



## Canadian Tax & Legal Alert

# Consultation on reforming and modernizing Canada's transfer pricing rules

June 19, 2023

### Executive Summary

On June 6, 2023, the Department of Finance (Finance) issued a much-anticipated consultation paper to gather stakeholder input on a range of questions and proposals related to Canada's transfer pricing legislation (the "Consultation Paper").<sup>1</sup> The deadline for stakeholders to provide their submissions is July 28, 2023.

Finance's intention to consult on amendments to Canada's transfer pricing rules was initially announced more than two years ago in the 2021 federal budget, following the Supreme Court of Canada's dismissal of the government's appeal of a Federal Court of Appeal decision in a landmark Canadian transfer pricing case.

The main legislative changes contained within the Consultation Paper concern amendments to the transfer pricing adjustment rule set out in section 247 of the *Income Tax Act* (the "Main Proposal"). These proposed amendments aim to align the transfer pricing adjustment rule in section 247 of the Act with the guidance provided by the Organisation for

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<sup>1</sup> Canada, Department of Finance, [Consultation on Reforming and Modernizing Canada's Transfer Pricing Rules](#) (Ottawa: Department of Finance, June 6, 2023).

Economic Co-operation and Development (OECD) in the latest version of its report on the general application of the arm's length principle: *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the "Transfer Pricing Guidelines").

The Consultation Paper also contains a discussion on various administrative measures that are being considered by Finance. These administrative matters are connected to transfer pricing, including documentation and penalty provisions, and the possibility of adopting more modern and simplified approaches in specific situations (the "Administrative Measures"). The Consultation Paper does not include draft legislation on these Administrative Measures.

Both the Main Proposal and the Administrative Measures are expected to be applicable on a prospective basis.

We expect that these proposed measures will lead to a reduced reliance on terms and conditions of intra-group contracts, which will introduce an increased level of subjectivity to transfer pricing. As a result, taxpayers may face increased uncertainty and more complex transfer pricing controversy in Canada. In addition, barring the impact of the proposed Administrative Measures, we also expect that the compliance burden will increase for taxpayers due to the requirement to consider all economically relevant circumstances, the associated conditions, and the options realistically available to the participants to the transaction.

This alert highlights Finance's objectives and motivations and summarizes the Main Proposal and the Administrative Measures.

## Finance's objectives and motivations

The objectives of Finance are to provide more explicit details 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 international consensus as described in the Transfer Pricing Guidelines.

The current transfer pricing legislation has remained substantively unchanged since 1997 when it first came into force.

Finance states in the Consultation Paper, as it did initially in Budget 2021, that the current version of section 247 of the Act "has led to an overemphasis on intra-group contracts, rather than on the factual substance of transactions."<sup>2</sup> Finance is of the view that "this has led to outcomes in which the profit allocations between the Canadian and non-resident taxpayer were at odds with the economic contributions of the parties."

Finance states that the ability to shift income based on intra-group contracts that do not align with factual substance is inappropriate in policy terms.

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<sup>2</sup> All excerpts reproduced throughout this document are taken from the Consultation Paper. Given the complexity of its contents and Finance's objectives and motivations, we have relied upon these direct excerpts to the extent possible to avoid any misinterpretation.

## The Main Proposal

The Transfer Pricing Guidelines provide three types of guidance: (i) general guidance on the application of the arm's length principle; (ii) guidance on administration; and (iii) detailed guidance on the application of the arm's length principle in specific situations.

The Main Proposal focuses on the general guidance on the application of the arm's length principle outlined in the first three chapters of the Transfer Pricing Guidelines, and specifically, the comparability analysis at the core of the application of the arm's length principle.

The measures proposed as part of the Main Proposal include:

- Amendments to incorporate steps requiring the delineation of transactions and the comparison of conditions into section 247 of the Act and the existing transfer pricing adjustment rule within it;
- Repeal of paragraphs 247(2)(b) and (d) of the Act, which currently comprise the transfer pricing recharacterization rule, and in place of it, the inclusion of a non-recognition and replacement rule; and
- Incorporation of the Transfer Pricing Guidelines into section 247 of the Act through definition and the addition of a consistency rule.

### **Incorporating steps for the delineation of transactions and the comparison of conditions into section 247 of the Act**

In the Consultation Paper, Finance summarizes the two main steps of a comparability analysis based on the Transfer Pricing Guidelines as follows:

1. identify the commercial and financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order to accurately delineate the controlled transaction (Step 1); and,
2. compare the conditions and economically relevant circumstances of the controlled transaction (as delineated) to the conditions and economically relevant circumstances of comparable transactions between independent enterprises (Step 2).

Finance further states that the Transfer Pricing Guidelines “provide that economically relevant characteristics are used in Step 1 to accurately delineate the controlled transaction and in Step 2 to determine whether a potential comparable uncontrolled transaction is in fact comparable to the controlled transaction and what adjustments, if any, are necessary to achieve comparability.”

