TRANSFER PRICING

What's it All About ?

And How's It Going to Affect Me ?

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Robert G. Kreklewetz

Transfer Pricing: What's Going On, and How's It Going to Affect Me ?

After-Dinner Presentation to Meeting of the TEI (October 9, 1997, Toronto, Ontario) – Since Revised

QUESTIONS ?

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Building Blocks

- As most people are aware, transfer pricing rules are aimed at taxpayers who participate in transactions or arrangements with non-resident persons with whom they do not deal at arm's length. The rules are aimed, therefore, at taking this non-arm's length transaction, and imposing an objective arm's length standard on it, ultimately to achieve what is considered to be an arm's length price, albeit in the context of a related party transaction. In Canada, the basic message is that taxpayers are expected to report taxable income on the basis of having charged a fair price for goods and services provided to non-resident affiliates, and of having paid no more than a fair price for goods and services received from non-resident affiliates. (And *vice-versa*).
- While this is the laudable goal, it is also important to understand the current subtext of the transfer pricing rules. Transfer pricing rules really started with U.S. concerns in the early 1920s as to the possible "anti-avoidance" strategies being practiced by U.S. corporations with increasingly international business. (In fact, the U.S. Congress expressed interest and concern about transfer pricing as early as 1917, with the a perceived need to "equitably determine the invested capital or taxable earnings" of a related corporate group, since many were then thought to be attempting to evade U.S. taxation by moving income out of high U.S. tax brackets by simply shifting the greater proportion of it to foreign subsidiaries).
- Today, and in the context of a globalizing economy, transfer pricing rules have gone far beyond simply anti-avoidance measures, and are meant to deal with more than the simple fear that certain multinational enterprises ("MNEs") may be artificially shifting income through artificial pricing strategies. In fact, most tax administrations are tending to view transfer pricing from a "national" rather than a global perspective, with transfer pricing rules basically directed toward securing appropriate national returns on taxpayers' revenues from international investment and trade, with various countries almost competing for the allocation of income of MNEs to their jurisdiction.
- In this sense, it can no longer truly be accepted that tax avoidance is the principal issue underlying transfer pricing guidelines. While some tax administrations may continue to view tax considerations as having serious influences on related-party transfer-pricing decisions, one wonders what merit there may still be in such concerns, especially in light of the many other influences on the pricing arrangements (e.g., customs duties, exchange controls, import quotas and price controls, appropriate jurisdiction of ownership, statutory protection of intellectual property, and anti-dumping laws).
- The resulting change in focus can in part explain the resulting changes we see in transfer pricing rules as we approach the 21st Century.

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Historical Basis

- International transfer pricing rules were really started, in the modern sense, with the 1968 U.S. enactment of detailed rules in regulations to section 482 of its Internal Revenue Code (the "482 Regulations"). These were the first transfer pricing rules of any country in the world, and helped establish the traditional *transaction-based* arm's length methods -- namely, the "comparable uncontrolled price" method ("CUP"), and the so-called *secondary transactional* methods of "cost plus" and "resale price".
- Mounting world interest in transfer pricing, and the U.S.'s own insurgence into the area, led the OECD to undertake a detailed study of the subject during the 1970s, culminating in the the Organization for Economic Co-operation and Development's ("OECD") 1979 transfer pricing guidelines, entitled *Transfer Pricing and Multinational Enterprises* (as updated in 1995, the "OECD Guidelines").
- Canada's own rules, found in sections 69(2) and (3) of the ITA were derived from older 1952 legislation, and could be ultimately traced all the way back to sections 23B of the *Income War Tax Act.* For the most part, however, Canada's rules have been determined by administrative practice, and the general guidelines set out in Revenue Canada's IC 87-2, five years in the making, and first published on February 27, 1987. They have also been greatly influenced by the OECD Guidelines.
- There is also very little jurisprudence on Canada's transfer pricing position, with a handful of cases dating from 1962, and dealing mostly with the importation of goods through interposed tax haven transshipment companies (e.g., *Spur Oil, Irving Oil, Dominion Bridge, Indalex*). Suffice it to say, these cases and the few others did nothing to explicate Canada's transfer pricing position, apart from (perhaps) suggesting that transfer pricing issues are a question of facts and circumstances, to be determined on their own merits, possibly within a framework like that suggested in the OECD Guidelines.
- For the most part, one often finds U.S. transfer-pricing regulations have tended to influence significantly any analysis in the area. While having marked effects on the OECD's own views, and therefore having a fairly "direct" influence on Canada's own approach (now that it has affirmed its intention to adopt the revised OECD model), U.S. regulations also have a "spill-over" effect on Canadian companies. This is evident when one takes into account the close ties most multinational Canadian companies have with the U.S.. Accordingly, U.S. regulations have very real implications for income determinations of Canadian MNEs with U.S. connections and Canadian subsidiaries of U.S. MNEs.

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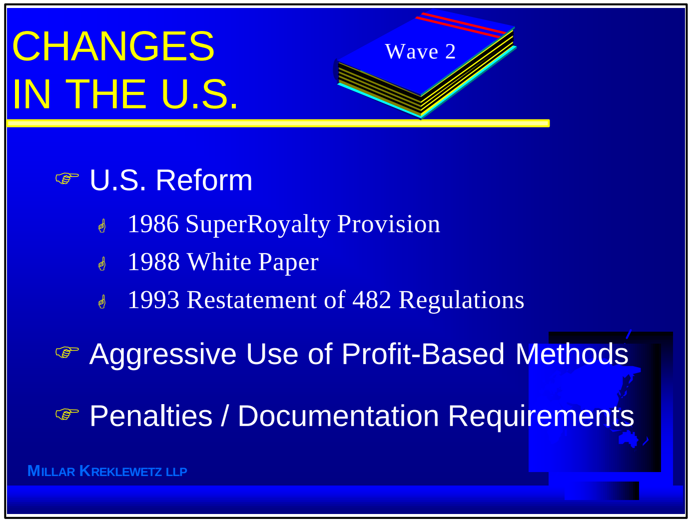

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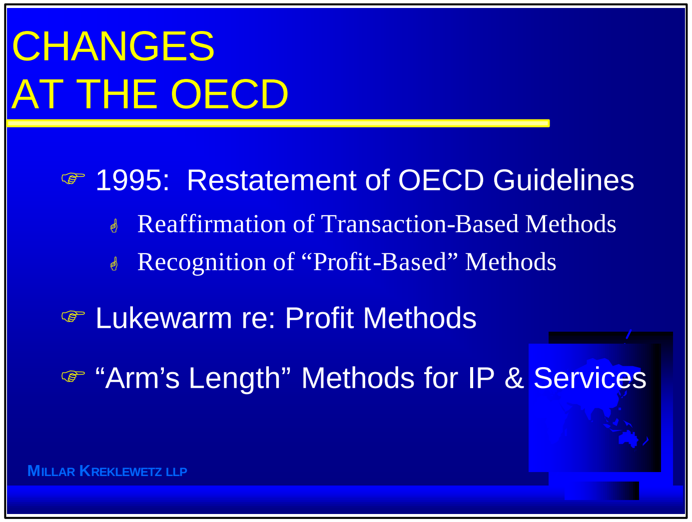
U.S. Position: Starting the Ball Rolling.

