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Canada's Transfer Pricing Laws: Keeping Pace with an International Trend

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Canada's Transfer Pricing Laws: Keeping Pace with an International Trend

Terry Thompson*

TABLE OF CONTENTS

I. INTRODUCTION	312
II. THE TRANSFER PRICING PROBLEM DEFINED	315
III. BACKGROUND	318
A. <i>Organization for Economic Cooperation and Development (OECD)</i>	320
B. <i>The United States</i>	322
C. <i>An International Trend</i>	324
IV. SECTION 247 OF THE INCOME TAX ACT	325
A. <i>The Arm's Length Principle</i>	326
1. <i>Adjustment and Recharacterization</i>	327
2. <i>At the Minister's Discretion</i>	329
B. <i>Arm's Length Methods</i>	330
1. <i>Traditional Transaction Methods</i>	331
a. <i>The Comparable Uncontrolled Price Method</i>	332
b. <i>Resale and Cost Plus Methods</i>	333
2. <i>Transactional Profit Methods</i>	335
a. <i>Profit Split Method</i>	336
b. <i>The Transactional Net Margin Method</i>	337
C. <i>Penalty</i>	339
1. <i>Calculating the Penalty</i>	339
2. <i>Soundness of the Penalty Provision</i>	343
3. <i>Penalty Review Board</i>	344
D. <i>Contemporaneous Documentation</i>	345
1. <i>Statutory Requirements</i>	346
a. <i>Reasonable Efforts</i>	348
b. <i>Reporting Requirements</i>	349
2. <i>Compliance Burden</i>	350
V. SPECIAL CONSIDERATIONS	351
A. <i>Intangible Property</i>	352

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B. Intra-Group Services	353
C. Cost Contribution Arrangements	354
VI. ADVANCED PRICING AGREEMENTS	357
VII. CONCLUSION	359

*What government does with scarce resources shows what its values are.
This government has set its priorities.*

The Honourable Paul Martin¹

I. INTRODUCTION

With the millennium almost upon us, countries and multinational enterprises² (MNEs) continue to struggle over the effects of the ever increasing globalization of business.³ This struggle is an ongoing odyssey that flows in large measure from the disparate interests of sovereign states and the non-territorial nature of MNEs.⁴ Sovereign states have witnessed the principles of territoriality being eroded away by technological advances that offer MNEs the opportunity to carry on business in

1. The Honourable Paul Martin, P.C., M.P., Minister of Finance Canada, Budget Speech, Budget 1997: Building the Future for Canadians (Feb. 18, 1997) (visited Jan. 20, 1998) <<http://www.fin.gc.ca/budget97>>.

2. For purposes of this Comment, I use the term "multinational enterprise" to refer to a business organization that does business in two or more countries. This type of business organization can take such forms as a corporation, partnership, joint venture, or otherwise. See generally Organization for Economic Cooperation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*, Committee on Fiscal Affairs Report, G-4 (Paris: OECD 1995) (Looseleaf) [hereinafter 1995 OECD report] (stating multinational enterprises are groups of companies that have business establishments in two or more countries); see Phillip I. Blumberg, *Nation-States and Multinational Corporations*, 646 *PLI/CORP* 149, 159 (1989) (asserting multinational enterprises are groups of corporations that have common managerial and financial control, and pursue integrated policies); International Labor Organization, *Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy*, 17 *I.L.M.* 422, 424 (1977) (defining multinational enterprises as businesses "which own or control production, distribution, services or other facilities outside the country in which they are based").

3. See generally Bob Jessop, *Changing Forms and Functions of the State in an Era of Globalization and Regionalization*, in *THE POLITICAL ECONOMY OF DIVERSITY: EVOLUTIONARY PERSPECTIVES ON ECONOMIC ORDER AND DISORDER* 102, 103-04 (Robert Delorme & Kurt Dopfer eds., 1994) (discussing how the global economy diminishes the regulatory capabilities of nation states).

4. See Daniel W. Schenck, Comment, *Jurisdiction Over the Foreign Multinational in the EEC: Lifting the Veil on the Economic Entity Theory*, 11 *U. PA. J. INT'L BUS. L.* 495 (1989) (describing how the European Community has had to stretch the "economic entity theory" to reach multinational enterprises). Multinational enterprises are characterized by their geographic dispersion whereas sovereign states are distinguishable by the territory they control or occupy. *Id.* at 496. Because multinational enterprises are able to influence a country's economy without creating a legal presence in the country, sovereign states may be unable to hold a multinational enterprise accountable for their actions. *Id.*

an increasingly unified world market that is not limited by geographic boundaries.⁵ The difficulty of reconciling a MNE's need for a global marketplace with a sovereign state's need for control illuminates the competing interests facing the world economy.⁶ Nowhere are these competing interests more opposed to one another than in the area of international taxation.⁷

With the spread of global industrialization, tax authorities and MNEs have become increasingly concerned about the direction and complexity of international tax problems.⁸ The growth in world trade and the corresponding growth in MNEs have caused sovereign states to develop intricate laws for the taxation of international transactions.⁹ This has led to important problems regarding the taxation of cross-border intercompany transactions.¹⁰

Seeking to achieve a balance between itself and MNEs, Canada has enacted new rules governing the taxation of cross-border intercompany transactions.¹¹ These new rules are in section 247 of the Income Tax Act and represent Canada's latest attempt to establish meaningful and functional transfer pricing laws to resolve the disputes caused by transfer pricing adjustments and double taxation.¹² One major provision in section 247 is the imposition of a penalty for failing to make reasonable efforts to determine and use an arm's length transfer price in cross-border trans-

5. See Andrew M. Snyder, Note, *Taxation of Global Trading Operations: Use of Advanced Pricing Agreements and Profit-Split Methodology*, 48 TAX LAW. 1057 (1995) (stating advances in technology have made it possible for financial institutions to conduct their trading activities around the globe, twenty-four hours a day).

6. See Masahiro Max Yoshimura, Comment, *The "Tax War" Between the United States and Japan Under Internal Revenue Code § 482: Is There a Solution?*, 12 WIS. INT'L L. J. 401, 403-04 (1994) (discussing the Internal Revenue Service's intense auditing of Japanese corporations and how this practice may be a breach of the U.S.-Japan Tax Treaty).

7. See Pamela L. Kayfetz & Leo B. Helzel, *Transfer Pricing: Achieving Fair National Taxation of International Transactions*, 3 ANN. SURV. INT'L & COMP. L. 193, 196-99 (1996) (stating the taxation of international transactions by individual nations often results in confusion, disagreement, multiple taxation and income which goes untaxed).

8. See Thomas F. Field, *IFA Congress Participants Tackle International Tax Issues*, 77 TAX NOTES 536, (Nov. 3, 1997) (relating the International Fiscal Association (IFA) Congress held its 51st session in New Delhi, India in October 1997). Because of the complexity of international tax issues, and the evolving nature of world trade, the participants often found themselves disagreeing over such tax issues as investment funds, electronic commerce, cross-border valuations and presumptive income taxation. *Id.* See also 1995 OECD report, *supra* note 2, at Preface ¶ 3 (stating the complex nature of international tax issues is due in part to the non-uniformity of tax laws among nations).

9. See generally Robert Brown & Michael Alexander, *Sovereignty in the Modern Age*, 20 CAN.-U.S. L. J. 273, 285 (1994) (asserting the United States' transfer pricing laws are undeniably the most sophisticated, complex and lengthy).

10. See Kayfetz & Helzel, *supra* note 7, at 194 (stating the fragmentation of taxation of international transactions provides businesses a significant opportunity to avoid taxation).

11. See Department of Finance Canada, Immediate Release, *Draft Legislation and Information Circular on Transfer Pricing Released*, 97-076 (Ottawa: Sept. 11, 1997) [hereinafter Press Release 97-076] (reporting that on September 11, 1997, the Canadian Ministers of Finance and Revenue issued a joint press release regarding the release of the draft transfer pricing rules). The Finance Minister noted that the information released was consistent with Revenue Canada's intention to devote more resources to the taxation of international transactions, and would make transfer pricing audits more efficient for both taxpayers and Revenue Canada. *Id.*

12. See Income Tax Act, R.S.C., § 247 (1998) (Can.).

actions.¹³ The penalty is designed to make tax under-reporting and non-compliance more costly than compliance.¹⁴ Section 247 also subjects MNEs to substantial increases in transfer pricing documentation¹⁵ and gives Revenue Canada¹⁶ the power to adjust both the quantum and the nature of amounts that are subject to the transfer pricing rules.¹⁷ MNEs failing to conduct studies of intercompany transactions to develop the facts and analysis necessary to satisfy the documentation requirements will be "deemed" to have fallen victim to the penalty provision in section 247(3).¹⁸ Moreover, and not surprisingly, section 247 and Draft Information Circular 87-2R¹⁹ are modeled after the recent transfer pricing work of the Organization for Economic Cooperation and Development (OECD).²⁰ Canada has since 1979 administered its transfer pricing laws based on the OECD's transfer pricing work.²¹

Understanding the dynamics between section 247, and the interrelationship between Canada's ancillary considerations and procedural matters concerning transfer pricing, is the key to understanding Canada's latest transfer pricing laws. To ensure the key for unlocking Canada's transfer pricing laws materializes, this comment is divided into seven parts. Part II defines the complex nature of international transfer pricing and illustrates why Revenue Canada is concerned about transfer pricing abuses. Part III provides background information on section 247 by focusing on the

13. See *id.* § 247(3). For a full discussion of the penalty provision, see discussion *infra* Section III.C.

14. See Steven Grodnitzky, *Revenue Canada Expects Proposed Transfer Pricing Legislation to Become Law Soon*, 97 TNI 210-4, available in LEXIS, Taxana Library, TNI File (reporting that Revenue Canada sees the penalty provision as an incentive for taxpayers to follow the arm's length principle).

