Canada’s Transfer Pricing Rules and Contemporaneous Documentation Requirements

The Canadian Bar Association:
2010 Tax Law for Lawyers
Queen’s Landing Inn, Niagara-on-the-Lake, Ontario
May 29th – June 3rd, 2011

Blake Murray
Partner
Osler, Hoskin & Harcourt LLP
Suite 6100
100 King Street West
TORONTO ON M5X 1B8
416-362-2111
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CANADA’S TRANSFER PRICING RULES

Blake Murray1
Osler, Hoskin & Harcourt LLP

Introduction
Canada’s transfer pricing rules, primarily contained in section 247 of the Income Tax Act (the “ITA”), regulate the amount that a taxpayer may deduct, or be required to include, in computing income for Canadian tax income purposes, in respect of the cost of property and services received by the taxpayer from a non-resident person with whom the taxpayer is not dealing at arm’s length or that were supplied by the taxpayer to such a non-resident person. The general rule for transactions between a taxpayer and a non-resident non-arm’s length person is that the amount deducted by a taxpayer for property and services received should not exceed the amount that would have been charged in a transaction between arm’s length persons (the “arm’s length amount”) and the amount included in computing the taxpayer’s income in respect of goods and services supplied by the taxpayer should not be less than the arm’s length amount. Intercompany transactions potentially affected by these rules include the sale of goods, the licensing of intellectual property and leasing of real and personal property.

Adverse transfer pricing adjustments may give rise to liability for additional Canadian income tax and interest. In addition, a 10% penalty may be triggered by adverse transfer pricing adjustments for a taxation year if the total adjustments for a taxation year exceed the lesser of (i) 10% of the taxpayer’s gross revenues for the year and (ii) $5 million. However, no penalty is payable in respect of a transaction if the taxpayer has met the contemporaneous documentation requirements, and has otherwise made reasonable efforts in establishing and applying arm’s length transfer pricing or an arm’s length allocation, in respect of the transaction. The application of, and defences to, the transfer pricing penalty are described in more detail below.

The Federal Budget of November 1, 1997 (the “1997 Budget”) stated that the intention of introducing section 247 was to harmonize Canada’s transfer pricing rules with the arm’s length principle in the OECD Guidelines1 and to ensure that all the methods described in the OECD Guidelines are available to taxpayers. The contemporaneous documentation requirements are also intended as an aid to CRA’s audit of cross border related party transactions. It has also been suggested by some that the transfer pricing penalty system and the contemporaneous documentation requirements are intended (i) to provide the CRA with the information it believes necessary to resist out-bound adjustments from countries with whom Canada has tax treaties and (ii) to counter any tendency taxpayers might otherwise have to bias their transfer pricing policies in favour of countries that impose penalties.

Canada’s transfer pricing rules, including the potential penalty for transfer pricing adjustments and the contemporaneous documentation requirements, are discussed below.

1 Blake Murray is a tax partner in the Toronto office of Osler, Hoskin & Harcourt LLP. His practice focuses on commercial tax matters including intercompany pricing and financing arrangements. He has dealt extensively with all levels of CRA including audit, appeals, rulings, and competent authority.
Transfer Pricing Adjustments

Affected Transactions

The transfer pricing rules set out in subsection 247(2) of the ITA and the potential penalty under subsection 247(3) of the ITA can apply to any transaction between a taxpayer and a non-resident person with whom the taxpayer is not dealing at arm’s length and between a partnership and a non-resident person with whom the partnership or a member of the partnership is not dealing at arm’s length. These rules do not apply to transactions between two Canadian resident taxpayers. Unless otherwise noted, a reference below to a “non-arm’s length transaction” means a non-arm’s length transaction with a non-resident person.

For Canadian income tax purposes, persons do not deal with each other at arm’s length if they do not, in fact, deal with each other at arm’s length or they are “related” under the rules defining the term. Two corporations will be related if one controls the other or if they are under common control. The issue of whether two persons are, in fact, dealing at arm’s length is decided under principles established in the case law. In general, this involves determination of whether (i) there is a common directing mind, (ii) parties are acting in concert without separate interests or (iii) there is de facto control of one party over another.

The applicability of these rules to transactions between a controlled Canadian subsidiary and its foreign parent company or foreign sister company and to transactions between a Canadian company and its controlled foreign subsidiaries is clear. However, these rules can also be applicable in less obvious circumstances, in particular, because they apply to any transaction between a Canadian taxpayer and a non-resident person with whom the taxpayer is not dealing at arm’s length, in fact, even though neither party has de jure control over the other.

The rules technically also apply to transactions between a Canadian taxpayer and a Canadian branch (permanent establishment) of a non-resident parent or sister company. The application of pricing adjustments, contemporaneous documentation requirements and potential penalties in this situation is anomalous since, by virtue of the branch operation (permanent establishment),

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2 With respect to partnerships, the preamble of subsection 247(2) provides that it applies, inter alia, to transactions between a partnership (e.g., a Canadian partnership) and a partnership (e.g., a US partnership) of which a non-resident person (e.g., ABCCo or XYZCo) is a member where that non-resident person does not deal at arm’s length with a member (e.g., ABCSub or XYZSub) of the first partnership (the Canadian Partnership). The relevant wording is as follows:

“Where a taxpayer or a 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 a series of transactions . . .

[emphasis added]”

3 See however subsections 69(1) and (4) of the ITA which can apply to non-arm’s length transactions between Canadian resident persons.

4 Section 251 of the ITA.

the non-resident parent or sister company will itself be liable to tax under Part I of the ITA on any income resulting from non-arm’s length pricing. It is difficult to see why the rules in section 247 are necessary to protect the Canadian fisc in these circumstances.

The transfer pricing rules could also potentially apply to transactions between two controlled foreign affiliates of a Canadian taxpayer on the basis that one of them is a non-resident person. In this regard, there is no requirement in the rules that the taxpayer referred to in subsection 247(2) be a resident of Canada.

