# Transfer Pricing: Considerations for U.S. Multinationals

Goodmans LLP

## What is Transfer Pricing?

One of the central issues facing multi-national enterprises (MNEs) is how to best allocate resources, revenue and costs among their various subsidiaries or business divisions around the world. A key consideration in that determination is the tax implications of having operations in more than one tax jurisdiction, and how to most effectively allocate revenue and expenses, and thus profits or losses, in light of the tax treatment in the different jurisdictions. This requires dealing with different taxing authorities and their respective rules and practices, as well as different accounting regimes.

Central to this issue of income allocation is the concept of "transfer pricing." When a MNE transfers products, goods, components, intellectual property or services between its related entities in different jurisdictions, the applicable value – the "transfer price" – that is assigned to the transaction needs to be determined for the purposes of calculating the profit or loss of the entities in each jurisdiction.

MNEs have a natural economic incentive to price transfers among related entities so as to minimize the combined tax payable across its jurisdictions. That is, MNEs are incentivized to price transfers between related entities so as to drive the maximum share of profits (maximizing revenue and minimizing costs) into the lower-tax jurisdiction, and correspondingly drive the minimum share of profits (minimizing revenue and maximizing costs), into the higher-tax jurisdiction. MNEs, in the absence of constraining regulation, would have the ability to advantageously price the transactions for tax purposes precisely because the transactions are not at arm's length on the open market. The countervailing pressure, of course, is the desire of each local government to maximize tax revenue.

As summarized by the Ontario Superior Court in a recent leading Canadian transfer pricing case:

> Transfer pricing is the act of assigning a monetary value, or price, to movements of resources or economic contributions that occur within a multinational enterprise across different taxing jurisdictions. Against the risk that companies attempt to use transfer pricing to increase operating income (and therefore taxable income) in jurisdictions with low income tax rates and correspondingly to decrease operating income in high-tax jurisdictions, tax authorities around the world have instituted regulations governing intercompany transfer pricing. These regulations centre on the arm's length principle. The arm's length principle necessitates that intercompany transactions be priced in a manner consistent with the way in which similarly situated uncontrolled parties bargaining at arm's length would price the transactions i.e., within an arm's length range.[1]

Determining the arm's length value of goods or services transferred can be a difficult task, but up-front planning or successful litigation can result in significant savings over many years. However, this exercise, like any other, is an art more than a science. This means there is always opportunity and risk in any transfer pricing planning exercise or dispute with a taxing authority.

---

[1] *Nortel Networks Corp.*, Re, 2014 ONSC 6973, para 131. This summary, and the paragraphs above, draw on the evidence of the Canadian entities' expert, Dr. Timothy Reichert of Economics Partners, LLP, a leading firm of transfer pricing economists.

## Transfer Pricing: Considerations for U.S. Multinationals

The recent North American Free Trade Agreement (NAFTA) negotiations have shone a spotlight on the extent of the integrated nature of the North American economy. In many sectors, of course, U.S. companies have had a long-standing and significant footprint with related entities in Canada - whether Canadian subsidiaries, branches or affiliated companies - where goods, services, licence rights and/or intellectual property are transferred cross-border between the related entities.

Political trends emerging from past federal elections in the U.S. and Canada caused a wider divergence in the comparative corporate tax regimes. The U.S. has significantly eased the corporate tax burden, with lower tax rates and changes to deductibility rules, while Canada's Liberal federal government has not kept pace, resulting in the U.S. generally now recognized as a lower-tax jurisdiction for corporations. This shift may well result in the escalation of transfer pricing issues for MNEs doing business in Canada, with MNEs looking to allocate taxable income in the respective jurisdictions so as to minimize their overall tax obligations. Similarly, MNEs may wish to prepare for possible increased review and enforcement of transfer pricing strategies they have adopted in Canada, and to review and re-evaluate their transfer pricing arrangements with respect to any operations in Canada.

Transfer pricing arrangements for MNEs may also pose a risk for civil liability in Canada. MNEs that have a controlling interest in operations in Canada where there is also a minority unrelated interest must also be alert to the perils of claims founded on their transfer pricing arrangements, including "oppression claims" under Canada's business corporation laws. Such claims have been asserted on the basis that a MNE has implemented a transfer pricing regime that unfairly prejudices the Canadian entity by under-allocating its share of income to it.

In this summary, we discuss how the Canadian transfer pricing regime, transfer pricing enforcement policies of the Canada Revenue Agency (CRA) – the Canadian equivalent to the Internal Revenue Service – and considerations from leading cases in the Canadian transfer pricing realm may affect U.S. companies with transfers between cross-border entities.

