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Transfer pricing alert

Canada updates guidance on role of multiple year data in transfer pricing analyses

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The Canada Revenue Agency (CRA) has issued its 16th Transfer Pricing Memorandum (TPM), *Role of Multiple Year Data in Transfer Pricing Analyses*, which was posted on its website February 13, 2015. TPM-16 provides guidance and direction to Canadian taxpayers on the use of multiple year data in determining the arm's length price in a transfer pricing context.

TPMs issued by the CRA do not have the force of law in Canada. However, along with Information Circular 87-2R, *International Transfer Pricing* (IC87-2R), TPMs are key documented sources of guidance to taxpayers regarding the CRA's views and administrative positions on a number of transfer pricing-related topics.

The key takeaways from TPM-16 are summarized below.

1. Results should not be averaged over multiple years

TPM-16 clarifies that the CRA's expectation when reviewing contemporaneous documentation or other transfer pricing representations from taxpayers is that observed outcomes from comparable transactions should not be averaged over multiple years. Instead, the CRA's preference is to apply the results for comparable data on a year-by-year basis.

2. Results may be averaged over multiple years in an APA context

One exception to the above policy regarding multiple year results averaging is that in an advance pricing arrangement (APA) context, the averaging of historical outcomes of comparable transactions over multiple years may form part of the analysis. The CRA still expects that transfer prices used will be verified on a year-by-year basis, however. In other words, while multiple year averages may be used in establishing the comparable range of outcomes to be used in the APA transfer pricing methodology for example, the taxpayer's prices in each year will be tested against the agreed APA transfer pricing methodology, rather than testing multiple year averages of taxpayer prices.

3. Multiple years of data may be used when establishing comparability

While the CRA's policy is to use single year data when evaluating the arm's length nature of a transaction, the CRA acknowledges that multiple years of data may be useful in establishing comparability. TPM-16 notes that multiple year data may be used if the additional information will improve the accuracy or reliability of the transfer pricing analysis. An important distinction to note is that the CRA endorses multiple years of data when establishing the comparability of uncontrolled transactions, as opposed to assessing the results of the chosen uncontrolled transactions. Once the comparable uncontrolled price of transactions is established (using multiple years of data if appropriate), it is a single year of results that is expected to be used in the transfer pricing analysis.

Specific factors noted in TPM-16 as being observable only over multiple years include business cycles, product life cycles, the useful life of capital and business strategies. Therefore, understanding these factors by observing multiple years of data is helpful in establishing the comparability of arm's length transactions. TPM-16 also refers to the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* guidance paragraphs 3.75 to 3.79 for situations where multiple years of data may be useful, including circumstances in which such data allows for the differentiation between a history of business losses and a loss due to a one-time cost increase, for example.

4. The average is the preferred statistical measure when selecting the most appropriate point in the range

Consistent with the OECD transfer pricing guidelines, the CRA has specifically noted in TPM-16 that it will not make a transfer pricing adjustment if the price or margin of a transaction is within the arm's length range. Where the price or margin falls outside the range however, the CRA will determine the most appropriate point in the range for the purposes of proposing an adjustment. In this regard, the CRA has concluded that averaging comparable outcomes within a single year can be helpful. Specifically, the CRA has stated that where no further distinction can be made on the basis of comparability, the most appropriate point may usually be determined by using the average.

It should be reiterated that the average is the single year average, as opposed to a multiple year average. The CRA has noted that since relevant economic characteristics change over time, using averages of data points over multiple years will not be representative of the comparable economic outcomes for the controlled transaction within a given year.

5. Other statistical measures are generally rejected

The CRA has indicated that the numerical value as measured by the profit level indicator is not relevant to the determination of comparability. Additionally, TPM-16 notes that in a transfer pricing situation, there is no scale of comparability. In other words, all of the chosen comparable transactions are equally comparable. For these reasons, the CRA has concluded that it is not possible to use statistics to describe the relative comparability of different observations and has therefore rejected the use of interquartile ranges (the relevant range for US purposes followed by the Internal Revenue Service) since the use of interquartile ranges inherently excludes "outliers" (observations below the lower quartile or above the upper quartile of the range). Since the CRA's position is that numerical values as measured by profit level indicators are not relevant to the determination of comparability, it follows that observations below the lower quartile and above the upper quartile cannot be deemed incomparable and excluded from the results. This would also seem to indicate that excluding comparable companies or transactions that are otherwise comparable due to the existence of losses would be inappropriate, since to do so would require determining comparability using the numerical value measured by the profit level indicator.

In this regard, TPM-16 is consistent with the CRA's existing guidance on the topic included in IC87-2R, which concluded that the use of statistical measures such as an interquartile range does not necessarily enhance the reliability of the comparable data considered in producing a range. Additionally, TPM-16 seems to indicate that the CRA's view is that the median is generally not a useful statistical tool.

Conclusion

TPM-16 does not fundamentally change the CRA's approach to transfer pricing analyses, but instead formalizes in writing and expands upon the rationale for some of its longstanding policies in respect of statistical measures and the use of multiple years of data. This adds welcome clarity and consistency in an audit context. However, since the TPM does not have the force of law in Canada and since tax authorities in other countries do not share the same views as the CRA on some of the matters discussed in TPM-16, outcomes in transfer pricing disputes that progress beyond the audit stage will not necessarily ultimately conform to the guidance provided in TPM-16.

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