- Following the 1979 OECD Guidelines, the mood in the U.S. regarding transfer pricing continued to be quite militant. The consensus was often that (then) current transfer pricing rules were more often than not an obstruction to the IRS in reviewing and challenging as appropriate the transfer pricing practices of MNEs (particularly the oft absence of "comparables", which made the traditional methods often quite unworkable, even at the behest of the IRS). The pricing of IP was also a major concern, particularly because of the increasing role IP was playing in international business. At the same time, evolving U.S. transfer pricing litigation seemed to be continuously considering *profit splits* as a means of reconciling the IRS's position with that o f the taxpayer.
- The result, in 1986, was a major development in U.S. transfer pricing rules, and the adoption of the "superroyalty rule", a controversial attempt by the U.S. to ensure that payments for IP -- whether subject to outright transfers of ownership (i.e., sale), or leased or licensed -- were generally commensurate with the income attaching to the intangible. Moreover, payments for IP would be required to be adjusted over time to reflect the income actually earned: a relevant factor now being the profit earned following the transfer. These changes ultimately led to a whole re-thinking of U.S. transfer policy, starting with a 1988 While Paper, and culminating in comprehensive proposed regulations to section 482 of the Code, finalized in July 1994, and re-addressing not only the rules relating to IP, but also the tests for valuing transfers of goods and services.
- While reaffirming the U.S. acceptance of traditional *transaction-based methods* (e.g., CUP, resale price, cost plus), the restated 482 Regulations also made the U.S. position quite clear regarding increasing acceptability of the so-called *profit-based* methods -- like the so-called "comparable profits method" ("CPM"), the "profit split" method, and various other unspecified methods, traditionally referred to as fourth" or "other" methods.

  Note: The CPM is based on the thesis that similarly situated taxpayers will tend to earn similar returns over a reasonable period of time, which can be used to determines arm's length consideration for a controlled transaction by referring to objective measures of operating profit (profit level indicators, like ROI, ROA, etc.) derived from uncontrolled taxpayers engaged in similar activities in similar circumstances.

- The Regulations' emphasis on "comparable" and "residual" profit splits tended to be the most significant aspect of the U.S. proposals, with the CPM generally viewed as *barrier to U.S. market penetration* (e.g., allocating substantial profits to new U.S. based start-up companies put these companies at an unfair disadvantage vis longer-established and profitable U.S. businesses, thereby insulating the latter from offshore competition).



Changes at the OECD

- In July 1995, the OECD published extensive changes to its transfer pricing guidelines.
- The 1995 OECD Guidelines provide both a background discussion of the so-called "arm's length principle", as well as acceptable transfer pricing methods, and some guidance on the documentation of transfer prices. Subsequently, in March 1996, Chapters VI and VII of the OECD Guidelines were published, dealing with special considerations for Intangible Property and Intra-group Services.
- The OECD Guideline's reaffirmed the use of traditional *transactional based methods* (e.g., CUP, cost plus and resale price) where at all possible. At the same time, and perhaps cognizant of the increasing use of *profit-based methods* in the U.S. (e.g., the CPM) the OECD Guidelines contained a very clear recognition as to the use of profit-based methods.
- While the subject of a very clear discussion, the OECD can generally be said to have put forward use of profit-based methods with some guarded optimism -- if not taking a very cautious approach to profit comparisons in generally, and particularly the U.S. endorsed CPM.
- The result seems to be a "secondary status" for Profit-Based Methods:

> [I]n those exceptional cases in which the complexities of real life business put practical difficulties in the way of the application of the traditional transaction method … application of the transactional profit methods (profit split and TNMM) may provide an approximation of transfer pricing in a manner consistent with the arm's-length principle. However, the transactional profit methods may not be applied automatically simply because there is a difficulty in obtaining data.
>
> (Paragraph 3.2 of the OECD Guidelines)

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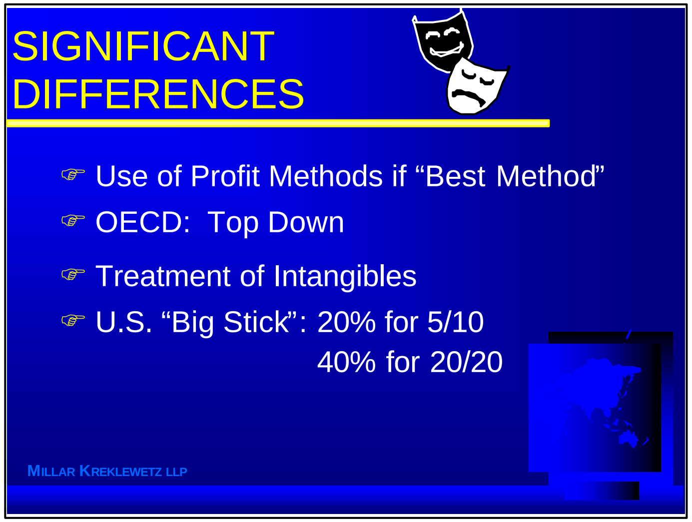

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Differences Between the U.S. and OECD Approaches

- One of the most controversial aspects of the 1995 OECD Guidelines was their seeming acceptance of U.S. sanctioned profit-based methods. While allowing for use of profit-based methods -- the OECD's version of the CPM was essentially the "transactional net margin methods" (TNMM") -- the OECD still took the position that in general terms, transaction-based methods were preferred, and were expected to be used where at all possible.
- A second difference was in the U.S. legislation of the "best method approach", which allowed U.S. taxpayers to use the method which provided the most reliable result, and which was interpreted by many as the authority to skip over transaction-based methods in favour of profit-based methods, without demonstrating *de rigeur* that all other methods were inapplicable. For its part, the OECD provided a much more systematic approach to the methods, beginning with CUP, and progressing "downward".
- Another key difference continued to be the treatment of intangibles. Under the U.S. approach, and still a somewhat holdover from the superroyalty rules, periodic adjustments are still required to ensure that the consideration charged over a period of years is "commensurate with the income" attributable to the intangible. This is clearly inconsistent with the OECD approach, especially to the extent independent parties would have agreed on long term rates. On the other hand, the U.S. limited somewhat the application of the superroyalty rules by providing for certain "safe harbours" in certain instances (e.g., where actual profits generated by the IP fell within 80 - 120% of the projected profits; or where a comparable transaction was used to value the IP, and which involved the same IP).
- A final distinction was in the U.S.'s use of penalties. Although not provided in the 482 Regulations, penalty provisions were provided for under section 6662 of the IRC, and provided for a 20% penalty where the net increase to taxable income, as a result of section 482 adjustments was either $5 million, or 10% taxpayer's gross revenues. A further 40% penalty applied where section 482 adjustments exceeded either $20 million or 20% of gross revenues. While the penalties could be avoided if certain steps were taken (e.g., if prescribed procedures were followed, including selection and application of a transfer pricing methodology which the IRS agreed provided the most reliable measure of an arm's-length result, and reasonable efforts were made to evaluate other methods, including the maintenance and availability of contemporaneous documentation.

