

# INBOUND INVESTMENT - CROSS-BORDER ISSUES

*Taxation of Non-Residents' Property Income*

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*Intercompany Pricing Rules*

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*Working with Tax Treaties*

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# Transactions with Non Residents

- Loans
- Leases and Licenses
- Services: Management, Administration, Purchasing, Marketing, Sales, etc.
- Sale of Goods

# Types of Payments

- Interest
- Rent and Royalties
- Service Fees
- Cost Sharing
- Reimbursements
- Trade Payables

# Other Payments

- Dividends
- Loan Repayments
- Appropriations

# Payor Issues

- Deductibility in computing income
- Withholding at source obligations

# Payee Issues

- Part I Tax on Business Income
  - ITA
    - **carrying on business test**
  - Treaty protection:
    - **permanent establishment test**

# Payee Issues

- Part XIII Tax and other withholding taxes
- Canadian provisions
  - Treaty rates

# Part XIII Non-Resident Withholding Taxes

- Taxes NRs on most types of Canadian property income
- Canadian payor has withholding, remitting & reporting obligations
- 25% statutory rate—may be reduced by treaty



# Interest Payments

- Only subject to withholding tax where interest is
  - not “fully exempt interest” that is paid to non-arm’s length non-resident, or
  - participating debt interest

# Non-arm's length interest

- Meaning of “arm's length”
  - Section 251 – specific rules may deem persons to be non-arm's length
  - Otherwise, it is a question of fact

# Fully Exempt Interest

- Exempt Payors
  - government debt
- Exempt Recipients
  - tax-exempts
- Exempt Debt
  - foreign personal mortgages

# Participating Debt Interest

- Similar to post-amble of old paragraph 212(1)(b)
  - interest any portion of which is contingent or dependent on use or production from property in Canada
  - or computed by reference to revenue, profit, cash flow, commodity price or similar criterion or by reference to dividends of any corporation
- Different from wording in the Fifth Protocol to Canada-U.S. Income Tax Convention

# Other Payments to Non Residents

- Dividends
- Rents & Royalties
- Management Fees

# Dividends

- Fifth Protocol contains special rules that apply to hybrid entities (Article IV)
  - U.S. limited liability corporations (LLCs)
  - Canadian unlimited liability corporations (ULCs)
- CRA has issued statements regarding its administrative position relating to the application of these rules

# Deeming Provisions

- Partnerships as deemed persons
- Non-residents as deemed residents
- Deemed payments
  - interest accruals & discounts
  - guarantee fees & standby charges
  - foreign branch banks -- notional interest
- Fees for services deemed to be property income
  - Actors

# Administration & Enforcement

- Interaction of Part XIII with Part I
  - Canadian branches
- Payor liability
  - taxes, penalties & interest
  - director liability
- Refunds & Assessments
  - no limitation period
  - excess withholding
- Objections & Appeals



# Other Withholdings

- Reg. 105 withholding re NR services performed in Canada
  - under Part I
  - waiver
- S. 116 withholding
  - 2008 Budget
  - 2010 Budget – definition of taxable Canadian property

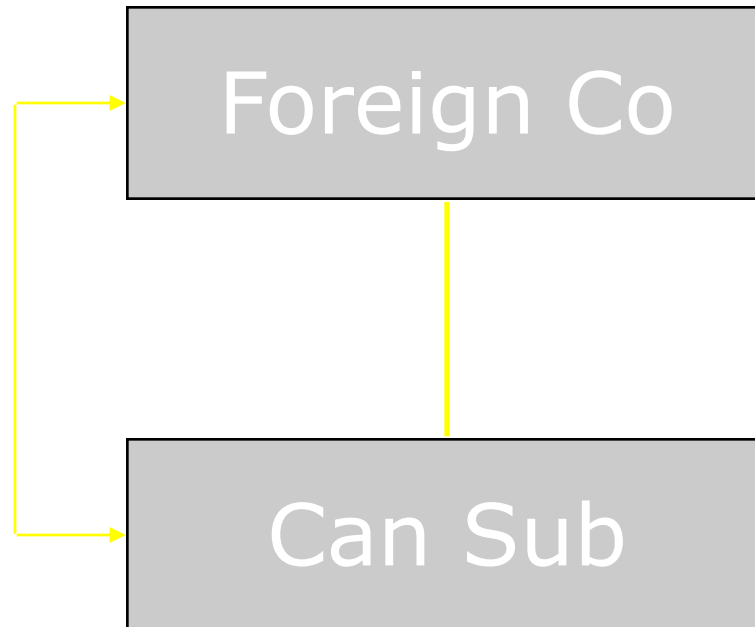
# Intercompany Pricing Rules

- The purpose of the Canadian transfer pricing rules is to ensure that the pricing of non-arm's length cross-border transactions conforms to the pricing that arm's length parties would establish for the same transactions
- Documentation requirements assist CRA's audit of the transactions
- Transfer pricing adjustments frequently result in consequential adjustments to non-resident withholding tax under Part XIII

