sup. Ct.) and *Ford Motor Co. v. Ontario Municipal Employees Retirement Board*, 79 O.R. (3d) 81, [2006] O.J. No. 27 (C.A.). Those cases would not reflect the constraints of section 247.

Table 1. Transfer Pricing Methodologies

	Traditional Transaction Methods		Transactional Profit Methods		
	CUP	**Resale Price**	**Cost Plus**	**Profit Split**	**Transactional Net Margin**
Canadian caselaw	Applied in *Cameco.* Applied in *Marzen.* Applied in *Alberta Printed Circuits.* Used by both parties in *Glaxo.*	Applied as a secondary check in *Cameco.*	Rejected in *Cameco.*	Applied in *Ford* and *Nortel* cases (not tax cases).	Rejected in *Cameco.* Rejected in *Marzen.* Rejected in *Alberta Printed Circuits.*
CRA commentary (general)	IC 87-2R, paras. 64-69	IC 87-2R, paras. 70-75	IC 87-2R, paras. 76-89	IC 87-2R, paras. 90-105	IC 87-2R, paras. 106-119
CRA commentary (specific)	Provides best evidence of arm's-length price (64). Transactions may be comparable if differences can be: (i) reasonably measured and (ii) adjusted for to eliminate effect of differences (66).	Most appropriate where seller adds little value to goods (74).	Most relevant where functions performed by tested party are the least complex, and tested party does not contribute valuable or unique intangible assets (89). Appropriate for intragroup services (162).	Most appropriate when parties' operations highly integrated and existence of valuable/unique intangibles makes it impossible to establish comparability to a one-sided method (97). Suitable where intangibles present and no comparables to use a one-sided method (99, 145).	Usually applied to least complex party that does not contribute to valuable or unique IP (108). Should be applied on a transactional basis and not companywide (118). Frequently used in MAP settlements (Section IV.B.2).

The 2010 version of the Guidelines essentially suggests that there is no strict hierarchy to be applied to the selection of a transfer pricing method. Rather the focus should be on the quality of the data that is available and, consequently, what will be the most appropriate method. At the same time, the Guidelines continue to suggest that there exists a natural hierarchy to the methods, as referred to in paragraph 2.3. The CRA agrees that the focus of determining the method to use should be the method that will provide the most direct view of arm's length behaviour and pricing. IC 87-2R states that a natural hierarchy exists in the methods. Both IC 87-2R and paragraph 2.3 of the 2010 version of the Guidelines state that the traditional transaction methods (e.g. CUP) are preferred over a transactional profit method. For the CRA, these changes do not firmly de-emphasize the natural hierarchy but they refocus the topic on what is truly relevant — the degree of comparability available under each of the methods and the availability and reliability of the data.[59]

[59] TPM-14.

The most recent expression of Canada's position is in its OECD country transfer pricing profile. It states that Canada's published domestic administrative guidance reflects the guidance in Chapter II of the OECD transfer pricing guidelines:

> The focus of method selection is on the degree of comparability available under each of the methods and the availability and reliability of the data. As such, the most appropriate method should be used. Where more than one method can be applied in an equally reliable manner the natural hierarchy prevails.

The courts have shown a preference for the CUP method when the data supports its use, but they are clearly focused on choosing whatever method will produce a reliable application of the arm's-length principle based on the facts of the case. The testing of one method via the use of others is necessary only if there are reasonable doubts regarding the reliability of the results.[60]

B. Specific Situations

1. Multiyear Data

TPM-16 sets out the CRA's formal administrative policy addressing multiyear data. That policy (which is not law) accepts that multiyear data may be useful for selecting, rejecting, or evaluating the comparability of potentially comparable transactions — especially in terms of the impact that a transaction's economic characteristics have on the degree of comparability to the taxpayer's transactions. However, the CRA generally uses only comparables from the same year as the taxpayer's transactions to substantiate transfer prices and rejects averaging results over multiple years. Statistical tools do not improve (and in fact may reduce) the comparability of transactions, according to the CRA. Left unaddressed is how taxpayers are supposed to obtain information on current-year comparable transactions when computing their transfer prices, because that information is rarely available in that time frame.

2. Third-Party Information

In auditing a taxpayer's transfer prices, the CRA frequently uses confidential information obtained from other taxpayers (third-party information).[61] In general, taxpayer information obtained from the CRA must be kept confidential. That creates tension among the CRA in conducting an effective transfer pricing audit, the taxpayer being audited (who has the right to know the facts and assumptions the CRA's assessment is based on), and the third party (whose information may contain highly sensitive commercial data).

In its OECD country transfer pricing profile, Canada states that "from an administrative perspective, the use of secret comparables as the basis for an assessment is an approach of last resort." The CRA's stated administrative policy is that "every effort should be made to develop an assessing position based on publicly available information," and that head office approval is required before sending the taxpayer a proposal letter using third-party information as the basis of an assessing position.[62]

Unless the third party has consented to the release of its confidential information, the CRA will refuse to disclose it to the taxpayer being audited. Should the taxpayer commence litigation, that process will generally entitle it to see the third-party information the CRA is relying on, subject to a court order to the contrary.

3. Intragroup Services

In *Cameco*, the Canadian taxpayer's head office personnel played an important role in the negotiation of uranium purchase contracts, which were ultimately entered into by its European subsidiary rather than by Cameco itself. An important element of the CRA's challenge to Cameco's transfer pricing was that its European sales subsidiary had a very small number of employees and had outsourced several (largely non-core) business functions to other members of the multinational group.

[60] *See, e.g.*, *Alberta Printed Circuits*, 2011 TCC 232, at para. 177.

[61] According to TPM-04, third-party information is often the most reliable data to use in a transfer pricing audit.

[62] TPM-04. The CRA frequently uses that information as a "sanity check" to screen the results produced by using publicly available information.

The court found that such intragroup outsourcing (at least of non-core functions) was normal business practice in corporate groups, saying, "The law in Canada has long been that there is no distinction between a corporation carrying on an activity by using its own employees and a corporation carrying on an activity by using independent contractors" (paragraph 833). So long as those kinds of intragroup services are appropriately priced, they must be respected as being performed for the entity paying for them and cannot be used to shift risks from that party to the service provider.[63]

TPM-15 sets out the CRA's approach to services performed by one multinational group member for another. CRA auditors are encouraged to review public documents (for example, websites, annual reports, securities law filings) to identify the importance of those services and verify them against any intragroup service agreements and transfer pricing documentation. In general, the CRA prefers a direct charge for each service rather than an allocation of centralized service costs proportionate to estimated benefits received.