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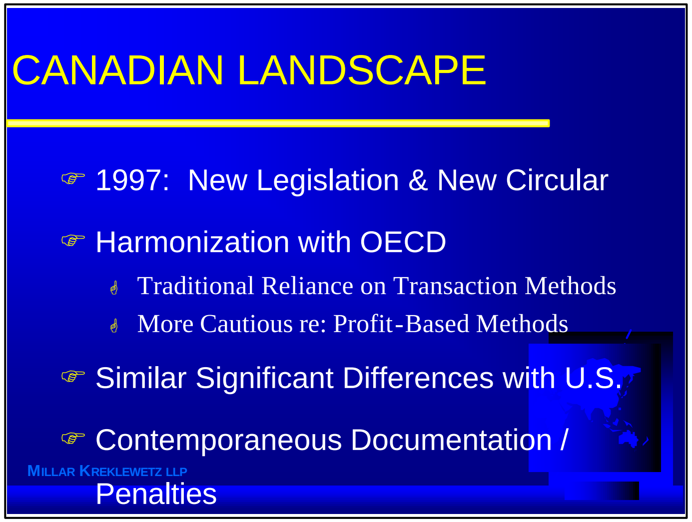

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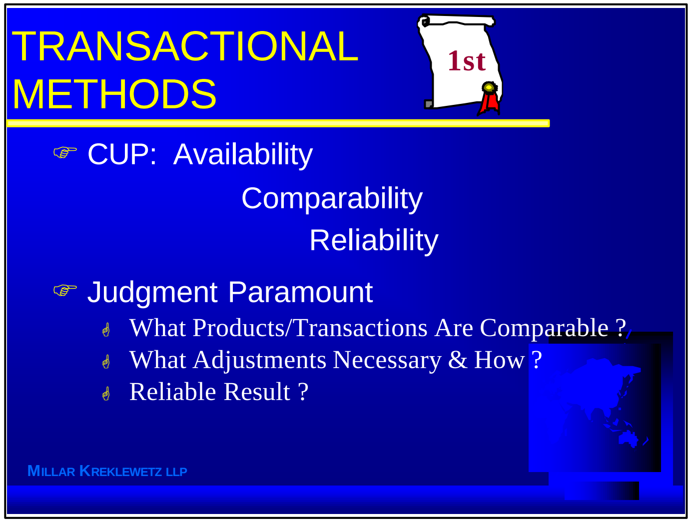
Canadian Happenings

- Following these steps at both the U.S. and OECD levels, the Canadian federal government made a February 18, 1997 Budget Announcement, confirming its intention to harmonize the standard contained in current section 69 of the ITA (i.e., providing for a "reasonable arm's length amount") with the arm's length principle as defined in the OECD Guidelines..
- The budget announcement was followed up on September 11th Press Release, which contained both proposed legislative changes to *Income Tax Act* dealing with transfer pricing, and a revised Information Circular 87-2R, which was updated to reflect these changes.
- In general, the clear focus of the Canadian government is now to support and follow the OECD Guidelines. For its part, Draft IC 87-R2 reflects the OECD Guideline's reaffirmation of traditional *transactional based methods* like CUP, cost plus and resale price, taking the position that the OECD Guidelines themselves (at paragraph 3.49) state that the traditional methods are preferable to the transactional profit methods.
- Accordingly, Canada's position and that the transactional profit methods should only be used as *methods of last resort*, "namely when the use of traditional methods would not produce a reliable arm's length price". This approach is not inconsistent with Canada's initial reaction to the potential use of "profit-based methods" in international transfer pricing. In fact, when the OECD's intentions were first made public, the Ministers of Finance and National Revenue issued a joint (Release, No. 94-003, January 7, 1994) release disavowing general acceptability of the CPM and "periodic adjustments" of the pricing of certain intangible property transfers between related parties.
- Perhaps taking this position a step further, Revenue Canada's position now seems to be that the OECD Guidelines do not express a clear preference for one transactional profit method over the other, and in fact *discourage the use of such methods*.
- This all suggests that use of profit-based methods in Canada will be held up to intense scrutiny, making transactional based methods the "methods of choice" for taxpayers wishing to avoid controversy in this area. (Use of Profits Methods, if any, may be restricted to a "Check-Balance" approach to more traditional transactions methods). The practical problem of course remains finding "comparable" information.
- More importantly for Canadian taxpayers, perhaps, was the simultaneous announcement that penalties would be imposed on taxpayers failing to make reasonable efforts to comply with Canada's transfer pricing rules.
- Given the attempted harmonization with the OECD, of course, there must now certainly remain some significant differences between Canada's new transfer pricing rules, and those applicable in the U.S..



Transaction Method: CUP

- CUP is a transfer pricing methodology based on the price charged for a property or services when transferred in a "controlled transaction", using that price as a proxy for the price which ought to be charged in the uncontrolled transaction, provided both arise in "comparable circumstances". The immediate difference between CUP and some of the other "secondary" transaction methods is its focus on comparable *product* being sold, whereas each of the secondary methods tend to focus on a *functional analysis* of the uncontrolled and controlled businesses, in the context of similar but not identical products.
- A CUP can be either *internal* or *external*. Internal comparables exist where the uncontrolled company sells a product or service to a related company, but also sells the same product to an independent enterprise (e.g., the "internal" CUP). An external CUP -- Revenue Canada calls it an "exact" comparable -- arises where an independent enterprise sells the same product to an unrelated enterprise. Accordingly, CUP requires that: (1) products being compared be the same, (2) conditions between controlled and uncontrolled transactions be similar, (3) reasonably accurate adjustments be made where differences exists which might materially effect the price in the open market.
- Some of the important factors in determining "comparability" include:

  Quality of the product

  Sales volume and level/place of the market

  IP associated with the product (e.g., branded vs. unbranded products)

  Other "terms" of the sale, included the cost of freight, insurance, credit, and warranty and returns of goods obligations, as well as other costs incurred.

  Alternative arrangements available to the buyer or seller.

  Other contractual terms (e.g., exclusive distributorships vs. non-exclusive).
- Problems with CUP continue to be finding *real* comparables, and reconciling the adjustments that are inevitably required where differences exist. Given the level of judgment required here, one should be understandable wary of having to undertake this process under the guise of a Revenue Canada auditor, whose entire experience in your business may be a 2 week audit of international transactions.
- For its part the OECD encourages flexibility in applying CUP, so as to extend its application. Where reliability uncertain, use "other methods" to support its reasonability. Revenue Canada also takes this approach in practice, and whenever significant adjustments are necessary, it is suggested that another method be employed as a "check & balance".