Power to Adjust Terms or Conditions or Substitute Transaction

Adjusting Terms or Conditions of the Transaction – Paragraphs 247(2)(a) and (c)

Under paragraphs 247(2)(a) and (c) of the ITA, if the terms or conditions in a non-arm’s length transaction are different from those that would have been made between persons dealing at arm’s length, (and paragraph (b) does not apply) Canada may adjust the quantum or nature of the amounts that would otherwise be determined in respect of the taxpayer to the quantum or nature that would have been determined if the terms and conditions were those that would have existed between persons dealing at arm’s length.

Although there are other provisions of the ITA which affect specific transactions, subsection 247(2) is the provision used principally by CRA to make transfer pricing adjustments. Two recent cases may help illustrate the application of subsection 69(2) and paragraphs 247(2)(a) and (c) by the CRA.

The leading case on transfer pricing under subsection 69(2) (currently under appeal to the F.C.A.) is GlaxoSmithKline Inc. v The Queen. In that case, the taxpayer, Glaxo, bought ranitidine, the active ingredient for its brand name pharmaceutical product, Zantac, from Adeschsa, a related non-resident company. The CRA reassessed Glaxo to reduce the purchase price paid by the taxpayer to that paid by generic pharmaceutical manufacturers to third-party suppliers.

The main issues raised at trial were:

(a) whether the price paid by generic manufacturers for an equivalent product to ranitidine constituted a CUP for the taxpayer’s purchase of ranitidine from Adeschsa for the manufacture of Zantac, considering the different business circumstances and the Glaxo group’s manufacturing standards for ranitidine and

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Canada’s previous transfer pricing rules in subsections 69(2) and (3) of the ITA are applicable to non-arm’s length transactions between a Canadian resident person and a non-resident person have been repealed for taxation years beginning after 1997. Under those rules the CRA could adjust the amount of the pricing agreed to by the parties to the amount that would reasonably have been agreed upon in the circumstances if the parties had been dealing at arm’s length. However, no power existed under those rules to adjust the nature of a payment or to substitute a transaction for the transaction or series of transactions actually carried out by the parties.

2008 TCC 324, 2008 DTC 3957
(b) whether the licensing fees payable by Glaxo to its parent company in respect of the Zantac trademark should be taken into account in determining the price that would have been reasonable in the circumstances for Glaxo to pay Adeschsa for ranitidine.

The Tax Court held that the prices charged by generic manufacturers of ranitidine were an appropriate comparable using the CUP method. The price that would have been reasonable in the circumstances for Glaxo to pay Adeschsa for a kilogram of ranitidine was the highest price that generic pharmaceutical manufacturing companies in Canada paid for a kilogram of ranitidine.

The Tax Court further found that only the amount paid for ranitidine was relevant. The amounts payable as licensing fees were not taken into account (relying on Singleton v. Canada, (2001), Bausch & Lomb, Inc. v. Commissioner, 1989 U.S. Tax Court).

In General Electric Capital Canada Inc. v. The Queen, the taxpayer (“GECCI”) paid fees to General Electric Capital Corporation (“GECUS”), its non-resident parent company, for unconditional guarantees of several billions of dollars of publicly-issued commercial paper and medium-term notes. The amount of the guarantee fee was, in general, 1% of the principal amount of debt obligations outstanding in each year.

The Minister disallowed the deductions of the guarantee fees payable by the taxpayer on the basis that the arm’s length price for the guarantees under subsections 69(2) and 247(2) was nil. The Crown asserted that: (i) GECCI’s debt obligations would have been rated AAA without a guarantee solely on the basis of “implicit support” from GECUS, and (ii) GECUS’s guarantee of GECCI’s debt obligations was unnecessary.

The Tax Court allowed the full amount of the guarantees. The Trial Judge found that the debt securities issued by GECCI would not have been rated close to AAA absent the guarantee. In particular, the Trial Judge found that “the ratings uplift from the stand-alone/status quo rating to take account of implicit support is three notches” and that GECCI’s credit rating, taking full account of implicit support, would have been in the range of BBB-/BB+ without the guarantee. The Trial Judge also concluded that the guarantee was in fact necessary for GECCI’s to carry out its business plan and that GECCI could not have obtained back-up lines of credit to support its Canadian commercial paper program without the guarantee. The Federal Court of Appeal dismissed the Crown’s appeal from the Tax Court.

Notably, subsection 247(2) potentially applies the arm’s length standard not only to determine the “quantum” of amounts but also the “nature” of amounts paid or payable to a non-resident person with whom the taxpayer is not dealing at arm’s length. By way of example, adjusting the nature of an amount payable could potentially affect whether an amount is treated as interest or something else or whether an amount is on income or capital account. An adjustment to the nature of a transaction under paragraph 247(2)(c) must relate to a change in the terms and

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8 2010 DTC 1007 (TCC); 2011 DTC 5011 (F.C.A.)

conditions of the transaction. It can reasonably be argued that an adjustment to the nature of an amount is more consistent with the application of paragraph 247(2)(b) which permits a different transaction to be substituted than the application of paragraph 247(2)(a) which retains the original transaction and adjusts only the terms and conditions.

Substitute Transaction – Paragraphs 247(2)(b) and (c)

Under paragraphs 247(2)(b) and (c) of the ITA, if (i) the transaction or series of transactions would not have been entered into between persons dealing at arm’s length and (ii) the transaction or series can reasonably be considered not to have been entered into primarily for business purposes, the CRA may adjust the quantum or nature of the amounts that would otherwise be determined to the quantum or nature that would have been determined if the transaction or series had been the transaction or series that would have been entered into between persons dealing at arm’s length under terms and conditions that would have been made between persons dealing at arm’s length.

The general anti-avoidance rule (“GAAR”) in section 245 of the ITA contains a similar “business purpose” test. Under GAAR the CRA can determine the tax consequences of an “avoidance transaction” as is reasonable in the circumstances in order to deny a “tax benefit” that would otherwise result, directly or indirectly, from the transaction or series of transactions. Under paragraph 245(5)(c), for this purpose, “the nature of any payment or other amount may be recharacterized”. Notably, however, GAAR does not apply to a transaction which does not result in a misuse or abuse of the provisions of the ITA when read as a whole. No such saving provision for non-abusive transactions exists under Canada’s transfer pricing rules.

The statutory wording chosen by Canada to permit the substitution of a transaction for transfer pricing purposes is difficult to reconcile with the approach taken in the OECD Guidelines (which Canada’s rules purport to follow) and may create considerable practical difficulties for Canadian taxpayers.