15. See Income Tax Act, R.S.C., § 247(4) (1998) (Can.).

16. See Revenue Canada, *1997 Index to Revenue Canada Services* (visited Feb. 8, 1998) <http://www.rc.gc.ca/~paulb/index97/english/about_rc.htm#the_mandate> [hereinafter *1997 Index to Revenue Canada Services*] (noting that Revenue Canada is responsible for administering the various tax programs in Canada). Among its responsibilities is revenue generation, trade facilitation, customs border services and income redistribution. *Id.*

17. See Income Tax Act, R.S.C., § 247(2) (1998) (Can.).

18. See *id.* § 247(4) (stating that for purposes of § 247(3), a taxpayer "is deemed not to have made reasonable efforts to determine and use arm's length transfer prices or arm's length allocations in respect of a transaction . . . unless the taxpayer" surrenders documentation for the transaction entered into which is subject to the contemporaneous documentation requirements).

19. Department of Finance Canada, *Draft Information Circular 87-2R International Transfer Pricing and Other International Transactions* (Sept. 11, 1997) [hereinafter *Draft Information Circular 87-2R*]. Information Circular 87-2R sets out Revenue Canada's views on transfer pricing. *Id.* It updates Information Circular 87-2 to reflect the developments in § 247 of the Income Tax Act and the most recent transfer pricing work of the OECD. *Id.* See generally Tax Management Portfolios, *Transfer Pricing: Foreign Rules and Practice Outside of Europe*, 897 TM III (1997) [hereinafter TM III] (stating Information Circular 87-2 [87-2R] is for the guidance of Canadian taxpayers that participate in intercompany cross-border transactions); Highland Foundry Ltd. v. The Queen [1994] C.T.C. 1, 10 (declaring Information Circulars do not have the force of law, but can be very useful in interpreting the meaning of legislation).

20. See Press Release 97-076, *supra* note 11 (declaring § 247 and Information Circular 87-2 have been updated to conform with the 1995 revised OECD transfer pricing rules).

21. Department of Finance Canada, Immediate Release, *OECD Transfer Pricing Guidelines Released*, 95-059 (Ottawa: July 28, 1995) [hereinafter Press Release 95-059] (maintaining Canada has administered its transfer pricing laws according to the OECD guidelines set out in the 1979 OECD report).

influences that have shaped Canada's transfer pricing laws. Part IV examines section 247 and its interrelationship between the various transfer pricing provisions. Part V discusses special considerations that arise with regard to transfer pricing in the area of intangible property, intra-group services and cost contribution arrangements. Part VI examines Canada's Advanced Pricing Agreement (APA) program in light of section 247. Finally, Part VII supplies a conclusion in which this Comment concludes that MNEs should not be surprised by section 247 or Information Circular 87-2R, and should take Canada's transfer pricing laws seriously because other taxing jurisdictions will follow Canada's lead.

II. THE TRANSFER PRICING PROBLEM DEFINED

The international tax problems associated with cross-border intercompany trade are attributable to the structure of MNEs.²² MNEs conduct business in more than one country by adopting legal structures to meet their business needs.²³ These legal structures can be branches, subsidiaries, partnerships or even joint ventures.²⁴ Despite the form, the operating units of MNEs are rarely independent.²⁵ Often a dominant parent or partner in one country will control the operating units in foreign jurisdictions.²⁶ As a result, cross-border transactions often take place between the parent and the units, and among the units collectively.²⁷ The prices charged or paid for goods or services in these cross-border intra-group transactions may or may not reflect market forces and are the transfer price.²⁸ Transfer pricing, therefore, is the internal price at which tangible goods, intangible property, services, loans and leases are exchanged between constituent parts of a MNE.²⁹

22. See generally Anthony Scaperlanda, *Trade in the 1990s: Is an International Organization for Multinational Enterprises Needed?*, 14 N. ILL. U. L. REV. 421 (1994) (discussing the complex structure of multinational enterprises and the potential for an international organization to monitor multinational enterprises).

23. See generally Richard Herring and Friedrich K. Degreesubler, *The Allocation of Risk in Cross-Border Deposit Transactions*, 89 NW. U. L. REV. 942, 973 (1995) (discussing the organizational structures a bank engaged in international business may adopt).

24. See generally Diane M. Ring, *Risk-Shifting Within a Multinational Corporation: The Incoherence of the U.S. Tax Regime*, 38 B.C. L. REV. 667, 678 (1997) (noting that banks frequently operate in foreign countries through branches).

25. ROBERT TURNER, *STUDY OF TRANSFER PRICING 5* (Technical Committee on Business Taxation, Working Paper 96-10, 1996). This committee was established by the Canadian Minister of Finance to evaluate ways to improve the economy and simplify administration of the Income Tax Act. *Id.* This study recognizes that units of a MNE are rarely self-sustaining or independent. *Id.*

26. See generally Scaperlanda, *supra* note 22 (arguing, in part, that an international organization for monitoring MNEs would frustrate the control parent corporations like to exert over their branches or subsidiaries).

27. See TURNER, *supra* note 25.

28. See 1995 OECD report, *supra* note 2, at Preface, ¶ 11 (Paris: OECD 1995) (defining "transfer prices" as "prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises").

29. See General Accounting Office, *International Taxation Problems Persist in Determining Tax Effect of Intercompany Prices*, TAX NOTES INT'L, July 22, 1992, available in LEXIS, Fedtax Library, Txnint File (detailing that transfer prices are the prices charged by one unit of an organization, such as an affiliate, department, or

In the course of determining taxable income allocable to Canada, it is necessary to determine a transfer price.³⁰ Determining a transfer price is easy when two independently self-interested parties determine by negotiations the price of goods³¹ because the income received is equal to the price paid.³² This type of exchange is referred to as an arm's length transaction and is reflective of the free market.³³ Because the two parties to this transaction are acting out of their own self-interest, and these interests are apparently opposed to one another,³⁴ there is no reason for Revenue Canada to scrutinize this type of transaction.³⁵ However, associated enterprises have no need to compete with each other because they are controlled by the same entity.³⁶ As such, intra-group trade is not affected by market forces.³⁷ To exploit this tax avoidance opportunity, MNEs have used a variety of methods to divert income from one associated company to another to reduce the tax liability of the combined operation.³⁸

division, for a product or services supplied to another unit in the same organization); Carl F. Steiss & Luc Blanchette, *The International Transfer-Pricing Debate*, 43 CAN. TAX J. 1566 n.1 (1995) (stating that transfer pricing refers to pricing between related entities and establishments of a multinational enterprise, particularly with respect to sales of tangible property and sales and licensing of intangible property crossing borders).

30. See generally TM III, *supra* note 19 (stating although determining a transfer price may be difficult, it is nevertheless necessary to determining the income of the taxpayer). But see Diane Francis, *Here's Hoping Rae Relentson Corporate Tax*, THE FINANCIAL POST, Nov. 14, 1990 (stating transfer pricing is difficult to prove and even illegal).

31. For the convenience of the reader, less otherwise stated, the word "goods" herein refers to both tangible and intangible commodities that can be transferred between constituent parts of a MNE.

32. See generally TM III, *supra* note 19 (stating that the issue of transfer pricing is concerned with transactions between associated parties).

33. See Organization for Economic Cooperation and Development, *Model Tax Convention on Income and on Capital*, ¶ 1, Art. 9, Committee on Fiscal Affairs Report (Paris: OECD 1977) (loose leaf) (defining the arm's length standard). Article 9 provides:

[When] conditions are made or imposed between . . . two [related] enterprises in the commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Id.

34. See ADAM SMITH, *THE WEALTH OF NATIONS* 13 (New York: Modern Library, 1776) (capturing the essence of human nature in the free market when he wrote "[n]obody ever saw a dog make a fair and deliberate exchange of one bone for another with another dog.").

35. See generally 1997 *Index to Revenue Canada Services*, *supra* note 16 (discussing how administratively, it would be impossible for Canada to scrutinize every international transaction). The government would have to allocate a substantial amount of money to hire and train auditors, and as a result, the government's broader economic and social policies would suffer. *Id.*

36. See TURNER, *supra* note 25.

37. But see 1995 OECD report, *supra* note 2, at ¶ 1.5 (stating taxation authorities should not assume that all controlled transactions will invariably deviate from what the open market would demand).

38. See Jeffrey C. Schwartz, Note, *Trawling for Taxpayers: Section 6038A and Transfer Pricing Regulations*, 42 CASE W. RES. L. REV. 993, 996-1000 (discussing the extent of the transfer pricing problem in the United States); see also Kayfetz & Helzel, *supra* note 7, at 196-99 (discussing the significance of transfer pricing issues to individuals, tax authorities, multinational enterprises and politics).

For a simple illustration, take a Canadian subsidiary with a United States (U.S.) parent corporation. Let us assume Canada taxes corporate income at a higher rate than the U.S.³⁹ The parent corporation, wanting to maximize the interests of the MNE, desires to pay as little in taxes as possible.⁴⁰ Given the choice between Canada and the U.S., the parent corporation naturally would choose to have the income generated by the MNE taxed in the U.S. One way the parent corporation could achieve this result would be to sell the Canadian subsidiary goods at a cost above the market price. By purchasing the goods at an inflated price, the subsidiary would experience an increase in its operating expenses. These additional expenses would reduce the subsidiary's taxable income because the profits from this transaction are less than the profits the subsidiary would have realized had the subsidiary sold the goods to an independent enterprise in an arm's length transaction. At the same time, this transaction would increase the income of the U.S. parent corporation because the parent corporation is receiving the income generated from this transaction at a price above the market price.⁴¹

The inverse of this transaction would also decrease the subsidiary's income and increase the parent's income. Instead of the parent corporation selling goods to the subsidiary, the subsidiary could sell goods to the parent. This time, however, the subsidiary sells the goods to the parent at a price below the market price. Since the parent is buying the goods at a price below market price, the parent does not incur expenses that are representative of the free market. As such, the parent's income is not reduced by an expense that a similarly situated company would experience had the parent bought the goods on the open market.⁴² Moreover, since the subsidiary does not charge the parent an arm's length price, the subsidiary's income is reduced because it is not receiving the income it would have earned had the transaction occurred between two self-interested parties.⁴³ This type of intra-group manipulation justifiably has Revenue Canada and other taxation authorities concerned that MNEs will use transfer prices as a means of improperly reducing

39. The difference in the corporate tax rate between Canada and the United States is not significant. Compare I.R.C. § 11 (1996) (listing the highest marginal corporate tax rate in the U.S. in 1997 as 35%), with TM III, *supra* note 19 (noting that the basic federal corporate tax rate for 1994 in Canada is 38%).

