Department of Finance Canada | Ministère des Finances Canada

Consultation on Reforming and Modernizing Canada's Transfer Pricing Rules

Canada

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Overview

Canada's international tax rules are reviewed on an ongoing basis as a part of the government's efforts to protect the Canadian tax base and ensure tax fairness. The government is committed to continuing to improve the integrity of its international tax rules. Budget 2021 announced the government's intention to consult on Canada's transfer pricing rules with a view of protecting the integrity of the tax system while preserving Canada's attractiveness as a destination for new investment and business activity.

Transfer pricing legislation requires that, for tax purposes, transactions involving entities of a multinational group must reflect the arm's length principle. This means that the conditions that differ from those that would have been applied by independent parties are taken into account, to ensure the appropriate amount of profit is reported in Canada. This proposal seeks to bring the application of the arm's length principle in Canada's transfer pricing rules in line with the current international consensus.

Our Objective

The government is carrying out this consultation in order to gather stakeholder input on a range of questions and proposals related to Canada's transfer pricing legislation. This legislation incorporates the arm's length principle into Canadian tax law. The main proposal concerns possible amendments to the transfer pricing adjustment rule in section 247 of the *Income Tax Act*.[1] These changes would provide greater clarity on the application of the arm's length principle in Canada in line with international consensus. This consultation also provides the opportunity to consult on administrative matters connected to transfer pricing, including documentation and penalty provisions and the possibility of adopting more modern or simplified approaches in specific situations.

When Canada introduced its transfer pricing legislation, section 247 of the *Income Tax Act*, in 1997, it took a high-level approach. The legislation does not make explicit how the arm's length principle should apply. Generally speaking, the legislation of countries with more modern transfer pricing legislation tends to contain significantly more detail. Transfer pricing thinking has also evolved since Canada's rules were first introduced.

The decision in *Her Majesty The Queen v Cameco Corporation*[2] has highlighted issues with Canada's domestic transfer pricing rules.[3] In particular, the lack of detail in the current version of

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1 RSC 1985, c1 (5th Supp) [the Act]. Unless otherwise noted, statutory references are to the Act.

2 2018 TCC 195 [*Cameco* TCC], aff'd *The Queen v Cameco Corporation*, 2020 FCA 112 [*Cameco* FCA], leave to appeal to SCC refused, 39368 (February 18, 2021) [Collectively referred to as "*Cameco*"].

3 A second recent case raised similar issues. (AgraCity Ltd and 101072498 Saskatchewan Ltd. v Her Majesty The Queen, 2020 TCC 91 [AgraCity].)

section 247 on the determination of the starting point of the comparison at the heart of the arm's length principle and on the operation of the comparison itself has led to an overemphasis on intra-group contracts, rather than on the factual substance of transactions. This has led to outcomes in which the profit allocations between the Canadian and non-resident taxpayer were at odds with the economic contributions of the parties. Taking into account the Courts' reasoning, the government believes that, without reform, the current transfer pricing rules permit the shifting of excessive amounts of income out of Canada, which adversely affects the Canadian tax base.

Sections II-IV of this paper discuss the need to review subsection 247(2), which provides for a transfer pricing adjustment. Section II discusses the international consensus on the application of the arm's length principle as expressed in the *Transfer Pricing Guidelines*. Section III describes the current state of Canadian transfer pricing tax law in light of this consensus. Section IV outlines proposed amendments to section 247. Included in section IV is a discussion of a possible role for the *Transfer Pricing Guidelines* in Canadian transfer pricing tax law and a potential non-recognition and replacement rule that would apply in specific situations. Draft legislative proposals are included in Appendix A.

Section V of this paper discusses administrative aspects of transfer pricing, including transfer pricing documentation, penalty provisions, possibilities for simplification or streamlining, and a discussion of the BEPS Action 13 Master file requirement.

Appendix B provides a listing of terminology and short forms used throughout this paper. Appendix C provides extracts from the legislation and regulations of certain other jurisdictions.

International Consensus on the Application of the Arm's Length Principle

Transfer pricing rules are used for tax purposes to allocate income or losses among the various entities of an MNE group. These rules direct inquiry into the conditions of the commercial or financial relations of associated enterprises. The proper application of these rules is important, as they determine the allocation of income (including losses) between Canadian taxpayers and non-resident entities with whom they do not deal at arm's length.

Because transfer pricing is a tax matter facing all MNE groups and because trade within MNE groups accounts for a significant share of international trade, the financial and economic magnitude of this area of tax law is significant. Canadian tax data show that in 2021, non-arm's length transactions with non-residents both into and out of Canada amounted to approximately $1.3 trillion (not including inbound and outbound capital flows in the form of debt and equity investments). Therefore, the pricing of these amounts has an important impact on corporate income tax revenues.

The accepted international standard for determining transfer pricing for tax purposes is the arm's length principle. This principle is set out in Article 9 (Associated Enterprises) of the OECD Model Tax Convention, which serves as the basis for the majority of concluded tax treaties and is included in Canada's tax treaties.[4] Generally, the OECD Model Tax Convention pursues the goal of taxing business profits where they originate economically. In the associated enterprises context, this policy goal finds expression in Article 9. The rationale for, and operation of, the arm's length principle in the OECD Model Tax Convention is set out briefly below.

When independent enterprises do business with one another, market forces will generally determine the conditions. However, when members of an MNE group do business with one another, they do not typically have independent and opposing interests. As a result, market forces will not necessarily come into play. Recognizing that MNE groups may establish conditions in their intra-group relations that differ from those that would be established between independent enterprises and that such differences may result in distortions in the profits accrued by associated enterprises, the arm's length principle requires that the profits accrued by associated enterprises be in accord with the profits that would have accrued had the conditions been those that would have been made between independent enterprises. The arm's length principle pursues a goal of tax parity between associated and independent enterprises.

Paragraph 1 of Article 9 of the OECD Model Tax Convention provides:

> [Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

While the basic articulation of Article 9 of the OECD Model Tax Convention has not changed since 1963, international thinking on transfer pricing and its application has evolved. Because transfer pricing under Article 9 involves the allocation of profits in at least two jurisdictions, the risk of tax disputes and economic double taxation is real. Recognising the importance of a common approach to, and the need for, additional guidance on the application of the arm's length principle so as to minimize the possibility of disputes between taxpayers and tax administrations and between different tax administrations, the countries of the OECD develop and keep up-to-date the *Transfer Pricing Guidelines*. These are developed in consultation with industry and used extensively by governments and the private sector.[5]

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4 The United Nations also adopts the arm's length principle in its model tax convention. See: UN Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries 2021 Update*, ST/ESA/378, online: un.org < [UN Model_2021.pdf] >.

5 Recommendation of the Council on the Determination of Transfer Pricing between Associated Enterprises OECD C(95)126/Final, as amended, reproduced in 2022 Guidelines, p 653.

The *1995 Guidelines* were amended by the *2010 Guidelines*. Following the completion of work resulting in the publication of the *BEPS 8-10 Final Report*, the *2017 Guidelines* were published. The most recent version, the *2022 Guidelines*, sets out new or updated guidance in specific areas including with respect to financial transactions, hard-to-value intangibles and the transactional profit split method.[6]

The *Transfer Pricing Guidelines* provide three types of guidance: general guidance on the application of the arm's length principle; guidance on administration; and detailed guidance on the application of the arm's length principle in specific situations. General guidance for the application of the arm's length principle is set out primarily in Chapter I. Chapters II and III provide additional general guidance. Guidance on administration and documentation of transfer pricing arrangements is set out in chapters IV and V while the remaining chapters VI through IX provide guidance on specific situations. The present discussion focuses on the *Transfer Pricing Guidelines*' general guidance in chapters I to III.

A. Comparability Analysis

The Transfer Pricing Guidelines state that comparability analysis is at the heart of the application of the arm's length principle.[7] Controlled transactions are the result of the commercial or financial relations between associated enterprises. Controlled transactions are assessed in the light of comparable uncontrolled transactions. The rationale underlying this comparison is that independent enterprises, when evaluating the terms of a potential transaction, will consider the options available to them, consider differences between options, and choose the option that best meets their individual commercial objectives.[8]

The purpose of the comparison is to determine whether the conditions (including, but not limited to prices) operating between the parties to the controlled transaction differ from the conditions that would have been made between independent enterprises in comparable circumstances. If there is a difference that results in an understatement of the profits accrued by a given associated enterprise, then it is necessary to correspondingly increase its profits for the purposes of calculating its tax liabilities.[9]

The comparability analysis has two main steps:

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6 OECD, News Release, "OECD releases latest edition of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (January 20, 2022) online OECD.org <OECD releases latest edition of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations - OECD>.

7 2022 Guidelines at 1.6.

8 2022 Guidelines e.g., at 1.38, 1.40.

9 2022 Guidelines at 1.7.

1. identify the commercial and financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order to accurately delineate the controlled transaction (Step 1); and
2. compare the conditions and economically relevant circumstances of the controlled transaction (as delineated) to the conditions and economically relevant circumstances of comparable transactions between independent enterprises (Step 2).[10]

The *Transfer Pricing Guidelines* provide that economically relevant characteristics are used in Step 1 to accurately delineate the controlled transaction and in Step 2 to determine whether a potential comparable uncontrolled transaction is in fact comparable to the controlled transaction and what adjustments, if any, are necessary to achieve comparability.

The *2022 Guidelines* identify the economically relevant characteristics as:

1. the contractual terms of the transaction;
2. the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices ("functional analysis");
3. the characteristics of property transferred or services provided;
4. the economic circumstances of the parties and of the market in which the parties operate; and
5. the business strategies pursued by the parties.[11]

The purpose of Step 1 is to establish a starting point for the comparison in Step 2. It requires the accurate delineation of the controlled transaction. This process is discussed in section D.1 of the *Transfer Pricing Guidelines* and involves identifying the controlled transaction with reference to its economically relevant characteristics.[12] The accurate delineation of the controlled transaction establishes the factual substance of the relations between the parties.

Determining the controlled transaction with reference to its economically relevant characteristics supports the rationale set out above, that independent enterprises will consider their options and choose the option that best meets their commercial objectives. Delineating the controlled transaction "reveals the range of characteristics taken into account by the parties to the transaction in reaching the conclusion that there is no clearly more attractive opportunity realistically available to meet their commercial objectives than the transaction adopted."[13] Put

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10 2022 Guidelines at 1.33.

11 2022 Guidelines and 2017 Guidelines at 1.36. See also: 2010 Guidelines at 1.39 et seq; and 1995 Guidelines at 1.19 et seq.

12 The economically relevant characteristics are also referred to as "comparability factors" in the *Transfer Pricing Guidelines*.

13 2022 Guidelines at 1.38.

otherwise, this exercise reveals the commercial interests of the parties to the controlled transaction posited as separate entities.[14]

In delineating the controlled transaction, the relevance of any given economically relevant characteristic is determined based on the extent to which it would have been taken into account by the participants to the controlled transaction had they been dealing at arm's length.[15]

In Step 2 the delineated controlled transaction is compared to a comparable uncontrolled transaction. Controlled and uncontrolled transactions are comparable if none of the differences between them could materially affect a condition relevant to the transfer pricing method(s) being applied, or a reasonably accurate adjustment can be made to eliminate the effect of the difference.[16]

The selection of the transfer pricing method takes into account:

- the respective strengths and weaknesses of the method or methods,
- the appropriateness of the method or methods considered in view of the nature of the controlled transaction with particular reference to the functional analysis,
- the availability of reliable information needed to apply a method or methods, and
- the degree of comparability between the economically relevant characteristics of the controlled transaction and the economically relevant characteristics of a potentially comparable transaction, or of potentially comparable data used to apply a transactional profit method, including the reliability of any modifications made to eliminate the effect of material differences between them.[17]

The standard for selection of a transfer pricing method is the most appropriate method for a particular case.[18]

As set out above, the comparison directs scrutiny on the conditions (including, but not limited to prices) operating between the parties to the controlled transaction to determine whether they differ from the conditions that would have been made between independent enterprises in comparable circumstances. The term "conditions" in this context has a broad scope and goes beyond the terms of the relevant contract(s). While the *Transfer Pricing Guidelines* do not define "conditions", they state that conditions include prices, but are not limited to prices.[19] A related OECD document provides that "conditions" include the financial indicators proper to the transfer pricing method(s) applied and the features beyond financial indicators that are relevant in

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14 The separate entity approach which underlies the arm's length principle of Article 9 is discussed at paras 5-7 of the Preface to the *2022 Guidelines*.

15 2022 Guidelines at 1.37.

16 *2022 Guidelines*, Glossary *s.v.* "Comparability analysis".

17 2022 Guidelines at 2.2.

18 2022 Guidelines ch II.

19 *2022 Guidelines* at para 1.7.

applying transfer pricing methods.[20] Other countries also have transfer pricing rules that provide for a broad conception of "conditions".[21]

Just as "conditions of the controlled transaction" has a broad scope, the economically relevant characteristics is also a broad category of factors, not limited to those resulting from intra-group contracts and other formal arrangements. This is particularly important in the transfer pricing context because intra-group relations have special characteristics that can affect, among other things, their intra-group contracts.

Contracts normally involve two parties who have separate interests coming to consensus with a view to each realizing a gain. Yet, in the case of intra-group contracts, an MNE group generally looks to the overall interests of the group, rather than those of its individual entities. While the rights and obligations arising from contracts are generally binding on the parties, intra-group contracts may be concluded, amended or cancelled without the need to address market pressures that apply between arm's length parties (including between members of the MNE group and its arm's length counterparties).

An over-emphasis on the role of intra-group contractual arrangements in assessing the arm's length nature of an MNE group's transfer pricing arrangements is problematic because it can lead to outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of the MNE group. Concerns with such outcomes led to the work on Actions 8-10 of the BEPS project.

B. The BEPS 8-10 Final Report

The *BEPS 8-10 Final Report* described the problem of manipulation of the arm's length principle in the following terms:

> However, with [the arm's length principle's] perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has also proven vulnerable to manipulation. This manipulation can lead to outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of an MNE group.[22]

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20 OECD, *Transfer Pricing Legislation – A Suggested Approach (June 2011)*, online: oecd.org <3. TP_Legislation_Suggested_Aproach.pdf (oecd.org)>.

21 Australia ITAA 1997 s 815-105 et seq ("actual conditions"). See also: Austl, Commonwealth, Tax Law Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 Explanatory Memorandum, at 3.40-3.45. UK Taxation Act 2010 s 147 et seq ("provisions"). See also: UK, HM Treasury, Explanatory Notes to The Finance (No. 2) Bill 1998 at para 41 of clause 106, cited in (1) DSG Retail Limited (2) Mastercare Coverplan Service Agreements Limited (3) Mastercare Service and Distribution Limited v The Commissioners for Her Majesty's revenue and Customs, (2009) UKFTT 31 (TC) at para 66.

