

DON'T TAKE TRANSFER PRICING FOR GRANTED

By David J. Kemp

The establishment of appropriate transfer pricing policies is vital to companies from both a business and tax point of view. Proper transfer pricing planning from a business perspective allows for accurate financial results, ensuring that business valuations and other financial decisions based on transfer prices are made using correct information. Proper transfer pricing planning from a tax perspective allows for potential global tax optimization, while ensuring compliance with applicable domestic legislation regarding documentation and reporting requirements.

In this issue we will provide an overview of the key business issues to be aware of regarding transfer pricing in various types of transactions and corresponding tax issues. From time-to-time we will feature other articles on transfer pricing in this newsletter, but if you would like to receive future articles focusing on specific transfer pricing issues and our comprehensive analysis of these topics, please contact us. (Contact information can be found on the insert entitled **External Assistance on Transfer Pricing Matters.**)

TRANSFER PRICING: A CONCEPT AND A METHODOLOGY

To compete globally, multinational enterprises often transact with their affiliates by way of sharing products, services, intangibles and funds. When these transactions (including an arrangement or event) are between affiliates in different tax jurisdictions they must be priced on an "arm's length" basis. The pricing of cross-border related party transactions on an arm's length basis is critical to tax authorities that fear the loss of revenue to other tax jurisdictions through the manipulation of intercompany prices. The arm's length concept is found in most countries' transfer pricing legislation and refers to the price, including other terms and conditions, at which third parties would have transacted.

Transfer pricing is ultimately the methodology used to determine a range of acceptable prices for cross-border

related party transactions. A complicating issue is the fact that transfer pricing is not an exact science – it requires significant professional judgment and reasonableness assessments.

BUSINESS ISSUES

While many think of transfer pricing as only a tax issue (likely because of the penalties and interest that can apply) – transfer pricing also comes into play in a purely business context. More specifically, if proper transfer prices are not applied to transactions between domestic divisions and/or subsidiaries of an enterprise, there can be significant unfavourable impact on the division's or subsidiary's financial results.

Transaction prices between domestic divisions/subsidiaries that are too high or too low create a variety of business issues. Common problems include:

- (i) uneconomic divisions/subsidiaries appear profitable, or profitable divisions/subsidiaries appear to be operating below standard;
- (ii) management of divisions/subsidiaries whose bonuses and future promotions depend on profitability are over or under rewarded;
- (iii) management is unable to accurately determine which of the divisions/subsidiaries are really adding the most value;
- (iv) divisions/subsidiaries that are allowed to either buy goods or services from outside suppliers, or source those goods or services internally, could make decisions that are not in the best interest of the company; and
- (v) unnecessary friction between divisional/subsidiary management can arise.

"PRICING OF
CROSS-BORDER
RELATED PARTY
TRANSACTIONS..."

IN OUR TRANSFER PRICING EXECUTIVE OVERVIEW ISSUE:

- Don't Take Transfer Pricing for Granted
- Typical Transfer Pricing Transactions
- Customs Concerns
- External Assistance on Transfer Pricing Matters (Insert)
- Upcoming Speaking Engagements (Insert)

"TO MEET THE REQUIREMENTS A TAXPAYER SHOULD PUT IN PLACE DOCUMENTATION..."

TAX ISSUES

Transfer pricing legislation came into force in Canada in June 1998, and since then, Canada Revenue Agency (CRA) has significantly increased its focus on related party cross-border transactions. Indeed, CRA has a team of auditors whose sole focus is on transfer pricing.

Companies must establish a detailed transfer pricing plan with comprehensive supporting documentation to ensure compliance with the legislation (to minimize potential of income tax reassessments and corresponding interest and/or penalties that may apply) and to ensure that global tax optimization is achieved.

The Canadian transfer pricing legislation technically only applies to transactions between affiliates in different tax jurisdictions. Historically, CRA has not tended to focus as much attention on domestic transactions between related parties because (ignoring loss carry forward scenarios), regardless of which Canadian division or subsidiary of a group reports the revenue, the overall Canadian tax base is unaffected.

LEGISLATION AND ADMINISTRATIVE PRACTICES

The transfer pricing rules are contained in Section 247 of the Income Tax Act (the Act). The transfer pricing rules apply to transactions between a taxpayer and a non-resident person with whom the taxpayer does not deal at arm's length (in other words, the rules apply to individuals, corporations, partnerships and trusts). The administrative practices of CRA with respect to the application of Section 247 are outlined in Information Circular 87-2R, "International Transfer Pricing" (the IC). Administrative practice set out in the IC is generally in keeping with the 1995 Organization for Economic Co-operation and Development Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators (OECD Guidelines). The general principles set out in the OECD Guidelines have been integrated into the transfer pricing legislation and policies of a number of countries.