40. See generally Kayfetz & Helzel, *supra* note 7 (noting it is no secret that MNEs are in business to make a profit). In most cases, the less a MNE has to pay in taxes, the more profit a MNE realizes. *Id.* Avoiding taxes by reallocating income from a higher taxing jurisdiction to lower taxing jurisdiction is one way MNEs can maximize their collective interests. *Id.*

41. See generally Eugene E. Lester, Comment, *International Transfer Pricing Rules: Conventional Wisdom*, 2 ILSA J. INT'L & COMP. L. 283, 285-87 (1995) (describing how a parent corporation can increase its profits through transfer pricing manipulation).

42. See generally Schwartz, *supra* note 38, at 996 (providing an example of how a foreign corporation with a subsidiary in the United States could charge a higher than normal price for goods).

43. See generally Lester, *supra* note 41, at 285-87 (describing how a parent corporation can increase its profits through transfer pricing manipulation).

taxable income by shifting profit to associated enterprises operating in low tax jurisdictions.⁴⁴

III. BACKGROUND

Along with countries with high levels of international investment, Canada has been aggressively scrutinizing the increase in cross-border trade among MNEs.⁴⁵ This increased scrutiny is due in part to the growing influence and role MNEs have in the Canadian economy.⁴⁶ It is estimated that MNEs account for sixty percent of all global trade,⁴⁷ while foreign trade accounts for roughly forty percent of the economic activity in Canada.⁴⁸ Of this forty percent, it is estimated that seventy percent of that trade is between associated enterprises.⁴⁹ Since Canada's economic growth is dependent upon foreign trade, the Canadian government cannot escape taking steps to make the country more attractive to MNEs.⁵⁰ Yet the Canadian government must walk a fine line because although MNEs bring jobs, technology

44. See generally Nathan Boidman, *Canadian Transfer Pricing Rules: Indalex v. The Queen*, 15 TAX MGMT. INT'L J. 239, 242-48 (1986) (analyzing *Indalex v. The Queen* [1986] 86 D.T.C. 6039, a transshipment arrangement that Revenue Canada characterized as a sham pricing arrangement).

45. See Ernst & Young, *Ernst & Young Transfer Pricing 1997 Global Survey*, 97 TAX NOTES TODAY 183-105, Sept. 22, 1997, available in LEXIS, Taxana Library, TNT File (noting that among the nearly 400 multinational parent corporations surveyed in 1997, 80% expect to face a transfer pricing examination by the end of 1999). Of the survey respondents based in Canada, 92% believe it is likely that they will be subject to a transfer pricing examination by Revenue Canada by the end of 1999. *Id.* Every year since 1995, Ernst & Young has commissioned a worldwide survey on the practices and trends of transfer pricing. *Id.*

46. See Emma J. Purdy & Jeffrey S. Zanchelli, *Revenue Canada Steps Up Scrutiny of Cross-Border Management Fees*, 7 J. INT'L TAX'N 397, 398 (1996) (stating Revenue Canada's frequent audit adjustments of management fees is attributable, in part, to many multinationals centralizing their head offices); Elizabeth Schwinn, *Transfer Pricing: Revenue Canada Official Downplays Impact of Proposed Transfer Pricing Laws*, 189 DAILY TAX REPORT G-1 (1997), available in WL 189 DTR G-1 (reporting the director of Revenue Canada considers Canada's new transfer pricing laws necessary to sustain Canada's growth in international trade and to monitor the increase in cross-border transactions between related parties); see also Kayfetz & Helzel, *supra* note 7, at 196 (stating business is the most influential force for change in the world).

47. See Jeffrey Owens, *Emerging Issues in Tax Reform: The Perspective of an International Bureaucrat*, 15 TAX NOTES INT'L 2035, 2053 (1997).

48. See Eric Beauchesne, *Feds Target Tax Havens, Revenue Loss: Revenue Canada to Tighten Lucrative Tax Loophole*, OTTAWA CITIZEN, Sept. 10, 1997 (visited Mar. 8, 1998) <<http://www.ottawacitizen.com/business/970910/1145675.html>>.

49. *Id.*

50. See *Multilateral Investment Pact Serves Canada's Interests*, THE FINANCIAL POST, Nov. 7, 1997 at 1, available in 1997 WL 14959345 (arguing Canada's economic health is dependent upon Canada attracting international investment).

and investment, MNEs operate out of their own self-interest.⁵¹ One of these interests is tax avoidance.⁵²

While transfer pricing laws go a long way towards protecting the Canadian tax base by assigning market prices to related-party transactions, Revenue Canada has not been content to rely solely on the honor system with MNEs.⁵³ Revenue Canada has significantly increased the number of audits it performs on corporations that enter into cross-border transactions.⁵⁴ In fact, Revenue Canada makes no secret of the fact that it selects MNEs with Canadian cross-border transactions as likely audit candidates.⁵⁵ By the year 2000, it is estimated that the number of international auditors in Canada will have increased by more than 400 percent from the 1993 level.⁵⁶ This evidence strongly suggests that Revenue Canada does not intend to have the Canadian tax base eroded by MNEs under-reporting their income.⁵⁷ Moreover, Canada's tightening of its transfer pricing laws is strong evidence that Canada does not intend to sit idly by as other countries intimidate MNEs into over-reporting their income.⁵⁸ By enacting tough statutory transfer pricing rules and adopting the recommendations in the 1995 OECD report, Canada has taken the first step to ensure taxpayers clearly reflect income attributable to controlled transactions.⁵⁹

51. Neville Nankivell, *Ottawa Should Throw the Door Wide Open to Foreign Investment: Manley and Others Argue for a More Flexible Approach But This is Not an Attitude Shared Widely in the Liberal Caucus*, THE FINANCIAL POST, Jan. 4, 1997 at 1, available in 1997 WL 4084159 (discussing the benefits of foreign-based multinationals in the Canadian economy).

52. See Lester, *supra* note 41, at 286 (stating tax avoidance is always an interest of a multinational enterprise).

53. See Charles F. Connolly, Comment, *The New Transfer Pricing and Penalty Regulations: Increased Compliance, Increased Burdens, and the Search for a Safe Harbor*, 16 U. PA. J. INT'L BUS. L. 339 (1995). In all fairness to Revenue Canada, few tax authorities rely on the honor system. *Id.* The United States has set up an elaborate framework for monitoring inaccurate transfer pricing arrangements. *Id.*

54. See generally Martin Przysuski & Esta Mikhail, *How to Prepare for an International Audit in Canada*, 14 TAX NOTES INT'L 937 (1997) (discussing how Revenue Canada approaches auditing international transactions, and how Canadian taxpayers can benefit by knowing ahead of time what Revenue Canada will be seeking); see also Purdy & Zanchelli, *supra* note 46, at 397 (discussing the significant increase in transfer pricing audits by Revenue Canada over management fees charged by the non-Canadian parent corporation to the Canadian subsidiary).

55. See Przysuski & Mikhail, *supra* note 54, at 937 (stating that Revenue Canada selects MNEs for transfer pricing audits based on Form T106). Using the authors' words, "[t]his means that multinational corporations with Canadian cross-border transactions are likely to be selected for audit." *Id.* Przysuski and Mikhail are two international tax auditors in Revenue Canada. *Id.*

56. See Ernst & Young, *supra* note 45, at ¶ 83 (stating the number of transfer pricing audits in Canada by the year 2000 is expected to grow sevenfold since 1993, and that the number of international auditors is expected to increase by 400% over this same time period).

57. See Alan Toulin, *Ottawa Plans to Tighten Transfer Pricing Rules*, THE FINANCIAL POST, Sept. 12, 1997 (reporting Finance Minister Paul Martin believes that § 247 will help protect Canada's tax base).

58. See Rob O'Conner and Alan Shapiro, *Canada Proposes Major Transfer Pricing Changes*, 97 TAX NOTES TODAY 38-8 (Feb. 26, 1997), available in LEXIS, Taxana Library, TNT File (declaring Canada's transfer pricing penalty provision is an attempt to protect the Canadian tax base from the U.S. transfer pricing penalty).

59. See generally Peter Menyasz & Sindhu G. Hirani, *Transfer Pricing: Canadian Transfer Pricing Proposal Includes New Documentation Rules, Stiff Penalties*, 177 DAILY TAX REPORT GG-1 (1997), available in WL 177 DTR GG-1 (stating that Revenue Canada has complained about the growing volume and complexity of

A. *Organization for Economic Cooperation and Development (OECD)*

Notwithstanding the United States, the biggest substantive influence on Canada's past and present transfer pricing laws has been the OECD.⁶⁰ Canada has openly endorsed the principles and approaches contained in the 1979 OECD transfer pricing report.⁶¹ The 1979 OECD report endorsed the arm's length principle as the international standard for dealing with transfer pricing issues⁶² and developed the transfer pricing methods for determining whether prices on transactions undertaken by related parties in different countries are in accordance with the arm's length principle.⁶³ In 1987, Revenue Canada incorporated much of the 1979 OECD report into Information Circular 87-2 as guidance for taxpayers on how the arm's length principle would be interpreted with respect to Canada's statutory transfer pricing laws.⁶⁴ When the circular was updated in 1997, Revenue Canada again relied on the OECD's transfer pricing work.⁶⁵

Since the release of the 1979 OECD report, the OECD has followed up with transfer pricing reports in 1984⁶⁶ and 1995.⁶⁷ While the 1984 OECD report dealt with mutual agreement procedures, banking, and the allocation of central management and service costs, the 1995 OECD report involved a comprehensive review and revision of transfer pricing issues to reflect recent developments in the member countries.⁶⁸ In a news release issued shortly after the 1995 report was published, Canada endorsed the report and observed that its current transfer pricing practices embraced the OECD guidelines set out in the 1979 report and outlined in Infor-

intra-group cross-border transactions).

60. See Steiss & Blanchette, *supra* note 29, at 1569, 1593; see also *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 1 (stating Canada's transfer pricing laws reflect the work of the OECD).