22 BEPS 8-10 Final Reports at p. 9.

The *BEPS 8-10 Final Report* introduced a number of changes to the *Transfer Pricing Guidelines*. In particular, the report introduced significant amendments to section D Chapter I of the *Transfer Pricing Guidelines* ("Guidance for applying the arm's length principle"). These changes developed guidance to ensure that:

- actual business transactions undertaken by associated enterprises are identified and transfer pricing is not based on contractual arrangements that do not reflect economic reality;
- contractual allocations of risk are respected only when they are supported by actual decision-making;
- capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to cash boxes without relevant substance; and
- tax administrations may disregard transactions when the exceptional circumstances of commercial irrationality apply.[23]

Amendments introduced to the *Transfer Pricing Guidelines* by the *BEPS 8-10 Final Report* included emphasizing the importance of identifying the controlled transaction according to its conditions (including prices, but not only prices) and the necessity of analyzing the transaction in light of its economically relevant characteristics, together with expanded guidance on these characteristics.[24] In particular, this expanded guidance focused on the analysis of risks of the controlled transaction.[25] When this analysis is completed, the controlled transaction is accurately delineated and as a result the factual substance of the controlled transaction will have been identified.[26]

C. Recognition of the Controlled Transaction

Generally, the arm's length principle is implemented through a transfer pricing adjustment rule, which applies to the transaction as structured by the taxpayer without regard to whether there was a tax avoidance motivation. In this regard, the *Transfer Pricing Guidelines* have consistently provided that the fact a controlled transaction is not seen between independent parties, or that a comparable cannot be identified on its own, does not mean that a controlled transaction satisfies the guidance for non-recognition and replacement discussed below.[27]

However, this application of the transfer pricing adjustment rule to the transaction as structured by the taxpayer does not have the effect of extending to taxpayers unlimited discretion as to how their transactions are analyzed for tax purposes.

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23 BEPS 8-10 Final Report p. 13.

24 BEPS 8-10 Final Report at p. 16.

25 See *2022 Guidelines* at section D.1.2 (Functional analysis).

26 *2022 Guidelines* at *e.g.*, 1.139-1.140.

27 *e.g.*, *2022 Guidelines* at paras 1.142 and 9.35.

In the first instance, respecting the transaction as structured by the taxpayer does not mean that the transaction analyzed narrowly reflects all of the information necessary to apply the arm's length principle. This shortfall often stems from the absence of market pressures in the constitution and execution of intra-group arrangements. As set out in the discussion of Step 1 above, it is necessary, in all cases, to identify the commercial and financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order to accurately delineate the controlled transaction prior to moving to Step 2.

In the second instance, respecting the transaction as structured by the taxpayer does not entail respecting the nature of amounts assigned by a taxpayer to the transactions for tax purposes.[28]

The effect of these two limitations on the discretion of the taxpayer to determine how transactions are analyzed for tax purposes will ensure that, generally, following delineation of the controlled transaction, the transfer pricing adjustment rule will apply to determine arm's length conditions. Depending on the transfer pricing policies implemented by an MNE group, this determination may or may not result in a transfer pricing adjustment.

The *Transfer Pricing Guidelines* further provide that there can be circumstances in which a controlled transaction as structured by a taxpayer should not be recognized (respected) for the purposes of applying the arm's length principle and set out conditions that must be met in order for it to be appropriate to disregard (*i.e.*, not recognize) a transaction as structured.[29]

In particular, it will be appropriate to disregard the actual transaction where the arrangements made in respect of 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; and
- prevent the determination of a price that would be acceptable to both parties taking into account
  - their respective perspectives, and
  - the options realistically available to each of them.

This guidance provides that where the circumstances for non-recognition justify it, tax administrations should replace the transaction used by the MNE group with a transaction that comports as closely as possible to the actual transaction, while achieving a commercially rational

28 In Canada, subsection 247(2) provides for the adjustment of the nature, as well as the quantum, of amounts under the transfer pricing adjustment rule.

29 2022 Guidelines, 2017 Guidelines and 2010 Guidelines, Chapter I, section D.2, 1995 Guidelines, C(ii).

expected result that would have enabled the parties to come to a price acceptable to both of them at the time the arrangement was entered into.[30]

This non-recognition and replacement rule protects tax bases from the unadjusted profit allocations that would result from such commercially irrational transactions by replacing them with a controlled transaction that has a commercially rational expected result and that can be priced from the point of view of arm's length parties taking their individual interests into account.

This non-recognition and replacement rule is discussed further in section 0 below.

The Current State of Canada's Transfer Pricing Tax Law

The arm's length principle is only a statement of principle. In most jurisdictions, including Canada, domestic transfer pricing legislation is required to make the principle operative. Canada adopted its transfer pricing legislation in 1997. This legislation is contained in Part XVI.1 of the Act. Since that time, the substantive provisions adopting the arm's length principle into Canadian tax law have not been subject to amendment.[31]

A. Overview of Canadian Transfer Pricing Legislation

The Canadian legislation takes a high-level approach; it does not explicitly detail how the arm's length principle should apply. Generally speaking, the legislation of jurisdictions with more recent transfer pricing legislation provides more detail.[32] Together with the development of the *Transfer Pricing Guidelines* since 1995, the question has arisen as to whether Canada's transfer pricing legislation should provide additional guidance on the application of the arm's length principle.

The guidance that is not set out explicitly in Canada's domestic transfer pricing legislation can be assessed in two broad groupings: (i) guidance with respect to establishing the starting point of the comparison; and (ii) guidance with respect to how the operation of the comparison itself is to be carried out. Each of these is discussed next, together with recent Canadian transfer pricing case law. A possible role in Canadian transfer pricing tax law for the *Transfer Pricing*

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30 *2022 Guidelines* at para 1.144.

31 Amendments to Part XVI.1 have included the introduction of subsections (12)-(15) addressing secondary adjustments (SC 2012, c 31, s 54) and of subsection 247(2.1) providing a statutory ordering rule (SC 2021, c 23, s 60).

32 In particular, the transfer pricing legislation of Australia was adopted in 2013 and that of New Zealand in 2017. For extracts from the legislation of these jurisdictions, see Appendix C. For a survey of the transfer pricing legislation of various countries, see OECD Transfer Pricing Country Profiles, online: OECD.org https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profiles.htm.

Guidelines and a potential non-recognition and replacement rule are discussed in section 0 further below.

As set out above, comparability analysis has two main steps: identification of the conditions and economically relevant characteristics of a controlled transaction (Step 1); and comparison to the conditions and economically relevant characteristics of comparable transactions between independent enterprises (Step 2).

As set out above, assessing a controlled transaction with reference to its economically relevant characteristics reveals the commercial reasoning supporting a controlled transaction from the point of view of each of the parties to it and is a necessary step in establishing the starting point for the comparability analysis. This exercise is not intended to assess the commercial reasoning from the point of view of the MNE group as a whole, but rather on an entity-specific basis.

Canadian transfer pricing legislation contains a list of elements that are broadly in line with the economically relevant characteristics. However, they are in the legislation's transfer pricing documentation rule in subsection 247(4). There is no direct connection between the consideration of the economically relevant characteristics and the rule providing for an adjustment, where necessary, to the profit earned by an enterprise to bring it in line with an arm's length profit allocation.

Step 1 also focuses on the conditions of a controlled transaction where "conditions" is broadly construed. It does not refer only to the conditions of any intra-group contract, but instead to the conditions (including price, but not limited to price) in respect of the controlled transaction. The rule in Canada's transfer pricing legislation, at paragraphs 247(2)(a) and (c), directs scrutiny at the "terms or conditions made or imposed" in respect of the controlled transaction. This language does not align with the broader reference to "conditions" in Article 9 and the *Transfer Pricing Guidelines* and could be inappropriately interpreted as focusing on the terms and conditions of an intra-group contract alone.

With respect to Step 2, while it may be argued that comparability is implicit in section 247, there is no explicit comparability requirement. In particular, by referring to "persons dealing at arm's length" with no further detail, subsection 247(2) does not provide legislative guidance as to the construction of the hypothetical arm's length party. The *Transfer Pricing Guidelines* are more explicit and provide that the comparison is made to a comparable uncontrolled transaction of an independent enterprise *in comparable circumstances*.[33]

A further concern arises if the hypothetical arm's length party is constructed in such a way as to incorporate assessments of the interests of the MNE group as a whole, for example by asking whether a controlled transaction pursues the overall business interests of the MNE group, or considering the reasonableness of an outcome at the consolidated group level. The introduction

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33 See *2022 Guidelines e.g.*, at 1.3, 1.6, 1.9, 1.33.

of these assessments into the hypothetical comparator is a concern, because they undermine the underlying hypothesis of the arm's length principle according to which the participants to the transaction are treated as separate entities dealing with one another at arm's length. For example, the reasons in *Alberta Printed Circuits* suggests that such an assessment of the interests of the MNE group as a whole was considered relevant.[34]

The assessments described above are distinguishable from the determination that, in positing an entity as a separate entity for the purposes of applying the arm's length principle, in some circumstances, it will be appropriate to posit it in its relationship within an MNE group, for example, as a subsidiary dealing with a parent. This was the hypothetical comparator established in *GE*[35] and this is reflected in the recent guidance of the *Transfer Pricing Guidelines* on financial transactions.[36] These assessments are distinguishable from those which incorporate the interests of the MNE group as a whole, because in the former case, the hypothetical comparator is posited as dealing at arm's length with the other participants to the controlled transaction, albeit as a member of an MNE group, while in the latter case, the interests of the MNE group take the place of entity-specific interests.

Finally, Canadian transfer pricing legislation has a rule in paragraph 247(2)(d) that provides for the substitution of the controlled transaction with the transaction that would have been entered into by parties dealing at arm's length under terms and conditions that would have been made between them. This rule applies if the conditions of paragraph (b) are met, namely: if 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.

The language used in these paragraphs does not clearly tie into the language of the *Transfer Pricing Guidelines* discussed in section 0(c) above. This has led to significant and ongoing uncertainty as to the purpose of this rule. The lack of clarity on the scope of the rule – it is integrated with the transfer pricing rule in paragraphs 247(2)(a) and (c) yet has a disjunctive relationship with it – has led to disputes between taxpayers and the Canada Revenue Agency with respect to the proper scope of both rules.

Question 1

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34 *Alberta Printed Circuits Ltd. v Her Majesty the Queen*, 2011 TCC 232 at para 190 (looking through the corporations to the identity of shareholders leads to reasoning that, in view of profit-sharing agreements made among shareholders, overall the MNE group transfer pricing policy led to the use of prices a reasonable business person would agree to).

35 *General Electric Capital Canada Inc. v Her Majesty the Queen*, 2009 TCC 563 at paras 198-201, 273, affirmed 2010 FCA 344 (in the context of a financial guarantee by a parent of a subsidiary, rather than eliminating all influences of the parent-subsidiary relationship, in applying of the arm's length principle, a fact-specific level of implicit support must be determined).

36 See *2022 Guidelines* Chapter X, esp C.1.1.3 and D.1.

- As it relates to the application of the arm's length principle, the consultation paper identifies two main areas where Canada's current transfer pricing legislation does not provide explicit guidance, together with proposed amendments to provide greater certainty in these areas. Are there other areas that would benefit from additional guidance in order to ensure that the arm's length principle, as articulated in the *Transfer Pricing Guidelines*, is applied in Canada?
- If so, please indicate the area and provide input as to the form(s) you consider such guidance should take (legislation, technical notes or administrative guidance).

B. Recent Canadian Transfer Pricing Case Law – *Cameco*

Similar to problems identified in the *BEPS 8-10 Final Report*, recent Canadian jurisprudence has emphasized intra-group contractual terms and other formal arrangements in applying the principle articulated in section 247. In addition, an emphasis on "pricing" in transfer pricing has not assisted in arriving at profit allocations that reflect the relative contributions of the MNE group members. This illustrates the need for more specific legislative guidance on the application of the arm's length principle.

In *Cameco* the corporate taxpayer (Cameco Canada) was the parent of an MNE group with subsidiaries in various jurisdictions, including Switzerland (Cameco Switzerland), the United States (Cameco US) and Barbados (Cameco Barbados).

Cameco Canada sold its current and future uranium output to Cameco Switzerland (intra-group uranium transactions). It also provided services to Cameco Switzerland. Cameco Canada made available to Cameco Switzerland a potential business opportunity related to the purchase and resale of de-enriched uranium. Cameco Canada acted as the guarantor for the performance of Cameco Switzerland's contractual obligations with third parties and it provided financing to Cameco Switzerland, both directly and indirectly. Generally, though not in all cases, these intra-group arrangements were supported by intra-group contracts.

Cameco Canada had an important Canadian presence. It operated uranium mines in Saskatchewan and uranium processing operations in Ontario, and maintained a complement of headquarters staff and C-suite executives. Cameco Canada employed approximately 1,500 employees[37] and accounted for approximately 84% of group assets.[38] Cameco Switzerland bought and sold uranium intra-group and exercised options for uranium under contracts with

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[37] Cameco, 2003 Annual Report (April 13, 2004) online: Sedar < https://www.sedar.com/>, p. 14. Employment as of December 31, 2003, Uranium, Cameco and subsidiaries: 1,515 in Canada; 147 in the United States; 77 in Kazakhstan; and 11 in Australia.

[38] Cameco, 2003 Annual Report (April 13, 2004) online: Sedar < https://www.sedar.com/>, p. 71. Geographic Segments – Assets (in millions) – Canada $2,833; United States $180.3; and Central Asia $346.1.

third parties. Cameco Switzerland had one employee[39] and was dependent on services provided to it by Cameco Canada.

Broadly, the intra-group arrangements resulted in income associated with the MNE group's uranium sales being recorded in Cameco Switzerland's books.[40] Cameco Canada recorded year-over-year negative operating margins.[41] The intra-group agreements were long-term agreements persisting beyond the taxation years subject to the litigation.

With respect to the transfer pricing rule at paragraphs 247(2)(a) and (c), the Crown challenged the transfer pricing used by the taxpayer in connection with the intra-group uranium transactions and the de-enriched uranium business.

In allowing the taxpayer's appeals, the Tax Court of Canada (TCC) found that the taxpayer's arrangements could be reconciled with the arm's length principle as articulated in Canada's transfer pricing tax law.

With respect to Step 1, the intra-group contracts supporting the intra-group uranium transactions established that there would be a potential for a price spread between the price at which Cameco Switzerland purchased uranium from Cameco Canada and sold it to third parties, resulting in price risk. The TCC concluded that the party assuming this risk was Cameco Switzerland and that the results of the spread belonged to it.[42] This conclusion was reached based on relationships created by intra-group contractual arrangements, notwithstanding Cameco Switzerland's minimal factual substance and Cameco Canada's assumption of related risks through the provision of performance guarantees to Cameco Switzerland.

With respect to Step 2, the TCC accepted that certain contracts concluded by or with third parties were comparable to the intragroup contracts supporting the intra-group uranium transactions and that the comparable uncontrolled price ("CUP") method was the appropriate method to assess the arm's length nature of these controlled transactions.[43]

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39 *Cameco* TCC at para 134.

40 Cameco US performed a sales function in the U.S. market and earned a 2% margin on its sales to third party customers. Through further intra-group arrangements and pursuant to an agreement with the Swiss tax authorities, approximately 50 per cent of Cameco Switzerland's profit was paid to Cameco Barbados nominally for services; Cameco Switzerland did not receive any services in return. (*Cameco* TCC at paras 130-131.)

41 *Cameco* TCC at para 546, Chart 3, see also at para 854.

42 *Cameco* TCC at para 838. Though the facts and litigation in *AgraCity* are different, a similar finding as to the assumption of risk by an entity with minimal factual substance was made. See: *AgraCity* at para 107.