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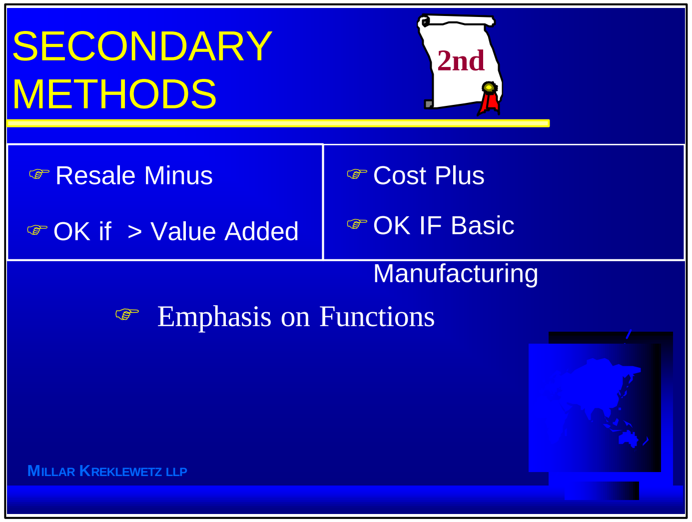

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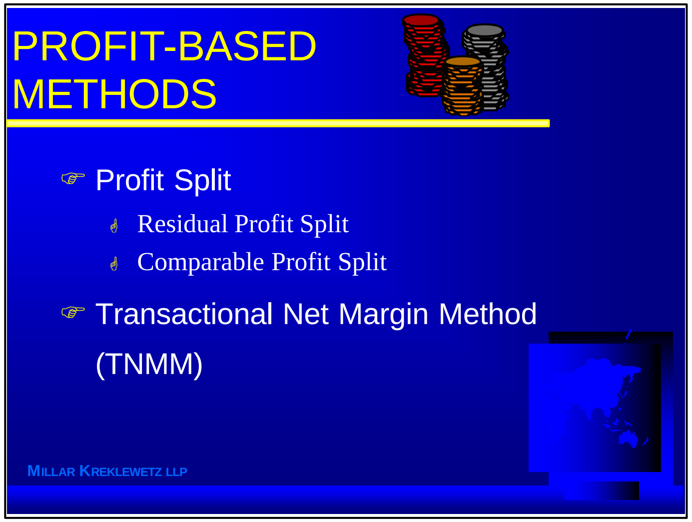
Secondary Methods: Resale Price and Cost Plus Methods

- Under the Resale Price Method, the selling price to third parties is known and an expected return for the functions performed by the seller established by reference to third party sales, or returns earned by persons performing the same or similar functions and selling similar goods to arm's length parties. Using the third-party resale prices as a starting point, the Resale Price Method deducts an appropriate gross margin, arriving at an arm's length price for the goods.
- In practice, and as well recognized by the OECD and Revenue Canada, the Resale Price Method is most appropriate in situations where the seller adds *relatively little value to the product*, since the greater the value-added by the seller's functions, the more difficult it is to determine an appropriate resale margin. Sellers employing high degrees of IP (e.g., a specialized marketing plan), further complicate use of this method, for the same reasons.
- The Cost-Plus Method is similar in concept to the Resale Price Method, in that each relies on comparisons of gross margins. Under Cost-Plus, it is the costs incurred for supplying a product or service which are known. Taking these costs as a starting point, the Cost-Plus Method adds on an appropriate gross margin (or mark-up), thereby also arriving at a putative arm's length cost price for the goods. An arm's length mark-up on the costs is determined from either the taxpayer's sales of the product or a similar product to third parties in comparable transactions, or from the mark-up realized by unrelated taxpayers in comparable transactions with third parties. The more comparable the products and/or functions, the more likely it is that the cost-plus method will produce an appropriate estimate of an arm's length result.
- In practice, and given the necessity to ensure comparable gross margins under the Cost-Plus method makes it appropriate only in fairly straight-forward manufacturing operations (i.e., where the seller has not integrated very much non-manufacturing activity), as in the case of a "contract manufacturer".
- The most significant difference in the focuses between CUP and each of these secondary methods is that under the latter, *functional comparability* is more important than *product comparability*. Minor product differences under the secondary methods are viewed as less likely to materially effect profit margins.
- Under both the Resale Price and Cost-Plus Methods, adjustments are also required where the transactions are not comparable in all respects and the differences have a material effect on price. Where significant adjustments are required, it may again be prudent to use another method as a check and balance.



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Profit-Based Methods

- Following the general approach taken at the OECD, Revenue Canada accepts two types of Profit-Based Methods, the *profit split*, and a modified version of CPM, the *transactional net margin method* ("TNMM").
- Revenue Canada indicates that the Profit Split can be applied where the operations of the non-arm's length parties are *highly integrated*, making it difficult (if not impossible) to evaluate their transactions on an individual basis. This inability to parcel out particular product and services, or particular functions, would generally preclude use of any of the traditional transaction-based methods.

  Note: Under the profit split method, the first step is to determine the total profit earned by the parties from their integrated operations, usually "operating profit", but sometimes gross profit. The profit is then split between the parties based on the relative value of their contributions to the non-arm's length transactions, again requiring as best as possible, a functional analysis of the functions performed, assets employed, and risks assumed (this generally requires a detailed and well documented analysis of the functions performed). Parceling out income based on similar returns on assets or investment will not be accepted.

  Amongst the various methods of splitting profits, Revenue Canada "prefers" the *residual profit split method* over other types. Under the residual profit split, operating income is split in two stages: first by allocation of a return to each party for the readily identifiable functions (e.g., manufacturing or distribution) based on standard returns established from comparable data; second the return attributable to the MNE's IP is established by allocating the residual profit (or loss) between the parties, usually based on an analysis of the facts and circumstances indicating how this residual would have been divided between arm's length parties.

  Under the OECD Guidelines, the other accepted profit split method is *contribution analysis,* where the combined profits are divided between the related enterprises simply based on the value of the functions performed by each party (e.g., there is no "two part" analysis of profits). Where possible, third party "comparable" information is used to value functions such as technical services, research and development and capital invested.
- The TNMM, which compares net profit margins under controlled and uncontrolled situations is really the method of last resort, with Revenue Canada considering its application only when the other recommended methods fail. (In Revenue Canada's view, if a sufficient degree of comparability exists between products and functions, a taxpayer should be able to use one of the traditional transactional methods, instead of the TNMM).

  Note: In practice, a number of factors make it difficult to use TNMM (e.g., differences in the age and productivity of plant and equipment, management abilities or philosophies and the business experience of the respective entities). Significantly, Revenue Canada is on record as indicating that industry profit data drawn from broad sources rarely satisfies the standards of comparability required to implement the TNMM.

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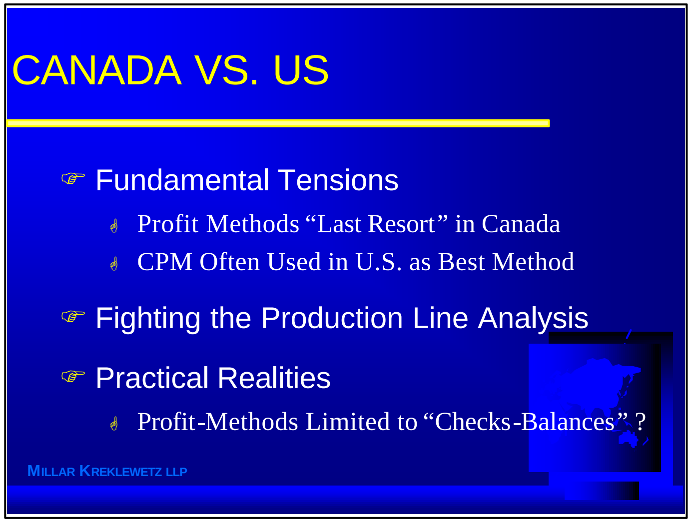

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Canada vs. U.S.