The CRA's two main transfer pricing concerns with intragroup services are (1) determining whether a service has actually been provided and, if so, (2) establishing an arm's-length value for that service. The CRA does not consider shareholder costs allocable to subsidiaries. Centralized costs of intragroup services not provided and charged for directly between entities may be allocated among subsidiaries based on an arm's-length charge that results in those costs being shared in proportion to the benefits received. Duplicate charges and fees for items that are not deductible for Canadian tax purposes are subject to extra scrutiny.

In pricing those kinds of services, the CRA prefers the CUP method, then the cost-plus method.[64] It acknowledges that arm's-length service providers would typically expect to receive a markup, so long as it is consistent with the benefit to the recipient and the other economic alternatives open to it. CRA auditors are instructed to ensure that cost savings generated from centralizing an activity are shared among the participants.

4. Intangibles

Intangibles are often particularly challenging in transfer pricing. In *Glaxo*, the taxpayer purchased ranitidine (the active ingredient in Zantac, a heartburn medicine) from an NALNR at a price above what generic manufacturers paid for it from other sources. The taxpayer was party to a license agreement that conferred various rights and benefits on it from intangibles owned by the multinational group and required it to purchase ranitidine from the NALNR under a supply agreement. Those agreements collectively enabled the taxpayer to acquire and deliver ranitidine under the Zantac trademark.

The CRA argued that section 247(2) should be applied transaction by transaction — that is, the tested transaction is considered independently from surrounding circumstances, other transactions, or other realities — requiring the taxpayer to justify the transfer prices paid for ranitidine without regard to the rights it received under the licensing agreement. The SCC rejected that approach, stating that while a transaction-by-transaction approach might be appropriate when no related transactions affecting pricing exist, that depends on the circumstances of each case (as the OECD guidelines acknowledged). The Court found that the ranitidine prices paid were set (in part) to compensate the MNE for rights and benefits received by the Canadian taxpayer under the licensing agreement, and those valuable intangibles could not be ignored in determining the reasonability of the prices paid under the raw materials supply agreement.

The CRA is particularly interested in transfer pricing issues regarding intangibles. For example, for royalties for the use of know-how, the CRA frequently challenges the existence; contribution to the Canadian taxpayer's profits; and value — that is, how easily it could be replicated.

It is clear that the CRA has a bias toward shorter-term licensing agreements with a large degree of risk sharing (for example, profit-based royalty rates) to reflect the uncertain value of many intangibles and the associated risk that

[63] *See also* para. 766: "While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important."

[64] IC 87-2R, para. 162.

creates for both parties. It says royalty rates should reflect:

- prevailing industry rates;
- geographic and time limitations, the degree of the intangible's uniqueness, and exclusivity rights;
- associated technical assistance, trademarks, and know-how;
- the licensee's anticipated profits; and
- any benefits to the licensor from knowledge gained from the licensee.[65]

5. Financial Transactions

Intragroup financial transactions are a frequent source of transfer pricing controversy. In *GE Capital Canada Inc. v. The Queen*, 2009 TCC 563, the Canadian taxpayer paid a fee to its U.S. parent for guaranteeing its capital market borrowings, which the CRA challenged under the GTPR. At trial, the parties agreed that the CUP, resale price, and cost-plus methods were inapplicable. The taxpayer advanced two alternative methods, one of which was a guarantee insurance model used exclusively for municipal bonds and asset-backed securities (not commercial paper), which the court rejected because an insurer would price the risk much higher by virtue of having much less control over the debtor than a parent corporation would. The court described the second method as being effectively analogous to the yield method advanced by the CRA as the correct method. It accepted the yield method, under which the taxpayer's interest cost savings of the explicit parent guarantee was determined by comparing the interest cost of unguaranteed debt (taking into account the value of implicit parent support) to that of guaranteed debt, which in turn required the court to determine the taxpayer's credit rating with and without that explicit guarantee.

The Tax Court determined that the ratings increase from the explicit parent guarantee was significant, and that the taxpayer's resulting interest rate savings were greater than the 1 percent guarantee fee paid to the U.S. parent. It also found that without the explicit parent guarantee, the taxpayer would have been unable to obtain standby letters of credit sufficient to cover its commercial paper program (paragraph 305).

McKesson also applied section 247 to financial transactions. The case involved a sale of receivables by the Canadian taxpayer to its Luxembourg parent, motivated by what the court determined was a tax reduction purpose. The CRA applied the GTPR to challenge the taxpayer's sales price for the receivables, which reflected various discounts the court found amounted to roughly 2.2 percent on receivables generally collected within about 30 days, equivalent to a 27 percent annual financing cost. The court concluded that a discount from the yield rate of between 0.959 and 1.17 percent — not 2.2 percent — would be what arm's-length parties would have agreed to, and dismissed the taxpayer's appeal.

Various circumstances should be considered in determining arm's-length terms and conditions for intragroup loans, particularly an arm's-length rate of interest. Loan documentation should include covenants, events of default, and similar terms that would be found in external financing; ideally, an indicative interest rate would be obtained from arm's-length lenders (as in *McKesson*). The borrower's credit rating should be assessed based on the degree of implicit parent support, and its profitability, liquidity, efficiency, and interest coverage ratios determined.[66]

6. Commodities

For commodities, *Cameco* endorsed the use of the CUP method (adjusted to eliminate the differences from comparable uncontrolled transactions) to produce the most reliable results. The CRA's experts sought to base their reasoning on the taxpayer's own subjective views of the uranium market and price and production cost forecasts, which led them to conclude that the taxpayer would have wanted to retain the upside of future uranium price variations and would be willing to leave the Swiss purchasing affiliate only with a routine distributor's return. On that basis, the CRA's experts, while claiming to be merely

[65] IC 87-2R, paras. 146-147.

[66] Jamal Hejazi and Mark Kirkey, "Best Practices in Determining Arm's Length Interest Rates on Intercompany Loans," XXI(1) *Int'l Tax Planning* 2-11 (2017).

repricing the relevant contracts to what arm's-length parties would pay, effectively recharacterized the transaction by ignoring the actual legal rights and obligations created by the parties' agreements (which left the risk and reward of price variations with the Swiss affiliate). The CRA's proposed repricing in fact reallocated the risks and rewards between the parties quite differently than the parties had agreed to.