61. See Organization for Economic Cooperation and Development, *Transfer Pricing and Multinational Enterprises*, Report of the OECD Committee on Fiscal Affairs (Paris: OECD, 1979) [hereinafter 1979 OECD report]; Scott Wilkie, *A Clearer Picture: Canadian Transfer Pricing Rules Keep Step with International Developments*, 97 *TNI* 183-18, available in LEXIS, Taxana Library, TNI File (noting Canada's reliance on the 1979 OECD report).

62. See 1979 OECD report, *supra* note 61 (endorsing the arm's length principle and rejecting any apportionment formula).

63. See generally Robert G. Clark, Comment, *Transfer Pricing, Section 482, and International Tax Conflict: Getting Harmonized Income Allocation Measures from Multinational Cacophony*, 42 *AM. U.L. REV.* 1155, 1168-76 (1993) (discussing the transfer pricing methodology embodied in the 1979 OECD report and used by the OECD members).

64. See Department of Finance, *Information Circular 87-2 International Transfer Pricing and Other International Transactions* (Feb. 27, 1987). Information Circular 87-2 incorporated many of the provisions in the 1979 OECD and reflected Revenue Canada's interpretation of § 69 of the Income Tax Act. *Id.* In 1997, Revenue Canada revised this circular [now Information Circular 87-2R] to reflect the recent developments in Canada's transfer pricing laws. *Id.*

65. See Press Release 97-076, *supra* note 11.

66. See Organization for Economic Cooperation and Development, *Transfer Pricing and Multinational Enterprises: Three Taxation Issues*, Report of the OECD Committee on Fiscal Affairs (Paris: OECD, 1984).

67. See 1995 OECD report, *supra* note 2.

68. See *id.* at P4.

mation Circular 87-2.⁶⁹ In fact, Canada has never wavered from its reliance on the OECD's transfer pricing work as the main mechanism for resolving transfer pricing issues.

The Canadian government has recognized that in order for the 1995 OECD report to have significance, the guidelines must represent the expression of an international consensus for allocating income and expenses.⁷⁰ Canada has continuously worked to build this international consensus as a means of promoting the goals of the OECD and avoiding transfer pricing disputes.⁷¹ This is an important point because without a multilateral approach for resolving transfer pricing issues national tax administrations will continue to waste time and resources over international disagreements, and MNEs will continue to face the prospect of double taxation.⁷² Moreover, since no statute, regulation, circular, opinion or report can provide an exhaustive discussion of transfer pricing, Canada's endorsement of the OECD's transfer pricing work provides taxpayers with a practical guide to transfer pricing issues.⁷³ Taxpayers, therefore, have an additional source for advice on how to apply the arm's length principle.⁷⁴

With respect to Revenue Canada, the growth of MNEs presents increasingly complex taxation issues because allocating intercompany cross-border transactions are highly technical.⁷⁵ As tax authorities around the world acknowledge, intercompany pricing questions do not lend themselves to one set of rules.⁷⁶ Rather, intercompany transfer pricing questions must be decided on a case-by-case basis.⁷⁷

69. See Press Release 95-059, *supra* note 21 (stating the 1995 OECD report represents a consensus among the OECD member countries and confirms Canada's administrative approach to transfer pricing).

70. See generally Schwinn, *supra* note 46 (quoting the director of Revenue Canada as saying "We're [Canada] joining the international community [by enacting § 247 of the Income Tax Act].").

71. See Brian J. Arnold & Thomas E. McDonnell, *Report on the Invitational Conference on Transfer Pricing: The Allocation of Income and Expenses Among Countries*, 41 CAN. TAX J. 899 (1993).

72. See Owens, *supra* note 47, at 2054 (discussing the harmful effects of tax competition among countries).

73. See 1995 OECD report, *supra* note 2, at ¶ 4.2 (recognizing that without cooperation among tax authorities the same item of income may be subject to more than one tax). Taxing the same income of a multinational enterprise two or more times is an impediment to international trade because double or multiple taxation is a disincentive for multinational enterprises to move goods and services across borders. *Id.* See generally James R. Mogle, *Competent Authority Procedure*, 23 GEO. WASH. J. INT'L L. & ECON. 725 (1990) (discussing double taxation and how it can be abated through the competent authority process).

74. See generally 1995 OECD report, *supra* note 2, at ch. 1 (discussing how associated enterprises and tax authorities should interpret and apply the arm's length principle to intercompany cross-border transactions).

75. See Przynski & Mikhail, *supra* note 54, at 937 (relating that transfer pricing audits can be very complicated because they can involve large amounts of money, and the nature and scope of the audit can be unlimited). Furthermore, the structure of a MNE can impede quick resolution because the corporate structure may be highly integrated. *Id.* Added to this is the fact that the applicable Canadian tax law may also be difficult to apply to a given situation. *Id.*

76. See Nathan Boidman, *The Section 482 White Paper - A Canadian Perspective*, 41 TAX EXECUTIVE 285, 286 (1989) (noting transfer pricing questions are not easily reduced to a scientific and objective formula to be applied uniformly between related parties).

77. See generally Salvador M. Borraccia, *Selected Canadian Litigation Aspects of International Pricing Disputes: Effect of Proposed Changes*, 44 TAX EXECUTIVE 467 (Nov.-Dec. 1992) (discussing Canadian administrative and judicial approach to solving transfer pricing disputes).

To MNEs, the "facts and circumstances"⁷⁸ disposition of transfer pricing is frustrating because large amounts of time and money is at stake.⁷⁹ The lack of a uniform multilateral tax structure often results in confusion, disagreement or multiple taxation.⁸⁰ Because transfer pricing laws differ from country to country, MNEs are required to comply with different laws and administrative requirements that a similarly situated enterprise operating solely within a single taxing jurisdiction can escape.⁸¹ When two countries disagree over income allocations attributable to transfer pricing, a MNE can end up being double taxed because both taxing authorities can make a transfer pricing adjustment to the cross-border transaction.⁸² Few issues concern MNEs more than having the same income taxed twice.⁸³ However, the 1995 OECD report goes a long way towards addressing the concerns of MNEs and tax authorities.⁸⁴ Therefore, with Canada recognizing that the significance of the 1995 OECD report rests in its role as an expression of an international consensus, MNEs are one step closer to securing globally accepted transfer pricing rules.⁸⁵

B. The United States

If the OECD has made significant contributions to Canada's development of transfer pricing laws, the United States has been the catalyst behind Canada's enactment of those laws.⁸⁶ Ironically, the 1979 OECD report was inspired by the United States' enactment of comprehensive pricing guidelines in 1968.⁸⁷ The 1968 regu-

78. See Nathan Boidman, *The Effect of the APA and Other U.S. Transfer-Pricing Initiatives In Canada and Other Countries*, 44 TAX EXECUTIVE 254, 255 (1992) [hereinafter *U.S. Transfer Pricing*].

79. See Andrew H. Kingissepp, *Strategies for Appealing Canadian Transfer Pricing Adjustments: Part I*, 6 J. INT'L TAX'N 322, 322 (1995) [hereinafter Kingissepp Part I] (asserting because litigation is costly in both time and money, the usual approach for seeking relief is through the competent authority procedure when it is available).

80. See Ernst & Young, *supra* note 45, at ¶¶ 77-117 (summarizing the transfer pricing laws of 12 different countries).

81. See Kayfetz & Helzel, *supra* note 7, at 193-94 (stating since taxation is based on the sovereignty of nations, taxation of international transactions is often inconsistent and confusing).

82. See Clark, *supra* note 63, at 1157 (describing how MNEs may be taxed on the same income in two countries on the same transaction).

83. See Ernst & Young, *supra* note 45, at ¶ 30 (finding that the single most important issue among multinational enterprises is double taxation). While the survey found that 88% of the respondents consider double tax relief to be the most important international tax issue, 52% said transfer pricing is the biggest international tax issue they expect to face in the next two years. *Id.* In comparison, only 16% felt that double tax relief was the biggest international tax issue they expect to face in the next two years. *Id.* at ¶ 32.

84. See 1995 OECD report, *supra* note 2, at ¶¶ 4.29-4.31 (outlining the mutual agreement procedure).

85. See generally Kayfetz & Helzel, *supra* note 7, at 228-29 (discussing the advantages of an international tax system).

86. See Steiss & Blanchette, *supra* note 29, at 1568 (crediting the United States with being the prime instigator for international unrest in the area of transfer pricing).

87. See Treas. Reg. § 1.482(1)-(2) (1994) (describing how the arm's length principle should be applied to a specific fact pattern); see generally John S. Nolan, *U.S. Final Transfer Pricing Regulations*, 50 U. MIAMI L. REV. 537, 538-46 (1996) (describing Treas. Reg. § 1.481-1).

lations marked a turning point in the debate over intercompany cross-border transactions because for the first time an attempt had been made to establish a detailed set of transfer pricing rules.⁸⁸ Since this time, the United States, with Canada in tow, has led the charge against MNEs to ensure MNEs properly allocate their income and expenses among the countries where they carry on business.⁸⁹ At times, however, the United States' aggressive stance against MNEs has had some fallout in Canada.⁹⁰ For example, in 1992 the United States proposed comprehensive transfer pricing regulations interpreting the "commensurate with income" phrase in section 482.⁹¹ These regulations were issued in response to a 1988 Treasury Department White Paper suggesting that the "super-royalty" provision, added to section 482 in 1986, did not depart from the arm's length standard.⁹² In the eyes of Revenue Canada, these regulations, as originally drafted, were a retreat from the internationally recognized arm's length principle because the regulations downgraded the traditional transaction methods⁹³ and accentuated the transactional profit methods.⁹⁴ Revenue Canada perceived the discounting of the traditional transaction methods as a departure from the arm's length principle and an obstacle for granting competent authority relief.⁹⁵ Although the final regulations, issued in July 1994, tempered much of the earlier criticism, Revenue Canada took the unprecedented step of publicly announcing their opposition to the regulations.⁹⁶

While the stepped-up enforcement efforts by the United States to protect its domestic tax base against transfer pricing abuses appears to be working, Canada in recent years has become increasingly concerned that these efforts may be causing United States based MNEs operating in Canada to over-report their Canadian income in the United States to avoid the imposition of a penalty by the Internal Revenue Service (IRS).⁹⁷ Currently, the IRS can impose stiff transfer pricing

88. See Steiss & Blanchette, *supra* note 29, at 1572.

89. See generally Connolly, *supra* note 53, at 340 (asserting the United States has led the attack on multinational enterprises that fail to satisfy the arm's length principle).