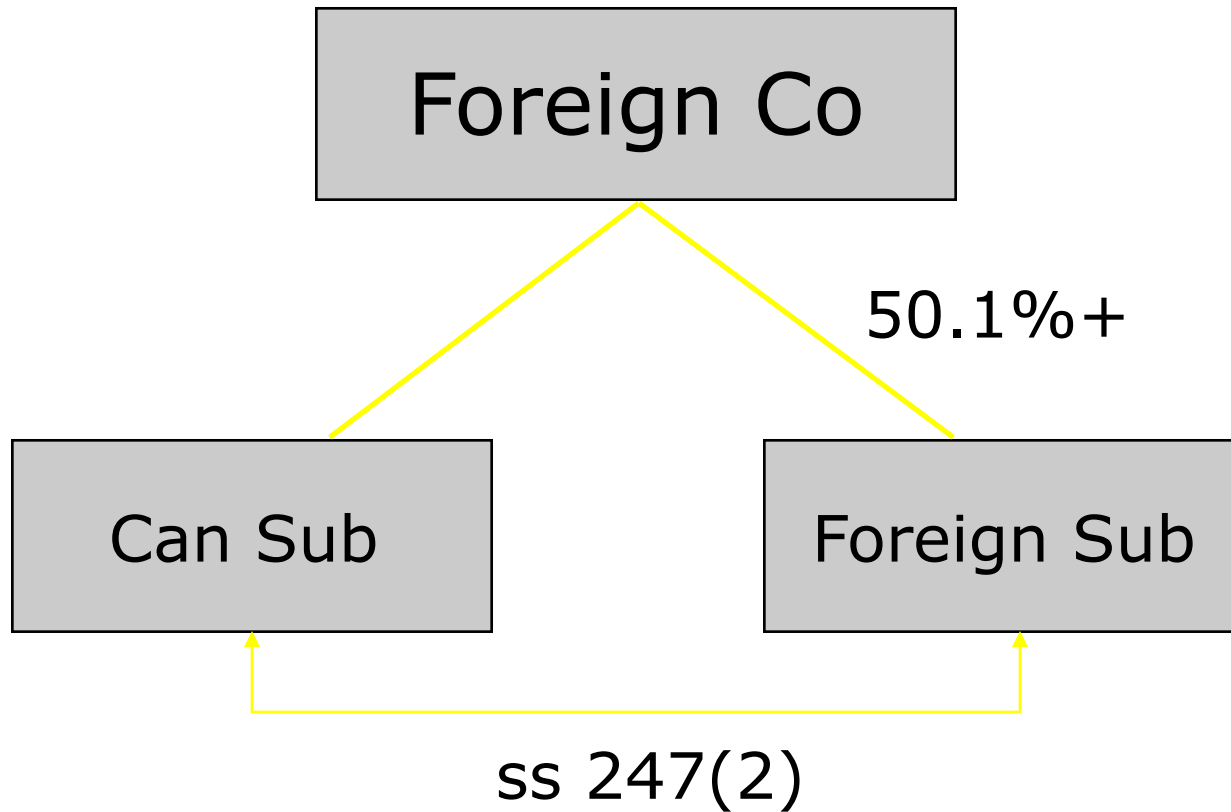
# Meaning of Arm's Length

- Related persons are *deemed* not to be dealing at arm's length – s.251(1)(a)
- Question of fact whether unrelated persons are dealing at arm's length – s.251(1)(c)