As a result, the court concluded that the CRA's experts failed to conduct the transfer pricing analysis required by traditional transfer pricing rules. It found they instead inappropriately relied on hindsight and on the parties' subjective views at the time rather than on objective benchmarks as required by the traditional transfer pricing rules.[67] Thus — at least for commodities when the parties have no control over the market price — the use of subjective evidence would not appear relevant to the application of the arm's-length principle under the GTPR.

7. Business Restructurings

Business restructurings are also a frequent source of controversy between taxpayers and the CRA. *Cameco* clarifies that there is nothing "commercially irrational" about a taxpayer forgoing a business opportunity in favor of another group member, so long as the taxpayer is fairly compensated.

The starting point is identifying which functions, assets, and risks each party has to begin with, based on existing legal relationships. If those are appropriately documented, the likelihood of disagreement with the CRA is reduced. The CRA can be expected to scrutinize existence, ownership, and value of various intangibles in a business restructuring. Establishing and documenting the primary purpose of the restructuring — that is, commercial versus tax-driven — will also frame the analysis, particularly regarding the CRA's predisposition to focus on economics rather than legal relationships and potentially apply the TPRR.

In TPM-14, the CRA commented on the 2010 update to the OECD guidelines regarding business restructurings:

> The Guidelines state that risks are critically important and are an essential part of any functional analysis, thus Part I focuses on the special considerations for risks. In that regard, it is important to review the contractual terms, the conduct of the parties, the allocation of the risks, and the consequences of that allocation.
>
> For transfer pricing purposes, the CRA is entitled to challenge the purported importance of a contractual allocation of risk between associated enterprises if it is not consistent with the legal substance and/or application of the arm's length principle, as described in section 247 of the Income Tax Act. Relevant but not determinative factors to consider are the identification of the party performing the functions which lead to the assumption of risk in fact, and the party with active control over that risk.
>
> ***
>
> Part IV reflects that, if an appropriate transfer price can be determined in the circumstances of the case (irrespective of the fact that the transaction or arrangement may not be found between independent enterprises and the tax administration may have doubts as to the commercial rationality of the multinational enterprise member entering the transaction), the transaction or arrangement would not be disregarded. If an appropriate transfer price cannot reliably be determined, the transactions may not be recognized if they are the result of conditions that would not have existed between independent enterprises.

Those comments (particularly those regarding when contractual relationships may be ignored or transactions disregarded) reflect the

[67] *See* para. 758:
The subjective views of the Appellant are not relevant to the transfer price of the Series or the Transactions, which involve dealings in a commodity with a market-determined value. The Appellant had no control over the market price of uranium and the Appellant's price and production cost forecasts had no bearing on the market price of uranium. Nor do these factors have any bearing on what terms and conditions arm's length persons would agree to in the same circumstances. A person's subjective view of a market is not an objective benchmark and reliance on such views introduces intolerable uncertainty into the transfer pricing rules.

CRA's overreliance on economic considerations based on the OECD guidelines; as discussed above (and since reinforced in *Cameco*), that is not supported by section 247.[68] The major (and growing) variance between the OECD guidelines and the constraints of section 247 make it difficult to rely on OECD business restructuring guidance.

III. Pre-Audit Matters

A. Filing Obligations

Form T2, the general Canadian corporate income tax return, includes various schedules regarding relationships between the Canadian corporation and nonresidents. There are also several reporting requirements specifically for transactions between the Canadian taxpayer and nonresidents, the most important being Form T106, "Information Return of Non-Arm's Length Transactions with Non-Residents."

A separate Form T106 must be filed for each nonresident with which the taxpayer has transacted during the year.[69] The form asks whether the taxpayer has made or obtained contemporaneous documentation for transactions with the relevant nonresident. A taxpayer may be assessed penalties for late filing or for knowingly failing to file, or for failing to fail in circumstances amounting to gross negligence.

A yearly budgeting process that includes the transfer pricing method used by the MNE reduces the likelihood of significant deviation from expected results. Intragroup amounts should be invoiced timely and consistently throughout the year. Canada allows year-end adjustments to transfer prices to achieve compliance with the arm's-length principle.[70] That may occur either before the financial statements for the year are finalized (via an adjusting entry) or after (by making an adjustment on Schedule 1 of the corporate tax return).

The CRA no longer accepts transfer pricing issues under its voluntary disclosure program.

B. Advance Pricing Agreements

1. The APA Program

The advance pricing agreement program was introduced in Canada in 1994, and APAs have been concluded with several countries since. The program is entirely administrative and is managed by the Competent Authority Services Division (CASD) of the CRA. IC 94-4R describes the CRA's general views on APAs.

The CRA will consider APAs for current and future intended — that is, not hypothetical — transfer pricing and related issues, such as the attribution of income between an entity's various PEs. Business restructuring transactions are generally not accepted into the APA program.[71] A simplified small-business APA program exists for smaller businesses to cover non-arm's-length transactions involving tangible goods or routine services.[72] In most cases, a bilateral APA (BAPA) is negotiated between the Canadian competent authority and a foreign counterpart to address transfer pricing issues and provide some degree of certainty for the taxpayer in both jurisdictions. A multilateral APA (MAPA) involves at least three countries.[73] If agreed to and complied with, the result of an APA is that the agreed-on transfer pricing method will be considered to have satisfied section 247.

The APA process has several steps. In the pre-filing meeting, the taxpayer meets with the CRA (anonymously, if desired) before formally filing an APA request to discuss to potential suitability of an APA for the taxpayer's circumstances. The taxpayer can then file a relatively short letter with the CRA formally requesting the negotiation of an APA and identifying the taxpayer, transactions, and tax years to be covered, as well as the representative acting on the taxpayer's behalf. That request may be withdrawn at any time. Next,

[68] *See* Richard Tremblay and Suarez, "The OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings — Canadian Considerations," 38 *Tax Mgmt. Int'l. J.* 98 (2009).

[69] Subject to an administrative de minimis exception for providing detailed information when transactions with that nonresident for the year are less than $25,000. A taxpayer is exempt from filing a Form T106 if its total reportable transactions with all nonresidents for the year is less than $1 million.

[70] OECD, "Transfer Pricing Country Profile — Canada" (last updated Oct. 2017).

[71] *See* CRA 2011-0427261C6.