90. See Boidman, *supra* note 76, at 286 (stating the Canadian government worries the enactment of the "super royalty" provision will lead to U.S. companies over charging Canadian companies); *U.S. Transfer Pricing*, *supra* note 78, at 254 (asserting the Internal Revenue Service's use of Advanced Pricing Agreements (APAs) has prompted Revenue Canada to test the procedure).

91. See Treas. Reg. § 1.482 (1994).

92. UNITED STATES TREASURY DEPARTMENT, A STUDY OF INTERCOMPANY PRICING UNDER SECTION 482 OF THE CODE (reprinted in Notice 88123, 1988-2 C.B. 458 (1988)).

93. See discussion *infra* Section IV.B.1 (discussing the traditional transaction methods).

94. See discussion *infra* Section IV.B.2 (discussing the transactional profit methods); Mary C. Bennett et al., *First U.S.—Ukraine Treaty; Canada Clarifies Transfer Pricing; Mexico Awaits Approval*, 5 J. INT'L TAX 'N 280, 282-83 (1994) (stating Canada finds the § 482 regulations unacceptable because they give the comparable profit methods a prominent role).

95. See Steiss & Blanchette, *supra* note 29, at 1594.

96. See Department of Finance Canada, Immediate Release, *Transfer Pricing Rules and Guidelines Clarified*, 94-003 (Ottawa: Jan. 7, 1994).

97. See Albertina M. Fernandez, *Tax Notes International: The Week in Review*, 15 TAX NOTES INT'L 1583 (Nov. 17, 1997), available in LEXIS, Taxana Library, TNI File.

penalties on MNEs that under-report their income or fail to document their transfer pricing transactions.⁹⁸ While it remains unclear whether the IRS's stepped up efforts have significantly intimidated MNEs into over-reporting their Canadian income in the United States to avoid these stiff penalties, what is clear is that section 247 is, in part, Canada's response to what it perceives as the United States supplementing its treasury at the expense of the Canadian treasury.⁹⁹ Perhaps in a show of courtesy, however, Revenue Canada, at least publicly, contends that section 247 is in response to Canada's growth in international trade and the corresponding growth in intercompany cross-border transactions.¹⁰⁰

C. An International Trend

Since the release of the 1995 OECD report several countries have taken the opportunity to update their transfer pricing laws.¹⁰¹ Among the countries that have most recently updated their transfer pricing laws are Australia,¹⁰² Mexico,¹⁰³ New Zealand,¹⁰⁴ Great Britain,¹⁰⁵ Brazil¹⁰⁶ and Korea.¹⁰⁷ With many of these countries looking for new ways to increase revenues and reduce national deficits, targeting

98. See I.R.C. § 6662 (1997).

99. See Alan Shapiro & Bill Dodge, *Three Downs and Out: New Canadian Transfer Pricing Rules Level the Playing Field*, 97 TAX NOTES INT'L 221-20 (Nov. 17, 1997), available in LEXIS, Taxana Library, TNI File.

100. See generally Schwinn, *supra* note 46 (stating Revenue Canada considers the new transfer pricing laws as necessary to accommodate Canada's growth in international trade and the growth in intercompany cross-border transactions); Courtney Tower, *New Canadian Tax Rules Aiming at Foreign Firms: More Documentation is Required for any Transfer-Pricing Practices*, J. OF COMMERCE, Sept. 16, 1997, Finance at 2A (saying the new transfer pricing laws are to protect the Canadian tax base from transfer pricing abuses).

101. See Ernst & Young, *supra* note 45, at ¶ 4 (relating many countries are developing formal transfer pricing documentation requirements and penalties to protect their own tax bases).

102. See Vikas Khanna, *Australia Widens its Anti-Tax-Haven and Foreign Income Tax*, 97 TAX NOTES INT'L 245-1 (Dec. 22, 1997), available in LEXIS, Taxana Library, TNI File (describing the recent changes in Australia's controlled foreign company (CFC) legislation and foreign-source income rules); see generally Ernst & Young, *supra* note 45, at ¶¶ 78-81 (providing a brief summary of Australia's transfer pricing laws).

103. See Albertina Fernandez, *Mexico's Maquiladora Transfer Pricing Safe Harbor to be Eliminated for 1999*, 97 TAX NOTES INT'L 185-17 (Sept. 24, 1997), available in LEXIS, Taxana Library, TNI File (discussing Mexico's transfer pricing safe harbor for maquiladoras).

104. See Andra Glyn-Jones, *New Zealand Releases Transfer Pricing Guidelines*, 97 TAX NOTES INT'L 209-18, (Oct. 18, 1997), available in LEXIS, Taxana Library, TNT File 97 TNI 209-18 (discussing the release of New Zealand's new transfer pricing guideline).

105. See *Regulation Extends Its Reach*, THE FINANCIAL TIMES, Dec. 11, 1997, at 10 (providing a brief overview of some of Canada's transfer pricing provisions); Anne O'Connell Devereaux, *Inland Revenue Official Summarizes U.K. Transfer Pricing Consultative Document*, 97 TAX NOTES TODAY 209-15 (Oct. 29, 1997), available in LEXIS, Taxana Library, TNT File; see generally Ernst & Young, *supra* note 45, at ¶¶ 111-14 (summarizing the United Kingdom's transfer pricing laws).

106. See Eduardo F. Goldszal & Lawrence Olson, *Highlights of Brazil's New Transfer Pricing Regulation*, 97 TAX NOTES INT'L 101-2 (May 27, 1997), available in LEXIS, Taxana Library, TNI File.

107. See Kyung Geun Lee et al., *Korea Announces New Law on Coordination of International Tax Matters*, 96 TAX NOTES INT'L 38-4 (Feb. 26, 1996), available in LEXIS, Taxana Library, TNI File; see generally Ernst & Young, *supra* note 45, at ¶¶ 98-100 (overviewing Korea's transfer pricing laws).

MNEs is politically much easier than domestic-based companies.¹⁰⁸ A major focus of this heightened scrutiny by tax authorities is to increase international audits because transfer pricing investigations yield a high ratio of tax to costs when compared with other forms of international tax investigative work.¹⁰⁹ To help international tax auditors make transfer pricing adjustments, most of the laws introduced increase or establish penalties for under reporting income and require MNEs to document their transfer pricing practices.¹¹⁰ New Zealand, for example, released a comprehensive transfer pricing guideline based on the 1995 OECD report that outlines how Inland Revenue interprets the arm's length principle, pricing methods, and what kind of documents taxpayers are expected to prepare to justify their transfer pricing position.¹¹¹ Not surprisingly, Inland Revenue's documentation requirements mirror the requirements contained in section 247(4).¹¹² The enactment of section 247 and the revision of Information Circular 87-2, therefore, suggests that Canada is making good its commitment to join the international community.¹¹³

IV. SECTION 247 OF THE INCOME TAX ACT

Section 247 contains three principle subsections that apply to transactions between a Canadian taxpayer and a nonresident person.¹¹⁴ First, under subsection 247(2), Revenue Canada is given the authority to adjust or recharacterize transactions it believes do not adhere to the arm's length principle or would not

108. See generally Kayfetz & Helzel, *supra* note 7, at 196 (discussing how nations use tax policy to support their goals).

109. See generally *Regulation Extends Its Reach*, *supra* note 105 (noting that while the political rhetoric claiming that billions of dollars are lost to transfer pricing abuses is unsubstantiated, transfer pricing audits do produce larger returns than cost).

110. See *id.* (stating that Canada, Australia and Spain have updated their transfer pricing laws to give their tax authorities a tough new weapon to combat transfer pricing abuses).

111. See INLAND REVENUE, TRANSFER PRICING DRAFT GUIDELINES: A GUIDE TO THE APPLICATION OF SECTION GD 13 OF NEW ZEALAND'S INCOME TAX ACT OF 1994, IRD TAX INFORMATION BULLETIN: VOL. 9, NO. 10 (Oct. 1997) Appendix ¶¶ 259-369. Currently, no statutory requirement exists in New Zealand that taxpayers prepare and maintain transfer pricing documentation. *Id.* However, Inland Revenue clearly believes that it is in the best interest of a taxpayer to adequately document their transfer pricing transactions in accordance with the new guidelines and the 1995 OECD report. *Id.* This is sage advice considering that if Inland Revenue makes a transfer pricing adjustment it will evaluate the taxpayer's documentation as a factor in determining whether to assess a penalty. *Id.*

112. See Income Tax Act, R.S.C., § 247(4)(a)(i)-(vi) (1998) (Can.).

113. See generally Schwinn, *supra* note 46 (quoting the director of Revenue Canada as stating that § 247 is Canada's means of "joining the international community" with respect to transfer pricing rules).