43 The CUP method is a transfer pricing method that compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. (*2022 Guidelines* at 2.14.)

On appeal to the Federal Court of Appeal (FCA), the issue was limited to the interpretation of paragraphs 247(2)(b) and (d); the judicial reasons do not address the various issues related to the interpretation of 247(2)(a) and (c).[44] The FCA determined that the hypothetical comparator at subparagraph 247(2)(b)(i) involved an objective test based on a hypothetical reasonable person.[45] That is, the test involved is whether the transaction or series of transactions would not have been entered into between any two persons dealing at arm's length, under any terms or conditions.[46]

C. Tax Policy Concerns with the Outcome in *Cameco*

The overall issue raised by the outcome in *Cameco* is that Cameco Switzerland was left with an allocation of income that did not correspond to the value it created through its underlying economic activity: while Cameco Canada had significant factual substance including a complement of C-suite executives and large scale mining and trading operations, Cameco Switzerland had minimal factual substance. Yet while Cameco Canada incurred negative profit margins it was Cameco Switzerland that was entitled on an ongoing basis to the residual return on the MNE group's business. There was a mismatch between where income was recorded for tax purposes and the economic origin of this income. Since transfer pricing arrangements generally persist year over year, the effect of the mismatch on the Canadian fiscal framework is cumulative and can be material.

The ability to shift income based on intra-group contracts and other formal arrangements that disconnect entitlement to income from underlying economic activity is inappropriate in policy terms. The result in *Cameco* reflects the concerns raised in the BEPS project discussed above.

Since their 2010 iteration, the *Transfer Pricing Guidelines* have stated that in applying the arm's length principle: "[i]t is important not to lose sight of the objective to find a reasonable estimate of an arm's length outcome based on reliable information."[47] Setting aside for purposes of this policy analysis how the case was argued, the tax policy challenge posed by *Cameco* is to elaborate transfer pricing rules that will require reasonable allocations of income (including loss) across the value chains supporting intra-group transactions.

As set out above, Canada's transfer pricing legislation lacks an explicit rule requiring the delineation of the controlled transaction with reference to its economically relevant characteristics and a rule providing that in assessing whether the test in the transfer pricing

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44 *Cameco* FCA at para 1. More specifically, though the judicial reasons address paragraphs 247(2)(a) and (c) in order to recognize an alternative argument made by the Crown with respect to them, the FCA did not substantively address this argument (or the interpretation of these paragraphs) in recognition of the applicable standard of appellate review. (*Cameco* FCA at para 90 *et seq*.)

45 *Cameco* FCA at para 43.

46 *Cameco* FCA at para 82.

47 2022 Guidelines at 1.13.

application rule is met, consideration is to be given, not only to price and other contractual terms, but also to other conditions of the controlled transaction. In the absence of such explicit rules, the TCC in *Cameco* focused on price and other contractual terms in applying paragraph 247(2)(a).

The text of Article 9 itself, the guidance in the *Transfer Pricing Guidelines* and the legislation of other jurisdictions provide that the application of the arm's length principle requires scrutiny of conditions beyond price and other contractual terms. The *Transfer Pricing Guidelines* establish that a necessary first step, which reveals the options realistically available to each of the parties to the controlled transaction and the transaction's factual substance, is the delineation of the controlled transaction.

Additional specific rules in the transfer pricing legislation would have framed the analysis of the controlled transactions differently. The first would have been a rule requiring that the intra-group uranium transaction be delineated with reference to its economically relevant characteristics including the functional analysis of Cameco Canada and Cameco Switzerland and how the functions performed by each contributed to the wider generation of value by the MNE group, the relationship between the numerous discrete intra-group uranium transactions which together amounted to the long-term sale of Cameco Canada's uranium output to Cameco Switzerland, and the economic circumstances of Cameco Canada and Cameco Switzerland and the market in which they operated. The second would have been a rule requiring that inquiry be directed into the conditions of the intra-group uranium transactions, not only their contractual terms.

Combined, these two rules would have led at Step 1 to consideration of a broad range of factors that Cameco Canada would have taken into account, had it been dealing at arm's length with Cameco Switzerland, in determining whether the conditions of the controlled transactions considered in light of its factual substance were clearly the most attractive opportunity available to it.

This in turn would have informed an assessment at Step 2 of the selection of comparable uncontrolled transactions, based on an assessment of their economically relevant characteristics and conditions, to determine whether any conditions of the intra-group uranium transactions differed from those that would have been included had the parties been dealing at arm's length in comparable circumstances. In particular, inquiry would have been directed at whether, in view of the long-term nature of the intra-group uranium transactions, comparable uncontrolled transactions would have included one or several conditions to mitigate the risk of year-over-year negative operating margins.

The FCA conclusion that the determination of the hypothetical comparator involves a test as to what *any* two (or more) persons dealing at arm's length would have agreed is based on the lack of legislative guidance as to the construction of the hypothetical arm's length party. Although the FCA conclusion was with respect to subparagraph 247(2)(b)(i), some may argue that it could apply more broadly to an interpretation of the arm's length principle in Canada that does not take the economic and commercial context of the particular taxpayers into account.

Proposed Solutions

This section outlines proposals to respond to the issues described above. Draft legislative proposals are set out in Appendix A. These include substantive changes, as well as some amendments that would update the rules to use modern legislative drafting conventions (*e.g.*, splitting up subsection 247(2) to eliminate the mid-amble). To better align the Canadian tax rules with the analytic framework described above, it is proposed that the Act's transfer pricing rules would have the following elements:

a) with respect to establishing the starting point of the comparison (Step 1):
   i. a rule requiring that the controlled transaction is to be determined with reference to its economically relevant characteristics. The transaction so determined becomes the "delineated transaction";
   ii. a definition of "economically relevant characteristics";
   iii. a rule requiring that scrutiny of the controlled transaction is to be directed at its conditions; together with an interpretive rule providing that "conditions" is to be broadly construed.

b) with respect to the operation of the comparison (Step 2):
   i. a rule providing that the hypothetical comparison is to what the parties to the controlled transaction would have included as conditions had they been dealing with one another at arm's length in comparable circumstances.

In addition, the provisions currently at subparagraphs (b) and (d) of subsection (2) are proposed to be repealed. Taking their place would be a rule at the step of establishing the starting point of the comparison where, under certain circumstances, a controlled transaction is not recognized as structured by the taxpayer and is instead replaced for the purposes of applying the transfer pricing adjustment rule. This rule is discussed in section 0(c) below.

Various consequential amendments would result from these proposals, which will be released at a later stage of the consultation.

The draft legislative proposals set out in Appendix A also do not include a proposed coming into force rule. Generally, it is expected that the proposed measures would be applicable on a prospective basis.

A. Step 1 - Establishing the Starting Point of the Comparison

In order to more explicitly align section 247 with the accepted international standard for establishing the starting point for the comparison (Step 1), several rules are contained in the draft legislative proposals.

A.1 Determination of the Transaction or Series

A first key proposed amendment would ensure that the comparability analysis starts on the right footing. Set out in proposed subsection (1.1), it would require that where a taxpayer and a non-resident person with whom the taxpayer does not deal at arm's length are participants in a transaction or series of transactions then the transaction or series is to be analyzed and determined with reference to its economically relevant characteristics. The transaction or series, analyzed and determined with reference to its economically relevant characteristics, is referred to as the "delineated transaction" in the *Transfer Pricing Guidelines* and under the proposed rule. Subject to the non-recognition and replacement rule discussed below, the transfer pricing application rule at paragraph (2)(b) applies to the delineated transaction.

A.2 "Economically Relevant Characteristics"

The second proposed amendment is directly related to the first set out above: it defines "economically relevant characteristics". Proposed to be added to subsection (1), the definition broadly follows the wording of the *2022 Guidelines*, with certain adjustments for the Canadian tax law context.

The proposed definition contemplates five factors that comprise the economically relevant characteristics, with each being set out in a separate paragraph in the definition. In summary, these five factors are: contractual terms; functional analysis; characteristics of the property or services; economic circumstances of the participants to the controlled transaction; and the business strategies pursued by the participants to the transaction or series of transactions.

The main clarification for the Canadian tax law context is the reference in the first two paragraphs of the definition to the "actual conduct" of the participants to the transaction or series. This focus on the actual conduct is consistent with the *Transfer Pricing Guidelines*, which calls for the controlled transaction to be determined in a way that sets out its factual substance.[48] This focus on actual conduct means more than just "not a sham" but rather that what is relevant in determining a controlled transaction is what was actually done from a factual perspective.

The first paragraph in the definition looks to the contractual terms in respect of the transaction or series. However, the contractual terms are relevant only to the extent that they are consistent with the actual conduct of the participants. The reference to actual conduct would cover both conduct that deviates from the strict terms of the relevant contracts and conduct that is not specified in the relevant contracts. It would also allow the identification of a transaction or series

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48 For reference to "actual conduct" and "factual substance", see *e.g.*, *2022 Guidelines* at 1.43 and 1.139-1.140, respectively.

not supported by an intra-group contract.[49] In addition, just as with the functional analysis described below, the contractual terms of other relevant transactions or series involving the MNE group would be taken into account.[50]

The reference to actual conduct in paragraph (a) is proposed to address the possibility that some specific language in the *Transfer Pricing Guidelines* read in isolation could lead to an interpretation in a Canadian tax law context that restricts the information relevant in delineating the transaction to intra-group contracts, unless it is established that these contracts do not provide a sufficiently complete picture of the controlled transaction.[51] The requirement to establish such insufficiency would be out of line with the overall intention of the *Transfer Pricing Guidelines* to delineate the transaction or series according to what was actually done from a factual perspective and thereby to take into account facts beyond those discernable only from a review of intra-group contracts and other formal documentation provided by the taxpayer.

The second paragraph in the definition looks to the actual conduct of the participants in the transaction or series to determine its "functional analysis". That is, the functions that each of the participants performs must be determined taking into account: (i) assets used and risks assumed, including risks that if materialized would be assumed; (ii) how the functions relate to the wider generation of value by the MNE group to which the participants belong; (iii) the circumstances surrounding the transaction or series; and (iv) industry practices.[52] In connection with the second item, a definition of "MNE group" is proposed to be added to the definitions at subsection (1).

The reference to risks that if materialized would be assumed is intended to ensure that the controlled transaction is delineated through reference to the parties who in fact bear or would bear the costs of the risks when or if they materialize. It is not sufficient to identify only the party who, according to an intra-group arrangement or contract, assumes the risk without taking into account the possibility of a mismatch between the party who nominally assumes the risk and the party who in fact assumes or would assume it if it were to materialize. When there is alignment, then there will be no difference in the attribution of the risk.

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[49] 2022 Guidelines at 1.49.

[50] The contractual terms of the transaction are discussed in the *2022 Guidelines* at D.1.1. The reference to the contractual terms of other intra-group contracts is similar to the provision currently at subparagraph 247(4)(a)(ii).

[51] This possible incorrect interpretation of some paragraphs when read in isolation may be understood by the fact that these guidelines are a consensus document used by decision makers in different jurisdictions with varying legal traditions. Generally speaking, some jurisdictions apply a substance over form approach while others, like Canada, absent direction to the contrary, favour a form over substance approach.

[52] Functional analysis is discussed in the *2022 Guidelines* at D.1.2.

The third paragraph in the definition looks to the characteristics of any property transferred or of services provided.[53] The fourth paragraph in the definition looks to the economic circumstances of the participants to the transaction or series of transactions and of the market in which these participants operate.[54] The final paragraph in the definition looks to the business strategies pursued by the participants to the transaction or series.[55]

In section IV(e) below, example 1 illustrates the proposed provision with respect to the relevance of contractual terms and actual conduct of the parties, while example 3 illustrates in a more comprehensive manner the application of economically relevant characteristics in the delineation of the transaction or series (Step 1).

Question 2

- The requirement proposed by the rule at (1.1) to establish the starting point of the comparison respects the transaction or series as structured by the taxpayer. There are, however, limits placed on this. The rule at (1.1) requires that a transaction or series meeting the conditions of paragraph (2)(a) must be augmented by relevant facts deriving from the elements of the definition of "economically relevant characteristics". In some cases, the *Transfer Pricing Guidelines* provide that the risks are to be reallocated based on the level of control over the risk and financial capacity to assume the risk.
- Does the proposed legislation provide sufficient direction or guidance for this delineation exercise consistent with the *Transfer Pricing Guidelines*? If not, what additional legislative direction or guidance would be required?

A.3 Conditions

The third proposed amendment would change the object of scrutiny in the transfer pricing application rule at paragraph (2)(b) from the "terms or conditions" of the controlled transaction to its "conditions". This amendment is supported by a proposed interpretive rule in subsection (1.4) that would provide that "conditions" is to be interpreted broadly. Combined, these amendments would align the language used in the transfer pricing application rule at paragraph (2)(b) with that used in Article 9 and by other jurisdictions and ensure that in analyzing the delineated transaction or series, scrutiny is directed to all conditions as opposed to only price or other conditions stemming from intra-group contracts. This would involve taking into account all information in respect of the transaction or series that would be relevant to determining amounts used in applying the provisions of the Act. Such information would include commercial or financial information relevant to the transaction or series.

53 Characteristics of property or services are discussed in the *2022 Guidelines* at D.1.3.

54 Economic circumstances are discussed in the *2022 Guidelines* at D.1.4.

55 Business strategies are discussed in the *2022 Guidelines* at D.1.5.

An illustration of a condition other than price or contractual terms is a profit level indicator. For example, where an MNE group member resident in Canada functions as an intra-group contract services provider and the appropriate profit level indicator is the return on total costs, then this profit level indicator bears on the income that the entity records for tax purposes for the year. As a result, the profit level indicator is information relevant to the determination of the quantum or nature of an amount that would be used in applying the provisions of the Act and as such is a "condition" of the delineated transaction.

In order for the transfer pricing application rule at paragraph (2)(b) to apply, the delineated transaction must include conditions different from arm's length conditions. Subsection (2.01) says this also includes the case when conditions are missing from the delineated transaction that would have been included had the parties been dealing at arm's length in comparable circumstances. This will ensure that the absence of a condition in the transaction or series does not artificially distort the inquiry into what would have been included as conditions had the parties been dealing at arm's length in comparable circumstances.

Question 3

- The transfer pricing application rule at paragraph (2)(b) would scrutinize the delineated transaction or series to determine whether it includes conditions that differ from those that would have been included had the parties been dealing with each other at arm's length in comparable circumstances.
- A proposed interpretive rule at subsection (1.4) would provide that "conditions" is to be interpreted broadly to include all information relevant to the determination of "initial amounts" as this term is used in subsection (2.1).
- Do you agree that the "conditions" of the delineated transaction or series would capture all relevant conditions that operate in respect of the delineated transaction or series?

B. Step 2 - The Operation of the Comparison

In order to more explicitly align section 247 with the accepted international standard with respect to the operation of the comparison involved in applying the arm's length principle (Step 2), several amendments are proposed in the draft legislative amendments to the transfer pricing application rule.

Proposed amendments, set out at paragraph (2)(b), would provide that the application of the arm's length principle requires determining what conditions of the delineated transaction or series would have been included had *the parties* to the delineated transaction or series been dealing with one another at arm's length *in comparable circumstances*.

