CANADA

Overview

Borden Ladner Gervais LLP, Taxand Canada

Canada's largest law firm offers clients advice on all aspects of business law from coast to coast in every major city across the country. BLG's Tax Group provides advice on all varieties of taxes in Canada, including transfer pricing in an income tax context. In particular, members of BLG's Tax Group have advised clients on obtaining advance pricing agreements, preparing contemporaneous documentation, managing transfer pricing audits, and resolving controversies at various levels, including mutual agreement procedures and before the courts.

We work with Taxand group members who have in-house economics and valuation expertise to address client needs on issues requiring such specialized transfer pricing knowledge.

General : Transfer Pricing Framework

Canada's transfer pricing regime in s. 247 of the Income Tax Act (Canada) "ITA" adopts the arm's length principle as its foundation. Unlike other regimes that are far more detailed and prescriptive, the Canadian statute adopts a somewhat minimalist approach. Briefly, where a Canadian and a non-arm's-length non-resident transact on terms and conditions that differ from those that would have been made between arm's-length persons, amounts that must be determined for Canadian tax purposes are adjusted to the amounts that would have been determined if the terms and conditions made by arm's length parties had applied. In limited circumstances, a so-called "recharacterization" rule allows the Canada Revenue Agency "CRA" to go beyond re-pricing a transaction and re-determine the amounts that would have resulted from whatever transaction (if any) arm's length parties would have entered into instead of the transaction actually undertaken by the taxpayer.

The Canadian rules require the particular transaction or series of transactions the taxpayer entered into with the non-arm's length non-resident (the "tested transaction") to be identified and then measured against the arm's-length standard set out in s. 247. Defining exactly what the tested transaction is can be critical, and is frequently a source of dispute. One of Canada's leading transfer pricing cases cautioned against "an overly broad series [that] 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." *(Cameco Corp. v. The Queen, 2018 TCC 195 at para. 704)*.

As a general rule Canadian transfer pricing jurisprudence has focused carefully on the legal rights and obligations created by each participating legal entity, and applied s. 247 based on those legal rights and obligations. The CRA adopts and applies the OECD Transfer Pricing Guidelines in its administration of s. 247, and as a result tends to focus less on actual legal rights and obligations and more on the economic results and what the CRA believes the taxpayer *should* have done. The result has been an increasing frequency of transfer pricing disputes in Canada, as courts have repeatedly observed that while OECD pronouncements may be a useful resource, "the [OECD Transfer Pricing] *Guidelines* 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 [the ITA] rather than any particular methodology or commentary set out in the *Guidelines*. (*Canada v. GlaxoSmithKline Inc.*, 2012 SCC 52, para. 20). Canada's transfer pricing regime is described in greater detail in Suarez, "Transfer Pricing in Canada", *Tax Notes International*, December 2, 2019, p. 781.

Accepted Transfer Pricing Methodologies

The Canadian statute does not prescribe any particular method or hierarchy for determining and applying arm's-length terms and conditions. The CRA endorses the "typical method" described in the OECD Transfer Pricing Guidelines for performing a comparability analysis, including a review for comparables, selection of the most appropriate transfer pricing method and application of the selected method to the taxpayer's facts. In this regard, the CRA identifies three traditional transfer pricing methods:

- comparable uncontrolled price "CUP";
- resale price; and
- cost-plus.

The profit-split and transactional net margin methods are also considered acceptable.

The CRA's view is that there is no strict hierarchy of transfer pricing methods, and that what is truly relevant is "the degree of comparability available under each of the methods and the availability and reliability of the data" for the purpose of providing "the most direct view of arm's length behaviour and pricing" (TPM-14). That said, the CRA continues to espouse the view that a "natural hierarchy" exists amongst these methods in favour of the traditional transaction methods (and in particular CUP). Transfer pricing disputes frequently involve disagreement as to what constitutes the most appropriate methodology in the taxpayer's particular circumstances.

Transfer Pricing Documentation Requirements

There are no "master file"/"local file" obligations in Canada. The primary role of documentation in Canadian transfer pricing is as a means of demonstrating to the CRA (and if necessary a court) that the taxpayer has carefully considered which transfer pricing methodology to use and applied that methodology in such a manner as to have made reasonable efforts to establish and use arm's-length transfer prices. The better the quality of the taxpayer's transfer pricing documentation, the easier it is to sustain the transfer prices in fact used by the taxpayer in the face of a CRA audit, so as to prevent the CRA from adjusting them.