[72] *See* Special Release 94-4R, "Advance Pricing Arrangements for Small Businesses" (Mar. 18, 2005).

[73] The CRA has a stated preference for negotiating BAPAs and MAPAs and will ask a taxpayer applying for a unilateral APA why a BAPA or MAPA is not being sought if the relevant transactions involve a country that has a tax treaty with Canada.

the CRA formally accepts the taxpayer's proposal to negotiate and sets out the terms under which it will proceed.

The taxpayer next files a formal APA submission, which is a substantive document providing the detailed functional analysis of the transactions to be covered. Essentially, the taxpayer is proposing and explaining a particular transfer pricing method and why it is appropriate. The CRA reviews the APA submission, identifies key issues and concerns, and develops a list of areas needing further information or analysis. It develops a case plan that sets out action items and a proposed timeline for completion.

During the review, analysis, and evaluation stage, the APA team conducts any required taxpayer site visits, delivers formal questions and information requests for the taxpayer, evaluates responses, reviews the proposed transfer pricing method, establishes a position, and exchanges position papers with any relevant foreign competent authority.

The Canadian competent authority negotiates the terms of a BAPA or MAPA with its foreign counterparts. Finally, the CRA documents, finalizes, and executes the actual APA with the taxpayer.

The typical term for an APA is three to five years. For each tax year covered by an APA, the taxpayer must file APA reports with the CRA describing actual operations for the period and demonstrating compliance with its terms. APAs may be revised by mutual consent to accommodate a change in the law, failure to meet critical assumptions, or a material change in circumstances. Taxpayer noncompliance with an APA, a material change in law, or failure to meet a critical assumption may cause the CRA to cancel or revoke an APA.

In its annual APA report for 2018, the CASD provided various operational statistics for the administration of the program. Thirty-two new cases were accepted in 2018, 25 of which were resolved.[74] Fifty-four percent of cases were with the United States. Of the 71 cases remaining in inventory at the end of 2018, 39.4 percent involved transfers of tangible property, 32.4 percent involved transfers of intangibles, 21.1 percent involved intragroup services, and the remaining 7.1 percent involved financing arrangements.

2. Rollbacks and Retroactive Application

The CRA typically entertains requests to apply the results of an APA to tax years before those covered by the APA (a rollback) in the following circumstances:

- the APA is not unilateral;
- the tax year in question is an open year that is not barred from being reassessed;
- the facts and circumstances of the earlier years are the same as those in the tax years addressed by the APA;
- the CRA has not made a contemporaneous documentation request for the earlier years (which effectively means the earlier years are not under audit);
- both the relevant foreign tax jurisdiction and the Taxation Services Office (TSO) responsible for auditing that taxpayer agree to accept the rollback request; and
- the taxpayer provides the CRA with a waiver extending the time for reassessing.[75]

A taxpayer's rollback request should be included in its prefiling APA package and will be considered to have been made once the taxpayer has met with CASD about a potential rollback. When the implementation of an APA rollback results in an upward transfer pricing adjustment, no section 247(3) penalties will be applied. The taxpayer's TSO typically will not issue a contemporaneous documentation demand if the taxpayer has requested a rollback.

For tax years under audit — that is, for which a contemporaneous documentation demand has been made — the taxpayer may still ask the CRA to apply the APA results retroactively to those years.[76] However, the protection from penalties offered by the formal rollback policy will not apply in those circumstances.

[74] Of the 25 completed APAs, 23 were bilateral, one was multilateral, and one was unilateral. Average completion time for BAPA/MAPA cases was 44 months (25 months of diligence, eight months of negotiations, and 11 months of post-negotiation completion work).

[75] TPM-11.

[76] IC 94-4R, para. 15.

IV. Audit and Resolution

A. Transfer Pricing Audits

The CRA began emphasizing transfer pricing audits in 2002 following the report of Canada's auditor-general calling attention to the topic, and that audit activity continues to intensify as the government allocates more resources to tax administration, particularly in the international sector (including transfer pricing). Expanded reporting requirements, more aggressive use of information-gathering powers and procedures, greater willingness to litigate disputes and apply penalties, longer periods allowed for reassessment, and enhanced information exchange procedures between tax authorities have all resulted in more (and often bigger) transfer pricing audits and reassessments.

1. Audit Selection and Commencement

The CRA has characterized its policy on transfer pricing audits as stressing "the importance of a risk-based approach to file selection, proper assessment of facts and circumstances relevant to OECD comparability factors, well supported and documented audit files, and assessments that respect the arm's length principle."[77] Taxpayers are evaluated for audit selection based on risk of noncompliance, increasingly via complex data algorithms designed to screen for perceived higher-risk files. In its risk modeling, the CRA uses taxpayer data from various sources, including forms and schedules filed with the tax return, company websites, country-by-country reporting, and public filings. Information received from other countries via the information exchange process is also used.

Apart from the quality of the taxpayer's contemporaneous documentation, several other factors will increase the likelihood of a transfer pricing audit:

- taxpayer history of transfer pricing deficiencies (substantive or in its contemporaneous documentation);
- high volume of cross-border intragroup transactions involving services (particularly management services), intangibles, or bundled services and intangibles;
- know-how transactions;
- participation in business restructurings;
- high-dollar-value transactions with low-tax jurisdictions; and
- a history of ongoing losses in Canada or low profits relative to industry average.

Sectors such as the pharmaceutical, technology, and financial services industries attract a high level of transfer pricing audit scrutiny.

The CRA's formal stated administrative policy is that requests for contemporaneous documentation must be issued by auditors at the initial stage of contact with taxpayers in all audits in which there are transactions between the taxpayer and NALNRs.[78] Thus, it is common to receive a formal request for contemporaneous documentation at the same time as, or very shortly after, receiving the initial audit letter. As noted, no extension of the 90-day period for delivering contemporaneous documentation to the CRA will be given, and failure to provide documentation meeting the statutory requirements will expose the taxpayer to penalties if there is a transfer pricing adjustment above the penalty threshold.

There are several general principles for effectively managing transfer pricing audits, including:

- developing and communicating an overall audit strategy as quickly as possible, so that everyone involved understands the objectives and procedures for achieving it;
- identifying a single taxpayer contact person through which the CRA can route requests, so that the same person is aware of separate audit workstreams;
- involving legal counsel from the outset, particularly for managing (and when appropriate, challenging) CRA information requests, establishing and preserving

[77] CRA 2011-0427291C6.