The use of the word "they" in the proposed amendment requires a hypothesis based on what the actual parties to the transaction or series would have included as conditions had they been dealing at arm's length, as opposed to one based on what any parties dealing at arm's length under any terms or conditions would have done. The words “comparable circumstances” provide that the comparison involves determining what the parties to the controlled transaction would have included as conditions had they been dealing at arm’s length *in comparable circumstances* and not in any circumstances. Example 2 below provides an example of the application of this proposed provision.

Question 4

- The arm’s length principle applies taking into account the commercial interest of the parties to the controlled transaction posited as separate entities and should not include assessments taken from the commercial interests of the MNE group as a whole. This approach is relevant whether the principle is applied directly through the transfer pricing application rule at proposed paragraph (2)(b) or the non-recognition and replacement rule at proposed subsections (1.2) and (1.3) (discussed next).
- The language proposed to adopt the non-recognition and replacement rule includes some guidance regarding the consideration of the separate perspectives of the parties to the transaction at the preamble to subsection (1.2). No similar language is proposed at paragraph (2)(b), because a consideration of the interests of the parties as separate entities underlies the statement of the arm’s length principle in that paragraph.
- Do you agree that the language at paragraph (2)(b) is sufficient to ensure that assessments of the commercial interests of the MNE group as a whole are not included in the test at proposed paragraph (2)(b), or do you consider that additional language is required to establish this approach?

C. Non Recognition and Replacement of Controlled Transactions

The sections above outline draft legislative proposals for establishing the starting point for the comparison of the controlled transaction and for the operation of the comparison itself. The draft legislative proposals would clarify the application of Canada’s transfer pricing rules by making explicit more of the technical requirements for the application of the arm’s length principle. With respect to the analysis of a controlled transaction, these rules are intended to, among other things, augment the scrutiny of an MNE group’s arrangements by determining the transaction with reference to its economically relevant characteristics and to focus on comparable circumstances.

The intention of these draft legislative proposals is to ensure Canada’s transfer pricing rules apply so as to arrive at overall profit (including loss) allocations that match the relative contributions of the MNE group entities.

As noted in section 0 above, the *Transfer Pricing Guidelines* have consistently recognized that there are circumstances in which a controlled transaction as structured by a taxpayer should not be recognized for the purposes of applying the arm’s length principle. Consistent with other jurisdictions that have adopted a non-recognition rule[56], the proposed legislative amendments in Appendix A set out a proposed non-recognition and replacement rule, in subsections (1.2) and (1.3).

The proposed non-recognition and replacement rule would apply as described below.

First, under the proposed transaction determination rule at subsection (1.1), a transaction or series involving a taxpayer and a non-resident person with whom the taxpayer does not deal at arm's length is determined with reference to its economically relevant characteristics. The resulting transaction is referred to as the "delineated transaction or series". Second, two tests are applied to the delineated transaction or series as follows:

- taking into consideration the respective perspectives of the participants to a delineated transaction or series and the options realistically available to each of the participants at the time of entering into the delineated transaction or series,
    - does the delineated transaction or series differ from the transaction or series that would have been entered into by the participants had they been dealing at arm's length in a commercially rational manner in comparable circumstances?
    - does the delineated transaction or series prevent the determination of a transfer price that would have been acceptable to the participants had they been dealing at arm's length in a commercially rational manner in comparable circumstances?

Generally, the proposed non-recognition and replacement rule will not apply to transactions or series delineated under (1.1), but if the two tests set out above are met with respect to the delineated transaction or series, then for the purposes of the transfer pricing application rule at paragraph (2)(b), it is deemed to include conditions different from the arm's length conditions. And, for the purposes of the transfer pricing adjustment rule at subsection (2.02), it is disregarded and replaced with a transaction or series that comports as closely as possible with the facts of the delineated transaction or series while achieving an expected result that, had the participants been dealing at arm's length in comparable circumstances, would have been commercially rational.

Related to this proposal, an amended definition of "transfer pricing" is included in Appendix A.

Question 5

- In addition to the application of the general anti-avoidance rule, a specific rule is required to protect the integrity of the rules that incorporate the arm's length principle for Canadian tax purposes.
- It is proposed that paragraphs 247(2)(b) and (d) be repealed and replaced with the non-recognition and replacement rule outlined above, which is designed to protect domestic

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56 Australia *ITAA 1997*, s 815-130(2) – (5), New Zealand *ITA 2007*, s GC 13(1C), UK *Taxation Act 2010*, s 151(2).

tax bases from profit allocations resulting from controlled transactions meeting the criteria of the rule at proposed subsection (1.2) by replacing them with controlled transactions that have a commercially rational expected result and that can be priced from the point of view of arm's length parties taking their individual interests into account.

- In your view, will the proposed rule be effective in protecting the integrity of the Canadian transfer pricing rules and the Canadian tax base? Taking into account the international consensus on transfer pricing, is there a different approach that you would propose?

D. Role of OECD Transfer Pricing Guidelines

To provide additional guidance on the application of the arm's length principle, a question arises as to whether Canadian transfer pricing legislation should follow the approach of a number of other jurisdictions and include a rule specifying the role of the *Transfer Pricing Guidelines* in applying this legislation.

At present, the *Transfer Pricing Guidelines* are a source of guidance. Canadian Courts have recognized that the *Transfer Pricing Guidelines* can be useful (*e.g.*, in explaining the operation of the transfer pricing methods), though not binding as if they were Canadian legislation or jurisprudence.[57]

A number of jurisdictions, including Australia, New Zealand and the United Kingdom, have adopted rules which specify a role for the *Transfer Pricing Guidelines* in applying their domestic legislation.[58] Very generally, these rules reference the *Transfer Pricing Guidelines* and create a rule according to which the domestic transfer pricing legislation is to be applied in a way that best secures consistency between the *Transfer Pricing Guidelines* and the domestic legislation (a "consistency rule").[59]

Beyond the status quo and the possible adoption of a consistency rule, a third option would be to incorporate the *Transfer Pricing Guidelines* into the Canadian transfer pricing rules, as part of the legislation or as regulations.

This last approach is not currently being considered because the *Transfer Pricing Guidelines* are not drafted as a cohesive set of rules but rather as guidance. This characteristic of the *Transfer Pricing Guidelines* likely explains why jurisdictions including Australia, New Zealand and the United Kingdom have not pursued such an approach.

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[57] *Canada* v *GlaxoSmithKline Inc.*, 2012 SCC 52 at para 20.

[58] The U.S. transfer pricing rules are set out in 26 USC § 482 and the U.S. *Treasury Regulations*. The rules are extensive, with the U.S. *Treasuring Regulations*, very generally, covering material that is similar in scope to that which is covered in the *Transfer Pricing Guidelines*.

[59] Australia *ITAA 1997*, s 815-135; New Zealand *ITA 2007*, s GC 6; UK *Taxation Act 2010*, s 164.

The approach currently being proposed is the adoption of a consistency rule in Part XVI.1 to ensure that the transfer pricing rules in section 247 are applied in a way to best achieve consistency with the *Transfer Pricing Guidelines*. Such a rule is set out in the draft legislative proposals (proposed subsection (2.03)) with a supporting definition of "Transfer Pricing Guidelines" (proposed subsection (1)).

Adopting a consistency rule would have some advantages:

1. Because of their broad use by foreign governments and the private sector, the adoption of a consistency rule with respect to the *Transfer Pricing Guidelines* could increase certainty in the application of the arm's length principle in Canada.
2. The use of the *Transfer Pricing Guidelines* in applying the Canadian transfer pricing rules would increase consistency when applying the arm's length principle where the other jurisdiction also uses the *Transfer Pricing Guidelines*.
3. The *Transfer Pricing Guidelines* bring a level of detailed guidance on the application of the arm's length principle, which is necessary given the magnitude and complexity of MNE group arrangements.

Adopting a consistency rule into legislation would also have disadvantages:

1. The *Transfer Pricing Guidelines* are not a document that provides a set of rules that is always clear or unambiguous. Instead, they discuss factors that should be taken into account and acknowledge that the relative importance of factors may vary from case to case, hence their admonition that transfer pricing is not an exact science requiring judgement on the part of both taxpayers and tax administrations.
2. The *Transfer Pricing Guidelines* are the product of a consensus approach that takes into account the divergent conditions and interests of OECD member countries. Unlike OECD Model Tax Convention and its commentaries, member countries cannot introduce reservations or observations to the *Transfer Pricing Guidelines*. As a result, where consensus cannot be reached, the *Transfer Pricing Guidelines* are silent or open-ended.

The possibility of adopting a consistency rule brings with it the question as to whether a static or an ambulatory approach to future versions of the *Transfer Pricing Guidelines* would be appropriate. Under a static approach, future versions would be incorporated into Canadian law only after passing specific legislative amendments (or promulgating regulations), while under the ambulatory approach future versions would apply automatically once adopted by the OECD. A static approach provides certainty to taxpayers and tax administrations. Generally, Australia, New Zealand and the United Kingdom have adopted static approaches according to which a legislative amendment (including regulation) is used to update the reference to the version of the *Transfer Pricing Guidelines*. The legislative amendments generally include a coming into force provision that is denominated in terms of taxation years beginning after a specified date.

An ambulatory approach would ensure that the reference in Canada's law is contemporaneous with the *Transfer Pricing Guidelines* as they evolve.[60] It would avoid the need to update references to new versions of the *Transfer Pricing Guidelines* as they are adopted.

To provide certainty to taxpayers and tax administrations, the approach currently being proposed is a static approach with the possibility of updating reference to the guidelines by legislative amendment (or promulgating regulations).

Question 6

- Do you agree that the inclusion in the proposed legislation of a consistency rule with respect to the *Transfer Pricing Guidelines* is a practical way of helping to align Canada's transfer pricing legislation with the international consensus? If not, what alternative approach would you recommend and why?
- The proposed consistency rule would adopt a static approach to the *Transfer Pricing Guidelines*. Do you agree with this approach? Or do you consider that an ambulatory approach would be preferable as it would ensure that Canada's transfer pricing legislation is contemporaneous with the guidelines as they evolve?

Assuming a static approach is adopted, what should be the considerations in the future when updating a reference to the *Transfer Pricing Guidelines*? Should they apply only prospectively? Would it matter if the updated version of the guidelines were beneficial to the taxpayer or the tax administration?

Question 7

- With reference to Appendix A, please comment on any other aspects of the proposed legislative changes to section 247.

E. Examples

Some examples of how section 247 would apply if amended as proposed are set out below. The description of the business models and the economically relevant characteristics of controlled transactions in these examples are simplified for illustration purposes. Because transfer pricing is fact intensive and generally involves the application of the analytic framework set out in the *Transfer Pricing Guidelines*, some language used in these examples ("functional profile") are transfer pricing terms of art drawn from these guidelines. These examples do not set out a

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60 Two recent rules in the Act, one adopted and the other proposed, regarding the common reporting standard and hybrid mismatch arrangements, respectively, include an ambulatory approach with respect to changes to related commentary. Generally, this is explained by the nature of these rules combined with a dependence for effectiveness on their symmetrical application by participating countries. (See s 270(2) and proposed s 18.4(2))

complete transfer pricing analysis, instead illustrating only certain elements of the proposed legislation.

Example 1: Application of "Economically Relevant Characteristics" in Determining the Delineated Transaction

Canco is a corporation resident in Canada. It transacts with Forco who operates as a manufacturer. Canco provides Forco with services that support Forco's manufacturing operations. Canco and Forco do not deal with each other at arm's length.

The controlled transaction is the provision of services by Canco to Forco. An intra-group contract between Canco and Forco states that Canco provides services in support of Forco's quality control function for remuneration based on an allocation of relevant costs plus a markup.

Applying the proposed transaction determination rule at subsection (1.1), the transaction is analyzed and determined with reference to its economically relevant characteristics (Step 1). This requires, among other things, consideration of the contractual terms of the intra-group contract supporting the transaction and the actual conduct of the parties.

Inquiry reveals that while the contractual terms of the transaction contemplate Canco providing solely services connected to Forco's quality control function, in fact, the former provides a broader range of services to Forco. While at the time the contract was executed Canco provided limited support services, over time, it had begun to provide other services in support of Forco's manufacturing operation, but the intra-group contract had not been updated.

The delineated transaction resolves the discrepancy between the description of the services in the intra-group contract and the services revealed by the actual conduct of the parties by determining that for the purposes of section 247 the delineated transaction is construed according to what was actually done: in this case, the full range of services actually provided.

The application of the test at paragraph (2)(b) will be based on the services actually provided.

Example 2: Application of the Hypothetical Comparator

Canco is a corporation resident in Canada. It has been transacting with Forco for more than 15 years. Canco and Forco do not deal with each other at arm's length. Canco develops and commercializes various products that it sells to non-arm's length parties, such as Forco, and arm's length parties. When selling to new customers, Canco will sometimes grant a concession on price for a limited period of time resulting in losses to it. Canco sells various products to Forco and the overall results of these sales in years 16, 17 and 18 is a loss.

In applying paragraph (2)(b), and in particular in determining the hypothetical comparator, the question is not whether Canco would have sold to any party for a loss, but whether it would have sold to Forco at a loss had the two been dealing at arm's length in comparable circumstances.

Because Forco is an existing customer and based on Canco's conduct with arm's length customers in comparable circumstances, had Canco and Forco been dealing at arm's length, the transaction would not have included a concession on price. Based on these facts, the test at (2)(b) is met: a condition of the transaction differs from the condition that would have applied had the participants been dealing at arm's length in comparable circumstances.

Example 3: Application of the Transaction Determination Rule and the Transfer Pricing Application Rule

Canco is a corporation resident in Canada and the ultimate parent of the MNE group. It sells all of its production ("product") to Forco, a wholly owned subsidiary that resells the product in markets outside Canada.

The transaction or series meeting the conditions of paragraph (2)(a) is the purchase by Forco of product from Canco.

The MNE group's transfer pricing policy treats Canco as a producer and intra-group seller of product and Forco as an entrepreneurial trader of this product. Under the terms of the MNE group's intra-group contract, Canco sells its product for a long-term renewable only at the option of Forco using a price that is between the median and the lower end of historical product pricing. Besides the possibility of annual inflation indexation under certain circumstances, the contract does not provide for price adjustments.

Applying the proposed transaction determination rule at subsection (1.1), the transaction or series meeting the conditions of paragraph (2)(a) is analyzed and determined with reference to its economically relevant characteristics (Step 1). The transaction or series so determined is the "delineated transaction or series". In this example, analysis determines that the delineated transaction or series is the purchase of product by Forco from Canco in which Forco takes title to the product and resells it, and Canco performs all significant risk control activities in connection with the economically significant risks and has the financial capacity to assume them.

Once the delineated transaction or series has been determined, the tests in subsection (1.2) and paragraph (2)(b) must be applied. First, it must be determined whether, taking into account the respective perspectives of Canco and Forco and the options realistically available to each of them at the time of entering into the delineated transaction or series, it does not differ from the transaction that would have been entered into by Canco and Forco had they been dealing at arm's length in a commercially rational manner in comparable circumstances and it is possible to determine a "transfer price" (as proposed to be defined subsection (1)) in respect of the delineated transaction. In this example, it is assumed that relevant facts exist to support the conclusion that the proposed non-recognition and replacement rules at subsection (1.2) and (1.3) do not apply.