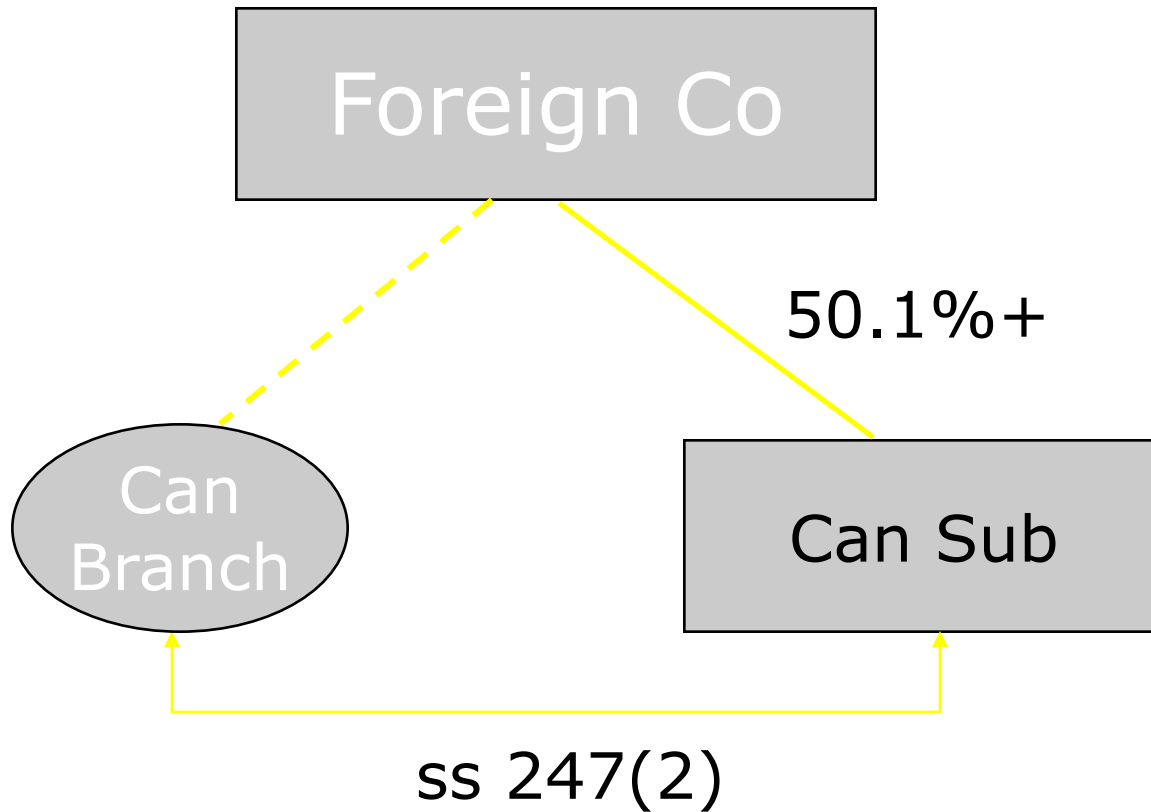
# Foreign Co and Canadian Sub



# Canco and Foreign Sisterco



# Foreignco with Cdn Branch



# OLD RULES / NEW RULES

- Subsections 69(2) and (3) apply for taxation years beginning prior to 1998
- Subsection 247(2) applies for taxation years beginning after 1997

# Former Rules: 69(2) and (3)

69.(2) Where a taxpayer has paid or agreed to pay to a non-resident person with whom he was not dealing at arm's length as price, rental, royalty or other payment for or for the use or reproduction of any property, or as consideration for the carriage of goods or passengers or for other services, an amount greater than the amount (in this subsection referred to as "the reasonable amount" that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, the reasonable amount shall, for the purpose of computing the taxpayer's income under this Part, be deemed to have been the amount that was paid or is payable therefor.



# Former Rules: 69(2) and (3)

69. (3) Where a non-resident person has neither paid nor agreed to pay to a taxpayer with whom the person was not dealing at arm's length as price, rental, royalty or other payment for or for the use or reproduction of any property or as consideration for the carriage of goods or passengers or for other services, an amount equal to or greater than the amount that would have been a reasonable amount in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, that reasonable amount shall, for the purpose of computing the taxpayer's income under this Part, be deemed to have been received or receivable by the taxpayer therefor.

# Current Rules: 247(2)

247.(2) 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 and

(a) the terms or conditions made or imposed in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm's length, or

(b) 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

## 247(2) (Continued):

Any amounts that, but for this section and section 245, would be determined for the purposes of this Act 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 that would have been determined if,

(c) where only paragraph (a) applies, the terms and conditions made or imposed, in respect of the transaction or series, between the participants in the transaction or series had been those that would have been made between persons dealing at arm’s length, or

(d) where paragraph (b) applies, the transaction or series entered into between the participants 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 Canadian Legislative Approach:

