Canadian transfer pricing update

October 19, 2021

Canada has seen numerous transfer pricing developments throughout 2021. Canada's transfer pricing rules are summarized here under 4, Transfer Pricing. For most multinationals with Canadian subsidiaries, transfer pricing constitutes the Canadian tax issue with the greatest potential exposure for challenge from the Canada Revenue Agency (CRA), which aggressively enforces Canada's transfer pricing rules in s. 247 of the *Income Tax Act* (Canada) (ITA).

2021 federal budget – Consultation announced

In February 2021, the Supreme Court of Canada (SCC) announced it would not hear the CRA's appeal of the taxpayer's decisive win in *Canada v. Cameco Corporation*, a development reviewed in our article from February 2021.

This case upheld the taxpayer's use of a European sales corporation to purchase and re-sell uranium to customers outside of Canada, resulting in profits that might otherwise have been realized in Canada to be instead realized in Switzerland due to increases in uranium prices after the purchase contracts were signed. The lower courts held that the CRA's attempt to use the "recharacterization" provision in Canada's transfer pricing rules was incorrect, and that such provision could apply only in cases of "commercial irrationality" where no arm's length parties would have entered into the transactions between Cameco and its Swiss subsidiary. As a result, the CRA's re-assessments of the taxpayer were overturn in their entirety.

In Cameco, the courts applied the arm's-length standard as it exists in s. 247 ITA, which does not incorporate variations such as the OECD's recent focus on abstract concepts such as "accurate delineation." Rather, in Canadian tax law (including transfer pricing) it applies based on the legal rights and obligations actually created by the taxpayer.

Unhappy with a result that was nonetheless demonstrably correct in the law, in the April 19, 2021 federal budget the government announced the Department of Finance would release a consultation paper in the following months to address (alleged) "shortcomings" in Canada's existing transfer pricing rules. The tax community is waiting on the release of this consultation paper, as well as further developments on the government's announced intent to "strengthen and modernize" the general anti-avoidance rule (GAAR) in s. 245 ITA. Multinationals with Canadian group members should watch for the release of this paper and be prepared to respond to it as

appropriate. Unfortunately, the government has drawn the wrong conclusions from the courts' decisions in Cameco, and taxpayers can expect frequent and more difficult transfer pricing disputes with Canadian tax authorities. For example, at a 2021 transfer pricing conference, the CRA commented that it is increasingly comfortable applying the recharacterization elements of Canada's transfer pricing rules other than as a last resort.

2021 federal budget – Enhanced disclosure

The 2021 federal budget also contained a variety of measures designed to provide the CRA with more information. This is accomplished through increasing the reporting and disclosure obligations upon taxpayers and by giving the CRA greater information-gathering powers.

Two budget developments are particularly relevant in (although not limited to) a transfer pricing context. First, the CRA will now have the ability to compel taxpayers to submit to oral interviews. This ability was limited by the courts in a previous transfer pricing case where the CRA's demand to interview 25 employees of the multinational group was denied.[1]

Moreover, the ITA will be amended to require specified corporate taxpayers to proactively report cases of uncertain tax treatment to the CRA, thereby providing Canadian tax authorities with a substantial head start on audits. These new rules will apply to corporations that are resident in Canada (as well as non-residents with sufficient Canadian tax nexus), if:

- the taxpayer has at least C$50 million of assets;
- audited financial statements under IFRS or similar country-specific accounting principles (*i.e.*, U.S. GAAP) are prepared for it or a related corporation; and
- those audited statements reflect uncertainty as to Canadian income tax.

Where applicable, the taxpayer must provide prescribed information relating to the uncertainty (*e.g.*, description of the issue; relevant facts and amounts, etc.). This enactment directly responds to the Federal Court of Appeal decision in BP Canada, which denied the CRA's attempt to force the taxpayer to turn over its tax accrual working papers.[2]

TPM-02 updated

The CRA's administrative policies on various aspects of transfer pricing are set out in a series of transfer pricing memoranda (TPMs). When the CRA assesses an adverse transfer pricing adjustment on a Canadian taxpayer, that amount is typically considered to be a dividend for Canadian tax purposes and subjected to Canadian dividend withholding tax (a "secondary adjustment"). In certain circumstances, the CRA will agree not to assess such dividend withholding tax if the amount in question is repatriated back to the Canadian taxpayer.

In June 2021, TPM-02 was replaced by TPM-02R, dealing with secondary transfer pricing adjustments, repatriation and non-resident withholding tax assessments. TPM-02R updates the CRA's administrative policy to reflect the 2012 enactment of ss.

247(12)-(15) ITA, which provides explicit statutory rules for these items. Previously, the CRA's policies were based on more general ITA provisions dealing with taxable benefits.

TPM-02R generally reflects the prior CRA administrative policy. It requires that a taxpayer have made *bona fide* attempts at determining arm's-length prices for repatriation to be considered, a policy that puts a premium on up-front analysis such as would be found in the taxpayer's contemporaneous documentation. Where repatriation is available, the CRA auditor must inform the taxpayer of this option and the following applicable conditions:

- The taxpayer agrees in writing to the proposed transfer pricing adjustment(s) (note: this does not preclude the taxpayer from seeking relief under the mutual agreement procedure of an applicable tax treaty).
- The taxpayer and the non-arm's length non-resident agree to the terms and conditions of the repatriation agreement (a sample such letter is contained in Appendix B to TPM-02R).
- The non-arm's length non-resident either:
    - immediately repatriates the funds equivalent to the gross amount, or a portion of it, arising from the transfer pricing adjustment(s), or
    - agrees in writing with the taxpayer to the repatriation and to the completion of all appropriate transfers and entries in the financial records of the taxpayer within 90 days from the signing of the repatriation agreement.
- An unconditional waiver of the right to object to and appeal the transfer pricing adjustment(s) is obtained prior to granting relief for the repatriation. If the taxpayer decides not to waive its right of objection or appeal at the audit stage, the CRA's Appeals Branch may still consider a request for repatriation during the objection process. Signing the waiver does not prevent the taxpayer from seeking assistance from the Competent Authority Services Division (CASD).

