The Joint Committee on Taxation of
The Canadian Bar Association and
The Canadian Institute of Chartered Accountants

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November 24, 2003

Mr. Tom Crowe
Manager, Compliance Programs Branch
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Canada Customs and Revenue Agency
6th Floor, 344 Slater Street
Ottawa, Ontario
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Dear Mr. Crowe:

Re: CCRA Draft Memorandum on Income Tax Transfer Pricing and Customs Valuation

The Joint Taxation Committee of the Canadian Bar Association and the Canadian Institute of Chartered Accountants (the "Joint Committee") appreciates the opportunity to provide comments to the Canada Customs and Revenue Agency ("CCRA") on its draft memorandum concerning the compatibility of transfer pricing for income tax and customs purposes (the "Draft Memorandum"). In providing these comments, the Joint Committee has had the benefit of input from members of the joint customs subcommittee of the CICA Commodity Tax Committee and the CBA Sales and Commodity Tax Section.

For the most part, the Draft Memorandum serves as a catalogue of the differences between the law and administrative policy regarding the determination of values for duty, on the one hand, and transfer prices for income tax purposes, on the other, in circumstances where transactions occur between related parties. As such, the Draft Memorandum should prove helpful to taxpayers and their advisors, particularly those who are less familiar with customs valuation and income tax transfer pricing. The Joint Committee has a number of specific suggestions and comments on the Draft Memorandum, which are contained in the attached Schedule.

A general observation we would make is that the Draft Memorandum, while acknowledging the desirability of reducing inconsistencies in administrative practices between the customs and income tax branches, does not provide information on how this objective is to be achieved. As the CCRA no doubt realizes, current differences in practices cause uncertainty for taxpayers and their advisors, and can give rise to inconsistent results. We understand that progress in this area has been made in other jurisdictions, particularly in the United States.

We recommend that the customs and income tax branches actively work together to determine how they can achieve consistency in their administrative practices, to the extent feasible. The Joint Committee would be pleased to participate in this process, in order to bring the perspective of those who have experience working with the two branches. One possible approach is the creation of a task force to develop recommendations to be agreed to by both

branches. In addition, we believe that there needs to be ongoing communication between the branches. Steps such as these are necessary, in our view, if there is to be a reduction in "the number of cases where customs valuations are found unacceptable for tax purposes or vice versa", as stated on page 30 of the Draft Memorandum.

In the Joint Committee's view, the following are particular areas in which the CCRA should strive for consistency:

- If the price of goods acquired from a related non-resident is determined to be at "arm's length" for income tax purposes, the price should be accepted as satisfying the requirement in subparagraph 48(1)(d)(i) of the *Customs Act* that the price was not influenced by the relationship between the purchaser and the vendor. In this case, the customs branch should not require the purchaser/importer to provide any additional information to prove that the requirement is met. Conversely, the income tax branch should be willing to accept as "arm's length" a price that the customs branch has determined was not influenced by the relationship between the parties.

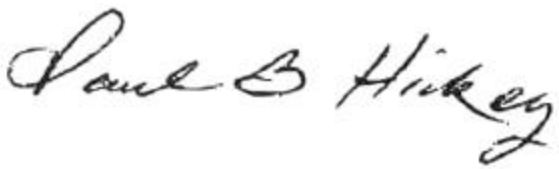
- If the price of goods is not accepted as an arm's length price for income tax purposes, then the transfer pricing methodology and the data and assumptions used to establish an arm's length price should also be used in determining the value for duty of the goods, to the extent that this can be done while complying with the requirements of the *Customs Act.*

- Terms used in the *Valuation for Duty Regulations* should be interpreted and applied in the same manner for customs purposes as for income tax purposes, except where this is not possible because of legislated definitions or rules. The terms we particularly have in mind are "carries on business" and "permanent establishment".

After the steps suggested above have been taken, the Joint Committee recommends that a second memorandum be prepared to reaffirm the commitment to consistency in the administration of transfer pricing and customs valuation, and to inform taxpayers and their advisors how this will be brought about. If it is concluded that some inconsistencies cannot be eliminated, the memorandum would address this as well. We also suggest that the second memorandum incorporate examples so that it can be understood in a practical way by taxpayers and their advisors. A similar suggestion was made when *Information Circular* IC 87-2R, the transfer pricing Circular, was being developed. As a result, specific examples were added to that Circular to assist taxpayers and their advisors in understanding the practical implications of the CCRA's views. It is possible that some of the examples in IC 87-2R could be further developed for inclusion in the second memorandum we are proposing.

We trust you will find our comments and recommendations helpful. We would be pleased to meet with you and your colleagues to elaborate on any of the points in this submission.

Yours truly,



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Chair, Taxation Committee
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cc: Mara Praulins
Director, International Tax Operations Division
CCRA

SCHEDULE

1. Guidelines vs. Law

The Joint Committee has a general concern about references to the CCRA's transfer pricing guidelines in IC 87-2R as if they had the status of law. For example, page 4 states that the transfer price for income tax purposes is *determined based on guidelines*. The guidelines merely set out the CCRA's view of how an arm's length price is to be determined. We suggest that the Draft Memorandum draw a clearer distinction between the CCRA's guidelines and the law.