The OECD Guidelines suggest that the power to recharacterize a transaction should be considered only in exceptional circumstances. See the general admonition in paragraph 1.36 of the OECD Guidelines which states:

“... In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured.”

The first circumstance discussed in the OECD Guidelines is where the economic substance of a transaction differs from its form. The wording of section 247 does not directly address this situation.

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10 An “avoidance transaction” is one that cannot reasonably be regarded as having been entered into primarily for business (i.e., non-tax) purposes.

11 See, however, paragraphs 44, 45 and 46 of Information Circular 87-2R which refer to the OECD Guidelines statement and imply that the CRA has this power.
The OECD Guidelines state that a taxing authority might also consider disregarding the actual transaction if it is not one that arm’s length parties would have entered into “behaving in a commercially rational manner” and the form of the transaction practically impedes the tax authority from determining an appropriate transfer price. The business purpose test adopted by Canada in section 247 is arguably a different standard than a test of commercially rational behaviour. One can envisage situations in which a transaction might be considered commercially rational but to have been structured a certain way primarily for tax purposes. Moreover, the requirement under the OECD Guidelines that the form of the actual transaction impede determination of the arm’s length amount is not explicitly reflected in the Canadian rules.

Application of Tax Treaties to Transfer Pricing Adjustments

In the event of an inconsistency between a Canadian tax treaty and the ITA, the provisions of the tax treaty prevail to the extent of the inconsistency. Consequently, to the extent that section 247 is inconsistent with the provisions of a tax treaty, the taxpayer may be able to challenge the CRA’s adjustment on this basis.

Insofar as subsection 247(2) of the ITA authorizes the adjustment of the quantum of an intercompany charge to the arm’s length amount, the wording appears to be generally consistent with Canada’s tax treaties.

By way of example, Article 9(1) of the Canada-U.S. Income Tax Convention (the “Convention”) states:

Where a person in a Contracting State and a person in the other Contracting State are related and where the arrangements between them differ from those which would be made between unrelated persons, each State may adjust the amount of the income, loss or tax payable to reflect the income, deductions, credits or allowances which would, but for those arrangements, have been taken into account in computing such income, loss or tax.

Tax treaties also generally make available a competent authority process, also known as the mutual agreement procedure, through which a taxpayer that is subject to a transfer pricing adjustment in one country can seek the corresponding adjustment to the income of a related party in the other country in order to obtain relief from double taxation. As a practical matter, the competent authorities frequently negotiate a settlement of the transfer pricing adjustments. If accepted by the taxpayer and the related party the competent authority settlement is processed by both countries. If the taxpayer does not concur in the settlement, the taxpayer may pursue the issue through its domestic appeals process provided the taxpayer has protected its statutory rights of appeal. In Canada, if a reassessment is issued, a taxpayer’s statutory appeal are protected by filing a valid notice of objection to the reassessment, having regard to the requirements for large corporations and if a notice of confirmation is issued by Appeals, filing a notice of appeal with the Tax Court of Canada.

Article 9(3) of the Convention authorizes competent authority relief for transfer pricing adjustment between Canada and the United States as follows:

Where an adjustment is made or to be made by a Contracting State in accordance with paragraph (1), the other Contracting State shall
(notwithstanding any time or procedural limitations in the domestic law of that other State) make a corresponding adjustment to the income, loss or tax of the related person in that other state if:

(a) it agrees with the first mentioned adjustment; and

(b) within 6 years from the end of the taxable year to which the first mentioned adjustment relates, the competent authority of the other State has been notified of the first mentioned adjustment. The competent authorities, however, may agree to consider cases where the corresponding adjustment would not otherwise be barred by any time or procedural limitation in the other State, even if the notification is not made within the 6 year period.

By way of illustration, if Canada were to make a transfer pricing adjustment to the income, loss or tax of a person\(^\text{12}\), the United States, as the “other Contracting State”, would be obligated to make a corresponding adjustment to the income, loss or tax of the related person in the United States but only if it agrees with the adjustment made by Canada and the United States has received notice of that adjustment within 6 years after the end of the taxation year to which the adjustment relates. Although the Convention contemplates that the competent authorities may agree to consider a case for relief even though the 6 year time limit has not been met, care should be taken to provide notice to the other country within that limit.

See also Article 26 of the Convention, and the corresponding provision of other tax treaties which allow a taxpayer to make application to competent authority for relief from taxation not in accordance with the Convention.

A taxpayer faced with a proposed reassessment should consider the availability of competent authority relief and also whether the reassessment otherwise complies with the provisions of the applicable income tax treaty. Consider, for example, the case where a Canadian resident corporation purchases intangible property from its U.S. parent corporation in return for a fair market value, lump sum purchase price. The CRA could possibly issue a reassessment under subsection 247(2) on the basis that an arm’s length party would have licensed the intangible property instead of purchasing it and therefore that the transaction should be recharacterized as a licence with taxation of both the Canadian resident based upon the payment of an arm’s length license fee (instead of purchase price) by the Canadian corporation to its U.S. parent corporation. Based upon Article XII of the Convention, it is arguable that the CRA is not entitled to impose withholding tax on the deemed license fee, on the basis that a payment of this kind does not fall within the Article XII definition of royalty and is otherwise exempt from Canadian tax under the Convention. The Canadian subsidiary and its US parent could request competent authority relief under Article 9 from double taxation and request relief under Article 26 on the basis that the Canadian treatment was not taxation in accordance with the Convention.

Detailed guidance with respect to the procedures to be followed in seeking competent authority relief under Canada’s tax treaties is set out in IC 71-17 R5 “Guidance on Competent Authority Assistance Under Canada’s Tax Conventions” dated January 1, 2005. See also the Memorandum of Understanding between the Competent Authorities of Canada and the United

\(^{12}\) Similarly, if the United States were to initiate the first adjustment relief could be sought from Canada under Article 9(3) of the Convention.
States of America dated November 12, 2010 which provides important guidance regarding requests for competent authority assistance and the arbitration procedure added to the Convention by the Fifth Protocol.