CRA ADJUSTMENTS

If the terms or conditions of the non-arm's length transactions differ from those that would have been made between third parties, CRA may adjust the transactions to reflect amounts that would have been applied in situations involving third parties. Further, the legislation also permits CRA to recharacterize the nature of a transaction. If parties enter into a transaction that would not have been entered into by persons dealing at arm's length, and it is reasonable to consider that the transaction was not entered into primarily for *bona fide* purposes other than to obtain a tax benefit, the nature of the transaction may be recharacterized.

PENALTIES

CRA can assess transfer pricing penalties if the net transfer pricing adjustment made for a taxpayer in a tax year exceeds the lesser of 10% of gross revenue and \$5 million. For purposes of the penalty, the net adjustment encompasses upward adjustments (in other words, an increase in a taxpayer's income, a decrease in a loss, or a decrease in a capital expenditure) where the taxpayer failed to make a reasonable effort to determine and use arm's length prices. The net adjustment also includes downward adjustments (in other words, a decrease in a taxpayer's income, an increase in a loss, or an increase in a capital expenditure) where the taxpayer has made a reasonable effort to determine and use arm's length prices.

Transfer pricing penalties imposed by the US and many other countries are computed as a percentage of the resulting tax increase, rather than a percentage of the income adjustment under the Canadian legislation. So, a Canadian taxpayer may still be assessed the penalty even if the taxpayer is not otherwise taxable in Canada that year (for example, if the taxpayer is in a loss position or claims a loss carry forward). Keep in mind that the penalty and interest are not deductible for Canadian tax purposes. Under US tax law, a penalty imposed by the Internal Revenue Service is not deductible but interest assessed on late payment of tax and penalties are deductible.

SMALL DOLLAR AMOUNTS CAN LEAD TO MATERIAL ADJUSTMENTS

Given that CRA can reassess prior years (generally, up to seven years after the mailing date of the original assessment for that year with respect to cross-border transactions under terms of the Canada-US Treaty), a rather minor transfer pricing error recurring over many years can lead to a material overall adjustment. The adjustment amount would be a combination of the additional tax owing, interest calculated at prescribed rates and compounded on a daily basis, and the transfer pricing penalty.

DOCUMENTATION

Taxpayer's are required to put in place documentation on or before the tax return filing due date for the tax year in which the transaction took place. If CRA requests it, the documentation must be provided within three months of receipt of a written request.

A taxpayer is deemed not to have made reasonable efforts to determine and use arm's length prices (also referring to allocations of profits or losses, and contributions to costs) if the taxpayer does not have the necessary documentation in place. To meet the requirements a taxpayer should put in place documentation that summarizes the following:

- the property or services to which the transaction relates;

- the terms and conditions of the transaction, and the relationship to other transactions between the parties;
- the identity of the parties, and the relationship between them;
- the functions performed, the property used or contributed, and the risks assumed, by the parties to the transaction;
- the data and methods considered and the analysis performed to determine the transfer prices; and
- the assumptions, strategies and policies that influenced the determination of the transfer prices.

The first three documentation requirements are relatively straightforward. The final three documentation requirements are the more critical documentation elements and generally are the areas focused on in any detailed transfer pricing planning and documentation study. (You can find a description of what's involved in completing a documentation study in the insert entitled: **External Assistance on Transfer Pricing Matters.**)

Though the US has similar rules regarding transfer pricing, there are some significant differences between the Canadian and US rules. So, the documentation prepared by a US affiliate will not necessarily meet the Canadian documentation requirements. For example, it is not unusual for a US parent company to have documentation in place that demonstrates that a Canadian subsidiary is not paying *less than* an arm's length price on goods purchased from the US parent. This type of documentation would likely satisfy the US tax authorities, but from a Canadian perspective CRA would likely want to see that the Canadian subsidiary is not paying *in excess* of an arm's length price.

AUDITS

CRA has dedicated transfer pricing auditors whose sole focus is on cross-border related party transactions. Their attention is not limited to large multinational enterprises or to any particular industry. When taxpayers do not establish proper transfer pricing documentation prior to an audit, the time and cost associated with responding to the audit and to negotiating with the auditors is typically significantly more than the cost of putting proper documentation in place to begin with.

If CRA determines the taxpayer's documentation is incomplete or inaccurate, there is a greater chance CRA will propose an adjustment. Further, if CRA concludes that a taxpayer did not make reasonable efforts to determine and use arm's length prices, a number of complications could occur, including:

- assessment of an upward adjustment, including corresponding interest and/or penalties;
- denial of an offsetting downward adjustment;

- what should be an ordinary audit could become more extensive and lengthy, and
- a reassessment could be proposed based only on the information made available (putting the onus on the taxpayer to dispute the reassessment).