Second, applying paragraph (2)(b), it is necessary to determine whether the delineated transaction or series includes conditions that differ from “arm’s length conditions”, namely, the conditions that would have been included had the participants been dealing at arm’s length in comparable circumstances. By virtue of proposed subsection (2.01), the test at proposed paragraph (2)(b) for a transfer pricing adjustment is met in cases where the delineated transaction or series includes conditions that differ from arm’s length conditions, or omits conditions that would have existed had Canco and Forco been dealing at arm’s length in comparable circumstances.

In this example, the delineated transaction or series reveals that Canco alone controls and assumes all of the economically significant risks. Positing Canco as a commercially rational party dealing at arm’s length with Forco in comparable circumstances, it would have expected the opportunity to participate in the market for the product. It would not have agreed to use a fixed price based on a relatively low historical product price thereby exposing itself over a prolonged period to the downside risk that its operating costs would exceed the intra-group selling price, all the while assuming all of the MNE group’s economically significant risks. Similarly, it would have retained some autonomy as to the disposition of its product over time. Whether by including different conditions or by omitting conditions, or both, the delineated transaction or series includes conditions that differ from arm’s length conditions. The conditions for the application of the transfer pricing adjustment rule at proposed subsection (2.02) are met.

Putting aside for the purposes of illustration the additional financial and economic analysis that would be required to apply a transfer pricing method, the overall result of the application of proposed subsection (2.02) would be the recognition by Canco of significant additional income in line with its functional profile all the while ensuring that Forco’s functional contributions attract appropriate remuneration.

Following the determination of adjusted amounts under subsection (2.02), pursuant to the provisions of existing subsection (2.1), each of the provisions of the Act (other than subsection (2.02) and for greater certainty, including section 245) would be applied using the adjusted amounts.

Administrative Measures

This paper also considers administrative measures that could be implemented to increase tax certainty and reduce the compliance and administrative burdens associated with complying with the arm's length principle. These measures also have the goal of aligning Canada with other jurisdictions through implementing the remaining international best practices of the *BEPS Action 13 Report*.

MNE groups are typically complex organizations and have evolved in ways that reflect structures and business models that may differ considerably from those of standalone businesses or domestic groups. This can lead to challenges in applying the arm's length principle. At the same time, MNE groups may have to devote significant resources to determining pricing for relatively low-risk activities that may become the subject of transfer pricing disputes with tax authorities and between different tax authorities. There may also be disputes over the adequacy of a taxpayer's transfer pricing documentation, which, in turn, can lead to the application of significant transfer pricing penalties.

To address these concerns, the government is considering measures that would:

1. Align Canada with other jurisdictions through implementing the remaining international best practices of the *BEPS Action 13 Report* while reviewing the overall integrity of the current legislative framework for transfer pricing documentation and penalties;
2. Reduce compliance burdens by introducing simplified documentation requirements for low-risk situations;
3. Increase the thresholds at which transfer pricing penalties would apply; and,
4. Introduce streamlined pricing approaches to reduce the burden of benchmarking arm's length returns.

These measures are intended to reduce transfer pricing disputes, ease the burden of compliance with the arm's length principle in appropriate situations, and allow the Canada Revenue Agency (CRA) to focus its resources on higher-risk transactions that represent a greater risk of base erosion. In developing these proposals, the government also reviewed other possible administrative approaches that it has decided not to develop further at this time (these are discussed further in Appendix D). This paper asks certain questions regarding the proposals detailed below. The government is also interested to hear from stakeholders regarding any other relevant comments or proposals.

A. Transfer Pricing Documentation and Penalty Provisions

Since their introduction in 1997, Canada's transfer pricing legislation has contained provisions to encourage taxpayers to have contemporaneous documentation supporting the arm's length nature of their transfer pricing arrangements. It has also contained provisions for penalties where a transfer pricing audit results in reassessments above specified thresholds and where the taxpayer did not make reasonable efforts to determine, document and use arm's length conditions for the controlled transactions.

Since Canada's contemporaneous documentation provisions were introduced in 1997, the international thinking on transfer pricing has evolved. There has also been a significant increase in the volume and complexity of controlled transactions and increased scrutiny of transfer pricing issues by tax administrations around the world, which have resulted in increased compliance costs for taxpayers.

In response to these pressures and the proposed revisions to the transfer pricing rules described above, this consultation provides a timely opportunity to consider updating and streamlining Canada's transfer pricing documentation requirements and transfer pricing penalty provisions, particularly in light of changes on the international stage introduced by the *BEPS Action 13 Final Report*. This approach is set out in Chapter V of the *Transfer Pricing Guidelines*.

It sets out three objectives of transfer pricing documentation requirements:

1. to ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises;
2. to provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment; and,
3. to provide tax administrations with useful information to employ in conducting an appropriate and thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction, although it may be necessary to supplement the documentation with additional information as it progresses.[61]

To achieve this, Chapter V lays out a standardized three-tier approach to documentation consisting of (1) a Master file, (2) a Local file; and (3) a Country-by-Country Report ("CbCR"). (It is also important for tax administrations to be able to access or demand, on a timely basis, all additional information necessary to conduct a comprehensive audit. In this regard, recent amendments were made to Part XV of the Act to ensure that the Canada Revenue Agency has the authority to gather information necessary to conduct audits, including, among other things, the authority to require answers to proper questions orally or in writing.[62])

In considering potential changes, the government is focussed on balancing:

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[61] 2022 Guidelines at 5.5.

[62] Bill C-32, *Fall Economic Statement Implementation Act, 2022*, 1st Sess, 44th Parl, 2022, cl 54(1) (assented to December 15, 2022). This amendment to subsection 231.1(1) of the Act was in response to a decision of the FCA, which called into question the extent to which CRA officials can require persons to answer all proper questions and to provide all reasonable assistance relating to the administration or enforcement of the Act. (*MNR v Cameco Corporation*, 2019 FCA 67).

i. the need for the CRA to have access to timely, accurate and relevant information to conduct transfer pricing risk assessments and efficient audits; and
ii. not imposing excessive or unnecessary compliance burdens on taxpayers.

In Canada, the CbCR, a minimum standard of the BEPS project, was implemented primarily through section 233.8 of the Act. The government is proposing to generally align the current documentation requirements of subsection 247 with those of the Local file and make provision of the Master file mandatory in certain cases (see below).

The government is also considering whether the current legislative framework contained in subsections 247(3) and 247(4) of the Act is still appropriate.

Generally, where a taxpayer is found not to have made reasonable efforts to determine and use an "arm's length transfer price" (as that term is defined under subsection 247(1)), and the amount of any adjustment to income or capital under subsection 247(2) is greater than the lesser of $5M or 10 per cent of gross revenues, a 10 per cent penalty applies to the amount of the transfer pricing adjustment in respect of which reasonable efforts to determine and use arm's length transfer prices were not made.

The legislation does not provide a set of criteria of what constitutes reasonable efforts under section 247. Subsection 247(4) deems a taxpayer not to have made reasonable efforts where it has failed to provide documentation that addresses completely and accurately in all material respects the information listed at subparagraphs (i) through (vi) of paragraph (4)(a) within three months of a written request by the CRA. A discussion of the thresholds at which the penalties apply is further down. The government is also interested in feedback more generally on how the penalty provisions can be improved, while maintaining the overall integrity of the legislative framework.

A.1 Local File

The Local file is broadly similar to Canada's current contemporaneous documentation provisions set out in subsection 247(4) of the Act. However, as the guidance in Chapter V (Documentation) of the *Transfer Pricing Guidelines* has evolved, some differences between the two have arisen. (Appendix E reproduces the information recommended to be included in the Local file provided in Annex II to the *BEPS Action 13 Report*.) Notably, the Local file provisions are not required for transactions that are not material. In this regard the government is proposing an alternative approach that would combine considerations of materiality while maintaining safeguards against potential base erosion (see below on reduced documentation requirements for low-risk transactions).

Otherwise, the government is proposing to bring the content required in Canada's documentation requirements in line with that laid out in Chapter V (Documentation) of the *Transfer Pricing Guidelines*.

A.2 Master File

The Master file is intended to provide a "blueprint" of the MNE group as a whole and include information on the group's structure, business (or businesses), intangibles, intercompany financial activities and tax positions. (Appendix F reproduces the information recommended to be included in the Master file provided in Annex I to the *BEPS Action 13 Report*.)

A number of other jurisdictions, including many G20 members, have implemented requirements for taxpayers to provide the Master file either on a regular basis or on request. Requiring Canadian taxpayers to complete and submit a Master file could provide the CRA with important high-level information relevant to the risk assessment and audit of MNE groups. Timely and standardized information could assist in making transfer pricing audits more focused, something that could also facilitate MNE groups' dealings with the CRA.

At the same time, implementation of a Master file reporting requirement would increase compliance requirements on businesses, which could be particularly burdensome for small and expanding businesses. On the other hand, as a number of other jurisdictions already require MNE groups to provide the Master file to their local tax administrations, there would, in many cases, be minimal additional effort required to also provide the Master file to the CRA.

The government proposes to balance these considerations by requiring filing of the Master file in prescribed form on request by the CRA, but for this provision to only apply in respect of taxpayers that are members of larger MNE groups, that is groups that are also subject to CbC reporting requirements. This will lessen the increase in compliance burdens, while providing the CRA with the opportunity to obtain valuable information.

Question 8

- What changes do you think need to be made to the transfer pricing documentation provision?

Question 9

- What changes do you think need to be made to the transfer pricing penalty provision?

Question 10

- Do you agree with the proposal to align the documentation requirements of subsection 247 with those of the Local file detailed in Appendix E?

Question 11

- Do you agree with this proposal to introduce Master file reporting requirements (on request) for taxpayers that are members of MNE groups that are also subject to CbC reporting requirements?

Question 12

- What information, if any, should be required to be completed for the Local file and Master file other than or instead of that described in Appendices E and F?

B. Simplified Documentation Requirements for Lower Value Transactions and Smaller Taxpayers

The government recognizes that documentation requirements impose a burden on taxpayers and that a balance needs to be struck between the competing needs for timely and reliable transfer pricing documentation and the cost of providing that documentation.

While the *Transfer Pricing Guidelines* note[63] that not all transactions that occur between associated enterprises are sufficiently material to require full documentation in the Local file, an exemption for non-material transactions could also pose risks. For example, a taxpayer that transfers an early-stage technical development to a related party outside Canada for nominal consideration should not avoid the obligation to properly document the controlled transaction. Nonetheless, the government recognizes that relief from compliance burdens could be provided by more streamlined documentation requirements for lower-risk transactions or taxpayers.

The government is considering the introduction of legislative provisions that would allow a taxpayer to satisfy transfer pricing documentation requirements for certain controlled transactions through an annual reporting schedule detailing, *i.a.*, the nature and magnitudes of these transactions, the methods used and the arm's length conditions determined. Access to this simplified approach would be detailed in a schedule of criteria to be established by the CRA. This would allow for a number of different fact scenarios to be taken into account, rather than simple revenue-based criteria. For example, Australia provides an administrative safe harbour[64] for transactions that satisfy certain risk-based criteria. Such a schedule would be updated as required.

This approach would reduce compliance burdens while still maintaining the obligation for taxpayers to comply with the application of the arm's length principle. The government is seeking input from stakeholders on how to identify the scope of any such approach and what sorts of information would be sufficient to satisfy the need for adequate support and appropriate safeguards.

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[63] Section D.3, Ch. V., *2022 Guidelines*. It notes that not all transactions that occur between associated enterprises are sufficiently material to require full documentation in the Local file. It further notes that documentation requirements based on the Local file should include specific materiality thresholds that take into account the size and nature of the local economy, the importance of the MNE group in that economy, and the size and nature of the MNE group. Measures of materiality may be measured in relative terms (e.g., transactions not exceeding a percentage of revenue) or in absolute terms (e.g., transactions not exceeding a fixed amount).

[64] See Practical Compliance Guideline, PCG 2017/2.

Question 13

- Do you agree with the proposal to provide simplified documentation requirements for low-risk taxpayers and transactions?

Question 14

- What criteria could be used to identify taxpayers and transactions to whom reduced documentation requirements would apply?

Question 15

- What content would be required to demonstrate compliance with the arm's length principle under such reduced documentation requirements?

C. Transfer Pricing Penalty Thresholds

The penalty provisions in Canada's transfer pricing rules are intended to support the efficient operation of the documentation requirements mentioned above. Generally, under the provisions of subsection 247(3), a taxpayer is liable for a penalty computed as 10 per cent of the amount by which the total of a taxpayer's "transfer pricing capital adjustment" and a "taxpayer's transfer pricing income adjustment" (as those terms are defined under subsection (1)) exceeds the amount of those adjustments in respect of which the taxpayer has made reasonable efforts to determine and use an "arm's length transfer price" (as that term is defined under subsection (1)). This penalty applies subject to a two-part *de minimis* threshold: the net adjustment must be greater than CA$5 million or 10 per cent of the taxpayer's revenue, whichever is less.

The government supports the ongoing role of the penalty provision in promoting compliance with the arm's length principle and by providing relevant, timely and accurate information to the CRA. At the same time, the $5 million threshold has not been adjusted since it was introduced in 1997. If the threshold were to be increased in line with inflation it would be approximately $8.4 million. The government is proposing to increase the absolute threshold to $10 million.

The government does not intend to change the relative threshold of 10 per cent. Although it may result in the requirement of significant resources in order to determine what may be a relatively small penalty amount, this relative threshold serves an important role in encouraging compliance among smaller taxpayers.

Question 16

- Should the $5 million threshold be changed? If so, would an increase to $10 million be appropriate?

Question 17

- Does the penalty provision operate as intended to encourage the preparation of contemporaneous documentation? If no, how could it be changed to encourage compliance?

D. Streamlined Pricing Approaches

The application of the arm's length principle often results in taxpayers having to devote significant resources to benchmark amounts supporting arm's length conditions. In a number of situations it may be possible to streamline these processes. From a policy and compliance perspective, streamlined approaches may be preferred to other approaches as they are likely less susceptible to abuse. They may also have the added benefit of reducing the number of potential tax disputes and, thereby, increasing tax certainty.

D.1 Low Value-Adding Intra-Group Services

One area that offers potential opportunities in this regard is the approach for pricing low value-adding intra-group services introduced in the *2017 Guidelines*, which has been adopted by a number of jurisdictions. This approach recognizes that many ancillary services that are not part of an MNE group's core business pose relatively low risk and that the return for these services is closely related to cost. It applies a standard deemed arm's length return of 5 per cent to these costs and then allocates these charges to those group members that benefit from these services. In the case of a Canadian service provider, adoption of this approach would mean that a 5 per cent return for all qualifying services would be accepted as being an arm's length return. Similarly, a 5 per cent return on the costs of an inbound service charge would also be accepted as arm's length. While cost allocations and eligibility for the approach would still be subject to audit, under this approach taxpayers would not have to carry out a comparability analysis to determine an arm's length return, and would face a less stringent benefits test[65] and simpler documentation requirements[66]. Similarly, while adoption of this approach would not guarantee the elimination of double taxation and consequent resorting to the mutual agreement procedures of Canada's tax treaties, the presence of the approach in the *Transfer Pricing Guidelines* may reduce the possibility of such occasions arising.