- While Draft IC 87-R2 generally reflects the OECD's reaffirmation of traditional transactional based methods (like CUP, Cost Plus and Resale Price), it tends to approach profit-based methods with much more trepidation. While indicating that the OECD Guidelines themselves prefer traditional transaction-based methods (presumably at paragraph 3.49), Revenue Canada also infers that the OECD Guidelines actively *discourage* the use of profit-based methods.
- Not surprisingly, then, Canada's position is that the Profit-Based methods should only be used as *methods of last resort*, "namely when the use of traditional methods would not produce a reliable arm's length price". This approach is fairly consistent with Canada's initial reaction to the potential use of "profit-based methods" in international transfer pricing, and particularly in accord with a joint release of the Ministers of Finance and National Revenue (Release, No. 94-003, January 7, 1994) which responded to the OECD's first draft Guidelines, and disavowing general acceptability of the CPM and "periodic adjustments" of the pricing of certain intangible property transfers between related parties.
- Unfortunately, this tends to put Canada in direct contradiction with many transfer pricing methodologies coming out of the U.S.. There, under the U.S. *best method approach*, CPM is often used, usually because under CPM it is generally easier to find comparables. In fact, the IRS itself often relies on a similar analysis to "check" U.S. compliance, perhaps creating an incentive in the U.S. for taxpayers to establish transfer prices which insulate the taxpayer from the severe penalties under the U.S. 482 Regulations.

  Note: Under CPM, net profits of a particular related party are determined by applying *profit level indicators* from comparable unrelated parties (e.g., ratios based on return on capital, operating profits to sales, gross profit to operating expenses, etc). Under CPM, the degree of comparability is generally less than that required under Resale Price or Cost Plus.
- The conflict therefore lies in the prevalent use of CPM in the U.S., but in Revenue Canada's refusal to accept CPM. While TNMM may come close to approximating CPM, we have already seen that this method will not likely be used a great deal in Canada. Where TNMM is used, it would seem that at least a residual or contribution profit split ought also to be completed as a check and balance.
- This all suggests that use of profit-based methods in Canada will be held up to intense scrutiny, making transactional based methods the "methods of choice" for taxpayers wishing to avoid controversy in this area. Again, use of Profit-Based Methods in generally may best be restricted to a "Check-Balance" approach to the more traditional transactions methods. The practical problem, of course, remains finding comparable and reliable information necessary to support the traditional methods.

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Intangible property

- The application of the arm's length principle to transfers of intangible property ('IP") often raises specific issues associated with the difficulty and uncertainty sometimes encountered with attributing an arm's length value to such transfers.

  Note: The difficulty might be traced to the very fact that the distinctive uniqueness of MNEs can often be directly linked to the IP enjoyed within the MNE. Attempting to find "comparable transactions" to measure the transfer of IP in the MNE context might therefore be viewed as somewhat of an oxymoron.

- Nonetheless, the cross-border transfers of IP and other technology is a modern reality. In this context, the OECD released Chapter VI of its Guidelines in March 1996, and has attempted to describe the commercial intangibles (e.g., patents, trademarks, proprietary processes, design technology, research and development capability, corporate name and logo, supply/sales contracts, marketing strategies/concepts, etc.), and the issues of determining whether IP in fact exists, and then valuing it based on an arm's length principle.

- The OECD Position was in response to the U.S.'s initial moves towards a "superroyalty" provision, and its most recent emphasis on "comparable uncontrolled transactions" ("CUT"). While rejecting the initial U.S. disposition to using hindsight to determine proper pricing for IP (under its "commensurate with income" approach), and in choosing to use what independent enterprises would have done on the basis of information available at the time, the OECD's Guidelines may well prove to be inadequate in their own right. While identifying and discussing many potential outstanding issues, the Guidelines do not provide much in the way of specific workable methods.

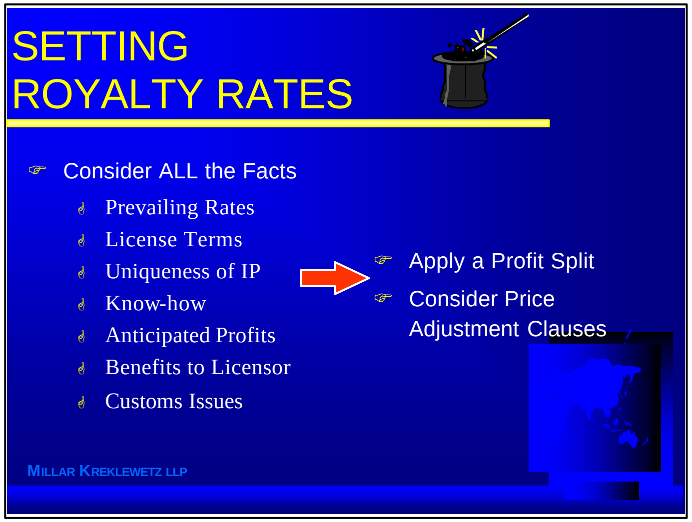
- Revenue Canada may have adopted almost carte blanche the OECD's limited attempts in this area. The result may well a set of guidelines which are less useful than might otherwise have been the case.

  For example, CUP is generally unworkable unless very particular situations (e.g., genuine third party offer exists, creating a "comparable"). Revenue Canada also takes the view that CUP could apply where "comparable intangible property has been sold or licensed to arm's length parties"; but would this be commonplace ?

  Where IP is highly valuable or unique, it is also highly improbable that secondary methods like "cost plus" methods would be available. In terms of Cost Plus, the reality is that *costs* would not likely be representative of successful development of the IP.

- For its part, Revenue Canada takes the view that the "profit split method" is most reliable here, and the best approach may well be a blend of the transaction and profit-based methods referred to above, perhaps with a full evaluation of all possible impacts on the value of the IP. Emphasis could also be placed, if possible, on the types of controls independent parties agree on (e.g., shorter term licenses, price adjustment clauses, etc.).

