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Tax Policy Branch
Department of Finance Canada
90 Elgin Street
Ottawa, ON K1A 0G5

Via email: prixdetransfert-transferpricing@fin.gc.ca

Re: Transfer Pricing Consultation – Deloitte's Comments

Dear Sir or Madam:

We are writing to provide our comments on the consultation paper entitled "Consultation on Reforming and Modernizing Canada's Transfer Pricing Rules" released by the Department of Finance (Finance) on June 6, 2023 (the "Transfer Pricing Consultation Paper"). We appreciate the fact that Finance has released a consultation paper to gather feedback on this important topic and believe that this affords stakeholders with the opportunity to provide input based on their experience and practical insights. We believe this approach will foster a greater understanding of the issues being addressed and will ultimately help to develop tax policy that will contribute towards a competitive Canadian economy.

Deloitte and its affiliated entities constitute one of the largest professional services firms in Canada. We work with many taxpayers, ranging from individuals and private businesses to Canadian and global multinationals, to advise and support them in their compliance obligations under the *Income Tax Act*[1] (the "Act").

Finance has achieved its primary objective

We understand that Finance's primary objective in issuing the Transfer Pricing Consultation Paper was to provide more detail on the application of the arm's length principle in Canada's transfer pricing legislation and to bring Canada's transfer pricing legislation in line with the international consensus, as described in the guidance provided by the Organisation for Economic Cooperation and Development (OECD) in the latest version of its report *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the "Transfer Pricing Guidelines").

Canada's existing transfer pricing legislation was enacted in 1997, and at that time it was stated that the intent of the legislation was to align Canadian transfer pricing with the recently published 1995 version of the Transfer Pricing Guidelines. While the Transfer Pricing Guidelines have undergone significant revisions since that time, the transfer pricing legislation in Canada has remained substantively unchanged.

[1] RSC 1985, c. 1 (5th Supp.), statutory references therein are to the Act.

In our view, Finance's proposed changes to the Canadian transfer pricing legislation position Canada to align with the international consensus. However, successful alignment with the international consensus will depend largely on the interpretation and administration of these proposed rules by the Canada Revenue Agency (CRA) to provide greater certainty to taxpayers.

With that being said, we believe that the inherently subjective nature and complexity of the concepts within the proposed legislation will result in heightened Canadian transfer pricing controversy in the period after its enactment.

In light of these overarching factors, the remainder of this letter provides our commentary on the Transfer Pricing Consultation Paper and the legislation and administrative measures proposed and discussed within it for Finance's consideration.

Consistency rule

The legislation within the Transfer Pricing Consultation Paper proposes the introduction of a consistency rule, which requires that the Canadian transfer pricing legislation be applied in a manner that best achieves consistency with the Transfer Pricing Guidelines unless context requires otherwise.

We believe that the inclusion of the Transfer Pricing Guidelines using a consistency rule is appropriate and practical. From our perspective, the Transfer Pricing Guidelines were not written in a fashion that lends itself to direct inclusion in legislation, but rather were written in an explanatory and consensus-driven fashion. We do, however, recommend that the legislation be more explicit regarding situations where it is to be applied in a manner that is not consistent with the Transfer Pricing Guidelines. For example, if it is intended that an exception be applicable where the application of the Transfer Pricing Guidelines would be inconsistent with a legal principle in Canada, then we suggest that it should be worded accordingly. We submit that the current wording ("unless the context requires otherwise") is too vague and subjective to allow taxpayers an appropriate level of certainty. At a minimum, some explanation (by way of principles or examples) of circumstances in which the context would require otherwise should be provided in the explanatory notes.

Clarifying certain terms in the proposed legislation

The proposed legislation contains the phrase "commercially rational" in a number of places. This phrase is not defined in the proposed legislation, and we submit that it can, and likely will, have a different meaning (potentially dramatically different meaning) to different taxpayers and the CRA. While this phrase is also used in the Transfer Pricing Guidelines and in the decision in *Cameco Corporation v. The Queen*,[2] its use is not the subject of substantive explanation or guidance. We suggest that additional guidance would be beneficial to the administration and interpretation of the phrase as it is used in the proposed legislation.

Applicability of transfer pricing penalties to small taxpayers

The Transfer Pricing Consultation Paper intimates that the current legislative framework relating to transfer pricing penalties, embodied in subsections 247(3) and 247(4) of the Act, is due for possible revisions. The two focal points are: the *de minimis* penalty threshold and the concept of "reasonable efforts."

Canada's two-part *de minimis* penalty threshold has remained unchanged since its introduction in 1997. Finance's proposal to raise the absolute penalty threshold from an assessed capital or income adjustment of

[2] 2018 TCC 195.