- Subsections 69(2)/(3) and 247(2)(a) express the legal standard differently:
  - Subsection 69(2): the amount “that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm’s length”
  - Subsection 247(2)(a): “the quantum or nature of the amounts that would have been determined if...(c)... The terms and conditions made or imposed, in respect of the transaction or series, between the participants in the transaction or series had been those that would have been made between persons dealing at arm’s length”

# Substitute Arm's Length Terms and Conditions – 247(2)(a)

- Determine nature or quantum based on terms and conditions that would have been made between arm's length persons
- Price the same transaction but with potential power to substitute “arm's length” terms and conditions
- Not clear that profit-based method authorized

# Substitute Arm's Length Transaction – 247(2)(b)

- Determine nature or quantum based on the terms and conditions of the substituted transaction that would have been entered into by arm's length persons if:
  - Arm's length party would not have entered into the NAL transaction *and*
  - NAL transaction was not primarily entered into for business (i.e., non-tax) purpose(s)

# Comparison of Legislative Provisions

- Section 247 provides for the following features that subsection 69(2) lacks:
  - Application to a “series of transaction” (in addition to a “transaction”)
  - Potential power to substitute terms and conditions
  - Potential power to recharacterize the transaction(s) under (b) for transfer pricing purposes
  - Transfer pricing penalties (generally 10% of the transfer pricing adjustment) may be assessed in addition to pricing adjustments if the taxpayer has not made reasonable efforts to determine and use arm’s length transfer prices and met the contemporaneous documentation requirements

# Article IX of the Canada U.S. Tax Treaty

1. 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.
2. For the purposes of this Article, a person shall be deemed to be related to another person if either person participates directly or indirectly in the management or control of the other, or if any third person or persons participate directly or indirectly in the management or control of both.
3. 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 six 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 limitations in the other State, even if the notification is not made within the six-year period.
4. In the event that the notification referred to in paragraph 3 is not given within the time period referred to therein, and the competent authorities have not agreed to otherwise consider the case in accordance with paragraph 3(b), the competent authority of the Contracting State which has made or is to make the first-mentioned adjustment may provide relief from double taxation where appropriate.
5. The provisions of paragraphs 3 and 4 shall not apply in the case of fraud, wilful default or neglect or gross negligence.



# Overview of Transfer Pricing Penalty System

- Penalty = 10% of subsection 247(2) adjustments if total adjustments exceed lesser of
  - 10% of gross revenue and
  - \$5 million
- Penalty applies to adjustments: not tax payable so taxpayer could be subject to penalty in a “loss year”

# Base For Penalty

- Transfer Pricing Capital Adjustment:
  - 1/2 of ACB and 3/4 ECE adjustments
  - 100% of Capital Cost adjustments
- Transfer Pricing Income Adjustment
  - income/loss adjustments
- Transfer Pricing Capital Set-off Adjustment
- Transfer Pricing Income Set-off Adjustment

# Base for Penalty Set-off Adjustments

- Credit given for 247(2) adjustments which favour taxpayer only if
  - (i) documentation requirements are met, and
  - (ii) CCRA exercises discretion re: 247(2) under 247(10)

# Defence to Penalty

- Penalty not applicable where contemporaneous documentation requirements are met and:
  - Taxpayer made “reasonable efforts” to determine arm’s length transfer prices or arm’s length allocation, or
  - Transaction is qualifying cost contribution arrangement

# Contemporaneous Documentation Requirements

records or documents that provide a description that is complete and accurate in all material respects of:

- (i) property or services to which the transaction relates
- (ii) terms & conditions / relationship to other transactions
- (iii) identity of participants

# Contemporaneous Documentation Requirements

- (iv) functions performed, property used and risks assumed
- (v) data and methods considered and the analysis performed to determine transfer prices
- (vi) assumptions, strategies and policies that influenced determination of transfer prices

# Continuing Transaction Requirements

- Taxpayer must make or obtain records/documents providing complete and accurate description of *material changes* to the above matters

# Contemporaneous Documentation Due Date

- Documentation must exist on or before due date for tax return (6 months after taxation year for corporations)
- Taxpayer must provide documentation *within 3 months of demand* by CRA



# Form T-106

- Early warning system to CRA for transfer pricing audits
- Name and address of nonresident
- Type of transactions
- Dollar value of transactions
- Transfer pricing method
- Contemporaneous documentation

# Transfer Pricing Committee

- CRA has established “Transfer Pricing Committee”
- Reviews/Recommends:
  - proposed use of recharacterization power under section 247(2)(b)
  - proposed transfer pricing penalty assessments