- Cost Sharing Arrangements might be entered into to avoid some of these difficulties (See also: IT-303). For example, have a Canadian Entity enter into a CCA with Foreign Entity, with both



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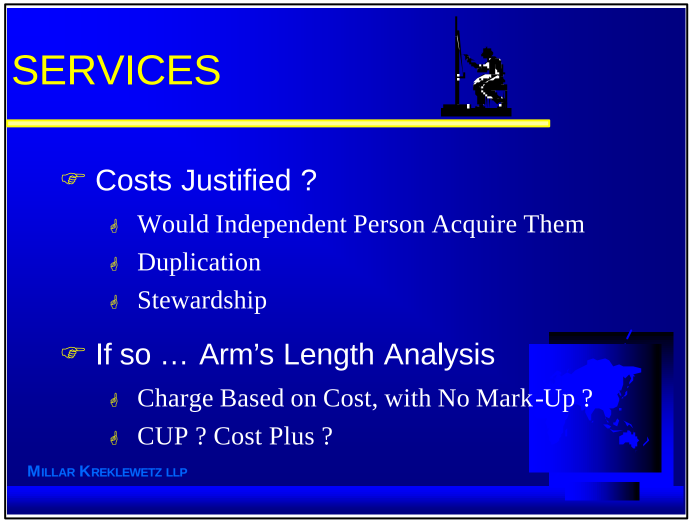

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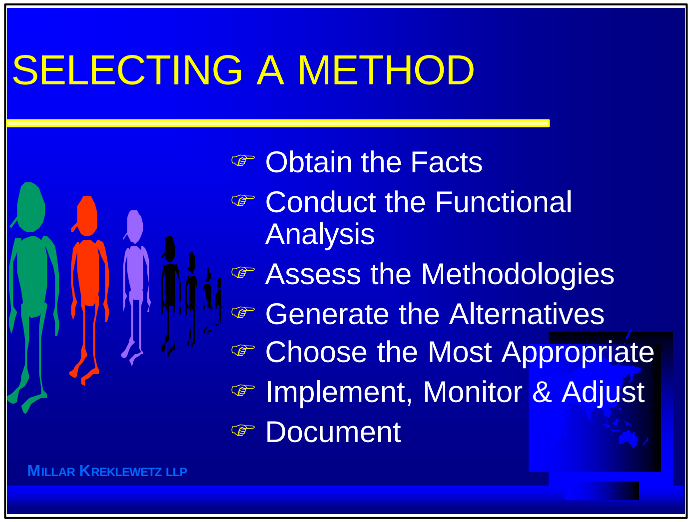
Services

- Revenue Canada (and the OECD Guidelines) deal with services in two parts. First, were the services provided in the MNE context truly *justified:* was the charge for a particular service . Second, and only where the service was in fact justified, *what is an appropriate amount to charge for the services*.
- To determine whether a charge is justified, Revenue Canada has generally maintained the old rules under IC-87R. This is now reflected in paragraphs 65 through 67 of the new circular, where Revenue Canada indicates, in general terms, the following:
  1. A simple and generally appropriate test to determine if a charge for an activity is justified, is *whether the entity for whom the activity is being performed would either have been willing to pay for the activity if performed by an independent entity*. Where it would not have been reasonable to expect the entity to either pay an independent entity for the activity or to perform it itself, it is unlikely that a charge for the activity would be justified.
  2. Duplication of Services is not generally allowable, unless in very specific circumstances, and a good business reason (e.g., necessary redundancy in operations, as in computer equipment and services).
  3. Costs are incurred for the sole benefit of shareholders (i.e., formerly referred to as "custodial or stewardship expenses") should not be charged to other members of the group. However, where certain costs are incurred specifically for other members of an MNE group (e.g., fund-raising costs incurred on behalf of a foreign subsidiary), it may nevertheless be appropriate to attribute the costs to that other member.
- Where a charge for a service is justified, Revenue Canada indicates that the amount charged "should be determined in accordance with the arm's length principle." Unfortunately, and apart from discussing some basis issues regarding the "profit component" in service charges (e.g., whether always necessary in an arm's length context), Revenue Canada (and the OECD Guidelines for that matter), do not provided that much help in understanding which methods may be most appropriate to services.
- On the other hand, Revenue Canada is clear that the matter of an arm's length price must be determined from the standpoint of *both* the supplier and the *recipient* of the service, perhaps allowing for charges based only on the "cost" of the services, with no commercial mark-up, with Revenue Canada agreeing that in principle, "[a]n arm's length charge does not necessarily include a profit element".
- Contrary to the OECD position, the 482 Regulations in the U.S. presume that the arm's length value of a service is equal to the costs of providing it, with exceptions only where the services are an "integral part" of either party's business activities. If the exception does not apply, services are generally priced "at cost", unless specific arm's length methods demonstrate that a mark-up should be included (e.g., under CUP, etc.) The "integral part of business activity" test where the provides is "peculiarly capable" to render the services, and such services are a principal element in the



Selecting an Appropriate Transfer Pricing Methodology

1. **OBTAIN THE INTERNAL FACTS.** Follow-up information requests with all operational aspects of your business involved in cross-border movements of goods, services, and intangibles. Get the costs of doing so, and find out what the current pricing strategies are. Understand your business, and its international dealings. Identify the "reportable transactions".

   OBTAIN THE EXTERNAL FACTS. Once internal transactions have been identified, search out possible "comparable" situations in your business (i.e., which your company has been involved), and in your particular industry (i.e., which involve similar property or services, in similar circumstances).

   CUP: Does your supplier supply the same goods or services to third parties (internal comparable) ? Do you acquire the same goods or services from third parties (internal comparable) ? Are there any independent parties supplying or acquiring the same goods or services under similar conditions ?

   Resale Price: Does your supplier supply similar goods to other third parties, such that a comparable gross margin could be obtained ? Do third parties sell similar products, while performing the same functions and assuming the same risks ?

   Cost Plus: Does your supplier supply similar goods to other third parties, such that a comparable gross margin could be obtained ? Do third parties sell similar products, while performing the same functions and assuming the same risks ?

3. **CONDUCT A FUNCTIONAL ANALYSIS** of each "transaction". Consider dealing with transactions by business unit. Develop a complete financial analysis of each business unit, including all controlled and uncontrolled transactions.

4. **ASSESS EACH OF THE "RECOMMENDED" TRANSFER PRICING STRATEGIES**, against the available comparables, and adjust for material differences as best as possible.

5. **GENERATE POSSIBLE "REASONABLE" ALTERNATIVES.**

6. **CHOOSE THE MOST APPROPRIATE/"RELIABLE" METHODOLOGY** from the reasonable alternatives generated.

7. **IMPLEMENT** the transfer pricing methodology, **MONITOR** the results, and **UPDATE** the methodology on an regular (no less than annual) basis for any material changes in circumstances.

8. **DOCUMENT** each and every step of the process. In the final analysis, the information which has been relied upon should be grouped and held for Revenue Canada audit. Other information not relied on should be kept on a confidential basis. **(Recall the "Confidentiality of Information" for pro-active strategies to "Protect Your Treasure Map")**.