$5 million to $10 million is appropriate and aligns with international standards. The second part of the penalty threshold, namely the "10% of taxpayer revenue," is proposed to remain unchanged. Given that the penalty threshold determination is a lesser of test, it is the relative revenue threshold that is frequently unfair for smaller taxpayers.

Accordingly, we recommend that Finance consider establishing a company size threshold at which transfer pricing penalties are not applicable for small taxpayers except in egregious circumstances. Other OECD member countries have transfer pricing regimes that include safe harbours, of sorts, for smaller taxpayers, where the threshold for "small taxpayers" is set based on people, revenue (turnover) and/or assets. For example, the United Kingdom has an exemption from transfer pricing legislation for small or medium-sized enterprises. The definition of "small" and "medium-sized" enterprises that is given in the UK legislation is linked to that in the Annex to the EU Commission Recommendation 2003/361/EC of May 6, 2003.[3] In this document, "medium sized" businesses are defined as those which employ fewer than 250 persons and which have an annual turnover not exceeding €50 million, and/or an annual balance sheet total not exceeding €43 million, with a "small business" being applicable where they employ no more than 50 staff and have an annual turnover or balance sheet of less than €10 million. As another example, in Denmark, companies (measured at a group level) that employ fewer than 250 employees and either have revenue below DKK 250 million or a balance sheet amount below DKK 125 million, are subject to more limited documentation requirements.

The interaction of the penalty threshold and Finance's proposed "Simplified Documentation Requirements for Lower Value Transactions and Smaller Taxpayers" should be carefully aligned. Eligible taxpayers that choose to avail themselves of "Simplified Documentation Requirements" and "Streamlined Pricing Approaches" should not be subject to penalty provisions for the relevant transactions.

Applicability of transfer pricing penalties and the concept of reasonable efforts

In Canada, penalties are applied where the transfer pricing adjustment exceeds the penalty threshold, and the taxpayer is deemed not to have made "reasonable efforts" in determining and using arm's length terms and pricing. The concept of "reasonable efforts" is discussed further in TPM-09.[4] We anticipate that the conflux of streamlined documentation approaches, and the proposed focus on delineating the transaction forms may lead to confusion as to what constitutes "reasonable efforts" at least until a body of praxis and/or jurisprudence is formed. We recommend that expectations in respect of reasonable efforts under the proposed rules and administrative measures be clarified through the issuance of additional guidance by the CRA.

Attribution of profits to permanent establishments

Canadian transfer pricing legislation in section 247 of the Act does not govern the attribution of profits to permanent establishments. This is governed under section 4 of the Act. In addition to transfer pricing, we believe that this is another area that requires consistency with the international consensus as articulated under the Authorised OECD Approach for the attribution of profits to permanent establishments. Like the approach in the Transfer Pricing Consultation Paper, we recommend that Finance contemplates the introduction of a consistency rule for permanent establishments and profit attribution rules, and considers

[3] OECD, *Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises*, 2003/361/EC (Brussels: OECD, 2003).
[4] TPM-09, *Reasonable efforts under section 247 of the Income Tax Act*, September 18, 2006.

the approaches being contemplated in or taken by countries around the world to meet this objective.[5] Closer alignment of Canadian legislation with the international consensus will provide taxpayers with more explicit guidance on attributing profits to their permanent establishments, but a consistency rule may also enable subsequent changes to be more quickly incorporated into Canadian law.

Acceptance of multi-year analyses

As noted above, we agree that it is appropriate for Finance to align Canadian transfer pricing legislation as reflected in the Transfer Pricing Guidelines. We note, however, that the Transfer Pricing Guidelines generally reflect principles, and not specific rules regarding how such principles are applied. One area where the Canadian application of the general transfer pricing principles deviates from that of many of its trading partners is with respect to the consideration and use of multi-year analyses.

The CRA published administrative guidance on the role of multiple year data in transfer pricing analyses in TPM-16.[6] This memorandum describes that

> It is the CRA's policy that the determination of arm's length prices used in related party transactions for Canadian taxpayers should be established for each individual tax year using the results obtained from comparable transactions in the relevant tax year. The relevant tax year of comparison is generally expected to be the year in which the controlled transactions were undertaken. Accordingly, the taxable income, and adjustments thereto, arising from a transfer pricing analysis, should be calculated on a year-by-year basis in accordance with the arm's length principle. Therefore, taxpayers should not average results over multiple years for the purpose of substantiating their transfer prices.[7]

We understand that the rationale for the CRA's above-noted policy is the view that the determination of income and taxable income is a process that must be performed in respect of each specific taxation year under the provisions of the Act.