[78] TPM-05R at para. 9. This CRA document includes standard sample contemporaneous documentation request letters.

lawyer-client privilege over sensitive analysis and communications, and optimizing the likelihood of success should matters ultimately proceed to the Tax Court; and
- calendaring deadlines for responding to CRA information requests, as well as submitting in writing as early as possible any extension requests.

Maintaining an open and constructive dialogue with the CRA audit team is almost always preferable. Auditors must follow various internal processes, and the taxpayer's time and energy are best spent exploring the most efficient and least costly ways to give the CRA the information necessary to complete the audit. While disagreements will inevitably arise over what is truly necessary and reasonable, there is usually enough room for compromise to keep the audit moving.

2. CRA Information-Gathering Tools

During an audit, taxpayers can expect to receive several written CRA query sheets asking for documents and information and setting a deadline for responding. Based on the volume and complexity of the information being sought and the nature of the queries, it is frequently necessary to request an extension for replying. It is good practice to ask the CRA auditor which query items are the most important so they can be prioritized, ask for extensions as promptly as possible after an initial review of the audit query, and document all extension requests and replies.

The CRA's statutory information-gathering powers are quite broad. If a demand for information or documents is part of a genuine inquiry into the taxpayer's Canadian tax liability (and not part of a criminal investigation), it will be subject to few practical constraints. Realistically, there are generally only two meaningful defenses to a CRA demand for taxpayer documents or information. First, recent jurisprudence has established that despite the broad wording of the CRA's statutory powers in ITA sections 231.1 and 231.2 to compel the disclosure of information, a purposive and contextual reading of those provisions indicates that a taxpayer's obligation to render assistance to CRA auditors does not extend to the point that it must essentially self-audit.[79] Second, and more important, Canadian courts zealously defend the confidentiality of documents, analysis, or information that is protected from disclosure under lawyer-client privilege, whether from the CRA or others.[80]

The CRA acknowledges the sanctity of documents and information protected by lawyer-client privilege, making it difficult to overstate the importance of ensuring that privilege is established for sensitive information and documentation whenever reasonably possible. When — as is often the case in transfer pricing — the work product of non-lawyers such as economists and accountants is necessary for the lawyer to provide confidential tax law advice, taxpayers should ensure they stay as clearly as possible in the boundaries of the privilege.[81] The CRA will generally ask to see virtually everything of possible relevance to the taxpayer's potential tax liability, and lawyer-client privilege is often the only basis on which to resist disclosure of any sensitive analysis or work product.

Oral interviews of taxpayer personnel (and employees of other multinational group members) are a key element of CRA transfer pricing audit practice. They help the audit team in its analysis of functions, assets, and risks within the group. Depending on the scope of the interviews requested and the conduct of the audit, a taxpayer may have concerns about agreeing to a particular oral interview request (in particular, with the number of people interviewed and their knowledge of the business). Recent litigation has established limits on the CRA's ability to insist on oral interviews,[82] and taxpayers receiving a request should carefully consider whether to

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[79] *See* Suarez, "Canada Revenue Agency Revises Administrative Policy on Obtaining Taxpayer Information," *Tax Notes Int'l*, May 13, 2019, p. 613. *See also* Suarez, "Canadian Appeals Court Denies CRA Demand for Taxpayer's UTP List," *Tax Notes Int'l*, Apr. 24, 2017, p. 289. In the case at issue, the court denied a CRA demand to see tax accrual work papers for general use as an audit road map, rather than for a specific issue under audit.

[80] *See* Suarez, "Canadian Appeals Court Reaffirms Common Interest Privilege," *Tax Notes Int'l*, Apr. 2, 2018, p. 221.

[81] See Suarez, "Canadian Court Orders Disclosure of Accounting Firm Diligence Report in *Atlas Tube*," *Tax Notes Int'l*, Dec. 24, 2018, p. 1283, for a discussion of best practices for bringing non-lawyer third parties under the scope of the lawyer-client relationship and the protection thereby offered.

[82] *See* Suarez, "Canada Revenue Agency's Demand for Oral Interviews of Taxpayer's Employees Refused by Court," *Tax Notes Int'l*, Aug. 28, 2017, p. 901.

consent and on what conditions. Oral interviews of appropriate scope often help expedite the audit, and taxpayers should understand that refusals are likely to generate more written audit queries.

Section 231.6 allows the CRA to issue a notice to a Canadian resident demanding any relevant tax information or document located outside Canada (foreign-based information or document, or FBID). The notice must describe the FBID sought; give a reasonable period of not less than 90 days to comply; and explain the consequences of failing to substantially comply, which is the inability in subsequent court proceedings to use any FBID described in the CRA's notice (including that provided to the CRA). That effectively prevents the taxpayer from choosing to disclose only favorable FBID, because the exclusion of all relevant FBID will make it challenging for the taxpayer to litigate its transfer pricing case.

Section 231.6 notices are subject to judicial review for reasonableness and potential defenses for noncompliance. On receiving a section 231.6 notice, a taxpayer should review it with counsel, clarify with the CRA any ambiguities or extensions for complying in writing, and consider whether an application for judicial review is appropriate.

The Canadian and U.S. competent authorities have established a formal arrangement on the exchange of CbC reports. Under its terms, the CRA and IRS exchange CbC reports on global income allocation, taxes paid, and indicators of economic activity to allow each tax authority to assess high-level transfer pricing and risks stemming from base erosion and profit shifting. While that data may be used as a starting point for making further inquiries of an MNE during an audit, the agreement makes clear that CbC data "cannot be used as a substitute for a detailed transfer pricing analysis of individual transactions and prices based on a full functional and comparability analysis."

3. The Transfer Pricing Review Committee

The CRA's Transfer Pricing Review Committee (TPRC) reviews all proposed reassessments invoking the TPRR and all proposed applications of penalties under section 247(3) to ensure consistency. For penalty referrals, the CRA auditor provides the taxpayer with a draft report explaining the proposed penalty application. The taxpayer can make written submissions and provide additional information to the auditor, who must include those in the final penalty referral report delivered to the TPRC.[83]

The committee determines whether (in its view) reasonable efforts were made and communicates its decision to the local TSO assistant director of audit, typically within about two months of receipt. The determination is limited to penalties, and basically accepts as correct the CRA auditor's proposed transfer pricing adjustments. The TPRC considers several factors, including:

- evidence of the taxpayer's efforts to determine and use arm's-length prices;
- the significance of the taxpayer's penalty-related transactions relative to its overall business;
- the magnitude of the proposed transfer pricing adjustments; and
- any potentially offsetting downward transfer pricing adjustments.[84]

The TPRC's memorandum to the local TSO summarizing its decisions and reasons are usually provided to the taxpayer on request.