**Authorized Pricing Methodologies**

Canada’s transfer pricing rules do not explicitly authorize any of the transfer pricing methodologies described in the OECD Guidelines and, in fact, make no reference to those guidelines. The wording of subsection 247(2) seems more consistent with the use of transaction-based methods (e.g., CUP) than profit based methods (e.g., profit split). Nevertheless, in light of the 1997 Budget statement with respect to the purpose of Canada’s transfer pricing rules and the CRA statements in Information Circular 87-2R, it seems that, as an administrative matter, the CRA will allow (and expects) transfer prices to be established using the following OECD methods:

(i) the “comparable uncontrolled price” method (“CUP”),
(ii) the “resale price” method,
(iii) the “cost plus” method,
(iv) the “transactional net margin” method (“TNM”), or
(v) the “profit split” method,

all in accordance with the principles governing the use of these methods set out in the OECD Guidelines and IC 87-2R. Reference should be had to those publications for guidance as to the application of each these methods. However, the following brief description may be useful.

**Comparable Uncontrolled Price Method**

The CUP method compares the price charged in non-arm’s length transaction to the price charged in a comparable arm’s length transaction.\(^{13}\) The “comparability” of two transactions depends on the nature of the product or service (e.g., the extent to which they are similar) and the circumstances surrounding the transactions (such as terms and conditions of sale, trade level of participants, etc.).

**Resale Price Method**

The resale price method compares the price charged in a non-arm’s length transaction to the arm’s length price determined by deducting from the resale price to an arm’s length person an amount equal to the gross profit margin realised in comparable arm’s length resale transactions. Comparability depends largely on the similarity of the functions being performed, the risks assumed and the contractual terms of the arrangements. Generally speaking, the resale price method will be most appropriate where property purchased in a non-arm’s length transaction is resold to an arm’s length party without any additional value being added through physical transformation of the property. It is generally considered inapplicable to the extent intangibles (e.g., patent rights) are held by the reseller.

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\(^{13}\) Comparables can be taken from transactions between the taxpayer and other arm’s length parties, or between a related party and other arm’s length persons or transactions between non-arm’s length persons who are not related. In the latter case, of course, there is frequently difficulty in obtaining detailed information.
Cost Plus Method

The cost plus method compares the price in a non-arm’s length transaction to the arm’s length price determined by adding to the cost of the product or service a gross profit mark-up equal to the mark-up realized in comparable arm’s length transactions. Comparability in this case depends largely upon the similarity of the activities performed by the non-arm’s length person and those performed in arm’s length comparable transactions. Typically, this method would be applied where a manufacturer performs manufacturing, assembling or other physical processing of goods which are then sold to a non-arm’s length person. The “arm’s length price” would be determined as the manufacturing cost plus the gross profit margin realised by arm’s length parties performing similar activities.

Profit Split Method

The profit split method determines the arm’s length allocation of total profit or loss attributable to transactions between related parties by evaluating the relative value of each non-arm’s length person’s contribution to that profit or loss. In a “residual profit split”, each party is first allocated an arm’s length profit for its routine contributions, such as manufacturing or distribution. The remaining or residual profit or loss is then allocated amongst parties based on an assessment of each non-arm’s length party’s contribution to the residual profit or loss. Frequently, this results in allocation of “excess” profit to parties holding intangibles (e.g. patent, trademark right, etc.).

Transactional Net Margin Method

The TNM method determines an arm’s length allocation of profit by reference to the net margin (i.e., operating profit as opposed to gross margin) that the taxpayer has realised on similar transactions with arm’s length parties or that would be realized in dealing between arm’s length parties.

Excluded Transactions

Canada’s new rules provide that the transfer pricing rules do not apply to a loan transaction referred in subsection 17(3) of the ITA. This subsection in turn, in effect, exempts from the rules that impute interest income to a Canadian corporate lender, loans made by such a lender to a non-resident wholly-owned subsidiary, provided that the money loaned is used in the subsidiary corporation’s business for the purpose of earning active business income. This exclusion is very narrowly worded and may suggest (consistent with the broad wording of subsection 247(2) discussed above) that the new transfer pricing rules are otherwise intended to apply to transactions involving financial instruments.

See also proposed subsection 247(7.1) of the ITA which will exclude the application of transfer pricing rules to guarantees by Canadian parent companies of the debt of a wholly-owned subsidiary in circumstances in which section 17 would have permitted the parent company to loan funds to that subsidiary without the imputation of interest income to the parent company (i.e., generally where the subsidiary uses the borrowed fund for the purpose of earning active business income).

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14 Subsection 247(7).
Paragraphs 20 to 24 of Information Circular 87-2R provide some comfort with respect to the treatment of loans that are subject to specific pricing rules. They appear to suggest that the CRA will look first to specific rules (e.g., in sections 15(2), 17 and 80.4). However, they do not rule out the use of section 247.

**Minister’s Discretion to Allow Set-Off for Favourable Adjustments**

Canada’s transfer pricing rules provide that a favourable adjustment (i.e., an adjustment other than an adjustment that results in or increases a transfer pricing capital adjustment or transfer pricing income adjustment for a taxation year) shall not be made unless, in the opinion of the Minister of National Revenue, the circumstances are such that it would be appropriate that such an adjustment be made\(^{15}\). This provision appears to give the Minister a limited discretion to refuse to make a downward transfer pricing adjustment the CRA consider inappropriate, but no similar discretion for transfer pricing adjustments that are adverse to the taxpayer. No explanation is provided in the technical notes for this lack of symmetry or the reason set-off adjustments should not be automatic.

Information Circular 87-2R indicates that the Minister might refuse to make a downward transfer pricing adjustment where the request has been prompted by the actions of a foreign tax country and the taxpayer has the right to request relief under the Mutual Agreement Procedure of the applicable treaty. The inference is that any such downward adjustment should be made only through the competent authority process. IC 87-2R also refers without explanation to situations in which “the taxpayer’s request can be considered abusive”.

The CRA has published a memorandum, TPM-03 *Downward transfer pricing adjustments under subsection 247(2)*, dated October 20, 2003 which provides useful information regarding CRA’s procedural requirements with respect to subsection 247(10).