114. Section 247 contains eleven subsections relating to transfer pricing. The three principle subsections relate to the arm's length principle, a penalty and the contemporaneous documentation requirements. See Income Tax Act, R.S.C., § 247(2) (1998) (Can.) (relating to the arm's length principle); Income Tax Act, R.S.C., § 247(3) (1998) (Can.) (pertaining to the transfer pricing penalty); Income Tax Act, R.S.C., § 247(4) (1998) (Can.) (describing the contemporaneous documentation requirements).

have been entered into by arm's length parties except to obtain a "tax benefit."¹¹⁵ This provision will apply to all transactions between related parties.¹¹⁶ Following the adjustment and recharacterization provision is a ten percent penalty provision that will apply to Canadian taxpayers that fail to make reasonable efforts to practice arm's length pricing.¹¹⁷ In the event a taxpayer fails to satisfy the documentation requirements in subsection 247(4), the last major subsection, the taxpayer is deemed to not have made reasonable efforts to satisfy the penalty provision.¹¹⁸

A. The Arm's Length Principle

Prior to the enactment of section 247(2), the arm's length principle was contained in the simply worded provisions of subsections 69(2) and 69(3).¹¹⁹ As embodied in these two subsections, the arm's length principle required that the cross-border transactions between related or associated persons be the same as prices in similar transactions between parties that are not related.¹²⁰ This definition was patterned on the internationally recognized authoritative statement of the arm's length principle contained in paragraph 1, of article 9, of the OECD model treaty.¹²¹ Canada's incorporation of the arm's length principle contained in the OECD model treaty, which is founded upon the separate entity approach,¹²² is based on the soundness of this principle and the fact that it provides taxation authorities with the best approximation of the workings of the open market when goods and services are shipped across international borders between related parties.¹²³ More important, Revenue Canada has found the arm's length principle to be workable and produce results that are acceptable, even though the transfer pricing methods may not always apply in a straightforward manner.¹²⁴

While section 247 replaces subsections 69(2) and 69(3), it does not fundamentally change Canada's position with respect to the dominate role that the arm's

115. See Income Tax Act, R.S.C., § 247(2)(a)-(b) (1998) (Can.). A "tax benefit" is defined in § 247(1) to mean "a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act."

116. See *id.* §§ 247(2) and 247(6).

117. See *id.* § 247(3). See generally Shapiro & Dodge, *supra* note 99 (stating the new Canadian penalty is potentially much more severe than the U.S. penalty because the Canadian penalty applies to the whole transfer pricing adjustment and not just the additional tax imposed like the U.S. penalty).

118. See Income Tax Act, R.S.C., § 247(3) (1998) (Can.).

119. See Income Tax Act § 69(2)-(3) (1985) (Can.) (*repealed*).

120. See *id.* § 69.

121. Organization for Economic Cooperation and Development, *Model Tax Convention on Income and on Capital*, ¶ 1 Article 9, Committee on Fiscal Affairs Report (Paris: OECD 1977) (loose leaf).

122. See 1995 OECD report, *supra* note 2, at ¶ 1.6 (noting because the arm's length principle seeks to replicate the terms and conditions of transactions between associated enterprises and independent enterprises, the members of a MNE must be treated as independent entities for such comparisons to be useful).

123. *Id.* at ¶ 1.13.

124. See generally TM III, *supra* note 19 (asserting that applying the transfer pricing methods is not an exact science).

length principle has played in the evaluation of international transfer pricing.¹²⁵ The arm's length principle remains the foundation of Canada's transfer pricing scheme.¹²⁶ However, subsection 247(2) expands the arm's length principle to improve compliance for associated enterprises that enter into arm's length transactions for purely tax purposes.¹²⁷ Giving Revenue Canada the power to disregard and restructure an arm's length transaction entered into for purely tax purposes goes beyond the arm's length principle contemplated in the 1995 OECD report because restructuring a legitimate business transaction is an arbitrary exercise.¹²⁸ Nevertheless, because Canada's new transfer pricing rules are based on individual transactions, and specific methods for determining whether those transactions meet the arm's length standard, MNEs will find the new rules a difference in degree and not a difference in kind from Canada's old transfer pricing rules.¹²⁹ However, one change that MNEs will find different is the power granted to Revenue Canada to recharacterize transactions.¹³⁰

1. Adjustment and Recharacterization

As already stated, subsection 247(2) embodies the arm's length principle.¹³¹ This subsection gives Revenue Canada the authority to adjust both the quantum and the nature of amounts in two situations. First, where transactions between related parties do not reflect the terms and conditions that would have arisen between persons dealing at arm's length, Revenue Canada is given the authority to make transfer pricing adjustments to reflect those amounts that would have been determined had the transactions been carried out between arm's length persons.¹³² Put another way, if the terms and conditions of cross-border transactions between related parties are found to differ from those that would have been found between independent enterprises in comparable transactions and comparable circumstances, Revenue Canada can adjust the associated enterprise's tax liabilities.¹³³ While this provision may at first glance appear more onerous than the previous provision, which stated that the transfer prices be "reasonable in the circumstances,"¹³⁴ this

125. See Press Release 97-076, *supra* note 11 (stating the arm's length principle remains in tact).

126. See generally Wilkie, *supra* note 61 (noting that the thrust behind § 247 is to preserve Canada's substantial adherence to the arm's length principle).

127. See Income Tax Act, R.S.C., § 247(2)(b)(I)-(ii) (1998) (Can.).

128. See *id.* § 247(2). It will be up to Revenue Canada to determine whether a transaction entered into by an associated enterprise would not have been entered into by persons dealing at arm's length, and whether the sole reason for entering into the transaction was to obtain a tax benefit. *Id.*

129. See generally Wilkie, *supra* note 61 (describing Canada's new transfer pricing rules as evolutionary rather than revolutionary).

130. See Income Tax Act, R.S.C., § 247(2)(b) (1998) (Can.).

131. *Id.* § 247(2).

132. *Id.* § 247(2)(a).

133. See Draft Information Circular 87-2R, *supra* note 19, at ¶ 14.

134. Income Tax Act, R.S.C. § 69 (1985) (Can.).

new provision will not fundamentally change the way Revenue Canada has applied the arm's length principle.¹³⁵ In fact, this provision is the quintessential interpretation of the arm's length standard recognized by OECD member countries.¹³⁶

Much more controversial is the second rule in subsection 247(2) that gives Revenue Canada the authority to recharacterize or disregard transactions that would not have been entered into between persons dealing at arm's length.¹³⁷ In the draft legislation, Revenue Canada was given broad power to ignore or recharacterize any transactions, which in its view, would not have been entered into between persons dealing at arm's length.¹³⁸ This powerful tool for attacking transfer pricing transactions was too much for the tax community to endure because it vested Revenue Canada with too much power.¹³⁹ After receiving significant criticism from the tax community, the Department of Finance revised this provision and narrowed the power to recharacterize the nature of a transaction.¹⁴⁰ Now for a transaction to be recharacterized, it must be shown that the transaction entered into would not have been entered into between persons dealing at arm's length, and that the transaction can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit.¹⁴¹

It follows from the foregoing that where an associated enterprise enters into a transaction that would not normally be entered into between independent enterprises, the transaction will not be recharacterized where the primary purpose of the transaction is not to obtain a tax benefit.¹⁴² Therefore, associated enterprises need to structure their transactions in a business fashion regardless of their intent.¹⁴³ However, if the non-arm's length parties are not careful, the transaction may still be subject to a transfer pricing adjustment in the event the transaction does not reflect the terms and conditions that would have arisen between persons dealing at arm's length.¹⁴⁴ Because transfer pricing adjustments can be costly, it would be wise

135. See generally Wilkie, *supra* note 61 (asserting the arm's length principle will remain central to Revenue Canada's evaluation of international transfer pricing).

136. See 1995 OECD report, *supra* note 2, at ¶¶ 1.2-1.3 (defining how OECD member countries interpret the arm's length principle).

137. Income Tax Act, R.S.C., § 247(2)(b) (1998) (Can.).

138. Department of Finance Canada, *Draft Legislation of Transfer Pricing*, Sept. 11, 1997, §247(2)(b) (giving Revenue Canada the power to recharacterize a transaction that would not have been entered into between persons dealing at arm's length).

139. See Francois Vincent, *Canadian Transfer Pricing: Finance Makes Changes But Cedes Little Ground*, 97 TAX NOTES INT'L 250-10, available in LEXIS, Taxana Library, TNI File.

140. Compare Income Tax Act, R.S.C., § 247(2)(b) (1998) (Can.), with Department of Finance, *supra* note 138. Subparagraph § 247(2)(b)(ii) was added to the final legislation to narrow the power of Revenue Canada to recharacterize transactions.

141. See Income Tax Act, R.S.C., § 247(2)(b) (1998) (Can.).

142. See *id.* § 247(2)(b)(ii).

143. See generally Vincent, *supra* note 139 (noting that transactions with a bona fide business purpose should not be subject to recharacterization by the Canadian tax authorities).

144. See Income Tax Act, R.S.C., § 247(2)(a) (1998) (Can.).

for tax practitioners to carefully evaluate each transaction or series of transactions separately to ensure the arm's length principle is satisfied.¹⁴⁵

Tax practitioners will need to consult Information Circular 87-2R and the 1995 OECD report to understand what terms and conditions will be considered at arm's length.¹⁴⁶ Because Information Circular 87-2R simply lists the factors determining comparability, and does not elaborate on criteria to be used to establish whether a transaction would not have been entered into between persons dealing at arm's length, it would be wise for tax practitioners to consult Chapter 1 of the 1995 OECD report.¹⁴⁷ Chapter 1 of the OECD report establishes the guidelines for applying the arm's length principle and discusses the attributes of the transactions or enterprises that affect conditions in arm's length dealings.¹⁴⁸ As recognized in Information Circular 87-2R, the attributes that must be considered are the functions performed by the parties, the economic circumstances of the parties, business strategies, the property or services transferred and the contractual terms of a transaction.¹⁴⁹

2. *At the Minister's Discretion*

Another interesting feature of the new rules relating to adjustments is contained in subsection 247(10).¹⁵⁰ Under this subsection, Revenue Canada is given the discretion not to impose transfer pricing adjustments that would result in a decrease in a taxpayer's taxable income.¹⁵¹ This gives the Minister a great deal of latitude because he has the option to only positively adjust a taxpayer's income.¹⁵² While this provision may be unfortunate for Canadian taxpayers that over-report their transfer pricing income, it is consistent with Canada's old transfer pricing laws and the "associated enterprises" articles of Canadian tax treaties.¹⁵³ Nevertheless,

145. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 17.

146. *Id.* at ¶ 15 (directing taxpayers to reviewing paragraphs 1.19 through 1.35 of the 1995 OECD report to determine the factors that may influence the degree of comparability of transactions).

147. See 1995 OECD report, *supra* note 2, at ¶¶ 1.1-1.70.

148. *Id.* at ¶¶ 1.19-1.35.

149. See *Draft Information Circular 87-2R*, *supra* note 19 ¶¶ 15-17; see also 1995 OECD report, *supra* note 2, at ¶¶ 1.19-1.35 (outlining the factors OECD member countries should use for determining comparability between controlled and uncontrolled transactions).