There are different ways in which such an approach could be established. At one end of the spectrum, it could be made a mandatory regime; at the other it could be established as a safe harbour. A medial position could be to establish the approach as the default for qualifying services[67], but allow taxpayers to justify a different return if this is appropriate.

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[65] *2022 Guidelines* at 7.54-7.55.

[66] 2022 Guidelines at 7.64.

[67] See section D.1 of Chapter VII of the *2022 Guidelines*.

Where the services constitute a significant part of an entity's activities, the risks of base erosion, double taxation or double non-taxation may increase. This suggests that it might be necessary to include a limit on the amount of service costs (absolute or relative total costs) to which these rules would apply.

Question 18

- Do you think that the low value-adding intra-group services approach should be adopted by Canada?

Question 19

- If this approach were to be adopted, should it be made mandatory, adopted as a default position or established as a safe harbour?

Question 20

- Should there be a cap on the amount of costs that could qualify for treatment under such an approach, either as a dollar amount or a percentage of total costs? If so, what should that cap be?

D.2 Standardized Returns for Distribution Activities

Canadian distribution subsidiaries of foreign-owned MNE groups may perform a wide range of activities that, at arm's length, would attract different returns. However, distributors that perform relatively routine activities and earn returns in line with these activities may pose relatively little risk in terms of base erosion. Therefore, a safe harbour return for such activities could reduce the compliance burdens of having to determine an arm's length return.

A challenge in adopting such an approach would be to define the scope of activities to which the standardized return would apply, and whether different standardized returns would be required for different types of distribution activity. As with the low value-adding intra-group services approach, the risks of deviation from arm's length return and double taxation might increase in line with the scale of the distribution activities undertaken. As a result, it might be necessary to limit the amounts to which these provisions would apply.

Other jurisdictions, such as Australia and New Zealand, have adopted standardized returns as part of their transfer pricing risk assessment procedures[68] rather than establishing a rule.

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[68] New Zealand requires no benchmarking for foreign-owned wholesale distributors with an annual turnover of under NZD30 million whose average earnings-before-interest-tax-and-exceptional-items (EBITE) ratio is 3 per cent or more. Australia's administrative guidance (see Practical Compliance Guideline PCG 2018/D8) identifies distributors from four different sectors as being either high-, medium- or low-risk depending on their average realized returns, which is then linked to the likelihood of audit.

A consultation paper on “Amount B” of Pillar One of the Inclusive Framework on Base Erosion and Profit Shifting-led multilateral efforts underway to revise the international tax rules also contemplates standardized returns for “baseline marketing and distribution activities”. This work has not yet been concluded[69], but offers the prospect of addressing the issue raised in this section in an internationally coordinated manner. Canada remains an active participant in these discussions and will consider the implementation of Amount B once the proposals are finalised.

D.3 Intra-Group Loan Conditions

When it comes to intra-group loans, the risks that are attached to a loan between arm’s length parties are not present when one member of a multinational group lends money to another member of the group. Furthermore, there are a wide number of loan features that can be observed at arm’s length and that can be attached to intra-group loans in an attempt to justify an increase to the interest rate. For example, it may be that an MNE group has a policy of borrowing from arm’s length parties only for terms of five years or less. However, the MNE group decides to capitalize its Canadian entity through a loan with a term of twenty years resulting in a higher interest rate than for a five-year term, even though twenty-year loans between other arm’s length parties (while they may exist) are rare. Challenging such arrangements can be difficult and resource-intensive. Documenting the arm’s length nature of interest rates for intra-group loans can also place significant burdens on taxpayers.

One way of addressing base erosion risks of this type and providing greater tax certainty to taxpayers is to limit the acceptable range of certain loan conditions when identifying the arm’s length transaction to be used as a comparable.[70] The key features of this proposed regime, in terms of assessing financial instruments, would be limiting the terms of intra-group loans (to five years), using the credit rating of the MNE group as a whole and removing subordination features and embedded options. Setting a limit of five years prevents potential abuse through the use of longer-term instruments while adoption of a group credit rating approach (see discussion on credit ratings in Box 1 below) would provide a streamlined approach[71]. Removal of

[69] See consultation paper released on 8 December, 2022.

[70] In 2018, New Zealand introduced a simplified approach by deeming the removal of certain features for the pricing of specified loans: terms of longer than 5 years (loans with terms longer than 5 years are to be priced by reference to loans with terms of 5 years); subordination features; deferrals of interest beyond 12 months; features resulting in payment other than in money (such as in the form of shares); options giving rise to interest rate premiums (such as for early repayment); promissory notes or other instruments that do not provide rights to foreclose or accelerate repayment; convertibility to equity or other consideration at the option of the borrower; and contingencies (such as in profit-participating loans). The New Zealand rules allow for these features where the MNE group borrows from external parties under similar conditions, although with safeguards to prevent groups borrowing small amounts at high rates to justify high-rate internal loans.

[71] Where a MNE group does not have an externally provided credit rating, publicly available tools could be used to determine a rating.

subordination features and embedded options would also simplify and provide protection from potential abuse.

Box 1: Credit ratings

One of the prime determinants of interest rates on loans and other financial instruments is the creditworthiness of the borrower, which represents the likelihood that the borrower will fulfill its obligations to repay principal and interest as set out in the contractual terms of the debt obligation. A credit rating is an assessment of the creditworthiness of a particular entity or financial instrument.

When an entity borrows from an independent lender, the interest rate it pays will depend on factors such as the amount of the loan, the term of the loan, the availability of collateral, the presence of embedded options, and so forth, as well as the creditworthiness of the borrower. At arm's length, commercial pressures will drive borrowers to carefully monitor financial conditions that could affect their creditworthiness. However, these pressures are not present for financial transactions between related parties. In addition, the attention to monitoring of an entity's individual financial conditions will generally be less important to the group than the financial conditions of the group as a whole. This may lead to an entity having a different capital structure than it would have had if it had been independent, which in turn would result in a different credit rating (in some cases, an MNE group may deliberately alter the capital structure of its Canadian entities in order to obtain a lower credit rating and generate higher deductions in Canada).

It is an extremely difficult task to try to determine the capital structure an entity would have had, had it been an independent party. Moreover, it is questionable whether such an exercise could produce a reliable result: a business's decision about how to structure its capital is an internal decision, dependent on the preferences of the business and the external market within which the business operates. Arm's length comparables for such preferences cannot readily be identified from other characteristics of the entity. For example, two businesses could have comparable capital structures but their different attitudes to risk might lead them to adopt different approaches to sourcing new funds in otherwise comparable circumstances.

Typical approaches used to establish entity-specific credit ratings can entail significant costs for taxpayers. They are also costly for the CRA to audit and the results may still be uncertain. For example, these approaches often involve the need to make subjective judgements, such as of the extent of implicit support (the assumed assistance that an entity would receive from related parties during a credit event) or the degree to which the taxpayer represents a core entity of the MNE group. Both of these considerations require extensive information gathering and analysis by both the tax administrator and the taxpayer without any assurance of certainty.

The best financial and other information within an MNE group that can be used to determine a credit rating on a reliable basis is that used by external parties to establish credit ratings for the group as a whole. Using the group credit rating to price intra-group financial transactions could considerably reduce compliance burdens for businesses and be easier for the CRA to audit, and could reduce opportunities for base erosion. Such an approach is also consistent with guidance on financial transactions in the *Transfer Pricing Guidelines* that points to the use of group credit ratings where it is difficult to obtain and verify the information required for entity-specific credit ratings on a reliable basis.

Introducing these restrictions in Canada would provide a set of safeguards when applying the arm's length principle, and would provide a complement to the thin capitalization rules and proposed interest deductibility (EIFEL) rules. The thin capitalization rules restrict the ability to deduct interest expense on debt owing to certain related non-residents and the EIFEL rules would limit the total amount of interest that can be deducted as a share of earnings for certain taxpayers. The introduction of limits on the features of intra-group loans would provide safeguards for the assessment of such debt under transfer pricing rules[72], reduce compliance burdens and increase certainty for taxpayers.

Simply allowing for the use of these approaches on a safe harbour basis would likely not reduce the burden on the CRA of auditing intra-group financial transactions given the asymmetry of information between taxpayers and the tax administration. An alternative could be to limit the use of such approaches to situations that pose higher risks of base erosion, such as loans that exceed certain thresholds, loans with related parties in low-tax jurisdictions, or where the borrower is relatively highly-leveraged.[73] However, the government views such approaches as increasing rather than decreasing complexity.

Question 21

- Do you agree that Canada should introduce limits on the features that may be taken into account for pricing intra-group financial transactions in line with those described above?

Question 22

- If so, should there be additional features?

Question 23

- Should these rules be applied on a universal basis or only in certain circumstances?

[72] The interest deductibility limitations proposed in Budget 2021, which apply after section 247, might have an impact on the overall amount of interest that could be deducted, but only to the extent that a taxpayer's earnings are sufficiently low and to the extent that the taxpayer is within the scope of the proposed rules.

[73] The New Zealand rules allow taxpayers to use the group credit rating on a voluntary basis and require it where domestic borrowers represent a 'high BEPS risk' (i.e., where highly leveraged, unless the group as a whole is similarly highly leveraged, or where borrowing from a lender resident in a jurisdiction with a tax rate of less than 15 per cent).

Appendix A – Draft Legislative Measures

1 (1) The definition transfer price in subsection 247(1) of the Income Tax Act is replaced by the following:

transfer price means, in respect of a transaction or series of transactions, an amount paid or payable or an amount received or receivable, as the case may be, by a participant in the transaction or series as consideration. (*prix de transfert*)

(2) Subsection 247(1) of the Act is amended by adding the following in alphabetical order:

economically relevant characteristics, in respect of a transaction or series of transactions, means

(a) to the extent that the following contractual terms are consistent with the actual conduct of the participants in the transaction or series,
  i. the contractual terms of the transaction or series, and
  ii. the contractual terms of each other transaction or series involving the participants, or any other member of the multinational enterprise group, that is relevant to the transaction or series;

(b) the actual conduct of the participants in the transaction or series, including the functions performed by each of the participants, taking into account
  i. assets used and risks assumed, including risks that if materialized would be assumed,
  ii. how those functions relate to the wider generation of value by the multinational enterprise group to which the participants belong,
  iii. the circumstances surrounding the transaction or series, and
  iv. industry practices;

(c) the characteristics of any property transferred or the services provided;

(d) the economic circumstances of the participants and of the market in which the participants operate; and

(e) the business strategies pursued by the participants. (*caractéristiques économiquement pertinentes*)

multinational enterprise group means the group made up of the taxpayer or the partnership, or member of the partnership, and the non-resident person (or a partnership of which the non-resident person is a member) who are participants in a transaction or series of transactions referred to in paragraph (2)(a), as well as any other person that does not deal at arm's length with any of the participants. (*groupe d'entreprises multinationales*)

Transfer Pricing Guidelines means the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, approved by the Council of the Organisation for Economic

Co-operation and Development on January 7, 2022, or any text prescribed by regulations. (*Principes applicables en matière de prix de transfert*)

(3) Subsection 247(2) of the Act is replaced by the following:

Determination of transaction or series
(1.1) For the purposes of this section, a transaction or series of transactions shall be analyzed and determined with reference to the economically relevant characteristics of the transaction or series (in this section referred to as "delineated transaction or series").

Determination of transaction or series — non-recognition
(1.2) Subsection (1.3) applies to a delineated transaction or series if, taking into consideration the respective perspectives of the participants to a delineated transaction or series and the options realistically available to each of the participants at the time of entering into the delineated transaction or series, the delineated transaction or series

(a) differs from the transaction or series that would have been entered into by the participants had they been dealing at arm's length in a commercially rational manner in comparable circumstances; and
(b) prevents the determination of a transfer price in respect of the delineated transaction or series that would have been acceptable to the participants had they been dealing at arm's length in a commercially rational manner in comparable circumstances.

Determination of transaction or series — replacement
(1.3) If this subsection applies to a delineated transaction or series

(a) for the purposes of paragraph (2)(b) the delineated transaction or series is deemed to include conditions different from arm's length conditions; and
(b) for the purposes of subsection (2.02), the delineated transaction or series is to be disregarded and replaced with an alternative transaction or series that comports as closely as possible with the facts of the delineated transaction or series while achieving an expected result that, had the participants been dealing at arm's length in comparable circumstances, would have been commercially rational.

Interpretation of "conditions"
(1.4) For the purposes of this section, "conditions" is to be interpreted broadly to include all information in respect of the delineated transaction or series relevant to the determination of the quantum or nature of initial amounts.

Transfer pricing adjustment — application
(2) Subsection (2.02) applies to a taxpayer or a partnership if

(a) the taxpayer or the 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 series of transactions; and

(b) the delineated transaction or series determined in respect of the transaction or series referred to in paragraph (a) includes conditions different from the conditions that would have been included had the participants been dealing at arm's length in comparable circumstances (in subsections (1.3), (2.01) and (2.02) referred to as "arm's length conditions").

Transfer pricing adjustment — application deeming rule

(2.01) For the purposes of paragraph (2)(b), a delineated transaction or series is deemed to include conditions different from arm's length conditions if a condition does not exist, but would have existed had the participants been dealing at arm's length in comparable circumstances.

Transfer pricing adjustment

(2.02) If this subsection applies to a taxpayer or a partnership, any amounts (in subsections (1.4) and (2.1) referred to as the "initial amounts") that would be determined for the purposes of applying the provisions of this Act (if this Act were read without reference to this section and section 245) 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 (in subsection (2.1) referred to as the "adjusted amounts") that would have been determined if arm's length conditions had applied.

Transfer Pricing Guidelines

(2.03) This Part is to be applied so as to achieve consistency, unless the context otherwise requires, between the determination of amounts under subsection (2.02) and the Transfer Pricing Guidelines.

Appendix B – Terminology and Short Forms

The following terminology is used throughout this paper:

- "comparable uncontrolled transaction" – a transaction that is compared to the controlled transaction in the course of applying a jurisdiction's transfer pricing laws;
- "controlled transaction" – a transaction that occurs within an MNE group and that falls within the scope of a jurisdiction's transfer pricing laws;
- "MNE group" – means the group made up of a taxpayer and a non-resident person who are participants in a controlled transaction to which a transfer pricing rule applies as well as any other person that does not deal at arm's length with either of the participants; and
- "transaction" – includes the plural, and includes arrangements or events.

The following short forms are used throughout:

Transfer Pricing Guidelines:

- OECD Model Tax Convention - OECD, *Model Tax Convention on Income and on Capital*, Condensed Version (Paris: OECD Publishing, 2017).
- 1995 Guidelines - OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, loose-leaf (Paris: OECD, 1997).
- 2010 Guidelines - OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Paris: OECD, 2010).
- 2017 Guidelines OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Paris: OECD, 2017).
- 2022 Guidelines - OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Paris: OECD, 2022).
- *BEPS 8-10 Final Report* - OECD/G20 Base Erosion and Profit Shifting Project, *Aligning Transfer Pricing Outcomes with Value Creation*, Actions 8-10: 2015 Final Reports (Paris: OECD Publishing, 2015).