**Penalties**

**Overview**

Subsection 247(3) of the *ITA* imposes a 10% penalty on transfer pricing adjustments in the event that such adjustments exceed the lesser of (i) 10% of the taxpayer’s gross revenue\(^{16}\) for the year and (ii) $5,000,000 subject to the potential defences described below.

The penalty does not apply in respect of a transaction if the contemporaneous documentation requirements described in subsection 247(4) are met for that transaction, and

(i) the taxpayer made reasonable efforts to determine the “arm’s length price” or “arm’s length allocation” in respect of the transaction, and to use that pricing or allocation for purposes of the ITA; or

\(^{15}\) Subsection 247(10).

\(^{16}\) “Gross revenue” is as defined in subsection 248(1) of the ITA, but read without reference to certain specified provisions of the ITA.
(ii) the transaction is a “qualifying cost contribution arrangement”,

Assuming the conditions for a penalty are met, the penalty applies to the full amount of the transfer pricing adjustments for a taxation year, rather than to any increase in taxable income or tax payable as a result of the adjustments. Accordingly, penalties could be exigible, together with non-deductible interest charges, even though no tax is payable because the taxpayer is in a loss position or may offset the transfer pricing adjustments by claiming discretionary deductions such as capital cost allowance or applying a loss carry-forward or carry-back. Unless the CRA exercises its discretion to allow a set-off, the penalty could be calculated on the aggregate of adverse transfer pricing adjustments, with no credit being given for any transfer pricing adjustments which would favour the taxpayer.

**Base for Penalty**

The *ITA* defines several elements included in calculating the amount of transfer pricing adjustments which are to be included in calculating the base for the 10% transfer pricing penalty. “Transfer pricing income adjustment” means any adjustment under the transfer pricing rules, other than a transfer pricing capital adjustment, that would result in an increase in the taxpayer’s income or a reduction of the taxpayer’s loss for the year.

“Transfer pricing capital adjustment” means ½ of any reduction in the adjusted cost base of non-depreciable capital property, ¾ of or to the amount of any eligible capital expenditures of the taxpayer and 100% of any reduction in the capital cost of depreciable property of the taxpayer.

Subject to the defences described below, the 10% penalty applies to the aggregate of the taxpayer’s transfer pricing income adjustment and transfer pricing capital adjustment, once the threshold of the lesser of 10% of gross revenue and $5,000,000 has been exceeded less any set-off for favourable adjustments.

**Defences to 10% Transfer Pricing Penalty**

As noted above in the overview, a transfer pricing penalty will not apply to a transfer pricing income adjustment or a transfer pricing capital adjustment made in respect of a transaction:

1. (a) if it is a transaction other than a *qualifying cost contribution arrangement*, the taxpayer or a partnership of which the taxpayer is a member made reasonable efforts to determine *arm’s length transfer prices* or *arm’s length allocations* in

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17 Subsection 247(10).

18 Subsection 247(1). Any decrease in income or increases in losses are included in “transfer pricing setoff adjustment” of a taxpayer.

19 Subsection 247(1). Any additions to ACB, ECE or capital cost are included in the “transfer pricing capital setoff adjustment” of a taxpayer.

20 This was changed from ¾ to ½ for capital property to correspond with the reduction of the capital gains inclusion rate.

21 Subsection 247(3).
respect of the transaction and the contemporaneous documentation requirements have been met in respect of the transaction; or

(b) if the transaction is a *qualifying cost contribution arrangement* the contemporaneous documentation requirements have been met in respect of the transaction.

**Reasonable Efforts Requirement**

In addition to providing the documentation specified in the ITA, the taxpayer must demonstrate that it has made reasonable efforts to determine and apply the arm’s length transfer price or arm’s length allocation, as the case may be.

“Arm’s length transfer price” is defined to mean an amount that would have been a transfer price in respect of the transaction if the participants in the transaction had been dealing at arm’s length with each other. The reference to “a transfer price” in this definition appears to recognize that a range of arm’s length prices may exist.

“Arm’s length allocation” is defined to mean the allocation of profit or loss that would have occurred between the participants in the transaction if they had been dealing at arm’s length with each other. This wording clearly authorizes the use of a profit split method. Also, the reference to “an allocation” appears to recognize that a range of arm’s length results may exist.

The concepts of “arm’s length transfer price” and “arm’s length allocation” are used only in connection with the penalty provisions and have no equivalent in subsection 247(2) which would govern any adjustment to the income of a taxpayer or the cost of an asset.

The concept of “arm’s length transfer price” differs from the concept set out in subsection 247(2). Arguably, the definition of arm’s length transfer price requires that the taxpayer determine the amount that would have been the transfer price for the particular transaction that was carried out without taking into account the terms and conditions of the transactions, or substituting a transaction, that arm’s length parties would have carried out. These additional factors, however, are required to be taken into account under subsection 247(2).

IC 87-2R states that the issue of whether reasonable efforts have been made will be analysed by reference to “principles of prudent business management”. In particular, a “prudent businessperson would attempt to weigh the significance of the transactions in terms of its business with the additional administrative costs required to prepare or obtain such documentation”. Unfortunately, this prudent man rule does not apply for purposes of the contemporaneous documentation requirements (which, as noted above, impose a fairly high standard). Moreover, notwithstanding that the information circular adopts a prudent business person test the Transfer Pricing Review Committee appears to be reading the “reasonable efforts” test as broadening the documentation requirements listed in subsection 247(4).

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22 Note as discussed below, the definition of such an arrangement contains its own reasonable efforts requirements.

23 Subsection 247(1).

24 Subsection 247(1).
Unless the contemporaneous documentation requirements set out in subsection 247(4) are met, the taxpayer will be deemed (i) not to have made reasonable efforts to determine and use the arm’s length transfer price or arm’s length allocations or (ii) not to have participated in a qualifying cost contribution arrangement, as the case may be.

It should equally be noted that unless a transfer pricing adjustment by the CRA with respect to the transaction in question is sustained, a transfer pricing penalty provisions will not apply, even if no contemporaneous documentation (or any other evidence of reasonable efforts by the taxpayer) exists.