For a proposed reassessment under the TPRR, the process begins when the CRA auditor makes an initial referral to the TPRC, which decides whether recharacterization should be pursued. If so, the committee asks the auditor to carry out an in-depth examination. The auditor advises the taxpayer that the TPRR is being considered and solicits relevant information. Once the audit is complete, the auditor prepares a formal referral report and provides the taxpayer with its factual elements. The taxpayer is invited to submit additional information and make formal representations, which are provided to the TPRC.

Once the TPRC makes its decision, the result is communicated to the taxpayer through the local TSO. If the TPRR has been approved as a reassessing position, the CRA auditor issues a formal proposal letter to the taxpayer, which then has a final opportunity to make further

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[83]TPM-13.

[84]TPM-09; Appendix A includes examples of when the TPRC has applied section 247(3) penalties.

submissions. Those are forwarded to the TPRC, which then makes a final determination on whether to proceed with reassessing under the TPRR. The taxpayer does not have the opportunity to appear and argue before the committee (on either penalties or the TPRR), so its written submissions are extremely important.

Table 2 sets out cumulative statistics of referrals to the TPRC.

Table 2. Cumulative TPRC Statistics (March 2019)

Section 247(3) Penalty Referrals (85.2%)		
Penalty recommended	296	42.0%
Penalty not recommended	408	58.0%
Total section 247(3) cases referred	704	
Section 247(2)(b) Recharacterization Referrals (14.8%)		
Denied/abandoned	52	42.6%
Assessed	23	18.9%
Ongoing	47	38.5%
Total cases referred	122	100.0%

4. The Proposal Letter

Before issuing a reassessment, the auditor documents the CRA's position in the form of a proposal letter to the taxpayer, setting out relevant findings of fact the audit team has made, areas of perceived noncompliance with the ITA, and proposed transfer pricing adjustments (including secondary adjustments) and taxes owing (plus any interest and penalties). The taxpayer generally is offered the opportunity to make further submissions regarding legal or factual issues in dispute (usually within 30 days, although further time may be allowed).

The taxpayer is generally entitled to receive a copy of the auditor's T20 report prepared at the conclusion of the audit and the working papers supporting the auditor's proposed adjustments. Those should be reviewed to identify factual discrepancies and better understand the underpinnings of the CRA's position. A request to the local TSO is usually sufficient to obtain those materials, but a request under the Access to Information Act can be made if necessary.

5. Limitation Period on Reassessments

Once a return for the tax year has been filed, the CRA must review it and issue an assessment "with all due dispatch" (there is no specified time frame). The CRA frequently issues an initial assessment fairly quickly after the tax return is received and without a formal audit. The issuance of the assessment starts the clock for the CRA's time limit to issue reassessments for that tax year. The normal reassessment period is four years from the date of the initial assessment for the tax year in question (three years if the taxpayer is a Canadian controlled private corporation). However, the CRA's ability to reassess beyond the normal reassessment period is extended in various circumstances, including:

- if the taxpayer has made a misrepresentation on its tax return that is attributable to neglect, carelessness, or willful default;
- if there is failure to withhold and remit required withholding tax on a payment to a nonresident under Part XIII of the ITA;
- if the taxpayer has filed (and not revoked) a waiver of the normal reassessment period with the CRA; or
- if the reassessment is issued within three years after the end of the normal reassessment period as a consequence of a transaction between the Canadian taxpayer and an NALNR.

Hence, in most cases the applicable limitation period for reassessing transfer pricing issues will be seven years (the normal four-year reassessment period extended three years for transactions with NALNRs), absent a misrepresentation or waiver that keeps the period open longer.[85] The CRA's position is that when a Canadian taxpayer acquires property from an NALNR for an amount above its FMV, a transfer pricing adjustment may be made not only in the year of acquisition but also in any later year in which the cost of the property is relevant (such as

[85]Unless a treaty provides otherwise, the domestic limitation period for the CRA to reassess is not shortened by any treaty-based limitation period for making transfer pricing adjustments. *See Alberta Printed Circuits*, 2011 TCC 232, at para. 126; and *McKesson*, 2013 TCC 404, at para. 396.

when the taxpayer disposes of it), even if the year of acquisition is barred by statute.[86]

If the end of the relevant limitation period is near, the CRA will typically approach the taxpayer about providing a waiver (failing which it will generally reassess the taxpayer based on the information available). While it is often in the taxpayer's interests to provide one, that is not always the case, and the advice of counsel should be sought. If a waiver is to be given, counsel should also advise on the form and wording thereof, as well as when a notice revoking the waiver should be issued (six months' notice is required).[87] For example, the waiver's wording should not go beyond its intended scope, and it is good practice to insist on separate waiver forms for each issue so that a waiver for one issue can be revoked without revoking the others.

B. Contesting the Reassessment

1. CRA Appeals Division

By filing a notice of objection with the Appeals Branch of the CRA, a taxpayer who has been assessed or reassessed may have CRA Appeals review the assessment. If the taxpayer wants to contest (or preserve its right to contest) the reassessment in any way (including via MAP or in court), it is almost always advisable to initiate the CRA appeals process because:

- doing so suspends the CRA's right to pursue collection of the amount of the reassessment (other than amounts for failure to withhold on payments to nonresidents);[88]
- filing a notice of objection involves relatively little cost and effort, and the process is private;
- it is the only Canadian avenue of relief available when the NALNR is resident in a country that does not have a tax treaty with Canada; and
- filing a notice of objection is a precondition to litigating the case before the Tax Court.

The notice of objection must be filed with the CRA within 90 days of the date of the objected-to notice of assessment (extensions are possible in some circumstances).

Large corporations[89] that want to file a notice of objection are subject to special rules requiring them to reasonably describe each issue to be decided; specify the amount relief sought, which effectively serves as the maximum relief a court will grant; and provide supporting facts and reasons. Those rules make the drafting of the notice of objection extremely important for large corporations and require them to carefully consider alternative approaches and potential consequential actions (for example, applying discretionary deductions).