The Main Proposal introduces amendments to section 247 of the Act and the transfer pricing adjustment rule it contains to incorporate Step 1 (identification of the conditions and economically relevant characteristics of a controlled transaction) and Step 2 (comparison to the conditions and economically relevant characteristics of comparable transactions between independent enterprises) to accurately delineate and compare a controlled transaction for purposes of applying the arm's length principle.

More specifically, Finance proposes that the transfer pricing rules in the Act would include the following elements:

- a. with respect to establishing the starting point of the comparison (Step 1):
  - i. a rule requiring that the controlled transaction is to be determined with reference to its economically relevant characteristics. The transaction so determined becomes the “delineated transaction”;
  - ii. a definition of “economically relevant characteristics”;
  - iii. a rule requiring that scrutiny of the controlled transaction is to be directed at its conditions; together with an interpretive rule providing that “conditions” is to be broadly construed.
- b. with respect to the operation of the comparison (Step 2):
  - i. a rule providing that the hypothetical comparison is to what the parties to the controlled transaction would have included as conditions had they been dealing with one another at arm’s length in comparable circumstances.

It is apparent that Finance intends to reduce the reliance on intra-group contracts in the application of the arm’s length principle and expand reliance on all economically relevant characteristics and related conditions for purposes of delineating transactions, and ultimately making transfer pricing adjustments. This new lens of delineating a controlled transaction is inherently subjective, and given this and the complexity of the proposed legislation and concepts contained within it, we expect that the proposed measures would lead to increased Canadian transfer pricing controversy.

## **Replacing the recharacterization rule with the non-recognition and replacement rule**

The Main Proposal would repeal paragraphs 247(2)(b) and (d) of the Act, which currently comprise the transfer pricing recharacterization rule that, subject to certain conditions, provides for the substitution of the controlled transaction with the transaction that would have been entered into by parties dealing at arm’s length.

Instead, a non-recognition and replacement rule is proposed.

This non-recognition and replacement rule is proposed to be introduced at the step of establishing the starting point of the comparison (i.e., Step 1) where a controlled transaction is not recognized as structured by the taxpayer if, taking into consideration the respective perspectives of the participants to a delineated transaction and the options realistically available to them, the delineated transaction or series:

- differs from the transaction or series that would have been entered into by the participants had they been dealing at arm’s length in a commercially rational manner in comparable circumstances; and,
- prevents the determination of a transfer price in respect of the delineated transaction that would have been acceptable to the participants had they been dealing at arm’s length in a commercially rational manner in comparable circumstances.

If the two tests set out above are met, then “for the purposes of the transfer pricing adjustment rule [at the proposed subsection 247(2.02)], the transaction as structured is disregarded and replaced with a transaction or series that comports

as closely as possible with the facts of the delineated transaction or series while achieving an expected result that, had the participants been dealing at arm's length in comparable circumstances, would have been commercially rational.”

## **Adding a consistency rule referencing the Transfer Pricing Guidelines in section 247 of the Act**

Finance contemplates whether Canadian transfer pricing legislation should follow the approach of several other jurisdictions (e.g., Australia, New Zealand, and the United Kingdom) and include a rule specifying the role of the Transfer Pricing Guidelines in applying this legislation.

As a result, the Main Proposal now introduces a definition of the Transfer Pricing Guidelines in section 247 of the Act and creates a rule according to which the domestic transfer pricing legislation is to be applied in a way that (unless the context requires otherwise) best achieves consistency with the Transfer Pricing Guidelines. The Consultation Paper does not elaborate on what situations might require an outcome that is inconsistent with the Transfer Pricing Guidelines.

## **The Administrative Measures**

The Administrative Measures considered in the Consultation Paper aim “to increase tax certainty and reduce the compliance and administrative burdens associated with complying with the arm's length principle.” These proposed measures would:

1. Align Canada with other jurisdictions through implementing the remaining international best practices of the *BEPS Action 13 Report* [i.e., Master File and Local File] while reviewing the overall integrity of the current legislative framework for transfer pricing documentation and penalties;
2. Reduce compliance burdens by introducing simplified documentation requirements for low-risk situations;
3. Increase the thresholds at which transfer pricing penalties would apply; and,
4. Introduce streamlined pricing approaches to reduce the burden of benchmarking arm's length returns.

In developing the Administrative Measures, Finance also reviewed other possible administrative approaches but opted not to further develop them at this time. Among these are measures to restrict the scope of transactions and taxpayers to which the transfer pricing rules apply, the use of safe-harbour interest rates, and special rules for “hard-to-value” intangibles.

## **Transfer pricing documentation and penalty provisions**

In respect of transfer pricing documentation, Finance is proposing:

- A requirement for Canadian taxpayers that are members of large multinational enterprise (MNE) groups and subject to Country-by-Country (CbC) reporting requirements to submit a Master File in prescribed form on request by the Canada Revenue Agency (CRA). While the specific content and format of this prescribed form is not provided, the Consultation Paper does indicate an intent to align the documentation requirements with Chapter V of the Transfer Pricing Guidelines.
- Bringing the content required in Canada's documentation requirements in line with the Local File requirements laid out in Chapter V of the Transfer Pricing Guidelines.