SECRET COMPARABLES

Perhaps one of the most troubling aspects of exposure to reassessment is the fact that the reassessment could also involve the use of "secret comparables", which are third party pricing benchmarks CRA has access to (for example, as a result of other transfer pricing audits it has conducted), the specifics of which are not made available to the taxpayer.

DISPUTE RESOLUTION

When a foreign tax authority makes an adjustment to a foreign affiliate's income, CRA does not automatically allow a corresponding adjustment to the Canadian taxpayer's income. Similarly, when CRA makes an adjustment to the income of a Canadian taxpayer, a foreign tax authority does not automatically allow an adjustment to the income of the foreign affiliate. Therefore, income could be taxed in both jurisdictions. There are a number of alternatives available to avoid a double tax scenario.

DISPUTING THE ADJUSTMENT

Generally, if the Canadian taxpayer believes the adjustment is incorrect and believes it can successfully dispute the adjustment, the taxpayer may proceed through the Appeals Process. This process is initiated by filing a Notice of Objection to the reassessment and is the first step of the Appeals process. Keep in mind that this is a domestic resolution process only.

COMPETENT AUTHORITY

Alternatively (or subsequently, if the taxpayer is unsuccessful in persuading CRA regarding the proper price), the taxpayer can seek relief through the Competent Authority process under the Mutual Agreement Articles of Canada's bilateral income tax treaties. The Competent Authority process is effectively a means of presenting the scenario to both the Canadian and foreign tax authorities and relying on the tax authorities to negotiate and resolve the matter and avoid the double tax.

Failing either the first step of the Appeals process or the Competent Authority process, a taxpayer can proceed along the Appeals process and try to resolve the issue through the tax courts.

ADVANCED PRICING ARRANGEMENTS

For situations where absolute clarity is desired on a specific transfer pricing matter, it may be desirable to obtain an Advance Pricing Arrangement (APA). This is effectively an agreement between the taxpayer and a tax authority. The APA can be unilateral (with a single tax authority party to the agreement) or it can be bilateral or even multilateral.

"DOCUMENTATION
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TYPICAL TRANSFER PRICING TRANSACTIONS

Transfer pricing encompasses all types of international intercompany transactions between affiliates. The transactions could include: tangible goods, intangible assets, services, management fees, and financial transactions. The analysis of each type of transaction has its own complications. We will focus on a few transactions that often require special consideration.

INTANGIBLE ASSETS

The key challenge of applying the arm's length principle to transfers of intangibles is that often the supplier and recipient share the risks and benefits associated with using the intangible, making it difficult to assess the appropriate price to be paid. Further, the valuation of the intangible itself requires a detailed analysis because:

- the value can fluctuate significantly over time;
- the value can be high even though the cost of creating the intangible was low, or vice-versa; and
- comparable intangible assets and corresponding royalty/license rates are often difficult to identify.

As a result of these difficulties, special consideration should be given to the life of the intangible. As well, to account for fluctuations in value, a price adjustment clause and/or use of a variable royalty rate tied to profits should be considered.

MANAGEMENT FEES

A multi-step process should be applied in pricing intra-group services. The first step is to determine if a charge for a particular service is justified, and then the amount to be charged should be determined. Deciding whether a charge is justified requires determining whether the taxpayer would have paid a third party for the service (in other words, does the activity confer benefits of value). Once a service is justified, the amount of the charge must be determined based on arm's length principles.

Often the most focused upon element of the management fee analysis is what allocation factor should be used to allocate costs from the service provider to the recipient. Deriving appropriate allocation factors requires a detailed assessment of the services, benefits and costs. However, using an entity's sales as a percentage of the total group's sales is rarely the most appropriate allocation method.

QUALIFIED COST CONTRIBUTION ARRANGEMENTS

A qualified cost contribution arrangement (QCCA) is a written agreement under which parties share the costs and risks of producing, developing or acquiring a property, or acquiring or performing a service, in proportion to the benefits each participant is reasonably expected to derive from the arrangement. QCCAs are often used in the development of intangibles in a corporate group and are frequently used in connection with global tax optimization strategies.

The allocation of the benefit should be based on the expected benefits to be derived from exploiting the results of the QCCA, not on the actual activities of the QCCA. The contribution must be consistent with what arm's length parties would have contributed, given the expected benefit. Therefore, consideration must be given to the contractual terms and economic circumstances of the arrangement.

FINANCIAL TRANSACTIONS

Financial transactions in companies are an area of potentially significant exposure from a transfer pricing perspective, because financial transactions have historically been focused on less than transactions involving traditional goods and services. Determination of appropriate arm's length interest rates or guarantee fees typically involves a multi-step process. First, using various analytical methods, a synthetic credit rating is derived for the recipient of the benefit. Then, based on the synthetic credit rating, a search is made for comparable loans to identify corresponding interest rates and/or guarantee fees.