# Role of the OECD Transfer Pricing Guidelines

- Courts have said that the OECD Transfer Pricing Guidelines may inform the interpretation and application of subsection 69(2)
  - “it appears to be common ground that the OECD Guidelines inform or should inform the interpretation and application of subsection 69(2) of the *Income Tax Act*. ...(*SmithKline Beecham* (F.C.A.) at para.8)
  - The Court in *Glaxo* cited from *SmithKline Beecham* and also referred to Article 9(1) of the OECD Model Double Taxation Convention on Income and Capital and the Minister’s information circulars on transfer pricing
- Courts will likely say the same in respect of section 247 because that provision was intended to conform with the 1995 OECD Transfer Pricing Guidelines
- In *Glaxo*, the Court reviewed the transaction methods described in the OECD Transfer pricing Guidelines and concluded that the CUP method was the best method where comparators were available

# OECD Pricing Methods

- Comparable uncontrolled price (“CUP”)
- Cost plus
- Resale price
- Transactional net margin
- Profit Split

# GlaxoSmithKline v. R.

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

# GlaxoSmithKline v. R

- Main issues raised at trial:
  - Whether the price paid by generic manufacturers for ranitidine constituted a CUP for the taxpayer's purchase of ranitidine from Adescha for the manufacture of Zantac, considering the different business circumstances and the Glaxo group's manufacturing standards for ranitidine
  - 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 Adescha for ranitidine

# GlaxoSmithKline v. R

## The Tax Court Decision

- *The issue*: whether the prices paid by Glaxo to Adechsa for ranitidine would have been reasonable in the circumstances if Glaxo and Adeschsa had been dealing at arm's length
- *Transfer pricing methods*: the CUP method is the best method where comparators are available; otherwise, the hierarchy of methods set out in the OECD Transfer Pricing Guidelines may be followed (relying on *SmithKline Beecham Animal health Inc. v. Canada* (2002))
- *CUPs*: generic companies in Canada are an appropriate comparator 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 the generic companies paid for a kilogram of ranitidine
- *“Bundling”*: only the amount paid for ranitidine was relevant: amounts paid as licensing fees were not taken into account (relying on *Singleton v. Canada*, (2001), *Bausch & Lomb, Inc. v. Commissioner*, 1989 U.S. Tax Court)

# Additional Cases Referencing Subsection 69(2)

Other Canadian cases concerning the arm's length principle:

- *SmithKline Beecham Animal Health Inc. v. Canada* (2002) – motion decision relating to an appeal concerning whether the amount paid to the taxpayer's non-resident affiliates for the active ingredient cimetidine in its drug Tagamet met the arm's length standard (the appeal has settled)
- *Safety Boss limited v. R.* (2000) – a bonus and fees paid by the taxpayer to its president and his company were fully commensurate with services rendered by him in oilfield firefighting and were not in excess of amounts that it would have been reasonable to pay had the parties been at arm's length
- *Indalex Ltd. V. R.* (1988) – the price paid by the taxpayer to a related non-resident company for certain aluminum products was reduced to the amount that the related non-resident company had paid to third-party supplies for those products



# General Electric Capital Canada Inc. v. The Queen

- Involves application of the arm's length principle under ss. 69(2) and 247(2) in the context of financial guarantees
  - The taxpayer paid fees to General Electric Capital Corporation, 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% (or 100 basis points) of the principal amount of debt outstanding in the 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

# WORKING WITH TAX TREATIES

# What is a Tax Treaty ?

- Income Tax Convention
- Beyond Income Tax
- Between Federal Governments
- Shield not a Sword

# Principal Purposes

- Avoid Double Taxation
- Encourage Economic Development
- Prevent Fiscal Evasion

# Avoid Double Taxation and Encourage Economic Development

- Techniques to Avoid Double Taxation
  - Partial Shield
  - Complete Shield
  - Foreign Tax Credit Mechanism
  - Tax Sparing

# Prevent Fiscal Evasion

- Techniques Used
  - Specific Anti-Avoidance Rules in Specific Areas
  - Associated or Related Persons Article
  - Exchange of Information Procedures
  - “As Filed” Information versus “Requested” Information
- Collection Assistance

# Interpretation

- Vienna Convention
- OECD Model
- Income Tax Conventions Interpretation Act
- U.S. Treasury Department – Technical Explanation
- Annex B to the Fifth Protocol
- Selected Cases

# When is Tax Treaty Relevant

- Always
  - Exchange of Information
  - Collection of Taxes
  - Tax Sparing
- Only After Domestic Law
  - Avoidance of Double Taxation