Transfer pricing documentation that is prepared within 6 months from the relevant taxation year-end and meets the substantive requirements set out in s. 247(4) ITA is a necessary (but not sufficient) condition to preventing penalties from being applied in the event that the CRA makes transfer pricing adjustments in excess of a specified threshold. There is no statutory obligation to prepare such documentation or to file it with the CRA however.

A Canadian taxpayer is obliged to file a Form T106 for each non-arm's length non-resident with whom the taxpayer has transacted during the year (subject to a *de minimus* exception). The Canadian taxpayer must also file a T106 Summary form annually summarizing all such transactions with all non-arm's-length non-residents during the year. These forms constitute the primary way in which the CRA is alerted to transactions of interest from a transfer pricing perspective. Each late-filed T106 form is subject to a penalty of $25/ day ($2,500 maximum) and a failure to file is penalized at $500 ($12,000 maximum), which is doubled ($1,000/ month, $24,000 maximum) where the CRA has served a demand to file.

Local Jurisdiction Benchmarks

Identification of suitable comparables remains the foundation of Canada's transfer pricing system. There are no legislative guidelines for establishing comparability, so determining appropriate comparables is an area of judgment on which taxpayers and the CRA frequently disagree. Foreign comparables are acceptable, and the CRA has expressed the view that while domestic comparables would be assumed to be more reliable where the Canadian taxpayer is the tested party, foreign comparables meeting the same standards of comparability are valid.

The CRA insists on establishing current-year comparables for each particular taxation year under review. Multi-year data is not considered acceptable for any particular year, and the use of an inter-quartile range is also rejected, at least formally (although it is sometimes used in practice). The are no "safe harbours" for these purposes.

The CRA often uses comparables taken from other taxpayers the source of which the CRA will refuse to disclose to the taxpayer under audit (so-called "secret comparables"). Such confidential third-party information can be frustrating to deal with during an audit, since without full knowledge of the source of the "secret comparable" it is difficult for the taxpayer to assess its true comparability. Usually the taxpayer will only be able to gain full knowledge of such "secret comparables" at the litigation stage, once the audit has been completed and the CRA Appeals process concluded.

Advance Pricing Agreement "APA"/Bilateral Advance Pricing Agreement "BAPA" Overview

APAs are available in Canada, and are frequently a cost-effective alternative to lengthy and expensive audit disputes. APAs may be unilateral, bilateral or multilateral. The CRA has a strong preference for bilateral or multilateral APAs. Business restructurings are not accepted for the APA program. The typical term of an APA is 3 – 5 taxation years.

The APA process involves a pre-filing meeting with the CRA to discuss potential suitability. This is followed by the taxpayer making a formal request setting out the relevant taxpayers, transactions and years to be covered by the APA requested. If the CRA accepts the taxpayer's proposal, the taxpayer prepares the formal APA submission setting out the proposed transfer pricing methodology and underlying data, for the CRA team to review. There are usually a number of follow-up information requests for the taxpayer from the CRA before the final version is settled and executed, as well as negotiations with other relevant tax authorities for bilateral or multilateral APAs. Depending on the countries and issues involved, two years is a common time-frame from start to finish.

Transfer Pricing Audits

The CRA regularly and aggressively conducts transfer pricing audits, which are extremely document-intensive and time-consuming to respond to. The CRA applies a "risk-based approach to file selection, proper assessment of the facts and circumstances relevant to OECD comparability factors, well-supported and documented audit files, and assessments that respect the arm's-length principle."

The audit process generally begins with a formal demand for the taxpayer's contemporaneous documentation, which triggers a 90-day period for the taxpayer to deliver such to the CRA (there are no extensions permitted for this deadline). The CRA audit team will generally also seek oral interviews with various personnel within the multinational enterprise of which the Canadian taxpayer is a member, and (depending on the circumstances) site visits. Recent legislative changes have significantly expanded the CRA's powers to require oral interviews, and the CRA views this tool (and in particular functional interviews to determine how functions and risks are allocated within the MNE) as an essential element of the audit process.

It is essential for the taxpayer to assemble a team of internal and external resources to conduct the transfer pricing audit in an organized and effective manner, and to minimize the risk of the CRA audit team receiving misinformation that creates an unfavourable or misleading image with the CRA. This is generally achieved by establishing a single point of taxpayer contact with the CRA audit team, a process for handling the CRA audit team's requests, and identifying communications and analysis that are protected from disclosure under lawyer-client privilege.