150. See generally Wilkie, *supra* note 61 (discussing § 247(10) as provided in the draft legislation issued on Sept. 11, 1997).

151. Income Tax Act, R.S.C., § 247(10) (1998) (Can.) (stating "[a]n adjustment (other than an adjustment that results in or increases a transfer pricing capital adjustment or a transfer pricing income adjustment of a taxpayer for a taxation year) shall be not be made under [§ 247(2)] unless, in the opinion of the Minister, the circumstances are such that it would be appropriate that the adjustment be made").

152. See generally Vincent, *supra* note 139 (describing under what circumstances the Canadian tax authorities can recharacterize a transfer pricing transaction).

153. See generally Wilkie, *supra* note 61 (stating the discretion accorded the Minister in § 247(10) is unjust with respect to the primary income tax computation).

allowing Revenue Canada the unfettered discretion not to make a downward adjustment to a taxpayer's taxable income has broad implications for taxpayers.¹⁵⁴

To illustrate the inequity section 247(10) poses to taxpayers, assume two associated enterprises, one in Canada and the other in Australian, undertake a transaction by which the Australian company charges the Canadian company a transfer price that is less than a comparable transaction undertaken between independent enterprises. In this situation, because an upward adjustment would decrease the Canadian company's income, Revenue Canada, under section 247(10), has the option not to make the adjustment.¹⁵⁵ Since granting an upward adjustment is wholly within the discretion of Revenue Canada, the overpayment will be considered part of the Canadian company's income and may be subject to penalty.¹⁵⁶ However, in a show of compassion, Revenue Canada is willing to consider yielding its discretion under section 247(10) should the Australian tax authorities make a downward adjustment in the Australian company's transfer pricing, and the Canadian company seeks relief under the competent authority procedure.¹⁵⁷

B. Arm's Length Methods

Although subsection 247(2) endorses the arm's length principle, it leaves to Information Circular 87-2R the task of elaborating what Revenue Canada's position is with respect to interpreting and applying the arm's length principle.¹⁵⁸ Since Revenue Canada holds that the best way of determining whether the arm's length principle is satisfied is to compare the prices charged in a controlled transaction with prices charged in a comparable transaction between two unrelated parties, Canadian taxpayers are forced to evaluate all the information they have available and compare that information with each transfer pricing method to determine which method produces the most reliable measure of the arm's length principle.¹⁵⁹ Only if the transfer pricing method used by the taxpayer produces the most reliable measure of the arm's length principle will Revenue Canada be under any obligation to accept the outcome.¹⁶⁰ However, once a taxpayer selects a particular method that provides the highest degree of comparability between transactions, the taxpayer is relieved from having to make determinations under a lower-ranking method.¹⁶¹

154. *Id.*

155. Income Tax Act, R.S.C., § 247(2) (1998) (Can.).

156. *Id.* § 247(3).

157. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 96 (stating that one circumstance where the Minister may find it appropriate to exercise his discretion to make a downward adjustment is where a taxpayer is entitled to request or has requested relief from double taxation under the mutual agreements procedures of a tax treaty).

158. See *id.* at ¶ 22 (describing the acceptable transfer pricing methods endorsed by Revenue Canada).

159. *Id.* at ¶ 23.

160. *Id.* at ¶ 27.

161. *Id.* at ¶ 26.

Information Circular 87-2R makes clear that the acceptable transfer pricing methods¹⁶² for determining an arm's length price or allocation are those outlined in the 1995 OECD report.¹⁶³ Although the discussion of the transfer pricing methods in the circular is relatively brief, and is intended to merely summarize the 1995 OECD report's discussion of transfer pricing methods, the circular strongly recommends that taxpayers choose the transfer pricing method that provides the highest degree of comparability that is appropriate under the facts and circumstances of the transaction.¹⁶⁴ Since finding transactions between independent enterprises that are similar enough to the controlled transaction may be difficult for associated enterprises, the circular accepts all five of the OECD's transfer pricing methods.¹⁶⁵ However, tax practitioners should be cautioned that the circular, like the 1995 OECD report, expresses a clear preference for the traditional transactional methods¹⁶⁶ over the transaction profit methods.¹⁶⁷

1. Traditional Transaction Methods

Information Circular 87-2R endorses three traditional transaction methods that associated enterprises can employ to determine whether the terms and conditions of a controlled transaction are comparable between similar transaction undertaken by independent enterprises.¹⁶⁸ The OECD also endorses these three methods and they are the comparable uncontrolled price method (CUP), the resale method (RSM) and the cost plus method (CPM).¹⁶⁹ Of these three transfer pricing methods, Revenue Canada accepts the CUP method as the most direct approach for

162. See generally Wilkie, *supra* note 61 (recognizing transfer pricing methods as tools for determining whether the conditions imposed in the commercial or financial relations between associated enterprises are consistent with the arm's length principle).

163. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 21 (explaining that Revenue Canada relies on the transfer pricing methods in the 1995 OECD report).

164. *Id.* at ¶ 25 (stating that the CUP method provides the highest degree of comparability).

165. *Id.* at ¶ 22.

166. *Id.* at ¶¶ 28-36; see also 1995 OECD report, *supra* note 2, at ch. 2 (explaining the three traditional transaction methods: (1) the comparable uncontrolled price method (CUP), (2) the resale price method (RPM) and (3) the cost plus method (CPM)). The traditional transaction methods seek to compare the *prices* charged in controlled transactions among associated enterprises with prices charged in comparable transactions between independent enterprises. *Id.*

167. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶¶ 37-46 (discussing the profit split methods); see also 1995 OECD report, *supra* note 2, at ch. 3 (explaining that there are two transaction profit methods: (1) the profit split method (PSM), and (2) the transactional net margin method (TNMM)). The transactional profit methods seek to compare the *profits* that arise from controlled transactions among associated enterprises with profits that arise in comparable transactions between independent enterprises. *Id.*

168. *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 22(a).

169. See generally 1995 OECD report, *supra* note 2, at ch. 2 (discussing the traditional transaction methods).

determining whether a transaction between associated enterprises adheres to the arm's length principle.¹⁷⁰

a. *The Comparable Uncontrolled Price Method*

The CUP method simply compares the prices charged for services or property transferred between associated enterprises with prices charged for services or property transferred between independent enterprises.¹⁷¹ In any tax system that adheres to the arm's length principle, this is the preferred method for making transfer pricing adjustments because this method focuses on the product being transferred.¹⁷² Since the CUP method is concerned with the price of the product being transferred, any difference in prices between transactions undertaken by associated and independent enterprises indicates that the terms and conditions of the transaction undertaken between the associated enterprises will need to be adjusted to reflect the terms and conditions of the transaction undertaken between the independent enterprises.¹⁷³

In theory, comparing transactions between associated and independent enterprises is easy.¹⁷⁴ In practice, however, finding uncontrolled transactions that are similar enough to make meaningful comparisons is difficult.¹⁷⁵ For example, small differences in the quality of the goods transferred between controlled and uncontrolled transactions can upset the price being charged.¹⁷⁶ However, even where comparables do not exist, Revenue Canada can still make a transfer pricing adjustment under the CUP method. Information Circular 87-2R incorporates the 1995 OECD report's recommendations that, even without strict comparables, a transfer pricing adjustment using the CUP method is applicable where a reasonably accurate adjustment can be made to eliminate the differences between the controlled

170. *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 25; *see also* *Indalex v. The Queen* [1986] 86 D.T.C. 6039, 6047-48 (accepting the theory of comparables, but finding no comparables existed); *see generally* *Boidman, Indalex v. The Queen*, *supra* note 44, at 245-46 (discussing the *Indalex* Court's treatment of comparables).

171. 1995 OECD report, *supra* note 2, at ¶ 2.6.

172. *See* Frances M. Horner, *International Cooperation and Understanding: What's New About the OECD's Transfer Pricing Guidelines*, 13 TAX NOTES INT'L 1065, 1077 (1996); *see also* George N. Carlson et al., *The U.S. Final Transfer Pricing Regulations: The More Things Change, the More They Stay the Same*, 9 TAX NOTES INT'L 333, 336 (1994) (stating the comparable uncontrolled price method is recognized to yield the most reliable results if sufficient data are available).

173. *See* John E. O'Grady, *An Overview of the New Temporary Transfer Pricing Regulations*, 6 TAX NOTES INT'L 211, 218-19 (1994) (discussing the CUP method under the 1993 temporary transfer pricing laws of the United States).

174. *See* Carlson et al., *supra* note 172, at 335.

175. *See* *Indalex v. The Queen* [1986] 86 D.T.C. 6039, 6048 (determining a transaction was not comparable where a third party purchased a third of the volume purchased by Alcan).

176. *See* 1995 OECD report, *supra* note 2, at ¶ 2.8 (noting that it is difficult to find transactions between independent enterprises that are similar enough to controlled transactions such that no differences have a material effect on price).

and uncontrolled transactions.¹⁷⁷ Therefore, when establishing a transfer price, tax practitioners must be especially careful when comparing goods or services being transferred between non-arm's length parties.¹⁷⁸ Nonetheless, since comparable transactions are not always available, Revenue Canada adopts the RSM and CPM.¹⁷⁹

b. Resale and Cost Plus Methods

The RSM and CPM operate in the same manner as the CUP method.¹⁸⁰ The difference is that the RSM and CPM focus on the gross margins from controlled and uncontrolled transactions to determine whether the terms and conditions between associated enterprises meet the arm's length principle.¹⁸¹ For example, the RPM focuses on the price at which a product purchased between related parties is resold to an independent enterprise.¹⁸² This resell price is then reduced by an appropriate gross margin (resale price margin).¹⁸³ The resale price margin is determined by adding together the amounts the reseller would seek to cover its selling and other operating expenses, and in light of the functions performed, make an appropriate profit.¹⁸⁴ The remainder, after subtracting the gross margin, is an arm's length price for the original transaction between the associated enterprises.¹⁸⁵ In other words, the RPM tries to determine what amount from the resell price is required to fully compensate the reseller for the services performed.¹⁸⁶ What is left is the arm's length transfer price.¹⁸⁷

Similarly, the CPM is achieved by focusing on the costs incurred by the supplier of property or services in a controlled transaction.¹⁸⁸ Using this method, an

177. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 30 (stating transactions may serve as comparable where the differences can be measured on a reasonable basis and an appropriate adjustment can be made to eliminate the effects of those differences).