Sometime after the notice of objection has been filed, it will be assigned to an appeals officer, who will initiate discussions with the taxpayer. Typically, taxpayers prepare formal submissions for the appeals officer to consider and engage in discussions (and in some cases meetings) to resolve the issues. The appeals process can be lengthy — complex matters such as transfer pricing cases frequently take at least two years to resolve. The appeals officer can confirm, vary, or vacate the reassessment.

Ninety days after a notice of objection has been filed, the taxpayer has the right to proceed directly to the Tax Court to litigate the matter rather than continue with the appeals process. Moving directly to the court may be desirable in situations where the taxpayer believes a favorable outcome from CRA Appeals is unlikely or the taxpayer wants to accelerate resolution.

It is important to understand the interaction of the CRA Appeals and MAP processes. Where the taxpayer wants to pursue the MAP process, it will be required to hold in abeyance the CRA Appeals process initiated by filing the notice of objection. Similarly, taxpayers wishing to pursue the CRA Appeals process after having initiated a MAP relief request must hold the latter in abeyance: Both processes may be initiated but cannot both be actively pursued at the same time. If the CRA Appeals process generates a result that the

[86] CRA 2016-0631631I7.

[87] In some cases, counsel may advise filing the notice of revocation at the same time as the waiver itself, effectively limiting the waiver to a six-month period.

[88] For large corporations, the suspension of collection applies to only 50 percent of the reassessment.

[89] Defined in section 225.1(8) as a corporation whose taxable capital used in Canada (including corresponding capital of related corporations) exceeds $10 million.

taxpayer has expressed "concurrence" with, the MAP process will be limited to CASD simply presenting that result to its foreign counterpart rather than negotiating the issue on the taxpayer's behalf.[90] This makes it very important to consider strategically which different paths of relief the taxpayer wishes to follow, in what order, and how far along each, based on the taxpayer's particular circumstances.

2. MAP and Competent Authority

The CASD administers Canada's MAP program, which dates to 1942. The MAP process applies when a taxpayer has been subject to taxation that is not in accordance with an applicable tax treaty. It imposes an obligation on the relevant competent authority (the CASD in Canada) to try to resolve the case, either unilaterally or by working with the competent authority in the other treaty country.

The MAP articles in Canada's tax treaties are generally based on the MAP article in the OECD model treaty, but because there are some variations, it is important to review the MAP requirements in the relevant tax treaty. Treaties often have time limits for a taxpayer to notify the relevant competent authority that it wants to engage in the MAP process that are typically two or three years from the date of the reassessment creating taxation not in accordance with the treaty.

Under the Canada-U.S. tax treaty, a taxpayer must notify the competent authority from which relief is being sought within six years of the end of the tax year in question. If that requirement is met, the competent authority can even provide relief for tax years that are time-barred by domestic law, which will be eligible for arbitration. Waivers are typically required from the taxpayer in other cases.

The CRA's administrative policies and procedures for MAP relief are set out in IC 71-17R5. While the CASD encourages taxpayers to file a notice of objection with CRA Appeals to protect their rights of appeal, it insists that taxpayers who have filed such a notice request the appeals process be held in abeyance pending the outcome of the MAP proceedings. If a court decision has been rendered, or the taxpayer concurs with the CRA Appeals decision on an issue, the CASD will present the case to the other competent authority without negotiating it, and relief will be at the discretion of the other competent authority.[91] A MAP application does not stop the CRA from pursuing collection of tax in dispute or the accrual of interest on taxes owed.

Once the competent authorities have agreed on a resolution, it is presented to the taxpayer, who may accept or reject it on an all-or-nothing basis. If accepted, the CASD will ensure that a reassessment implementing the resolution is issued. Competent authorities will not negotiate interest and penalties arising from Canadian transfer pricing adjustments: Those amounts are simply the result from whatever transfer pricing adjustment itself the competent authorities negotiate (which the taxpayer may accept or reject).

In addition to seeking MAP relief, taxpayers may request an accelerated competent authority procedure (ACAP) for the same (and recurring) issue arising in subsequent tax years, which effectively rolls forward the resolution. An ACAP request should be filed simultaneously with the original MAP request (the CRA will not accept an amended MAP request), the objective being to allow the relevant competent authorities to negotiate the MAP and ACAP years simultaneously. The taxpayer must accept or reject the MAP and ACAP results together.[92]

When successful, the MAP process avoids potential double taxation among the countries involved, unlike a purely domestic process that addresses only the Canadian side. Thus, unless the Canadian taxpayer believes its transfer pricing position will be completely upheld by the courts or its transactional counterparty is not in a taxpaying position,[93] a request for MAP relief is usually the most fruitful resolution strategy (particularly given that the taxpayer is not

[90] IC 71-17R5 at para. 41. "Concurrence" generally involves a formal acceptance by the taxpayer. CRA negotiating positions in the MAP process generally are based on OECD guideline principles.

[91] *Id.*, paras. 38-43.

[92] *See* TPM-12, and IC 71-17R5 at paras. 21-23.

[93] For example, by virtue of being an NALNR in a loss position or in a low-tax jurisdiction.

Figure 3. Overview of Audit and Resolution Process

[1]May be done prior to reassessment if necessary to meet notification time limit (IC 71-17R5, para. 18).
[2]Includes arbitration if provided for in treaty.
[3]Consider request for interest relief (IC 71-17R5, para. 52).
[4]MAP relief request possible but limited to presenting court/CRA Appeals result to other competent authority.

obligated to accept the result). Figure 3 illustrates the audit and appeals process.

The CRA's actions in conducting a MAP are subject to judicial review, based on a standard of reasonableness and basic procedural fairness.[94] The courts have held that taxpayer-accepted MAP resolutions prevent the CRA from reassessing in a manner contrary to the terms of the agreement.[95]

The most recent year for which the CRA has issued a MAP report is 2017. Roughly 80 percent of MAP cases involving negotiations with other countries were transfer pricing cases, and 114 transfer pricing cases were resolved in 2017. The transactional net margin method was used in almost 88 percent of the resolved cases.

The CASD has historically been effective in obtaining relief from double taxation. Of the 114 transfer pricing cases closed in 2017, unilateral relief was provided in nine, with competent authority agreement fully resolving double taxation in another 95. Roughly 75 percent of Canadian MAP cases resolved in 2017 were initiated by Canada (most of the remaining cases were initiated by the United States).