The combined 1995 Guidelines, 2010 Guidelines, 2017 Guidelines and 2022 Guidelines are collectively referred to as the "Transfer Pricing Guidelines".

Other jurisdiction legislation and regulations:

- Australia *ITAA 1997* - Australia: *Income Tax Assessment Act 1997* (Cth), subdivision 815-B.
- New Zealand *ITA 2007* - New Zealand: *Income Tax Act 2007* (NZ).
- UK Taxation Act 2010 - United Kingdom: Taxation (International and Other Provisions) Act 2010 (UK) c 8.
- U.S. *Treasury Regulations* - United States: 26 CFR § 1.482.

Appendix C – Extracts from Other Jurisdiction's Legislation

Australia

Income Tax Assessment Act 1997 (Cth), subdivision 815-B

815-105 Object

(1) The object of this Subdivision is to ensure that the amount brought to tax in Australia for cross-border conditions between entities is not less than it would be if those conditions reflected:

> (a) the arm's length contribution made by Australian operations through functions performed, assets used and risks assumed; and
> (b) the conditions that might be expected to operate between entities dealing at arm's length.

(2) This Subdivision does this by specifying that, where an entity would otherwise get a tax advantage from actual conditions that differ from arm's length conditions, the arm's length conditions are taken to operate for income tax and withholding tax purposes.

[...]

815-115 Substitution of arm's length conditions

(1) For the purposes covered by subsection (2), if an entity gets a transfer pricing benefit from conditions that operate between the entity and another entity in connection with their commercial or financial relations:

> (a) those conditions are taken not to operate; and
> (b) instead, the arm's length conditions are taken to operate.

Note 1: The conditions that operate include, but are not limited to, such things as price, gross margin, net profit, and the division of profit between the entities.

[...]

815-120 When an entity gets a *transfer pricing benefit*

(1) An entity gets a ***transfer pricing benefit*** from conditions that operate between the entity and another entity in connection with their commercial or financial relations if:

> (a) these conditions (the ***actual conditions***) differ from the arm's length conditions; and
> (b) the actual conditions satisfy the cross-border test in subsection (3) for the entity; and
> (c) had the arm's length conditions operated, instead of the actual conditions, one or more of the following would, apart from this Subdivision, apply:
> (i) the amount of the entity's taxable income for an income year would be greater;
> (ii) the amount of the entity's loss of a particular sort for an income year would be less;

(iii) the amount of the entity's tax offsets for an income year would be less;
(iv) an amount of withholding tax payable in respect of interest or royalties by the entity would be *greater*.

[...]

Absence of condition

(2) For the purposes of (1), there is taken to be a difference between the actual conditions and the arm's length conditions if:
(a) an actual condition exists that is not one of the arm's length conditions; or
(b) a condition does not exist in the actual conditions but is one of the arm's length conditions.

[...]

815-125 Meaning of arm's length conditions

(1) The ***arm's length conditions***, in relation to conditions that operate between an entity and another entity, are the conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances.

Most appropriate and reliable method to be used

(2) In identifying the arm's length conditions, use the method, or the combination of methods, that is the most appropriate and reliable having regard to all relevant factors, including the following:

(a) the respective strengths and weaknesses of the possible methods in their application to the actual conditions;
(b) the circumstances, including the functions performed, assets used and risks borne by the entities;
(c) the availability of reliable information required to apply a particular method;
(d) the degree of comparability between the actual circumstances and the comparable circumstances, including the reliability of any adjustments to eliminate the effect of material differences between those circumstances."

Note 1: The possible methods include the methods set out in the documents mentioned in section 815-135 (about relevant guidance material).

Comparability of circumstances

(3) In identifying comparable circumstances for the purpose of this section, regard must be had to all relevant factors, including the following:

(a) functions performed, assets used and risks borne by the entities;
(b) characteristics of the property or services transferred;
(c) the terms of any relevant contracts between the entities;
(d) the economic circumstances;
(e) the business strategies of the entities.

(4) For the purposes of this section, circumstances are comparable to actual circumstances if, to the extent (if any) that the circumstances differ from the actual circumstances:

(a) the difference does not materially affect a condition that is relevant to the method; or

(b) reasonably accurate adjustment can be made to eliminate the effect of the difference on a condition that is relevant to the method.

815-130 Relevance of actual commercial or financial relations

Basic rule

(1) The identification of the arm's length conditions must:

(a) be based on the commercial or financial relations in connection with which the actual conditions operate; and

(b) have regard to both the form and substance of those relations.

Exceptions

(2) Despite paragraph (1)(b), disregard the form of the actual commercial or financial relations to the extent (if any) that it is inconsistent with the substance of those relations.

(3) Despite subsection (1), if:

(a) independent entities dealing wholly independently with one another in comparable circumstances would not have entered into the actual commercial or financial relations; and

(b) independent entities dealing wholly independently with one another in comparable circumstances would have entered into other commercial or financial relations; and

(c) those other commercial or financial relations differ in substance from the actual commercial or financial relations;

the identification of the arm's length conditions must be based on those other commercial or financial relations.

(4) Despite subsection (1), if independent entities dealing wholly independently with one another in comparable circumstances would not have entered into commercial or financial relations, the identification of the arm's length conditions is to be based on that absence of commercial or financial relations.

(5) Subsections 815-125(3) and (4) (about comparability of circumstances) apply for the purposes of this section.

815-135 Guidance

(1) For the purpose of determining the effect this Subdivision has in relation to an entity, identify arm's length conditions so as best to achieve consistency with the documents covered by this section.

(2) The documents covered by this section are as follows:

(a) [2017 Guidelines[74]]
(b) a document, or part of a document, prescribed by the regulations for the purposes of this paragraph.

(3) However, the document mentioned in paragraph (2)(a) is not covered by this section if the regulations so prescribe.

(4) Regulations made for the purposes of paragraph (2)(b) or subsection (3) may prescribe different documents or parts of documents for different circumstances.

New Zealand

Income Tax Act 2007 (NZ) 2007/97

GB 2 Arrangements involving transfer pricing

When this section applies

(1) This section applies in relation to a person if an arrangement has a purpose or effect of defeating the intent and application of –

(a) section GC 7 (Excess amount payable by person):

(b) section GC 8 (Insufficient amount receivable by person):

(c) section GC 9 (Compensating arrangement: person paying less than arm's length amount):

(d) section GC 10 (Compensating arrangement: person receiving more than arm's length amount).

[...]

Transfer pricing arrangements

GC 6 Purpose and application of rules and nature of arrangements

Purpose of rules

(1) The purpose of this section and sections GC 7 to GC 14 is to substitute an arm's length consideration in the calculation of a person's net income if the person's net income is reduced by the conditions of a cross-border arrangement –

(a) with an associated person or with a party to a financial arrangement that is a cross-border related borrowing of the person under subsection (3B); and
(b) for the acquisition or supply of goods, services, or anything else, or that includes a financial arrangement that is a cross-border related borrowing.

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74 Treasury Laws Amendment (2019 Measures No. 3) Bill 2019, cl 116.

Rules apply consistently with OECD transfer pricing guidelines

(1B) This section and sections GC 7 to GC 14 apply consistently with the OECD transfer pricing guidelines.[75]

What is a transfer pricing arrangement?

(2) An arrangement is a **transfer pricing arrangement** if –

(a) the arrangement involves the supply and acquisition of goods, services, money, other intangible property, or anything else; and
(b) the arrangement –

(i) is between a supplier and acquirer who are associated persons or are a company and a person who is a member of anon-resident owning body that has an ownership interest in the company o 50% or more: [sic]

(ii) includes a financial arrangement that is a cross-border related borrowing; and

(c) the arrangement is a cross-border arrangement under subsection (3).

GC 13 Calculation of arm's length amounts

Determining arm's length amounts

(1) An arm's length amount of consideration for a supply and acquisition under a transfer pricing arrangement must be determined by –

(a) identifying as required by subsection (1B) and (1C), a transaction reproducing the supply and acquisition (the identified transaction) or the absence of such a transaction; and
(b) identifying the conditions (the arm's length conditions) that independent parties after real and independent bargaining might be expect to agree upon for the identified transaction; and
(c) applying which 1 or a combination of the methods listed in subsection (2) produces the most reliable measure of the arm's length amount of consideration (the arm's length amount) that independent parties after real and independent bargaining would have agree upon as the price for the identified transaction as part of the arm's length conditions.

Determination of identified transaction

(1B) A transaction reproducing a supply and acquisition under a transfer pricing arrangement is determined by—
(a) accurately delineating the transfer pricing arrangement using the approach given in the OECD transfer pricing guidelines, chapter I, section D.1; and
(b) identifying a transaction of supply and acquisition under the transfer pricing arrangement as delineated under paragraph (a).

No transaction or differing transaction

[75] "OECD transfer pricing guidelines" are defined in New Zealand *ITA 2007*, s YA 1.

(1C) If the requirements of the OECD transfer pricing guidelines, paragraph 1.122 are met, the approach described in the OECD transfer pricing guidelines, chapter I, section D.2 must be used to treat a transfer pricing arrangement involving a supply and acquisition as instead involving –

(a) no supply and acquisition; or
(b) an identified transaction that differs from the supply and acquisition under the accurately delineated transfer pricing arrangement.

Available methods for calculating arm's length amount

(2) The arm's length amount of consideration for a supply and acquisition under a transfer pricing arrangement is zero [where a specific anti-avoidance rule applies], or is the amount calculated for the identified transaction under arm's length conditions by performing a comparability analysis as required by the OECD transfer pricing guidelines, chapter III suing any 1 or a combination of:

(a) the comparable uncontrolled price method:
(b) the resale price method:
(c) the cost plus method:
(d) the transactional profit split method:
(e) the transactional net margin method.

Criterial for choice and application of method

(3) The choice and application of a method or methods must be made having regard to each of the following factors:
(a) the degree of comparability between the transactions used for comparison and the transactions of the taxpayer under the transfer pricing arrangement:
(b) the completeness and accuracy of the data relied on:
(c) the reliability of all assumptions:
(d) the sensitivity of a result to possible deficiencies in the data and assumptions.

[...]

United Kingdom

Taxation (International and Other Provisions) Act 2010 (UK) c 8

147 Tax calculations to be based on arm's length, not actual, provision

(1) For the purposes of this section "the basic pre-condition" is that –

(a) provision ("the actual provision") has been made or imposed as between any two persons ("the affected persons") by means of a transaction or series,
(b) [...]
(c) [...],
(d) the actual provision differs from the provision ("the arm's length provision") which would have been made as between independent enterprises.

(3) the profits and losses of the potentially advantage person are to be calculated for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision.

[...]

151 "Arm's length provision"

(1) In this Part "the arm's length provision" has the meaning given by section 147(1)

(2) For the purposes of this Part, the cases in which provision made or imposed as between any two persons is to be taken to differ from the provision that would have been made as between independent enterprises include the case in which provision is made or imposed as been two persons but no provision would have been made as between independent enterprises; and references in this Part to the arm's length provision are to be read accordingly.

[...]

164 Part to be interpreted in accordance with OECD principles

(1) This Part is to be read in such manner as best secures consistency between –

(a) the effect given to sections 147(1)(a), (b) and (d) and (2) to (6), 148 and 151(2), and
(b) the effect which, in accordance with the transfer pricing guidelines, is to be given, in cases where double taxation arrangements incorporate the whole or any part of the OECD model, to so much of the arrangements as does so.[76]

(2) Subsection (1) has effect subject to –

[...]

United States

IRC § 482 ("Allocation of income and deductions among taxpayers"), supported by detailed Treasury Regulations 26 CFR § 1.482.

1.482-1 Allocation of income and deductions among taxpayers

(a) In general.

(1) Purpose and scope

The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions.

[76] The Taxation (International and Other Provisions) Act 2010 Transfer Pricing Guidelines Designation Order 2022, SI 2022 No. 1147 identifies the relevant current version of the guidelines as the 2022 Guidelines.

Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. This section sets for general principles and guidelines to be followed under section 482. [...]

(b) Arm's length standard

(1) In general.

> In general. In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances. See § 1.482-1(d)(2) (Standard of comparability). Evaluation of whether a controlled transaction produces an arm's length result is made pursuant to a method selected under the best method rule described in § 1.482-1(c).

(c) Best method rule

(1) In general.

> The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result...

[...]

(d) Comparability

(1) In general.

> Whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. For this purpose, the comparability of transactions and circumstances must be evaluated considering all factors that could affect prices or profits in arm's length dealings (comparability factors). While a specific comparability factor may be of particular importance in applying a method, each method requires analysis of all of the factors that affect comparability under that method. Such factors include the following –

(i) Functions;
(ii) Contractual terms;
(iii) Risks;
(iv) Economic conditions; and
(v) Property or services.

[...]

(f) Scope of review

(2) Rules relating to determination of true taxable income.

(ii) Allocation based on taxpayer's actual transactions.

> (A) In general.
> The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the Commissioner may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. In such cases the Commissioner may adjust the consideration charged in the controlled transaction based on the cost or profit of an alternative as adjusted to account for material differences between the alternative and the controlled transaction, but will not restructure the transaction as if the alternative had been adopted by the taxpayer.

[...]

Appendix D: Other Administrative Measures Considered

In developing the proposals above, the government also reviewed other possible administrative approaches that it has decided not to develop further at this time. Chief among these are measures to restrict the scope of transactions and taxpayers to which the transfer pricing rules apply, the use of safe-harbour interest rates and special rules for 'hard-to-value' intangibles.

A. Measures Concerning the Scope of the Transfer Pricing Rules

A broad approach to providing certainty and reducing compliance burdens used in some jurisdictions is to eliminate or reduce compliance obligations for certain types of transactions or taxpayers that seemingly pose relatively low risk to the tax base.

A.1 Exemption for Transactions Below a *de minimis* Threshold

One way in which the burden of transfer pricing compliance could be reduced would be to use revenue-based criteria such that the rules would only apply to transactions whose aggregate value exceeds a specific dollar threshold. The benefit of such an approach would be the elimination of the need to determine and use arm's length conditions for controlled transactions that present relatively low risk. This approach could be of particular benefit to businesses that are beginning to expand outside Canada, for foreign MNE groups starting operations in Canada, or for smaller entities that engage in regular cross-border trade but whose transaction volumes are relatively low. (At the same time, an exemption for low value transactions would not exempt MNE groups from transfer pricing requirements in other jurisdictions.)

However, these benefits need to be balanced against the risks that MNE groups could structure their arrangements so as to minimize the relevant tax base in Canada. For example, taxpayers could fragment transactions into several smaller transactions so as to benefit inappropriately from this exemption. They would also not be obliged to use arm's length conditions provided the relevant revenue base was below the threshold.

This shows that it would be important to clearly define the scope of any exclusion and whether this should be determined on a transactional basis, on the aggregate amount of all cross-border transactions, or some combination of the two (such as a lower transactional limit coupled with a cap on the overall volume of transactions). Additional safeguards would be required for circumstances where transactions are priced under the *de minimis* limit but arm's length parties would have agreed to a price significantly above the limit. These concerns, the importance and efficiency of maintaining the arm's length principle as a common approach, mean that this option is less favoured than the introduction of simplified documentation requirements and streamlined pricing approaches described above.