Near the end of the audit, the CRA team leader will issue a "proposal letter" indicating the adjustments that the CRA intends to make and inviting final submissions in response (the usual response time offered is 30 days, which can often be lengthened if requested). Following that process, the taxpayer will generally receive a final letter stating what adjustments the CRA is making, followed by the issuance of a formal notice of re-assessment. The taxpayer has 90 days from there to initiate the appeals process within the CRA Appeals branch by filing a Notice of Objection, with other potential recourse (i.e., MAP, litigation before the courts) potentially available. The taxpayer can usually obtain a copy of the auditor's T20 report and supporting working papers on request, which should be scrutinized for factual deficiencies.

Transfer Pricing Penalties

Transfer pricing penalties apply under s. 247(3) ITA in certain circumstances, serving as a deterrent to under-allocating income to Canada. The amount of the penalty is computed as 10% of the taxpayer's net adverse transfer pricing adjustments made by the CRA (not 10% of the increased tax resulting therefrom). As such, penalties can apply even if the taxpayer is in a loss position for the year, and are onerous by international standards.

These penalties apply where the taxpayer's net transfer pricing adjustment for the year exceeds the lesser of C$5 million and 10% of the taxpayer's gross revenue for the year. In this regard, the taxpayer's net transfer pricing adjustment for the year is defined to exclude those adjustments in respect of which the taxpayer made "reasonable efforts" to determine and use arm's-length prices and allocations – as such, "reasonable efforts" are a defence against penalties even where an adverse adjustment occurs. While what constitutes such "reasonable efforts" is not set out in the statute (there are no safe harbours) and so must be determined in each case based on the taxpayer's particular circumstances, a taxpayer is deemed not to have made such reasonable efforts unless it prepares contemporaneous documentation within 6 months of each taxation year-end (a shorter time period than the 1 year applicable in many countries) that meets the substantive requirements in s. 247(4) ITA, and delivers it to the CRA within 90 days of a demand for it. Whenever the dollar threshold is met for transfer pricing adjustments, the CRA will frequently assess penalties on the basis that the taxpayer's contemporaneous documentation does not meet the required substantive standard. Such a penalty assessment requires approval from the CRA's internal Transfer Pricing Review Committee.

While not a penalty per se, when adverse transfer pricing adjustments are made to the Canadian taxpayer, there will usually be a "secondary adjustment" to reflect the value of the Canadian taxpayer having charged too little for goods and services it has delivered to, or paid too much for goods and services received from, a non-arm's-length non-resident. The amount of that secondary adjustment will usually be treated as a deemed dividend triggering non-resident withholding tax (25% unless reduced by a tax treaty), unless the non-resident has repatriated the relevant amount back to the Canadian taxpayer with the CRA's concurrence.

Local Hot Topics and Recent Updates

In June 2023, the federal government released a consultation paper on Canada's transfer pricing rules, which included draft legislative amendments to the ITA. If enacted, these proposed amendments would significantly amend Canada's existing transfer pricing regime. While ostensibly providing "greater clarity" on the application of the arm's-length principle, the proposals are clearly geared towards moving Canada's transfer pricing rules further towards the OECD Transfer Pricing Guidelines by de-emphasizing reliance on the legal rights and obligations created by the parties and elevating the importance of their "economically relevant characteristics."

This initiative is a response to the government's resounding defeat in the Cameco case, where the CRA sought unsuccessfully to apply the "recharacterization" rule in s. 247(2)(b) and (d) ITA. The proposed amendments would make it easier for the government to entirely replace (rather than merely reprice) the taxpayer's intra-group transaction. They would also include a rule requiring Canada's transfer pricing rules to be generally interpreted in a manner consistent with the OECD Transfer Pricing Guidelines.

The proposals set out in the June 2023 transfer pricing consultation paper also include the following:

- increasing to $10 million the threshold for transfer pricing adjustments to potentially trigger penalties;
- aligning existing contemporaneous documentation standards with those used by the OECD; and
- adopting streamlined approaches for certain situations (e.g., intra-group loans, routine distribution activities, etc.).

CANADA

Documentation threshold

Master file	Not Applicable
Local file	Not Applicable
CbCR	€ 750M

Submission deadline

Master file	Not Applicable
Local file	Not Applicable
CbCR	12 months from year-end

Penalty Provisions

Documentation – late filing provision	Not Applicable; however, absence/inadequacy of timely contemporaneous documentation exposes taxpayer to penalties if transfer pricing adjustments exceed prescribed threshold
Tax return disclosure – late/incomplete/no filing	Late filing penalty of 5% of taxes owing plus a further 1% per month late (maximum 12 months)
CbCR – late/incomplete/no filing	$500/month to a maximum of 24 months

CONTACT

Steve Suarez
Borden Ladner Gervais
SSuarez@blg.com
+ 416 367 6702