2. Price Setting

Page 5 of the Draft Memorandum contains a paragraph that starts: *"Taxpayers themselves may have competing incentives in setting values for customs and income tax purposes. ..."*

We suggest that this paragraph be deleted. The comments in the paragraph are not relevant to a discussion of the legal principles governing the determination of the value for duty of goods and the price of the goods for income tax purposes. Moreover, the paragraph does not accurately reflect the dynamics that underlie the determination of prices in many related party transactions. Prices are often negotiated, and the purchaser's objective is to obtain the best business deal.

3. Royalties – "Functions" Irrelevant

Page 5 of the Draft Memorandum states: *"For customs purposes, an examination of the functions being performed will be done in order to determine if the royalty is one that should be included in the value for duty."*

A royalty is added to the price paid or payable only if it is paid in respect of the imported good, and is paid as a condition of the sale for export of the good. The "functions being performed" are not relevant and, therefore, should not be considered. What is relevant are the terms of the royalty agreements.

It would be helpful to communicate a more complete understanding of the royalty provisions in the *Customs Act* by making reference to the court decisions in *Mattel* and *Reebok*.

4. Timing of Valuation

Page 5 of the Draft Memorandum states: "*... for income tax purposes, goods are valued at the time of transfer of title."*

This statement does not accurately reflect the way in which the transfer pricing rules apply. The test, in our view, is whether the price is an arm's length price, which is a determination that would be made based on all the circumstances at the time the parties agree to the transaction. The value at the time of the transfer of title may or may not be relevant, depending on the particular circumstances.

5. Exchange Rates

Page 6 of the Draft Memorandum states: *"Timing of exchange rates ...Normally, it is the rate of exchange prevailing at the time of the transaction (refer to IT-95R, Foreign exchange gains or losses). This can result in goods being valued at different times."*

Any difference in the "timing of exchange rate" would not result in "the goods being valued at different times", but in the exchange rates that are used to convert those values being different.

Further, the reference to the rate of exchange prevailing at the time of the transaction is confusing, since it is not clear specifically what is meant by the "transaction". In addition, we do not think that IT-95R is relevant since it deals with the determination and characterization of foreign exchange gains and losses as opposed to the determination of the cost of goods.

6. Valuation for Duty Regulations – Resident and Purchaser in Canada

Page 9 of the Draft Memorandum states: *"In order for a person to meet the definition of resident under subsection 2.1(a) of the Valuation for Duty Regulations, Meaning of Purchaser in Canada, significant presence is required."*

In order for a person to meet the definition of resident under paragraph 2.1(a) of the Regulations, the person must "meet the definition", and nothing more. The definition is as follows:

(a) an individual who ordinarily resides in Canada;

(b) a corporation that carries on business in Canada and of which the management and control is in Canada; and

(c) a partnership or other unincorporated organization that carries on business in Canada, if the member that has the management and control of the partnership or organization, or a majority of such members, resides in Canada.

In as much as the definition does not mention "significant presence", it is not "required" by the Regulations. Although the CCRA may choose to use this as a criterion, we think it is important to appreciate that this is an expression of administrative policy and not a prerequisite that is specifically referred to in the legislation.

Also on page 9 of the Draft Memorandum is the statement: "*If a person is not resident in Canada, customs will then determine if the person has a permanent establishment in Canada and qualifies as a purchaser in Canada*."

If a person has a permanent establishment in Canada, that person is, under the Regulations, a purchaser in Canada. The Regulations do not provide the CCRA scope to decide otherwise.

7. Price Reductions

The Draft Memorandum seems to equate a reduction in price pursuant to the transfer pricing rules to an actual reduction in price. For examples, we refer you to the bullet on page 6 of the Draft Memorandum headed "Retroactive price adjustments", and also the response to question 4 on page 33 of the Draft Memorandum. While the parties might actually adjust the price paid (e.g., as part of the overall settlement, in order to avoid issues with respect to subsections 15(1) and 56(2) of the *Income Tax Act*), this does not necessarily have to happen.

8. Purchaser in Canada vs. Taxpayer

(a) Importer Role – Possibly Irrelevant

Page 10 of the Draft Memorandum states: *"In order to do this, customs will look beyond the paper transaction to determine the importer's role in the sales transaction*."

The importer and purchaser in Canada need not be the same person. Therefore, the "role" of the importer may be irrelevant.

If the goods are sold to a person that falls within the definition of "purchaser in Canada", the *Customs Act* does not allow the CCRA the option of looking beyond the "paper transaction". If the CCRA is of the view that the transaction between two parties does not constitute a *bona fide* sale between a seller and a buyer, this is a separate matter from the "purchaser in Canada" requirement and is not addressed explicitly in the valuation provisions of the *Customs Act,* which do not define the term "sale".