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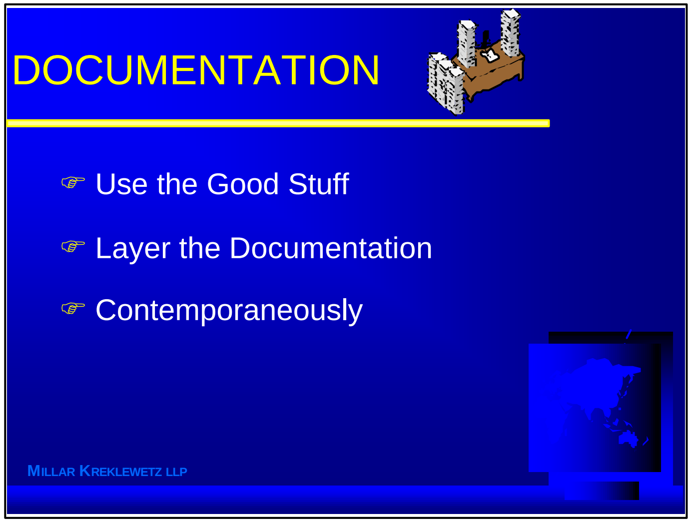

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Documentation Requirements

- IC 87-R2 describes documentation requirements as requiring that which *principles of prudent business management* would demand. "A prudent businessperson would attempt to weigh the significance of the transactions in terms of its business with the additional administrative costs required to prepare or obtain such documentation. Therefore, the obligation to find comparable transactions for purposes of applying the arm's length principle is not an absolute one, but may take into account the cost and likelihood of finding such comparables relative to the significance of the transactions to the taxpayer."
- While these sentiments seem to follow directly from recommendations in the OECD Guidelines (see for example Paragraph 5.4), it is difficult to imagine how a Revenue Canada auditor -- as the "policeman" of the rules -- could either "weigh the "business significance" of the transactions against "the additional administrative costs" required to prepare or obtain such documentation, or to imagine a Revenue Canada auditor with the powers to determine whether a particular business was reasonable in this light. Accordingly, while Revenue Canada may indicate that the obligation to find comparable transactions is *not* an absolute one, the practical reality may be that more often than not, documentation to this effect will be requirement.
- Perhaps more problematic is the adoption of a new legislative "deeming rule" in proposed section 247(4), which creates a *reverse onus* provision by deeming a taxpayer *not* to have made reasonable efforts to determine and use arm's length transfer prices *unless* the taxpayer makes or obtains, within 60 days after the end of the taxation year/ fiscal period *records or documents* which provide a complete and accurate description of:

  (i) the property or services to which the transaction relates,

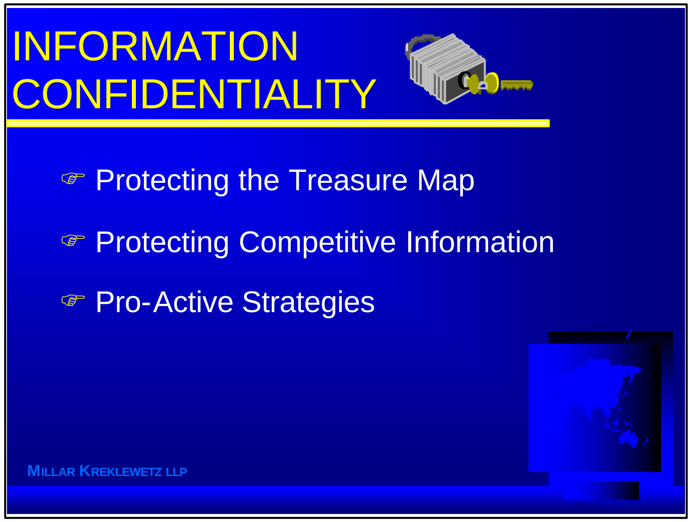
  (ii) the terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the participants in the transaction,

  (iii) the identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into,

  (iv) the functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction,

  (v) 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, as the case may be, in respect of the transaction, and

  (vi) the assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction;
- Additional requirement is that such records be made and retained each year thereafter, within 60 days of the year end, and be provided to Revenue Canada within 60 days of a written request therefor. **In fact, the text of the rules make it clear that the documentation referred to in items**



Confidentiality of Information

- First things first: Protect the Treasure Map
- Second, think about protecting your confidential information: Revenue Canada is generally required to keep all information forwarded to it confidential. However, while these rules may apply in the course of an audit, all bets are off in the course of litigation, where Revenue Canada may be forced to release *your information* to *your competitor.* This follows a significant exception to the confidentiality rules in section 241(4)(b) of the ITA which provides that where legal proceedings have commenced with respect to the assessment issued, namely where the taxpayer has filed a Notice of Appeal with the Tax Court of Canada, the Department may well release the details on the comparables to the taxpayer assessed.
- Adopt proactive strategies to ensure that your business is not compromised in these fashions.

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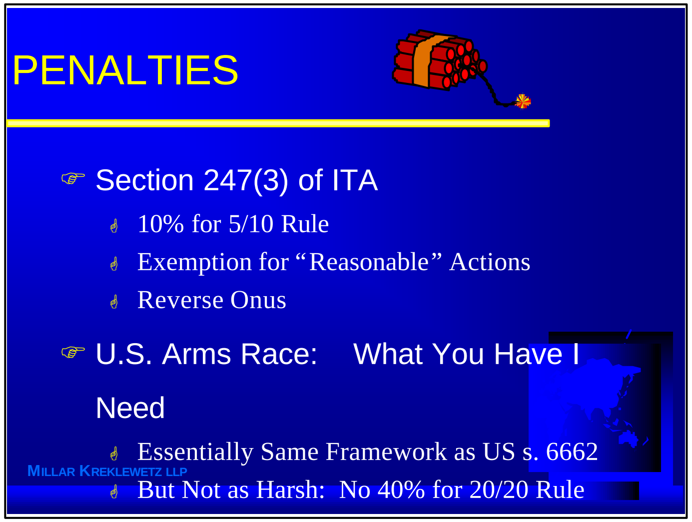

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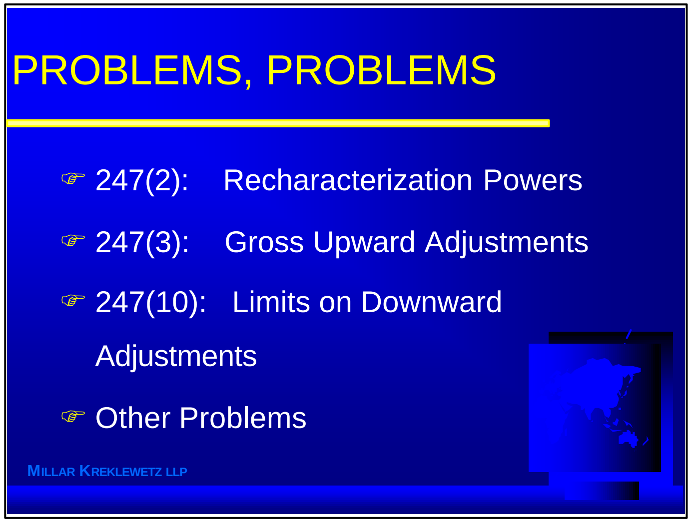
Penalties