A.2 Exemption for Small Taxpayers

An approach that would assist "small" taxpayers, including many in a start-up phase, could be to exempt "small" taxpayers altogether from the transfer pricing rules in Canada.[77] This would recognize that smaller taxpayers may not have the same resources as larger MNE groups and that compliance with the transfer pricing rules represents a relatively greater burden for such taxpayers that outweighs the potential inaccuracies.

However, any exemption could increase the opportunities available to such smaller taxpayers to engage in inappropriate tax avoidance arrangements using transfer pricing. Targeted exceptions to any exemption could be necessary, and this could lead to greater complexity in the application of the transfer pricing rules rather than less.[78]

Again, an exemption for small taxpayers in Canada would not provide them with an exemption from the requirement to comply with transfer pricing rules in other jurisdictions.

B. Safe-Harbour Interest Rates

An approach used by some countries, including the United States and Switzerland, is to provide safe harbour interest rates or ranges of interest rates for intra-group financial instruments that are deemed to be arm's length rates (taxpayers can use rates other than those specified in the safe harbour rule, provided that they are supported as being arm's length rates). These offer benefits to both taxpayers and tax authorities in terms of compliance and administration costs and bringing greater tax certainty (fixed rates of interest are already required in certain domestic contexts). However, they arguably allow for greater divergences from arm's length pricing than the simplified pricing approaches described above. There is also a requirement to determine and

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[77] The United Kingdom, for example, generally provides an exemption for small and medium-sized enterprises, defined as those having fewer than 250 employees, annual turnover of less than €50 million and/or a balance sheet of less than €43 million. (See E.U. Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises, as referenced in Section 172, Chapter 3, Part 4, 2010 Chapter 8, Taxation (International and Other Provisions) Act 2010.) Small enterprises are those that have no more than 50 employees and either an annual turnover or balance sheet total of less than €10 million. There are certain exceptions that apply to the exemption: transactions with parties in certain jurisdictions, the enterprise is party to a transaction that is relevant to a patent box claim and appropriate cases where the tax administration has issued a notice. (Further, a business can elect for the exemption not to apply.)

[78] A proxy approach for providing exemptions for smaller taxpayers could be to provide an exemption from the transfer pricing rules for a temporary period after incorporation or the establishment of a non-Canadian permanent establishment. However, such provisions seem inappropriate for a number of reasons. A temporary exemption for a set number of years after incorporation would not be of benefit for businesses that spend time building up their business in Canada before expanding operations abroad, and this could create an un-level playing field with businesses that begin non-Canadian operations relatively soon after starting up. A temporary exemption starting from the establishment of a non-Canadian permanent establishment could pose risks, for example by providing a window for the off-shoring of valuable intangibles.

update the safe harbour rates on a regular basis in order to minimize these risks. As a result, the government views that the streamlined pricing approaches outlined above provide a more flexible and accurate approach to transfer pricing for intra-group loans, as well as other related-party cross-border financial transactions.

C. Hard-to-Value Intangibles

The *2017 Guidelines* introduced a new pricing approach for "hard-to-value intangibles".[79] These are intangibles whose value is highly uncertain at the time of transfer from one MNE group member to another and for which no reliable comparables exist. For example, it may be that a Canadian enterprise transfers an intangible to a related offshore entity at an early stage of development. If the intangible later achieves market success, the CRA may have difficulties in challenging the value of the intangible due to uncertainties at the time of the transfer as there may be little independent information to substantiate taxpayers' claims. Because of this information asymmetry and the resultant base erosion risk, the hard-to-value intangibles approach allows tax administrations to use *ex post* information on financial outcomes as evidence of the appropriateness of *ex ante* pricing arrangements, while at the same time taking into account whether those financial outcomes could have been reasonably foreseen (and were documented) at the time at which the arrangement was entered into.

However, the government is of the view that the existing and prospective legislative framework in combination with the *Transfer Pricing Guidelines* are sufficient to address such difficult situations without the need for specific measures.

[79] See section D.4 of Ch.VI. Participants in this consultation are encouraged to consult this reference in order to be familiar with the specifics of this approach, including conditions for its application and safeguards for taxpayers.

Appendix E – Information Recommended to be Included in the Local File

This appendix reproduces the information required to be included in the Local file provided in Annex II to the *BEPS Action 13 Report*.

Local entity

- A description of the management structure of the local entity, a local organisation chart, and a description of the individuals to whom local management reports and the country(ies) in which such individuals maintain their principal offices.
- A detailed description of the business and business strategy pursued by the local entity including an indication whether the local entity has been involved in or affected by business restructurings or intangibles transfers in the present or immediately past year and an explanation of those aspects of such transactions affecting the local entity.
- Key competitors.

Controlled transactions

For each material category of controlled transactions in which the entity is involved, provide the following information:

- A description of the material-controlled transactions (e.g. procurement of manufacturing services, purchase of goods, provision of services, loans, financial and performance guarantees, licences of intangibles, etc.) and the context in which such transactions take place.
- The amount of intra-group payments and receipts for each category of controlled transactions involving the local entity (i.e., payments and receipts for products, services, royalties, interest, etc.) broken down by tax jurisdiction of the foreign payor or recipient.
- An identification of associated enterprises involved in each category of controlled transactions, and the relationship amongst them.
- Copies of all material intercompany agreements concluded by the local entity.
- A detailed comparability and functional analysis of the taxpayer and relevant associated enterprises with respect to each documented category of controlled transactions, including any changes compared to prior years.[80]
- An indication of the most appropriate transfer pricing method with regard to the category of transaction and the reasons for selecting that method.
- An indication of which associated enterprise is selected as the tested party, if applicable, and an explanation of the reasons for this selection.

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[80] To the extent this functional analysis duplicates information in the master file, a cross-reference to the master file is sufficient

- A summary of the important assumptions made in applying the transfer pricing methodology.
- If relevant, an explanation of the reasons for performing a multi-year analysis.
- A list and description of selected comparable uncontrolled transactions (internal or external), if any, and information on relevant financial indicators for independent enterprises relied on in the transfer pricing analysis, including a description of the comparable search methodology and the source of such information.
- A description of any comparability adjustments performed, and an indication of whether adjustments have been made to the results of the tested party, the comparable uncontrolled transactions, or both.
- A description of the reasons for concluding that relevant transactions were priced on an arm's length basis based on the application of the selected transfer pricing method.
- A summary of financial information used in applying the transfer pricing methodology.
- A copy of existing unilateral and bilateral/multilateral APAs and other tax rulings to which the local tax jurisdiction is not a party, and which are related to controlled transactions described above.

Financial information

- Annual local entity financial accounts for the fiscal year concerned. If audited statements exist, they should be supplied and if not, existing unaudited statements should be supplied.
- Information and allocation schedules showing how the financial data used in applying the transfer pricing method may be tied to the annual financial statements.
- Summary schedules of relevant financial data for comparables used in the analysis and the sources from which that data was obtained.

Appendix F – Information Recommended to be Included in the Master File

This appendix reproduces the information required to be included in the Master file provided in Annex I to the BEPS Action 13 report.

Organizational structure:

- Chart illustrating the MNE's legal and ownership structure and geographical location of operating entities.

Description of MNE's business(es):

- General written description of the MNE's business including:
  - Important drivers of business profit;
  - A description of the supply chain for the group's five largest products and/or service offerings by turnover plus any other products and/or services amounting to more than 5 percent of group turnover. The required description could take the form of a chart or a diagram;
  - A list and brief description of important service arrangements between members of the MNE group, other than research and development (R&D) services, including a description of the capabilities of the principal locations providing important services and transfer pricing policies for allocating services costs and determining prices to be paid for intra-group services;
  - A description of the main geographic markets for the group's products and services that are referred to in the second bullet point above;
  - A brief written functional analysis describing the principal contributions to value creation by individual entities within the group, i.e. key functions performed, important risks assumed, and important assets used; and
  - A description of important business restructuring transactions, acquisitions and divestitures occurring during the fiscal year.

MNE's intangibles:

- A general description of the MNE's overall strategy for the development, ownership and exploitation of intangibles, including location of principal R&D facilities and location of R&D management;
- A list of intangibles or groups of intangibles of the MNE group that are important for transfer pricing purposes and which entities legally own them.
- A list of important agreements among identified associated enterprises related to intangibles, including cost contribution arrangements, principal research service agreements and licence agreements.

- A general description of the group’s transfer pricing policies related to R&D and intangibles.
- A general description of any important transfers of interests in intangibles among associated enterprises during the fiscal year concerned, including the entities, countries, and compensation involved.

MNE’s intercompany financial activities:

- A general description of how the group is financed, including important financing arrangements with unrelated lenders.
- The identification of any members of the MNE group that provide a central financing function for the group, including the country under whose laws the entity is organised and the place of effective management of such entities.
- A general description of the MNE’s general transfer pricing policies related to financing arrangements between associated enterprises.

MNE’s financial and tax positions:

- The MNE’s annual consolidated financial statement for the fiscal year concerned if otherwise prepared for financial reporting, regulatory, internal management, tax or other purposes.
- A list and brief description of the MNE group’s existing unilateral advance pricing agreements (APAs) and other tax rulings relating to the allocation of income among countries.

Appendix G – Summary of Questions Asked

With Respect to The Current State of Canada's Transfer Pricing Law

Question 1

- As it relates to the application of the arm's length principle, the consultation paper identifies two main areas where Canada's current transfer pricing legislation does not provide explicit guidance, together with proposed amendments to provide greater certainty in these areas. Are there other areas that would benefit from additional guidance in order to ensure that the arm's length principle, as articulated in the *Transfer Pricing Guidelines*, is applied in Canada?
- If so, please indicate the area and provide input as to the form(s) you consider such guidance should take (legislation, technical notes or administrative guidance).

With Respect to Proposed Solutions

Question 2

- The requirement proposed by the rule at (1.1) to establish the starting point of the comparison respects the transaction or series as structured by the taxpayer. There are, however, limits placed on this. The rule at (1.1) requires that a transaction or series meeting the conditions of paragraph (2)(a) must be augmented by relevant facts deriving from the elements of the definition of "economically relevant characteristics". In some cases the *Transfer Pricing Guidelines* provide that the risks are to be reallocated based on the level of control over the risk and financial capacity to assume the risk.
- Does the proposed legislation provide sufficient direction or guidance for this delineation exercise consistent with the *Transfer Pricing Guidelines*? If not, what additional legislative direction or guidance would be required?

Question 3

- The transfer pricing application rule at paragraph (2)(b) would scrutinize the delineated transaction or series to determine whether it includes conditions that differ from those that would have been included had the parties been dealing with each other at arm's length in comparable circumstances.
- A proposed interpretive rule at subsection (1.4) would provide that conditions is to be interpreted broadly to include all information relevant to the determination of "initial amounts" as this term is used in subsection (2.1).
- Do you agree that the "conditions" of the delineated transaction or series would capture all relevant conditions that operate in respect of the delineated transaction or series?

Question 4

- The arm's length principle applies taking into account the commercial interest of the parties to the controlled transaction posited as separate entities and should not include assessments taken from the commercial interests of the MNE group as a whole. This approach is relevant whether the principle is applied directly through the transfer pricing application rule at proposed paragraph (2)(b) or the non-recognition and replacement rule at proposed subsections (1.2) and (1.3) (discussed next).
- The language proposed to adopt the non-recognition and replacement rule includes some guidance regarding the consideration of the separate perspectives of the parties to the transaction at the preamble to subsection (1.2). No similar language is proposed at paragraph (2)(b), because a consideration of the interests of the parties as separate entities underlies the statement of the arm's length principle in that paragraph.
- Do you agree that the language at paragraph (2)(b) is sufficient to ensure that assessments of the commercial interests of the MNE group as a whole are not included in the test at proposed paragraph (2)(b) or do you consider that additional language is required to establish this approach?

Question 5

- In addition to the application of the general anti-avoidance rule, a specific rule is required to protect the integrity of the rules that incorporate the arm's length principle for Canadian tax purposes.
- It is proposed that paragraphs 247(2)(b) and (d) be repealed and replaced with the non-recognition and replacement rule outlined above, which is designed to protect domestic tax bases from profit allocations resulting from controlled transactions meeting the criteria of the rule at proposed subsection (1.2) by replacing them with controlled transactions that have a commercially rational expected result and that can be priced from the point of view of arm's length parties taking their individual interests into account.
- In your view, will the proposed rule be effective in protecting the integrity of the Canadian transfer pricing rules and the Canadian tax base? Taking into account the international consensus on transfer pricing, is there a different approach that you would propose?

Question 6

- Do you agree that the inclusion in the proposed legislation of a consistency rule with respect to the *Transfer Pricing Guidelines* is a practical way of helping to align Canada's transfer pricing legislation with the international consensus? If not, what alternative approach would you recommend and why?
- The proposed consistency rule would adopt a static approach to the *Transfer Pricing Guidelines*. Do you agree with this approach? Or do you consider that an ambulatory approach would be preferable as it would ensure that Canada's transfer pricing legislation is contemporaneous with the guidelines as they evolve?

- Assuming a static approach is adopted, what should be the considerations in the future when updating a reference to the *Transfer Pricing Guidelines*? Should they apply only prospectively? Would it matter if the updated version of the guidelines were beneficial to the taxpayer or the tax administration?

Question 7

- With reference to Appendix A, please comment on any other aspects of the proposed legislative changes to section 247.

With Respect to Transfer Pricing Documentation and Penalty Provisions

Question 8

- What changes do you think need to be made to the transfer pricing documentation provision?

Question 9

- What changes do you think need to be made to the transfer pricing penalty provision?

Question 10

- Do you agree with the proposal to align the documentation requirements of subsection 247 with those of the Local file detailed in Appendix E?

Question 11

- Do you agree with this proposal to introduce Master file reporting requirements (on request) for taxpayers that are members of MNE groups that are also subject to CbC reporting requirements?

Question 12

- What information, if any, should be required to be completed for the Local file and Master file other than or instead of that described in Appendices D and E?

With Respect to Simplified Documentation Requirements for Lower Value Transactions and Smaller Taxpayers

Question 13

- Do you agree with the proposal to provide simplified documentation requirements for low-risk taxpayers and transactions?

Question 14

- What criteria could be used to identify taxpayers and transactions to whom reduced documentation requirements would apply?

Question 15

- What content would be required to demonstrate compliance with the arm’s length principle under such reduced documentation requirements?

With Respect to Transfer Pricing Penalty Thresholds

Question 16

- Should the $5 million threshold be changed? If so, would an increase to [$10] million be appropriate?

Question 17

- Does the penalty provision operate as intended to encourage the preparation of contemporaneous documentation? If no, how could it be changed to encourage compliance?

With Respect to Streamlined Pricing Approaches

Question 18

- Do you think that the low value-adding intra-group services approach should be adopted by Canada?

Question 19

- If this approach were to be adopted, should it be made mandatory, adopted as a default position or established as a safe harbour?

Question 20

- Should there be a cap on the amount of costs that could qualify for treatment under such an approach, either as a dollar amount or a percentage of total costs? If so, what should that cap be?

Question 21

- Do you agree that Canada should introduce limits on the features that may be taken into account for pricing intra-group financial transactions in line with those described above?

Question 22

- If so, should there be additional features?

Question 23

- Should these rules be applied on a universal basis or only in certain circumstances?