TPM-02R sets out the following specific cases in which the CRA will not allow repatriation to grant relief from non-resident withholding tax:

- the CRA has applied either the transfer pricing recharacterization rule in s. 247(2)(b)/(d) ITA (which it is increasingly willing to do) or the general anti-avoidance rule in s. 245 ITA;
- other anti-avoidance rules have been applied to the relevant transactions;
- the taxpayer (or non-arm's-length non-resident) has not honoured a requirement or compliance order issued under the ITA with respect to the relevant transactions; or
- any other circumstances where the CRA does not concur with repatriation.

Therefore, multinational groups should not assume that repatriation will be available in all cases to prevent Canadian dividend withholding tax from applying to a transfer pricing adjustment. Where applicable, withholding tax may be reduced under the terms of an applicable tax treaty (if any) between Canada and the non-arm's length non-resident. In some cases, direct shareholding in the Canadian taxpayer is required for the lowest treaty rate to apply, while others contemplate indirect shareholding.

TPM-17: government assistance

The Canadian government enacted various income-support initiatives in response to the COVID-19 pandemic, most notably the Canada Emergency Wage Subsidy (CEWS). The CRA's general views concerning the impact of government assistance are set out in Transfer Pricing Memorandum (TPM)-17, which states

> "When a cost-based transfer pricing methodology is used to determine the transfer price of goods, services, or intangibles sold by a Canadian taxpayer to a non-arm's length non-resident person and the Canadian taxpayer receives government assistance, the cost base should not be reduced by the amount of the government assistance received, unless there is reliable evidence that arm's length parties would have done so given the specific facts and circumstances. . . . When a Canadian taxpayer receives government assistance and participates in a cross-border controlled transaction, it is presumed that the Canadian taxpayer will keep the government assistance, unless it can be proven that arm's length enterprises would effectively share all or part of that assistance.

The CRA has reiterated that this general position applies to COVID-19 support such as CEWS, and that simply assuming that such support would impact transfer prices would not respect the arm's-length principle. It is anticipated that the impact of CEWS payments on transfer prices will be an area of frequent dispute between the CRA and taxpayers.

2020 APA report

The Competent Authority Services Division (CASD) of the CRA administers the Canadian advance pricing agreement (APA) program. APAs are negotiated between taxpayers and tax authorities to provide certainty on transfer pricing issues for future years, although they may also be "rolled back" to apply to pre-agreement taxation years in certain circumstances. An APA may be unilateral (*i.e.*, with only one taxpayer authority), bilateral (*i.e.*, where the competent authorities of two countries agree) or multilateral.

In the 2020 APA report, CASD identified a number of key findings:

- during 2020 19 new applications were received and 15 cases completed, leaving a year-end inventory of 69 cases;
- only 10.5 per cent of cases since 2016 have been unilateral APAs, reflecting the CRA's strong preference for bilateral or multilateral agreements;
- in 2020 the average time to complete a bilateral APA was 36.9 months, down from 51.1 months in 2019; and
- at the end of 2020, 42 per cent of the APAs still in progress involved transfers of tangible property, while another 27.5 per cent related to intangible property and 26 per cent were for services (the remainder was for financing arrangements).

In 2021, CASD announced that it would no longer charge APA applicants for recovery of its costs in negotiating and concluding APAs.

As of October 2021, the APA caseload was quite robust, with many taxpayers seeking greater certainty on transfer pricing in an unsettled pandemic environment and the CRA still dealing with workplace disruption and a significant backlog created by the

pandemic. As a result, those contemplating an APA involving Canada are well-advised to begin the process as early as possible (the first step is a pre-filing meeting to determine the suitability of the taxpayer's facts for an APA, to be held within 180 days after the end of the first taxation to be covered by the APA).

For more information on the Canadian transfer pricing update, please reach out to any of the key contacts below.

[1] For more on this case see Suarez, "Canada Revenue Agency Revises Administrative Policy on Obtaining Taxpayer Information," *Tax Notes International*, May 13, 2019, p. 613.

[2] See Suarez, "Canadian Appeals Court Denies CRA Demand for Taxpayer's UTP List," *Tax Notes International*, April 24, 2017, p. 288.

By

Steve Suarez

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BLG Offices

Calgary
Centennial Place, East Tower
520 3rd Avenue S.W.
Calgary, AB, Canada
T2P 0R3
T 403.232.9500
F 403.266.1395

Ottawa
World Exchange Plaza
100 Queen Street
Ottawa, ON, Canada
K1P 1J9
T 613.237.5160
F 613.230.8842

Vancouver
1200 Waterfront Centre
200 Burrard Street
Vancouver, BC, Canada
V7X 1T2
T 604.687.5744
F 604.687.1415

Montréal
1000 De La Gauchetière Street West
Suite 900
Montréal, QC, Canada
H3B 5H4
T 514.954.2555
F 514.879.9015

Toronto
Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada
M5H 4E3
T 416.367.6000
F 416.367.6749

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