CUSTOMS CONCERNS

In addition to income tax, multinational enterprises should also pay attention to possible Customs Act implications related to transfer pricing. The Customs Act includes self-assessment requirements that put the burden on companies that are aware of any errors affecting previously reported transactions to voluntarily disclose them.

If a transfer pricing adjustment must be made because incorrect prices were used previously, a customs compliance issue may arise. In this scenario, it may be necessary to make a voluntary customs disclosure to restate the value of the goods imported. Even if there is no impact from a duties perspective (if, for example, the goods are NAFTA free), this disclosure may be required because Administrative Monetary Penalties (AMPs) apply for simply not being in compliance from a customs reporting perspective.

If you do not receive *Value Added* on a regular basis and would like to receive future issues, please send us your business card at the fax number or address below:

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EXTERNAL ASSISTANCE ON TRANSFER PRICING MATTERS

April 2005

A broad range of services are available to businesses interested in putting their transfer pricing matters in order as companies frequently seek external advice and assistance with transfer pricing matters. Below is a description of some areas our Transfer Pricing Practice is often called on to help with:

RISK ASSESSMENTS

As a first step, a risk assessment is typically conducted to assess exposure to transfer pricing adjustments, and corresponding interest and/or penalties. This process typically involves a review of all relevant transactions, along with supporting analyses and documentation. From this initial assessment, management can confidently identify and prioritize the company's transfer pricing issues and focus time and resources accordingly.

PLANNING

Whether developing transfer pricing policies for the first time, or revising current policies due to changes in the business structure and/or operations, proper planning is essential. The overall goal is to determine if any potential global tax savings can be achieved, based on how a transaction is structured. The level of profitability allocated to an entity is directly related to functions performed, risks borne, and assets utilized. Appropriate allocation of profits increase as:

- the level of functions performed increase and/or become more complex;
- the degree of risks borne heightens; and/or
- as intangible assets are utilized.

Tax optimization can be achieved by structuring operations accordingly.

BENCHMARKING

From a business planning perspective, it is often necessary to determine what an appropriate transfer pricing policy and price may be based on a proposed fact scenario. This is done by assessing the characterization of a company based on the proposed fact scenario, and then undertaking a search for comparable prices and/or companies' profit level indicators based on the company's characterization. The resulting transfer price can then be used in the company's financial projections and in determining if the proposed business structure is viable and tax efficient.

DOCUMENTATION

Completion of a comprehensive documentation study summarizing the transactions and supporting analyses is necessary for all companies. The documentation must be suitable for presentation to the Canadian and/or foreign tax authorities, and to provide penalty protection. A documentation study typically encompasses an analysis of the following:

- transactions – including the terms and conditions;
- industry;
- company;
- products/services;
- functions performed;
- risks borne; and
- assets utilized.

Based on these analyses, decisions can then be made regarding characterization of the company from a transfer pricing perspective and the most appropriate transfer pricing methodology.

Based on these determinations, a search is typically undertaken to arrive at comparable prices and/or companies' profit level indicators, to determine appropriate arm's length pricing. Benchmarking tests are then conducted to assess the reasonableness of the results.

DISPUTE RESOLUTION

Managing a transfer pricing audit requires significant time and resources. Overseeing this process carefully can minimize costs and potentially reduce or eliminate proposed transfer pricing adjustments.

Defending transfer pricing policies to the Canadian and foreign tax authorities may include:

- completion of Notices of Objections in the Appeals Process;
- Competent Authority Submissions; and
- Advanced Pricing Arrangements.

UPCOMING SPEAKING ENGAGEMENTS

April 14, 2005 – Andrew Harington will present on the Market Valuation Challenges, at the Mergers & Acquisition Conference sponsored by the Canadian Institute in Toronto.

May 16-18, 2005 – David Kemp and Andrew Harington will present on “Transfer Pricing from a CFO Perspective” at the Cross-Border Tax Conference sponsored by the Canadian Association of Importers and Exporters in Toronto.

May 30 & 31, 2005 (Tentative) – David Kemp and Andrew Harington will present on “Transfer Pricing – Importance from a Tax and Business Perspective”, at the Managing a Value-Driven Tax Department Conference sponsored by Federated Press in Toronto.

June 21 & 22, 2005 – Bill Dovey & Scott Davidson will be presenting at the Financial Reporting Conference sponsored by Federated Press in Toronto.

August 10, 2005 – Scott Davidson will present on “Valuation of Trade-marks” at the Understanding Trade-marks Course sponsored by the Intellectual Property Institute of Canada and McGill University in Montreal.

HOW WE CAN ASSIST YOU?

Our Global Transfer Pricing Practice team can provide assistance in regards to all the services described in this newsletter. We have extensive experience assisting multinational enterprises with transfer pricing planning, documentation and dispute resolution matters.

For assistance or to discuss a transfer pricing issue, please contact one of the following:

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