- The draft legislation contains section 247(3) which imposes a penalty equal to 10% of the total of the transfer pricing income (and capital adjustments) of transactions in which a taxpayer has failed to make reasonable efforts to determine and use arm's length transfer prices. Whether a taxpayer has made reasonable efforts to determine and use arm's length transfer prices or allocations is generally a question of fact, although a special deeming rule in section 247(4) provides a limited legislative exemption where certain contemporaneous documentation is kept. Unfortunately, the exemption is not the sort of "safe harbour" most taxpayer's would expect, since it essentially operates as a reverse onus clause, by actually deeming a taxpayer *not* to have made reasonable efforts to determine and use arm's length transfer prices *unless* certain rather onerous documentation requirements are fulfilled (see below).
- Significantly, Revenue Canada indicates that it will generally considers reasonable efforts to require *the application of a recommended method.*
- The imposition of penalties in these instances is similar to the U.S. "misstatement" penalties. Under the U.S. legislation, similar reporting requirements must be complied with by taxpayers on a regular basis in order to fall within the exemption from income misstatement penalties. The old U.S. "reasonable cause and good faith" exception was replaced in 1993 with precise documentation and reporting requirements. In all instances, contemporaneous documentation is required, with the taxpayer required to prepare, at the time a tax return is filed, documentation supporting and substantiating the transfer pricing methodology selected.
- In reality, it is likely that Canada is simply "catching up" on this initiative which, in the U.S., was put in place to deal with the problems encountered by the IRS in obtaining appropriate information to enable it to pursue pricing examinations on a timely basis, particularly with respect to U.S. activities of foreign-based entities.
- While the OECD Guidelines attempt to caution against overly harsh penalty systems, and are generally critical of penalties where "good faith" and "reasonable" attempts to comply with the objectives of the transfer-pricing rules are made (e.g., see Paragraphs 4.26 and 4.28), experience in other areas of the Income Tax and GST requiring "reasonable efforts" and "good faith" indicate that Revenue Canada's notions of these concepts may well be on a total different level than most others'.
- Given the potential for stiff penalties, there are some concerns that might be raised in the context of the "substantive" allocations provision in section 247(2), which on its face, might pose a number of issues for taxpayers (see below).



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Problems with the Substantive Allocation Rule

- Having described how Revenue Canada's transfer pricing rules seem intended to operate, there are a number of issues that seem to create problems.
- First and foremost are Revenue Canada's powers to "recharacterize" a non-arm's length transactions, seemingly, as it see fit. While the OECD Guidelines also took the view that in *limited instances* it might be necessary to recharacterize a transaction for tax purposes, Revenue Canada may have take a few giant leaps forward from this position, particularly given the constant reference to "recharacerizations" in the legislation.
- In ordinary circumstances, however, Revenue Canada has indicated that it will generally accept business transactions as they are structured by the parties. Consistent with OECD Guidelines, the two types of situations where the recharacterization of a transaction would be considered are:

  (1) *Where Substance of Transaction Differs from its Form.*

  Revenue Canada indicates that where the form of a transaction does not accurately reflect its "substance", it will be subject to recharacterization.

  <u>Example</u>: Investment in a related enterprise in the form of interest-bearing debt, where arm's length parties would have structured their investment as a subscription of capital.

  (2) *Transaction Not "Commercially Reasonable".*

  Revenue Canada indicates that where a transaction differs from that which independent enterprises behaving in a commercially rational manner would have entered into, *and* the structure of the transaction makes it nearly impossible to determine an appropriate transfer price, it will be subject to recharacterization.

  <u>Example</u>: Taxpayer performing research sells, for a lump sum payment, unlimited entitlement to intellectual property it is developing. Arm's length parties would not have structured the transaction in this manner. In such cases, the Department might seek to recharacterize the transaction, for tax purposes, as a form of continuing research agreement.
- While having a seemingly innocuous intention behinds its powers, the powers are extensive, and might well be far in excess of the sorts of powers envisioned at the OECD.
- Other problems included that fact that the rules regarding transfer pricing adjustments (for income and capital) provide for net adjustments, but the penalties provision in section 247(3) takes into account only gross upward adjustments.
- Another issue is the quite unintelligible limitation put on the power to make a *downward* adjustment to transfer pricing income or capital found in section 247(10).

Interplay with Customs Valuation Rules

- Revenue Canada, now integrated as between its Customs, Excise and Taxation functions, is surprisingly on record as indicating that the methods for determining value for duty under the current provisions of the *Customs Act* may not have perfect symmetry with the transfer pricing rules used by Taxation.
- As such, Revenue Canada is taking the position that it is under "no obligation to accept the value reported for duty when considering the income tax implications of a non-arm's length importation."
- While somewhat anomalous, this approach is generally consistent with Custom's historical position, and is indicative of the problems facing taxpayers involved in Customs Valuation reviews: they are faced with a "whipsaw", with high customs values being assessed by Canada Customs, but no ability to translate those assessments into positive income tax implications.
- The situation in the U.S. may differ somewhat, as the Internal Revenue Code has rules (e.g., section 1059A) aimed directly at ensuring that a valuation for U.S. Customs purposes be the same, subject to certain limitations, as an acceptable transfer price for U.S. Taxation purposes.

  Note: While initially meant as a "sword" for use by the IRS in combating possible tax avoidance strategies amongst related parties (e.g., importing at a low price, but selling for income tax purposes at a much higher price), the rules may also be available to taxpayers as a "shield", preventing U.S. Customs and the IRS from arriving at similarly asymmetrical results.

- Unfortunately, these rules do not function to absolutely preclude asymmetry, and the U.S. is still far away from a perfectly symmetrical environment. While a dialogue exists aimed at developing a means of addressing both tax and customs issues in the U.S., not formal procedures have yet been developed.

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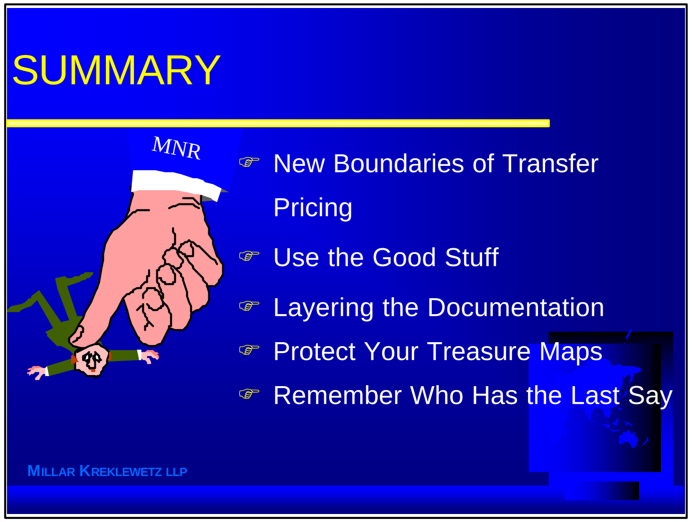

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- A key issue in the years ahead may not be the methods to be used for determining and testing transfer prices, but rather the economic and political struggle for tax revenues within and between major countries. Accordingly, it is likely that tax audits of MNEs will increase in both intensity and sophistication. The scope and direction of those audits will be facilitated and influenced by existing and perhaps further expanded information requirements with respect to the operations, structuring, and intercompany transactions of MNEs.

- Increasing audit activity, as then Minster of National Revenue Jane Stewart indicated contemporaneous with the February 18th Budget that the federal government would be spending some $30 million over the next three years to monitor the implementation and compliance of Canada's new transfer pricing rules.

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