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TRANSFER PRICING (TP) UPDATE

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Agenda

- Legislation
- Recent cases
- Cross-border management fees

Legislation

- S. 247 - applies for all purposes of the *Income Tax Act (ITA)*
- Essential requirement is to follow the arm's-length principle
- Canada Revenue Agency's (CRA) preferred pricing method:
 - CUP (comparable uncontrolled price) for tangibles
 - CUT (comparable uncontrolled transaction) for intangibles
 - No special rules for inter-company indebtedness
 - Services: cost incurred, with or without a mark-up
- Penalty: 10% of net TP adjustment, with a threshold determined by the lesser of:
 - 10% of gross revenues
 - \$5,000,000

Legislation (cont'd)

- Form T106: Information return for reporting transactions with related non-residents
 - Filing threshold: total of transactions \geq \$1,000,000
 - Similar to Form 5472 reporting with foreign related parties for US tax purposes
- Protection against adjustments and penalties:
 - Contemporaneous documentation on file
 - Demonstrate reasonable effort
 - Should be provided within 90 days on request
 - Advance Pricing Arrangements (APAs)

Legislation (cont'd)

- Re-assessment period is 6-7 years (normally 3-4 years)
- S 231.6: “90-day notice” to produce foreign-based information; failure to comply can result in non-admittance of relevant information in court.
- S. 247(7) provides a specific exemption with respect to an interest-free loan to an active foreign subsidiary (extended definition)
- TP adjustments can also be triggered under a tax treaty (e.g., Canada-U.S. Tax Convention Art IX (1))
- No adjustment unless appropriate (S. 247(10))
 - CRA may not apply S. 247(2) where double taxation may occur

Recent Cases

GlaxoSmithKline Inc. [2010]

- Tax Court (TCC): Prices paid by arm's length generic drug companies for a key drug ingredient (ranitidine, in Zantac) were comparable for determining reasonableness; however, considerably higher prices were paid on non-arm's length basis for substantively the same ingredient by Glaxo Canada (subsidiary) to Glaxo UK (parent).
- The appellant justified the prices paid on the basis that it bought from its parent pursuant to:
 - Supply Agreement-annually reviewed and adjusted, specified the price
 - License Agreement- permitted the Canadian sub to use the Glaxo branding for manufacture and sale of Glaxo's range of drug products in Canada for a 6% royalty fee
- The Licence Agreement was necessary for brand differentiation from the generic products.

Recent Cases - GlaxoSmithKline Inc. [2010] (cont'd)

- The TCC judge stated that, "... the business circumstances and strategies that the appellant submits distinguishes itself from the generic companies have no bearing on the transfer pricing issue", setting aside the Licence Agreement, Glaxo's trademark, and the portfolio of other Glaxo products.
- The FCA ruled that the Licence Agreement would have existed even had the appellant been dealing at arm's length, and should be considered, thus referring the matter back to the TCC.

Recent Cases - GlaxoSmithKline Inc. [2010] (cont'd)

- The Crown appealed; leave to appeal granted by SCC-expected hearing Jan 2012. At issue:
 - (a) should an arm's length party pay some premium to obtain the benefit of the licensing/branding of the other party's product, and
 - (b) how to determine the quantum of this premium?

Recent Cases (cont'd)

General Electric Capital Canada Inc.[2010]-FCA

- GECC paid \$135 million from 1996 to 2000 to its US Parent as guarantee fees related to borrowings for use in its financial services business.
- CRA denied deduction on the basis that GECC would have received the benefit of Parent's "implicit support" without explicit guarantees, and thus GECC derived no benefit from payment of the fees. (After all, it did not pay guarantee fees for Parent's explicit guarantees from 1988 to 1995)

Recent Cases – GE Canada (cont'd)

- TCC concluded:
 - An arm's-length party would find that “implicit support” was relevant in pricing a guarantee,
 - GECC’s relative economic importance did not make abandonment by Parent impossible.
 - Without the explicit guarantees GECC's S & P credit rating would have been BBB-/BB+, not the AAA rating it enjoyed with the guarantee.
 - Since net economic benefit to GECC under a yield approach comparison exceeded 1.83 %, the 1 % guarantee fee it paid did not exceed what an arm's-length party would have paid in similar circumstances.

Recent Cases

Alberta Printed Circuits Ltd.[2011]

- APC received customer data, prepared it for use in manufacturing (the set-up), and manufactured circuit boards.
- In 1996, the taxpayer's shareholders incorporated APCI under the Barbados Companies Act and transferred the set-up operations to Barbados.

Recent Cases – APC (cont'd)

- Contracts between APC and APCI made APCI responsible for
 - development, supply, and maintenance of database systems software;
 - the set-up operations previously carried out in Calgary; and
 - development and maintenance of APC's website.
- APCI's only customer was APC, and its remuneration was based on
 - the set-up charges billed to APC's customers (with no markup)
 - plus square-inch fees (or bonuses) for the non-set-up work performed by APCI.

