Canada
Tax

Transfer pricing alert

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Federal budget 2012: clarity on transfer pricing secondary adjustments and repatriation

Up to now, while there were various administrative practices followed on the treatment of secondary adjustments arising from primary transfer pricing adjustments, there was no clear policy codified in the Income Tax Act (the Act). The federal budget introduced proposed legislation that provides some clarity on secondary adjustments that arise as a result of a transfer pricing audit. While it is a positive development to have a legislative framework to deal with this issue, the wording of the new rules leave room for controversy.

Secondary adjustments

Section 247 of the Act allows the Minister of National Revenue (the Minister) to adjust the price of an intercompany transaction if the price differs from what would be expected if it was conducted in arm's length circumstances. A transfer pricing adjustment that increases income arises when the Canadian taxpayer has paid too much (or received too little) in an intercompany transaction. The existing legislation provides that any amounts determined for the purpose of the Act are to be adjusted to take into account the transfer pricing adjustment.

The primary impact of a transfer pricing adjustment is an increase in the income for tax purposes of the Canadian taxpayer by the amount of the adjustment. The term "secondary adjustment" refers to the manner in which the excess payment to the non-resident is characterized. Historically, the Canada Revenue Agency (the CRA) has been inconsistent in the manner in which secondary adjustments are treated. Where the non-resident in question is not a subsidiary of the Canadian taxpayer, the CRA has generally treated the excess payment as a benefit conferred on the non-resident under one of a variety of provisions, with the result that such benefit is eventually recast as a dividend subject to withholding tax. Inconsistency in the application of secondary adjustments have arisen because of, among other reasons, complexities in corporate structures and transaction flows.

The budget introduces a new provision within section 247 of the Act that specifically deems the amount of the net transfer pricing adjustment with a specific non-resident to be a dividend paid to that particular non-resident. If the non-resident person is a controlled foreign affiliate of the Canadian taxpayer, the provision is not applicable.

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The wording of the provision is clearly intended to provide clarity as to which non-resident person a benefit is considered to be conferred upon. The new provision requires the transactions with each non-resident to be considered as though the taxpayer had no other transactions. On this basis, if a transfer pricing adjustment arises then the secondary adjustment is considered a dividend paid to that particular non-resident. However, the manner in which the provision is drafted is likely to still lead to controversy. For example, in a typical business structure a Canadian taxpayer may purchase goods from one non-resident and pay a royalty to a second non-resident, as was the situation in the GlaxoSmithKline case recently heard by the Supreme Court of Canada. As the Glaxo case illustrates, the price paid for the goods might be considered appropriate taking into account the licence, but excessive if the licence is disregarded. While the new legislation provides helpful clarity regarding which non-resident should be considered the recipient of a deemed dividend, it is unfortunate that it does so by requiring the evaluation of a hypothetical situation (*i.e.*, the rules are centered around the assumption that there are no other transactions impacting the arm's length price).

Repatriation

As an administrative practice, the CRA has historically been allowing a taxpayer to avoid having a secondary adjustment if the taxpayer arranges for a non-resident to "repatriate" the amount of the transfer pricing adjustment to the Canadian taxpayer – effectively putting the Canadian taxpayer in the same financial position as it would be if the price had been "right" in the first instance.

The new legislation provides that the deemed dividend is to be reduced to "the amount that the Minister considers appropriate" if the non-resident repatriates funds to Canada with the concurrence of the Minister. While it is a welcome change to have a legislative framework allowing for repatriation, it is unclear why the repatriation itself, and the quantum of the adjustment to the dividend, must be considered appropriate by the Minister. Traditionally, foreign exchange movements between the date of the original transaction and the date of the repatriation have created some complexity in the analysis of the impact of transfer pricing adjustments and secondary adjustments, and presumably the legislative construction is intended to reflect that some flexibility is required. Nonetheless, it is concerning to see that level of discretion provided to the Minister.

Interest

Where a deemed dividend is assessed because of a secondary adjustment, the withholding tax liability under Part XIII of the Act that results from this adjustment will be subject to interest computed from the end of the taxation year in question. The new legislation clarifies that if a repatriation occurs, the notional Part XIII liability that would have existed but for the repatriation will still be subject to interest from the end of the taxation year in question to the time of repatriation. The legislation permits the Minister to further reduce the assessment of interest if it is considered appropriate. The legislation notes that a consideration in its evaluation of interest relief is whether the country of residence of the non-resident involved in the transaction provides reciprocal treatment.

Waiver of appeal rights

As noted above, historically the CRA has been willing to allow a taxpayer to avoid a secondary adjustment if the non-resident repatriates the amount of the transfer pricing adjustment. A condition that has generally been imposed in order to obtain this treatment, at least at the audit level, is that the taxpayer must agree to the adjustment. The draft legislation is silent on this issue, and it is hoped that the administrative practice of requiring the taxpayer to concede the transfer pricing adjustment will cease.

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