**Contemporaneous Documentation Requirements**

Under the contemporaneous documentation requirements a taxpayer must make or obtain, on or before the “documentation due date” (i.e., tax return filing date) for the taxation year in which the transaction is entered into, “records or documents” which provide a description that is “complete and accurate in all material respects” of the following:

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

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

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

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

(v) the data and methods considered and the analysis performed to determine the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction; and

(vi) the assumptions, strategies and policies, if any, that influenced the determination of the transfer prices, or the allocation of profits or losses or contributions to costs, as the case may be, in respect of the transaction;

The documentation due date for a corporation is 6 months after the end of the taxation year for a corporation. The documentation must be “in existence” as of that date even though it is not required to be produced until a request is received from the CRA. The taxpayer must also, for each subsequent taxation year in which the transaction continues, make or obtain, before the documentation due date, records or documents that “completely and accurately describe” any material change to the matters described in (a)(i) to (vi) above.

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25 Subsection 247(4).
The *ITA* requires a taxpayer to have records and documents that provide a description that is complete and accurate in all material respects of the six items set out in subsection 247(4). The Canadian rules can be read as simply requiring the taxpayer to record its transfer pricing analysis but they could possibly be interpreted in such a way that a taxpayer could be held not to have complied because it failed to recognize the existence of a particular transaction, risk or other item required to be described by the Canadian rules. Consider the following examples:

1. The Canadian rules require a complete and accurate description of “the property or services to which the transaction relates”. It may often be difficult to determine what is a sufficiently detailed description, particularly where there are numerous varieties of the product or service and/or the product or service is of a complex, technical nature.

2. The Canadian rules require a complete and accurate description of “the data and methods considered and the analysis performed to determine the transfer prices” used. The CRA states in IC-872R that this includes not only the detailed analysis and support relating to the transfer pricing method actually used, but also the analysis performed using any other methods that were considered and the reasons that led to the selection of the preferred method.\(^{26}\)

3. The Canadian rules require a complete and accurate description of “the assumptions, strategies and policies, if any, that influenced the determination of the transfer prices”. The CRA states in IC-872R that this includes all factors that materially affect the development of transfer prices. The circular refers to market penetration strategies as an example.\(^{27}\) Beyond this, neither the ITA nor the Information Circular provides any real guidance as to how broadly the words “assumptions, strategies and policies” will be construed. By way of contrast, the corresponding requirement in the U.S. penalty regulations appears to be narrower. It simply requires an explanation of the economic analysis and projections relied upon in developing the transfer pricing method.

The taxpayer must provide the records and documents to the CRA within 3 months after service of a written request for these from the CRA. CRA has adopted the practice of automatically issuing a request for the contemporaneous documentation at the beginning of each transfer pricing audit.

While many large taxpayers may already maintain transfer pricing documentation equivalent or substantially equivalent to the statutory requirements, the requirement to finalize such documentation on or before the due date for filing a tax return may well create some practical hardships. A still larger problem for taxpayers will be the difficulty of determining whether its records and documents meet the “complete and accurate in all material respects” requirement. This standard may make it difficult for a taxpayer to be sure that it has prepared sufficient documentation. In this regard, the phrase “in all material respects” arguably goes to the extent of the required level of description but may not excuse a taxpayer who fails to include a particular item.

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\(^{26}\) See paragraph 187 of the Circular.

\(^{27}\) Ibid. paragraphs 200 and 201.
As an example of this concern, consider the taxpayer’s position with respect to the documentation described in subparagraph 247(4)(a)(iv) if the taxpayer completes its documentation as a result of a *bona fide*, good faith and thorough effort, but the CRA identifies an economic risk in the transaction that is not dealt with in the taxpayer’s documentation. Does the failure to identify a risk mean that the taxpayer’s documentation is not “complete and accurate”? Can it reasonably be argued that any risk or other listed items that is not material need not be documented.

It appears that if a transfer pricing adjustment above the penalty threshold amount is made the CRA could also assess penalties if a taxpayer failed to prepare contemporaneous documentation with respect to a non-arm’s length non-resident person, which is not a related person, because the taxpayer, in good faith, believed that it was dealing at arm’s length with that person.

As noted above, even if the taxpayer satisfies the contemporaneous documentation requirements, it will still be open to the CRA to allege that the 10% penalty applies because the taxpayer did not make “reasonable efforts” to determine and use arm’s length transfer prices or arm’s length allocations and the transaction is not a qualifying cost contribution arrangement.

Failure to meet the contemporaneous documentation requirements will disentitle a taxpayer to any defence to a penalty in respect of a transaction which is the subject of a transfer pricing adjustment. Compliance with the contemporaneous documentation requirements, however, does not, by itself guarantee a taxpayer a defence against penalty.

**Qualifying Cost Contribution Agreement**

The Canadian transfer pricing rules recognize that non-arm’s length parties may choose to share the cost of developing property or obtaining services and that different considerations should apply where the parties wish to enter into a cost sharing arrangement. Under a *qualifying cost contribution agreement*, as opposed to making reasonable efforts to arrive at arm’s length price or profit allocation in respect of the property or services in question, the parties are expected to make reasonable efforts to establish an arrangement for sharing the cost of developing property or providing services in proportion to the reasonably expected benefits.

The definition of a “qualifying cost contribution agreement” reads as follows:

“qualifying cost contribution arrangement” means an arrangement under which reasonable efforts are made by the participants in the arrangement to establish a basis for contributing to, and to contribute on that basis to, the cost of producing, developing or acquiring any property, or acquiring or performing any services, in proportion to the benefits which each participant is reasonably expected to derive from the property or services, as the case may be, as a result of the arrangement.”

Note that the arrangement must cover not only the basis for contribution (i.e., the agreed sharing of costs) but the actual contribution.
In Information Circular 87-2R, the CRA identifies the contemporaneous documentation requirements for a qualifying cost sharing arrangement as follows:

(a) identification of participants in the CCA and non-arm’s length parties;
(b) scope of activities covered by the agreement;
(c) duration of the agreement;
(d) nature and extent of each participant’s beneficial interest in the results of the CCA activities;
(e) manner or basis upon which proportionate shares of expected benefits are to be measured;
(f) form or valuation of each participant’s contributions;
(g) allocation of tasks and responsibilities;
(h) procedures for entering or withdrawing from the arrangement and the consequences thereof;
(i) policies and procedures governing “balancing payments” (may be required where a person’s contribution is not consistent with its share of the expected benefit).