In 2019 Canada ratified the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, which enters into force December 1. Canada thereby adopted changes regarding MAP and mandatory binding arbitration in several of its tax treaties as set out in its status of list of reservations and notifications upon deposit of the instrument of ratification.

3. Mandatory Binding Arbitration

Article XXVI(6) and (7) of the Canada-U.S. income tax convention provide for binding arbitration between the CASD and its U.S. counterpart when they are unable to resolve a MAP case. Essentially, each country nominates one member of the arbitration panel, and those two persons agree on the third member, who acts as the chair. Each competent authority prepares and submits its proposed resolution, and the panel must select one. Interest and penalties are not addressed; they are instead determined under each country's domestic law.

The arbitration process is governed by the November 2010 Canada-U.S. memorandum of understanding.[96] Transfer pricing cases are among those considered eligible for arbitration, including unresolved bilateral APA cases and ACAP requests, other than on issues for which a court decision has been rendered or that have been settled with CRA Appeals. To be accepted for arbitration, all concerned persons must sign a nondisclosure agreement and suspend pursuit of domestic law remedies pending the outcome of arbitration.

If the affected taxpayers accept the arbitration panel's decision within 30 days, the decision binds both competent authorities.[97] Otherwise, the case ends, and each taxpayer is left with whatever remedies exist under its respective domestic law. That ACAP requests are eligible for arbitration allows panel resolutions on particular issues to be rolled forward to later years for which tax returns have filed.[98]

The existence of binding arbitration to resolve Canada-U.S. transfer pricing disputes gives taxpayers a higher degree of certainty in avoiding double taxation. That is important, because the IRS has sometimes expressed the threshold for a transfer pricing adjustment in a treaty context differently than the CRA has.[99]

4. Settlement

The CRA believes itself legally obligated to conclude settlements on a principled basis, meaning that it will not simply agree to a dollar amount that cannot be connected to the discrete resolution of specific issues. That constraint tends not to significantly impede settlements in a

[94] *See CGI Holdings LLC v. Canada*, 2016 FC 1086; and *Teletech Canada Inc. v. Canada*, 2013 FC 572.

[95] *Sifto Canada Corp. v. R.*, 2017 TCC 37.

[96] That is supplemented by arbitration board operating guidelines issued the same month by the U.S. and Canadian competent authorities.

[97] If the six-year notification requirement in treaty article IX(3)(b) has not been met for a particular tax year, the competent authorities may, but need not, apply the panel's resolution to that year if it is not time-barred under domestic law.

[98] That is also the case for unresolved APAs for future years as described in section 20 of the MOU.

[99] As explained by Danilack, *supra* note 1: "If the taxpayer has, in good faith, completed a sound analysis to establish an arm's-length result under accepted transfer pricing principles and fully documented that effort in both countries, and if it's apparent from the situation, and from all the evidence, that the taxpayer has not misused transfer pricing to reduce its overall tax burden, then the treaty should limit the ability of either contracting state to make an adjustment."

transfer pricing context if a range of supportable valuations exist. Agreements regarding waivers of interest, the application of different valuations to different periods (including future years), and secondary adjustments can also be sources of flexibility in justifying a potential dollar settlement on a suitably principled basis.

The taxpayer and the CRA can settle a file at any time during audit, appeals, and litigation. As a practical matter, once a file has proceeded to court, settlement is most likely to occur after the parties have completed discovery and have learned more about the strengths and weaknesses of their respective cases. Settlement agreements are generally binding on the CRA. In fact, in *Sifto Canada Corp. v. The Queen*, 2017 TCC 37, the Tax Court forced the CRA to assess the taxpayer in accordance with a settlement agreement reached under the MAP between Canada and the United States.

5. Litigation

If the taxpayer is dissatisfied with the results from the CRA administrative process, it may appeal to the Tax Court. Tax Court decisions may be appealed to the Federal Court of Appeal, while FCA decisions may be appealed to the Supreme Court only with its permission, which is granted infrequently. Therefore, as a practical matter, the FCA is usually the ultimate judicial forum for resolving tax disputes.

Once CRA Appeals has issued a notice confirming the reassessment, the taxpayer has 90 days to file a notice of appeal with the Tax Court (extensions are available only in limited circumstances with court approval). The drafting of the notice of appeal is important, because that document sets the parameters of the litigation to some degree. Large corporations can appeal only matters for which they complied with the specific requirements regarding their notices of objection (Section IV.B.1), preventing them from raising new issues on appeal.

The CRA has 60 days to file a notice of reply. The reply lists the facts the CRA relied on in making its reassessment (which are assumed to be true unless the taxpayer can demonstrate otherwise), which of the taxpayer's facts the CRA accepts or contests, and the legal basis of the CRA's position.

The CRA may add the TPRR to its court pleadings even if it was not raised on audit and subjected to the usual TPRC review (or even if the TPRC actually rejected applying it).[100]

Thirty days after the exchange of notices, either party can make a formal settlement offer. The Tax Court rules encourage the settlement process by requiring a party who rejects an offer that was more favorable to it than the result of the litigation to pay an increased amount of the other party's litigation costs.

The parties exchange lists of the documents they intend to rely on, followed by the exchange of the actual documents, which is followed by discovery.[101] The document production process on discovery may be limited to only those documents on which a party proposes to rely (Rule 81 partial disclosure) or alternatively disclosure of all relevant documents that are (or have been) in a party's possession (Rule 82 full disclosure). The latter may include millions of documents and emails and require extensive searching of records, dramatically increasing the cost and work involved in litigating a transfer pricing case.

The management of experts and their reports during litigation is critical in transfer pricing cases, because the court must often resolve the case based on conflicting expert opinions. Specific rules govern how experts and their reports can be introduced and challenged, and a good understanding of the appropriate strategy for managing experts is important. In February 2019 the Tax Court announced a new protocol for "hot-tubbing" experts as part of managing the litigation process to help judges better understand where the parties' respective experts agree and disagree. ■

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[100] *See Cameco Corp. v. The Queen*, 2010 TCC 636, at para. 53; and *Burlington Resources Finance Co. v. The Queen*, 2013 TCC 231.

[101] For analysis of Canada's tax litigation process, see Patrick Lindsay and Salvatore Mirandola, "Resolving Tax Disputes in Canada," *Tax Notes Int'l*, June 11, 2012, p. 1043.