We note that most of Canada's major trading partners allow (or require) evaluation of whether transfer pricing is consistent with the arm's length principle by considering data over multiple years. We therefore submit that it would be beneficial to align Canada's transfer pricing legislation by introducing a provision within section 247 of the Act establishing that an evaluation of whether prices are consistent with the arm's length principle can be done taking into consideration multiple years of data.

The Competent Authority Services Division and Canadian MAP/APA programs

The draft legislation proposes to repeal the current provisions in paragraphs 247(2)(b) and (d) of the Act and instead sets out a proposed non-recognition and replacement rule that is consistent with the Transfer Pricing Guidelines. However, as acknowledged in the Transfer Pricing Consultation Paper, the Transfer Pricing Guidelines do not provide a set of rules that are always clear or unambiguous. More specifically, there is no bright line test for what may or may not be considered "commercially rational" for purposes of applying the non-recognition and replacement rule. Hence, there would be a spectrum of subjectivity in the determination of the options realistically available to each of the participants at the time of entering into the delineated

[5] For example, HM Revenue & Customs issued a consultation paper on June 19, 2023, discussing this topic.
[6] TPM-16, *Role of Multiple Year Data in Transfer Pricing Analyses*, January 29, 2015.
[7] Ibid., at para. 9.

transaction or series, and what conditions, including those beyond contractual conditions, may be appropriate in the circumstances. With this ambiguity and subjectivity, it is anticipated Canadian taxpayers may be faced with increased transfer pricing controversy matters. Recognizing that the objectives of Finance are to bring Canada's transfer pricing legislation in line with international consensus as described in the Transfer Pricing Guidelines, taxpayers should have the ability to deal with all transfer pricing disputes, whether raised by the CRA or any other tax authority, through the mutual agreement procedures (MAP) program.

Currently, under IC71-17R6,[8] the Canadian Competent Authority Services Division (CASD) "will not negotiate cases where the (re)assessment relies on any anti-avoidance provisions under the Act," including paragraph 247(2)(b). Further, as it pertains to arbitration provisions (whether negotiated under a bilateral treaty or effective pursuant to the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*), Canada will not allow cases where a Canadian reassessment is based on an anti-avoidance provision to be eligible for arbitration.

Upon the enactment of new Canadian transfer pricing legislation that is aligned with the international consensus as set out in the Transfer Pricing Guidelines, it is recommended that all transfer pricing adjustments (including adjustments resulting from the application of the non-recognition and replacement provisions) be treated as "negotiable" and eligible for arbitration under the provisions of any treaty.

Additionally, to further administer the anticipated additional need for competent authority assistance, increased staffing within the CASD should be a priority in anticipation of the greater need for dispute resolution through the MAP program.

The Transfer Pricing Consultation Paper also considered certain administrative measures that could be implemented to increase tax certainty and reduce the compliance and administrative burdens associated with complying with the arm's length principle. Certain of these proposed administrative measures put forward streamlined pricing approaches that may have the benefit of reducing the number of potential tax disputes and thereby, increasing tax certainty for more routine-type activities and transactions.

It should be noted that the purpose of the Advance Pricing Arrangement (APA) program administered by the CASD is to provide a co-operative process for resolving transfer pricing issues on a prospective basis and for preventing transfer pricing disputes and providing the CRA and taxpayers with tax certainty. However, in our experience, the policy of the CASD has limited acceptance of APA requests into the APA program to more routine-type activities and transactions. To the extent certain administrative measures include safe harbours or that streamlined approaches are adopted, the APA program may have less beneficial application with these limitations. It is recommended that the CRA considers an approach similar to the one that has been undertaken in the United Kingdom by HMRC to restrict APAs to cases that have the following factors taken together: involve transfer pricing issues that are complex, whereby "complex" means there is "real doubt" as to how the arm's length standard should be applied; without an APA there is a high likelihood of double-taxation; and the revenue authority considers it is a good use of taxpayer and governmental resources.[9]

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[8] *Information Circular 71-17R6*, "Competent Authority Assistance under Canada's Tax Conventions," June 1, 2021, at para. 43.
[9] See HM Revenue & Customs, Statement of Practice 2 (2010), which was last updated on July 12, 2019, at para. 16.

We hope that our specific comments are helpful in your consideration of the evolution of the transfer pricing rules. We would be pleased to meet with you or other officials to discuss our submission as Deloitte is committed to making a significant contribution to help shape Canada's tax policy and its application to the future of our country.

Yours very truly,

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