(b) Purchaser – Not Carrying on Business in Canada

Page 10 of the Draft Memorandum states: *"Ultimately, customs is trying to draw a line between a person that is acting more "like a selling agent" versus a person that is acting more "like a buyer and reseller" of the goods. For example, if it is determined that a Canadian corporation is not carrying on business in Canada, the transaction value will not be seen to be between the non-resident corporation and the related Canadian corporation*."

A Canadian corporation is not required to be "carrying on business" in Canada in order to be the purchaser of the goods. The *Valuation for Duty Regulations* define when the purchaser is "in Canada", not whether a person is the purchaser. The CCRA cannot treat the transaction between the purchaser and the vendor as if the transaction did not occur. It may, however, conclude that the transaction does not meet the requirements of the *Customs Act* because the purchaser is not "in Canada", in which case, the proper course of action is to proceed to another method of valuation.

(c) Selling Agents

Page 10 of the Draft Memorandum states: *"Rather, it may be found that the related Canadian corporation is acting more like a selling agent for the non-resident corporation and, therefore, the sale to the ultimate Canadian purchaser will be*

considered to be the sale for export to Canada. The selling price between the Canadian corporation and the ultimate Canadian purchaser would then, for customs purposes, be the basis for the transaction value."

If there is a sale between the "Canadian corporation" and the "ultimate Canadian purchaser" (that is, if the "Canadian corporation" has the legal right to transfer the property rights in the goods for a money price) there must have been a prior sale between the "non-resident corporation" and the "Canadian corporation" (in which sale the "Canadian corporation" acquired the right). If the CCRA, for whatever reason, rejects the price in the latter sale as the basis for transaction value, it could only use the price drawn from the subsequent re-sale in Canada as the basis for a value for duty that is determined under the deductive method.

(d) Meaning of "Resident", "Carrying on Business", "Permanent Establishment"

The purpose of the comments in the last paragraph of page 10 of the Draft Memorandum is not clear. It would be helpful to expand on the comments. Further, it is not accurate to state that the terms "resident" and "carrying on business" are defined in the *Income Tax Act*. There is no comprehensive definition of either term in that statute.

9. Post-Importation Payments or Fees (Subsequent Proceeds)

Page 15 of the Draft Memorandum states: *"Payments or fees that are paid on a post-importation basis, by a purchaser to a vendor, as a result of a subsequent resale, disposal or use of the imported goods are normally amounts paid to related vendors, payable as a percentage/fixed per-unit amount and include management fees, administrative fees, and marketing fees based on resale in Canada. These payments are considered subsequent proceeds under subparagraph 48(5)(a)(v) of the Customs Act to be added to the price paid or payable when determining the value for duty."*

Subparagraph 48(5)(a)(v) of the *Customs Act* refers to:

> the value of any part of the proceeds of any subsequent resale, disposal or use of the goods by the purchaser thereof that accrues or is to accrue, directly or indirectly, to the vendor.

The *Customs Act* does not refer to "fees" (which would, obviously, have to be paid from income earned by the purchaser in the course of carrying on its business in Canada). To avoid confusion between the express requirements of the law, and the CCRA's interpretation of the law, we suggest that the last sentence in the above-quoted paragraph on page 15 of the Draft Memorandum be amended to read:

> The CCRA considers these payments to be "subsequent proceeds" under subparagraph 48(5)(a)(v) of the *Customs Act* with the result that they are to be added to the price paid or payable when determining the value for duty.

10. Transportation and Associated Costs

Page 15 of the Draft Memorandum states: *"If these [transportation and associated] costs arise prior to and at the place from which the goods begin ..."*.

Subparagraph 48(5)(a)(vi) of the *Customs Act* refers to:

> the cost of transportation of, the loading, unloading and handling charges and other charges and expenses associated with the transportation of, and the cost of insurance relating to the transportation of, the goods **to** the place within the country of export from which the goods are shipped directly to Canada.
>
> [Emphasis added.]

There is no provision in the legislation that would allow the addition of transportation and associated costs arising at the place of direct shipment.

11. Tangible Assists

Regarding the discussion on page 17 of the Draft Memorandum, it is not clear why tangible assists would necessarily be dealt with as a separate transaction for transfer pricing purposes.

12. Price Reduction After Importation – Income Tax

The discussion on page 19 of the Draft Memorandum concerning price reductions after the importation of goods states that price reductions would be acceptable for income tax purposes to the degree that arm's length parties would have agreed to the reductions. It is unclear to us why an excessive price reduction would necessarily be unacceptable, as the reduction would generally result in an increase in the purchaser's income.

Also, the paragraph states that an agreement that is, in substance, the same as one that arm's length parties would have entered into would not usually be subject to adjustment. Implicitly, that suggests that adjustments might be made. It is not clear to us why adjustments would ever be made in such a case.

13. Deductive Value vs. Resale Price

Page 22 of the Draft Memorandum states: *"Specifically the deductive value of the goods is ... the price per unit."*

The deductive value is not the price per unit. The price per unit is, rather, the basis upon which the deductive value is calculated.