Prudent taxpayers in a cost sharing arrangement and who wish to meet the definition of a qualifying cost contribution agreement may wish to meet the above administrative requirements of the CRA described in IC 87-2R as well as the contemporaneous documentation requirements set out in subsection 247(4).

**Application of Interest to Penalties**

It appears that interest may only be calculated pursuant to existing paragraph 161(11)(c) of the ITA on the amount of any penalty assessed pursuant to subsection 247(3) from the date the notice of assessment for such penalty is issued (i.e., the date of mailing) by the CRA.

**Transfer Pricing Review Committee**

All potential penalty situations and applications of the recharacterization rule under paragraph 247(2)(b) and (d) of the ITA are reviewed by the Transfer Pricing Review Committee (“TPRC”) of the CRA. That committee is comprised primarily of CRA officials within the International Tax Operations Directorate in Ottawa. There is a mandatory referral to the TPRC of any transfer pricing assessments that will exceed the threshold limits in subsection 247(3) (i.e., the lesser 10% of gross revenue and $5 million). The field auditor prepares a penalty referral report to the TPRC outlining the nature of the adjustments and the taxpayer’s compliance with the contemporaneous documentation requirements. The TPRC considers whether or not the documentation requirements have been met and issues a recommendation to the auditor as to whether or not a penalty should be assessed. See TPM-07 “Referrals to the Transfer Pricing

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28 Paragraph 194 of the Information Circular.
Review Committee", dated August 2, 2005, which describes the role of the TPRC with respect to penalty referrals and recharacterization referrals.

Relevance of Tax Treaties to Penalties
Where a corporation resident in Canada has been reassessed in respect of a transaction with a related party that is resident in a treaty country, with the result that the corporation and a non-resident related corporation are collectively subject to double taxation, the normal recourse for the taxpayer would be to apply for competent authority relief under the mutual agreement procedure of the applicable tax treaty.

The competent authorities generally do not, however, appear to have the power under tax treaties to waive the 10% penalty discussed above. Query the effect on a penalty if Canadian competent authority agrees under the mutual agreement procedure to reduce the amount of the transfer pricing adjustment made by the CRA.

Coming-into-Force of Transfer Pricing and Penalty Rules
The substantive transfer pricing rules, other than the penalty regime, apply to taxation years and fiscal periods that begin after 1997. The penalty rules will apply to transfer pricing adjustments made for taxation years and fiscal periods that begin after 1998, except that those rules will not apply with respect to a transaction completed before September 11, 1997.

Applying the main part of this rule, for a taxpayer with a December 31 taxation year, the transfer pricing adjustment rules will first apply to the taxation year ending December 31, 1998 and the penalty rules will first apply to the taxation year ending December 31, 1999. On the other hand, for a taxpayer with a June 30 taxation year, the transfer pricing adjustment rules will first apply to the taxation year ending June 30, 1999 and the penalty provisions will first apply to the taxation year ending June 30, 2000.

The reference to September 11, 1997 in the exception is somewhat confusing given that the transfer pricing adjustment rules do not apply before December 31, 1997. Possibly, this transitional rule is tied to the ability to substitute new terms and conditions and new transactions under subsection 247(1). The substituted terms or transaction could result in adjustments to taxation years after 1997 but the transitional rule precludes this where the transaction was, in fact, completed before September 11, 1997. It implies that a transaction completed after September 11, 1997 but before 1998 could be subject to the transfer pricing rules and the penalty provisions. In light of this risk taxpayers may wish to meet the contemporaneous documentation requirements for transactions completed after September 11, 1997.

The ITA also provides that a record or document made or obtained or provided to the Minister of National Revenue on or before the documentation-due date for the taxpayer’s first taxation year that begins after 1998 is deemed for purposes of the contemporaneous documentation requirements to have been made, obtained or provided on a timely basis.

Limitation Period For Adjustments
Paragraph subsection 152(4) of the ITA limits the Minister’s power to assess tax interest or penalties for a year. If the taxpayer (i) has not filed a valid waiver of the limitation period, (ii) has not committed fraud in filing the return or supplying any information under the ITA and (iii)
has not made any misrepresentation that is attributable to neglect, carelessness or wilful default, generally the Minister may not assess tax interest or penalties after the “normal reassessment period” has expired for the taxation year. The normal reassessment period for a corporation is 4 years (3 years in the case of a CCPC) from the date of mailing of a notice of an original assessment under Part I in respect of the taxpayer for the year or the date of mailing of an original notification that no tax is payable by a taxpayer for the year. Consequently, the limitation period will not begin to run until the taxpayer has filed a tax return and the original notice of assessment in respect of that return has been received.

In the case of transfer pricing adjustments, the normal 4 year limitation period (3 years for a CCPC) subparagraph 152(4)(b)(iii) the normal limitation period by 3 years for an assessment “made as a consequence of a transaction involving the taxpayer and a non-resident person with whom the taxpayer was not dealing at arm’s length”. In the result, the limitation period for transfer pricing adjustments and penalties, absent a waiver, fraud, neglect, carelessness, misrepresentation etc. is generally 7 years from the date of the original notice of assessment for a taxation year.

It should also be noted that certain of Canada’s treaties further limit Canada’s power to reassess tax and penalties effectively imposing a treaty limitation period. See for example Article 9(3) of the Canada-Switzerland Treaty which absent fraud or wilful default precludes transfer pricing adjustments more than 5 years after the end of a taxation year. Although the Canada-U.S. Tax Convention previously contained a similar 6 year limitation period on transfer pricing adjustments, this was eliminated by a protocol to the Convention effective for the 1996 and subsequent taxation years.

**Advance Pricing Agreements**

In light of the risk of tax, interest and penalties arising from unfavourable transfer pricing adjustments, taxpayers may wish to consider applying to the CRA for an advance pricing agreement. Although such an agreement is not likely to relieve taxpayers of the obligation to prepare contemporaneous documentation, it will substantially reduce the risk of reassessment. Taxpayers should, of course, carefully weigh the pros and cons of the APA process, including the time and cost involved in obtaining an APA, before committing to this approach. Detailed guidance with respect to Canada’s APA program and the procedure for obtaining an APA is published in Information Circular 94-4R “International Transfer Pricing and Advance Pricing Arrangements” dated March 16, 2001.