In considering potential changes in respect of the transfer pricing documentation and penalty provisions in the current transfer pricing legislation, Finance is focused on balancing: “(i) the need for the CRA to have access to the appropriate information to conduct transfer pricing risk assessments and efficient audits; and (ii) not imposing excessive or unnecessary compliance burdens on taxpayers.”

To this end, Finance continues to consider “whether the current legislative framework on this matter contained in subsections 247(3) and 247(4) of the Act is still appropriate.”

The Consultation Paper also highlights that current legislation does not provide a set of criteria of what constitutes reasonable efforts under subsection 247(3) of the Act. Finance has expressed its interest in “feedback more generally on how the penalty provisions can be improved, while maintaining the overall integrity of the legislative framework.”

## **Simplified documentation requirements for lower value transactions and smaller taxpayers**

Finance is considering the introduction of legislative provisions to implement more streamlined documentation requirements. These changes would allow a taxpayer to meet transfer pricing documentation requirements for certain controlled transactions. A taxpayer could meet these requirements through an annual reporting schedule, providing details on the nature and scale of these transactions, the methods used as well as the arm’s length conditions determined.

This approach aims to “reduce compliance burdens while still maintaining the obligation for taxpayers to comply with the application of the arm’s length principle.”

Finance is seeking input from stakeholders on (i) the scope of any such approach, (ii) the type of information that would be sufficient considering the need for adequate support, and (iii) the appropriate safeguards.

## **Transfer pricing penalty threshold**

At a high-level, under the provisions of subsection 247(3) of the Act, a transfer pricing penalty of 10% is applied on the amount of adjustment in respect of which the taxpayer has not made reasonable efforts to determine and use arm’s length transfer prices. This penalty applies if the adjustment is greater than the lesser of \$5 million or 10% of the taxpayer’s revenues.

Finance is proposing to increase the absolute threshold in subsection 247(3) of the Act from \$5 million to \$10 million. Finance does not intend to change the relative threshold of 10%, as “this relative threshold serves an important role in encouraging compliance among smaller taxpayers.”

## **Streamlined pricing approaches**

Finance notes that the “application of the arm’s length principle often results in taxpayers having to devote significant resources to benchmark amounts supporting arm’s length conditions.” In several situations, Finance is of the view it may be possible to streamline these processes.

As such, Finance is considering:

- Adopting the approach for pricing low value-adding intra-group services from the Transfer Pricing Guidelines, which applies a standard deemed arm’s length return of 5% on costs related to the provision of low value-adding intra-group services for the benefit of other group members.
- Adopting a safe harbour return, in coordination with the OECD’s ongoing Pillar One “Amount B” work, for distributors that perform relatively routine activities to reduce the compliance burdens of having to determine an arm’s length return.

- Limiting the acceptable range of certain loan conditions – specifically: (i) limiting the terms of intra-group loans to five years; (ii) using the credit rating of the MNE group as a whole; and, (iii) removing subordination features and embedded options – when identifying the arm’s length transaction to be used as a comparable.

## Takeaways

While the intention of Finance is to implement changes to the Canadian transfer pricing rules to tighten up the interpretation of the application of the arm’s length principle, it remains to be seen if these proposed changes will accomplish this objective when tested in court. The reduced reliance on terms and conditions of intra-group contracts will introduce an increased level of subjectivity to transfer pricing through the determination of the economically relevant characteristics to delineate a transaction and the appropriate associated conditions. As a result, taxpayers may face increased uncertainty and more complex transfer pricing controversy in Canada. This may be further heightened when resolving disputes with other jurisdictions.

Certain Administrative Measures considered in the Consultation Paper by Finance are intended to increase tax certainty and reduce the compliance and administrative burdens associated with complying with the arm’s length principle. While implementing certain safe harbours and minimum thresholds may, in certain circumstances, reduce compliance burdens on taxpayers, these benefits may be more than outweighed with a taxpayer’s need to perform a robust transfer pricing analysis for transactions not covered under the Administrative Measures in order to thoroughly document the economically relevant characteristics associated with its controlled transactions, the associated conditions and the options realistically available to the parties to the transaction under review.

Although the timing of when a change to the Canadian transfer pricing rules will take effect is still unknown, we anticipate that the new legislation will likely not deviate substantively from what is proposed in the Consultation Paper. As such, taxpayers should re-evaluate their existing intercompany transactions and intra-group contracts in the context of the proposed legislation to assess potential risk and, if entering into new intra-group contracts, taxpayers also need to ensure all economically relevant circumstances are considered in establishing the associated conditions. Those taxpayers seeking greater certainty on their intercompany transactions should also consider (or reconsider) seeking an advanced pricing arrangement with the CRA.

## How can Deloitte help you?

Deloitte’s professionals can help you understand how these measures may impact your business.

If you have questions on any of the above or to learn more about the Consultation Paper, please reach out to your Deloitte advisor or any of the Deloitte transfer pricing advisors noted on this alert.



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