Recent Cases – APC (cont'd)

- CRA reassessed on the basis that the parties were not acting at arm's length, and that APCI was overpaid by \$3.4 million during the 1999, 2000, and 2001 taxation years.
- The TCC judge ruled in favour of the taxpayer based on:
 - CRA's failure to consider the CUP method with adjustments for comparability (CRA used the Transactional Net Margin Method)
 - CRA's expressed preference (IC 87-2R) for "unbundling" .
- APC's appeal was mostly allowed though \$880,000 of the CRA adjustment of \$3.4 million was upheld re additional services.

Recent Cases – APC (cont'd)

- The TCC judge emphasized that the transfer pricing rules require that
 - an attempt be made to obtain comparables using the CUP method, and
 - distinguish differences through adjustments to the price.
- This is similar to the US Tax Court's admonishment to the IRS in Compaq Computer Corp.
 - which overturned deficiency notices in circumstances where the IRS failed to consider the CUP method in determining the arm's-length price of computer circuit boards manufactured in Singapore.

Cross-border Management Fees

- Most frequent & often significant CRA TP adjustment
- Reasons:
 - subjective nature of allocations
 - lack of supporting documentation
 - lack of statutory guidelines
- For fees paid by CanCo to related USCo to be deductible for Canadian tax purposes:
 - must be paid to earn income
 - reasonable in the circumstances (must satisfy the arm's length principle)

Cross-border Management Fees (cont'd)

- W/h tax 25%,
 - with exemption for reimbursement of specific expenses
 - relief under the business profits article of Canada-U.S. treaty (Art. VII)
- Unreasonable portion of fee may be re-characterized by CRA as a deemed dividend
 - with Part XIII tax (25%) implications
 - with/without treaty relief

Cross-border Management Fees (cont'd)

- Distinct from services of an industrial, commercial or scientific nature, which are part of business profits; price should include a mark-up even between related parties.
- The term "management or administration" is generally considered to include functions performed at the managerial level: planning, direction, control, coordination, and systems design
- These functions may involve services for various departments: accounting, financial, legal, electronic data processing, employee relations, management consultation, labour relations, and taxation.
- Determine how much arm's-length parties would be willing to pay for these services in order to establish whether a markup is appropriate or not.

Cross-border Management Fees (cont'd)

- IRS policy :
 - Determine whether services are “integral” (commercial/business) and necessitate a mark-up, or “non-integral” that can be charged at cost
 - To qualify as “integral”
 - The renderer or recipient must engage in providing similar services to unrelated parties, and they constitute one of its principal activities (> 25% of Selling, General and Administrative expenses)
 - The renderer is particularly capable of providing these services which are a “principal element” in the recipient’s operations and the recipient receives a “substantial amount” of these services during the year
 - Safe-harbour rule – services to related parties may be charged at cost

Cross-border Management Fees (cont'd)

- Recommended approach acceptable to both CRA and IRS :
 - Compile background information, i.e., a functional analysis to establish the relationship between the relevant services provided and the recipients' activities.
 - Identify the costs, direct and indirect, to be included in each service department
 - Apply sound accounting principles
 - Select an allocation basis so that costs are shared in proportion to benefits received
 - Allocation should be consistent with that adopted by comparable independent enterprises

Cross-border Management Fees (cont'd)

- Perform a final reasonableness review
- Compile the documents relied on and developed at each step to serve as supporting documentation for the management fees charged
- A management fee agreement should be put in place between the parties setting out
 - the fee methodology
 - the fact that the allocation does not contain a mark-up and
 - the departments providing the services

Cross-border Management Fees (cont'd)

- Benefits of documenting a comprehensive analysis:
 - CRA may decide not to visit USCo, avoiding substantial costs
 - Should the CRA still decide to visit, time spent should be considerably reduced
 - Personnel in the US will be prepared
 - Reduces risk of a TP adjustment
 - Serves as a valuable internal management report
 - Initial investment of time and resources recovered in future; annual calculation is simply updating the data in the model, provided business/services provided have not changed significantly.

To conclude:

- If CRA or IRS make a TP adjustment, two options available to Canadian taxpayer, but not at the same time:
 - Invoke either competent authority
 - Appeals procedure
- Multinationals consider competent authority procedure unsatisfactory because of:
 - Length of the process
 - Non-deductible interest continues to accrue on underpaid taxes (CRA may waive under “fairness” provisions)
 - May affect basis of filing subsequent returns

To conclude: (cont'd)

- Uncertainty of outcome
 - Additional work and related additional costs
 - Multinational loses control since it is not involved in the negotiation
 - Competent authority decisions do not set a precedent.
- However, a competent authority decision is the only way to relieve a double taxation situation.

If you have any questions

Please do not hesitate to contact us

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