**Form T-106 Requirements**

Subsection 233.1(a) of the ITA imposes an obligation on (i) every resident in Canada, (ii) every non-resident of Canada carrying on business in Canada and (iii) every partnership in which a Canadian resident is a member or which carries on business in Canada to file an information return regarding transactions with non-resident person with which the reporting entity does not deal at arm’s length. The prescribed form for this purpose is Form T-106 which must be filed on or before the reporting person’s filing due date for the year. Under a de minimis exception no information return is required to be filed for a year unless the total fair market value of the person’s reportable transactions exceed Cdn. $1 million.
General Obligation to Maintain Records and Books

Apart from the contemporaneous documentation requirements subsection 230(1) of the Income Tax Act (Canada) (the “ITA”), requires a Canadian taxpayer to maintain records and books of account in such form and containing such information as will enable to tax payable under the ITA to be determined.

Although the term “books of accounts” is not defined in the ITA, the term “records” is defined in Subsection 248(1) of the ITA as follows to include:

“record” includes an account, an agreement, a book, a chart or table, a diagram, a form, an image, an invoice, a letter, a map, a memorandum, a plan, a return, a statement, a telegram, a voucher, and any other thing containing information, whether in writing or in any other form.

Absent that definition “records” would include any written account of a transaction or event (see Black’s Law Dictionary definition of record as “a written account of some act, transaction or instrument”). The statutory definition in the ITA extends the ordinary meaning of a “record” beyond written materials to include among other things, information stored electronically or otherwise.

Audit Power

Subsection 231.1 of the ITA allows a CRA auditor to inspect, audit or examine the books and records of a taxpayer and any document of the taxpayer or of any other person that relates or may relate to the information that is or should be in the books or records of the taxpayer. Further, an auditor may require any owner or manager of the business and any other person on the premises to give all reasonable assistance and to answer all proper questions relating to the administration or enforcement of the ITA.

The term “records” for purposes of subsection 231.1(1) of the ITA is not confined to records necessary to the determination of the taxpayer’s liability for tax. The CRA is entitled to audit all records of the taxpayer.

Requirements for Records or Documents

Subsection 231.2(1) of the ITA allows the CRA to serve notice requiring that any person provide any information or additional information or any document within such reasonable time as is stipulated in the notice. Subsection 231.3 allows the CRA to obtain a search warrant permitting it to enter and search any building and to seize any document or thing that may afford evidence of the commission of an offence under the ITA.

Requests for Foreign Based Information

Subsection 231.6 of the ITA allows the CRA to serve a notice requiring a taxpayer to produce any information or document that is available or located outside Canada (“foreign-based information or document”). In addition to liability for a fine or imprisonment, discussed below, if a person fails to comply substantially with a notice under this provision then in any subsequent civil litigation proceedings under the ITA, the court is required on motion by the CRA to prohibit the introduction of the foreign based information or document.
Sanctions for Non-Compliance

Failure of a person to comply with any of the general provisions described above is an offence under subsection 238(1) of the ITA punishable by a fine of up to $25,000 and/or imprisonment for a term of up to 12 months.

Under subsection 239(1) of the ITA it is a criminal offence to destroy, alter, mutilate, secret or otherwise dispose of the record or books of account of a taxpayer to evade payment of a tax imposed under the ITA. On summary conviction the punishment for breaching subsection 239(1) is a fine of 25% to 200% of the tax that was sought to be evaded or that fine plus imprisonment for up to 2 years. If prosecuted on indictment and convicted, the punishment is a fine of 100% to 200% of the tax that was sought to be evaded or that fine plus imprisonment for up to 5 years.

Under section 242 of the ITA where a corporation commits an offence under the ITA, any officer, director or agent of the corporation which directed, authorized, assent to, acquiesced in or participated in the commission of the offence is a party to and guilty of the offence and is liable on conviction to the punishment provided for the offence.

Exchange of Information Under Treaties

All of Canada’s international tax treaties contain exchange of information provisions which permit Canada or its tax treaty partner to request the other taxing authority to furnish taxpayer information for the purposes of avoiding double taxation and preventing tax evasion. Note however many of Canada’s treaties do not require a treaty partner to seek information it does not already have.

Article XXVII of the Canada – US Convention imposes broad obligations on Canada and the United States. It reads as follows:

“1. The competent authorities of the Contracting States shall exchange such information as is relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes to which the Convention applies insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article I (Personal Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the taxation laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the administration and enforcement in respect of, or the determination of appeals in relation to the taxes to which the Convention applies or, notwithstanding paragraph 4, in relation to taxes imposed by a political subdivision or local authority of a Contracting State that are substantially similar to the taxes covered by the Convention under Article II (Taxes Covered). Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. The competent authorities may release to an arbitration board established pursuant to paragraph 6 of Article XXVI (Mutual Agreement Procedure) such information as is necessary for carrying out the arbitration procedure; the members of the arbitration board shall be subject to the limitations on disclosure described in this Article.
2. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall endeavor to obtain the information to which the request relates in the same way as if its own taxation was involved notwithstanding the fact that the other State does not, at that time, need such information. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall endeavor to provide information under this Article in the form requested, such as depositions of witnesses and copies of unedited original documents (including books, papers, statements, records, accounts or writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other State with respect to its own taxes.

3. In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation:

- (a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
- (b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State; or
- (c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (order public).

4. For the purposes of this Article, the Convention shall apply, notwithstanding the provisions of Article II (Taxes Covered):

- (a) to all taxes imposed by a Contracting State; and
- (b) to other taxes to which any other provision of the Convention applies, but only to the extent that the information is relevant for the purposes of the application of that provision.”

the CRA has indicated that tax treaty exchanges of information may be (a) routine or automatic, (b) specific (i.e. requested) or (c) spontaneous (unsolicited).

Conclusion
Canada’s transfer pricing system imposes a substantial compliance burden and potential liability for tax, interest and penalties on Canadian taxpayers who engage in cross-border non-arm’s length transactions. It is hoped that this paper has provided a brief but useful introduction to the statutory and administrative rules applicable to transfer pricing.

BM/