## A. Comparative Review of U.S. and Canadian Transfer Pricing

Canada, like the U.S. and most sophisticated tax jurisdictions, has a tax regime in place to control the effect of a MNE's pricing between its various companies and branches. Both the Canadian and the U.S. regimes focus on the well-known "arm's length standard". This standard also forms the core of the Organisation for Economic Co-operation and Development (OECD) transfer pricing guidelines, which aim to set out universal principles of transfer pricing. Essentially, the arm's length standard requires that non-arm's length transfers within a MNE be priced as if the transfer had been a transaction between arm's length entities at a fair market value.

However, the regulation of transfer pricing in Canada is far less comprehensive than what is set out in U.S. tax regulation. Section 482 of the U.S. *Internal Revenue Code* prescribes an extensive transfer pricing code, as statutory law, including rules around the 'best method' of transfer pricing for particular cases, the role of the terms of the transactions between the related entities, standards of comparability for determining what an arm's length pricing range might be, as well as examples of the application of the transfer pricing principles it refers to.

By contrast, the transfer pricing provisions in Canada's *Income Tax Act* are almost skeletal in nature and are set out in one fairly short section (section 247). In essence, section 247 enables the CRA to make adjustments to a taxpayer's reported income where the terms or conditions of a MNE's cross-border transaction (i) differ from those that would have been made between arm's length parties; or

(ii) would not have been made by arm's length parties and can reasonably be considered not to have been entered into for *bona fide* purposes other than to obtain a tax benefit. Thus, they give the CRA power to both adjust the reported income of the taxpayer and recharacterize a transaction where appropriate.

In addition to adjustments to income, section 247 provides for specific penalties where a taxpayer is found to engage in improper transfer pricing, which penalties are impacted by whether the taxpayer made "reasonable efforts" to determine arm's length prices. Reasonable efforts include making contemporaneous records or documents detailing the relevant transaction(s), the property or services being contributed, the functions, contributions and risks of the participants, the data and analysis used to determine the pricing, as well as other factors. Consistent with recent changes made to the OECD guidelines in 2016 resulting from the OECD's "BEPS" (Base Erosion and Profit Shifting) project, Canada requires filing of "country-by-country" reports, along with other returns specific to transactions with foreign affiliates. The country-by-country reports are aimed at ensuring transparency and consistency on the part of a MNE in allocating income across jurisdictions.

Although the Canadian tax statute centres around the arm's length standard, it does not detail how the standard is to be satisfied in pricing transactions within a MNE or which of the available methods to achieve this will be accepted as appropriate. (The Supreme Court of Canada has expressly noted the absence of such guidance in section 247.[2]) The CRA provides some *administrative* guidance in this regard, however, the most relevant being the almost 20 year-old "Information Circular 87-2R", as well as CRA "Transfer Pricing Memoranda." The guidance is in some respects outdated and does not fully reflect updated approaches adopted in the current OECD guidelines for transfer pricing, but it provides some practical insight as to the CRA's approach to transfer pricing issues. Importantly though, it is clear that, unlike section 482 of the *Internal Revenue Code* in the U.S., neither the Transfer Pricing Memoranda nor the Circular have the force of law in Canada, although Canadian courts have referred to the Circular in some transfer pricing litigation. Similarly, it is established that the OECD guidelines do not have the force of law in Canada, and ultimately the sole question in a tax authority challenge is whether the section 247 test is met, rather than whether any particular method or commentary in the OECD guidelines has been followed. Canadian courts have referred to the OECD guidelines, however, in both tax authority challenges and in analyzing the robustness of a transfer pricing arrangement in a civil dispute between stakeholders of different entities within a MNE.[3]

The relative dearth of a binding legal framework for transfer pricing in Canada arguably leads to a wider scope for dispute as to the validity of any particular transfer pricing arrangement and its compliance with the arm's length standard; however, it also may provide greater leeway in structuring modern transfer pricing arrangements that would otherwise be constrained by the highly codified system in the U.S.

## B. Some Recent Trends

Transfer pricing issues have arisen in different contexts in Canada, not just by way of challenges against the taxpayer by the CRA. Indeed, the highest-stakes transfer pricing dispute litigated in Canada was not a CRA challenge to the taxpayer's transfer pricing, but rather a claim made in a large cross-border insolvency proceeding of a Canadian-based MNE. Nortel Networks was, at one time, one of the leading telecommunications companies in the world, and Canada's largest company, with operations and dozens of subsidiaries spanning the globe. Nortel collapsed shortly after the financial crisis in the fall of 2008. During Nortel's insolvency proceedings, claims were made against the Canadian parent company by European subsidiaries for hundreds of millions of dollars, alleging historical under-allocation of income to European subsidiaries as a consequence of Nortel's transfer pricing arrangements.

---

[2] *GlaxoSmithKline Inc.*, 2012 SCC 52, para. 21.

[3] See, *e.g.,. GlaxoSmithKline, supra*, paras. 20-25, 39-42; *Marzen Artistic Aluminum Ltd. v. R*, 2016 FCA 34, paras. 15-18; *Nortel, supra,* paras. 133 and 139 *ff.*

In that case, the Ontario Superior Court ruled in favour of the Canadian parent company and accepted the validity of Nortel's complex, world-wide transfer pricing regime, which centered on a well-documented "residual profit split" method. In its decision, the Court emphasized Nortel Canada's compliance with the principles set out in the OECD guidelines. The Court also made clear it preferred the Canadian parent's expert transfer pricing evidence that invoked and accurately applied the principles set out in the OECD guidelines over expert evidence that was not based on these principles.[4]

Other recent cases in Canada have also shown the importance of the contractual documents in transfer pricing arrangements and of their relation to the economic substance of the transactions. One of the traditional presumptions in transfer pricing principles is that the formal contractual terms (and the actual arrangements) between the MNE's entities are to be respected for purposes of transfer pricing, unless they do not reflect the economic substance of the transactions involved. Notably, although a pre-BEPS case, in *GlaxoSmithKline* the Canadian Supreme Court sent back for redetermination the CRA's $51 million upward adjustment to the taxpayer's income: the Court held that the CRA failed to assess whether the (ostensibly above-market) price paid to a subsidiary for a key pharmaceutical ingredient in fact also compensated for various licence and use rights that the MNE's arrangements appeared to include.

Since the BEPS changes to the OECD Guidelines (discussed above), much has been written in transfer pricing literature suggesting the focus will now be primarily or even solely based on an assessment by tax authorities of the relative "value creation" by each entity. However, a close examination of the revised OECD guidelines, and the lack of an amendment to section 247, suggest that careful, diligent contractual and implementation documentation among the related parties, that accords with the economic substance of the transactions, will still be an important part of a defensible transfer pricing regime in Canada.

## C. Avoiding Disputes and Minimizing the Risks from Disputes

Not surprisingly, a CRA challenge of a MNE's transfer pricing can have significant consequences to a MNE. First, it may result in a reassessment, an audit and/or any accompanying fines or other penalties. Second, inconsistent treatment of transfer pricing among different tax jurisdictions can result in double taxation for the MNE as a whole.

As in other jurisdictions, MNEs operating in Canada can reduce the chance of a successful (or any) reassessment – and the consequences of not meeting any applicable contemporaneous documentation requirements – by robust development and documentation of their transfer pricing arrangements with the expertise of outside transfer pricing professionals.

Arguably, the "gold standard" of risk management for transfer pricing is the "Advance Pricing Agreement" with the CRA. The CRA will enter into an agreement with a MNE and other taxing authorities under its Advance Pricing Arrangement program, where appropriate, including "bilateral" or "multilateral" Advance Pricing Agreements. Bilateral or multilateral Advance Pricing Agreements involve tax authorities from more than one jurisdiction, with the aim of ensuring that each of the participating tax authorities will recognize the same transfer pricing regime and thereby avoid double taxation by virtue of one tax authority taking a different position from another. The binding nature of a Bilateral Advance Pricing Agreement, in the face of a later attempt at reassessment by the Canadian tax authority, was emphasized recently by the Tax Court of Canada.[5] The Advance Pricing Agreement program in Canada remains optional for a MNE operating in Canada, and though the process may require significant effort and resources in complex cases, including analysis by independent expert transfer pricing economists, it can avoid the uncertainty and expense associated with later challenges to a transfer pricing regime.

---

[4] *Nortel, supra.* (Graham Smith, one of the authors of this note, was the lead transfer pricing litigation counsel for the Court-appointed Monitor in the insolvency proceedings of the Nortel group of companies.)

[5] *Sifto Canada Corp. v. R.*,, 2017 TCC 37.

## About Goodmans

Goodmans is internationally recognized as one of Canada's pre-eminent business law firms. Based in Toronto, the firm has market-leading expertise in M&A, corporate and transaction finance, private equity, real estate, tax, restructuring, litigation and other business-related specialties.

The firm represents a broad range of Canadian and foreign clients from entrepreneurial businesses to multinational corporations, financial institutions, pension funds and governments and has a reputation for handling challenging problems, often international in scope, which demand creative solutions.

At Goodmans, our lawyers excel in their fields to help our clients excel in theirs – ensuring exceptional levels of service and business success. We deliver intelligent results, responsiveness, energy, talent and determination to get the deal done.

Bay Adelaide Centre - West Tower
333 Bay Street. Suite 3400
Toronto, ON  M5H 2S7

Tel: 416.979.2211
Fax: 416.979.1234

goodmans.ca

Goodmans LLP