178. See generally Menyasz & Hirani, *supra* note 59 (noting that U.S. companies need to be careful in their transfer pricing planning and defense in light of § 247).

179. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 22 (listing the two groups of transfer pricing methods accepted by Revenue Canada).

180. See 1995 OECD report, *supra* note 2, at ¶¶ 2.14 and 2.32 (noting the RPM and the CPM seek to compare the prices charged in controlled transactions with uncontrolled transactions).

181. See BLACK'S LAW DICTIONARY 703 (6th ed. 1990) (defining "gross margin" as the difference between the amount of sales after returns, allowances, and the cost of goods sold).

182. See Marc M. Levey & Lawrence W. Shapiro, *OECD Transfer Pricing Avoids Overpapering the Best Method*, 6 J. INT'L TAX'N 52, 55-56 (1995) (discussing how the RSM is most useful when it is applied to marketing operations).

183. See Diane Hay et al., *Past and Present Work in the OECD on Transfer Pricing and Selected Issues*, 9 TAX NOTES INT'L 249, 258 (1994).

184. 1995 OECD report, *supra* note 2, at ¶ 2.14 (describing how OECD member countries should calculate the RSM).

185. *Id.*

186. See INLAND REVENUE, *supra* note 111, at ¶ 79 (discussing the RSM from the economics approach).

187. *Id.*

188. 1995 OECD report, *supra* note 2, at ¶ 2.32 (explaining how the CPM should be applied by OECD member countries).

appropriate gross margin (cost plus markup) is added to the costs incurred by the supplier in a controlled transaction.¹⁸⁹ To put it differently, the CPM seeks to determine what amount over the supplier's cost needs to be added to the product to give the supplier an appropriate profit in light of the functions performed and the market conditions.¹⁹⁰

Accordingly, the same approach for determining comparability using the CUP method is used for determining the RPM and the CPM.¹⁹¹ This means the resell price margin or cost plus markup in an uncontrolled transaction needs to be comparable to a controlled transaction.¹⁹² An uncontrolled transaction is comparable to a controlled transaction if one of two requirements is met. The first condition is that there must be no difference between the transactions being compared or between the enterprises undertaking those transactions that could materially affect the price, the resale price margin or the cost plus markup in the open market with respect to the particular method being employed.¹⁹³ Second, if there are material defects, reasonably accurate adjustments can be made to eliminate the material effects of such differences.¹⁹⁴ However, with respect to the RPM, comparability can be determined by comparing the resale price margin that the same seller earns on items purchased and sold in comparable uncontrolled transactions.¹⁹⁵ Similarly, comparability can be established by reference to the cost plus markup that the same supplier earns in comparable uncontrolled transactions.¹⁹⁶

To illustrate how Revenue Canada will apply the RPM and CPM, assume Company A, which is in Canada, purchases product X for C\$1,000 from related Company B, which is in Mexico. Company B manufactured product X for C\$850, and company A sold product X to Company C, an independent enterprise in Canada, for C\$1,400. Additionally, assume company A sold a product comparable to product X to company D, also an independent enterprise in Canadian, where the resell price margin was C\$250. Finally, assume two independent enterprises, company E, located in Canada, and company F, located in the U.S., entered into a transaction comparable to the transaction between A and B where the cost plus markup is C\$300.

Applying the above facts using the RPM, the arm's length price between Company A and B is C\$1,150. Since there is a comparable uncontrolled transaction

189. See Hay et al., *supra* note 183, at 258.

190. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 31 (stating how Revenue Canada will apply the CPM to a individual cross-border intercompany transaction).

191. See 1995 OECD report, *supra* note 2, at ¶¶ 1.15-1.35 (discussing the five factors for determining comparability). The five factors for determining comparability are: the characteristics of the property or services; functional analysis; contractual terms; economic circumstances; and business strategies. *Id.*

192. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶¶ 33 and 35.

193. 1995 OECD report, *supra* note 2, at ¶¶ 2.7, 2.16, 2.34 and 1.15-1.35.

194. *Id.* at ¶¶ 2.7, 2.16 and 2.34.

195. *Id.* at ¶ 2.15.

196. *Id.* at ¶ 2.33.

where the resell price margin is C\$250, the arm's length price is easy to calculate because all that must be done is subtract the comparable resell price margin (C\$250) from the resell price (C\$1,400).¹⁹⁷

Just as easy to determine is the arm's length price using CPM. Using the same facts with the CPM, the arm's length price between company A and B is also C\$1,150. This amount is reached by adding the cost incurred by the supplier (C\$850) and the comparable cost plus markup between companies E and F (C\$300).¹⁹⁸ Ideally, however, the cost plus markup should be determined by comparing the cost plus markup the supplier earns in controlled transactions with what the supplier earns in comparable uncontrolled transactions.¹⁹⁹

Obviously, one drawback to prioritizing the transfer pricing methods is where a taxpayer is unable to use the comparable uncontrolled price method. In this situation, the taxpayer must select at least the cost plus method and the resale price method and determine which one of these methods provides the highest degree of comparability because neither the 1995 OECD report nor Information Circular 87-2R prefers one method over the other.²⁰⁰ This is an important point to remember because if a taxpayer only prepares documentation for the cost plus method, and Revenue Canada later determines that the resale price method is more reflective of the arm's length principle, the taxpayer will be deemed not to have made reasonable efforts in determining an arm's length price.²⁰¹

2. Transactional Profit Methods

There are two transactional profit methods endorsed by Information Circular 87-2R and the 1995 OECD report.²⁰² These two methods are the profit split method (PSM) and the transactional net margin method (TNMM).²⁰³ In contrast to the traditional transaction methods that rely on comparability of prices, the PSM and TNMM examine the profits that arise from controlled transactions.²⁰⁴ Under the PSM and TNMM, the profits arising from controlled transactions are then compared with profits that would have been made by independent enterprises in comparable

197. See generally Shapiro & Dodge, *supra* note 99 (comparing the approach the United States and Canada take with respect to the resale price method).

198. *Id.* (discussing the approaches the United States and Canada take with respect to the cost plus method).

199. See 1995 OECD report, *supra* note 2, at ¶ 2.33 (discussing the two ways the cost plus mark up can be established).

200. See generally Levey & Shapiro, *supra* note 182, at 54-56 (stating although the RPM and CPM have equal stature, the 1995 OECD report does not prefer one method over the other).

201. See Income Tax Act, R.S.C., § 247(4) (1998) (Can.).

202. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 22(b) (listing the two transactional profit methods that are acceptable to Revenue Canada).

203. See Levey & Shapiro, *supra* note 182, at 56 (referring to the profit split method and transactional net margin method as the "other methods").

204. See 1995 OECD report, *supra* note 2, at ¶ 3.2 (discussing the two transactional profit methods).

circumstances.²⁰⁵ Information Circular 87-2R indicates Revenue Canada's reluctance to accept the PSM and TNMM.²⁰⁶ However, where a taxpayer relies on one of the transactional profit methods, the circular prefers the PSM to the TNMM.²⁰⁷ In all transfer pricing cases, therefore, Revenue Canada considers the TNMM as the method of last resort.²⁰⁸ Nevertheless, both profit methods are subordinate to all three of the traditional transaction methods, and should be used only in exceptional cases.²⁰⁹ An exceptional case exists where the practical difficulties of a business situation cause the traditional transaction methods to become unreliable or impossible to apply.²¹⁰

a. Profit Split Method

Under the PSM, associated enterprises seek to achieve the same profits independent enterprises would have expected to receive from a comparable transaction.²¹¹ This method is useful when transactions between associated enterprises are very interrelated and cannot be assessed on a separate basis.²¹² As applied, the PSM identifies and splits profits among associated enterprises based on what would have been anticipated and reflected in an agreement made at arm's length.²¹³ Since entering into transactions where profit is a condition in the transaction is unusual for independent enterprises, the contribution of each associated enterprise is heavily dependent upon a detailed analysis of the functions performed.²¹⁴ Ordinarily, the profits to be combined will be the operating profits.²¹⁵

Once the profits to be split among associated enterprises are identified, Information Circular 87-2R prefers a residual analysis over a contribution analysis or any other method for determining the division of profits.²¹⁶ A residual analysis is achieved by first allocating to each associated enterprise a basic return appropriate for the functions undertaken in the transaction.²¹⁷ This amount is reached by

205. *Id.*

206. *Draft Information Circular 87-2R, supra* note 19, at ¶ 23 (noting the transactional profit methods should only be used as methods of last resort).

207. *Id.* at ¶ 24.

208. *Id.* (stating Revenue Canada considers the TNMM as the method that should be used only when all the other transfer pricing methods are inapplicable).

209. *See generally* Wilkie, *supra* note 61 (noting Revenue Canada will first try to determine whether a traditional transaction method will satisfy the arm's length principle).

210. *See* 1995 OECD report, *supra* note 2, at ¶ 3.1.

211. *Id.* at ¶ 3.2.

212. *See Draft Information Circular 87-2R, supra* note 19, at ¶ 37 (noting the PSM may be applied where the operations of two or more associated enterprises are highly integrated).

213. *See generally* Levey & Shapiro, *supra* note 182, at 56-57 (discussing the PSM).

214. *See Draft Information Circular 87-2R, supra* note 19, at ¶ 38 (explaining the first step in determining the total profits earned by parties from their integrated operations).

215. *See id.* at ¶ 37.

216. *See id.* at ¶ 40.

217. 1995 OECD report, *supra* note 2, at ¶ 3.19 (discussing how a residual analysis works).

comparing the returns established from comparable transaction undertaken by independent enterprises.²¹⁸ After the basic return has been allocated, the second step involves allocating the residual profits or losses between the associated enterprises.²¹⁹ This allocation is reached by analyzing the facts and circumstances surrounding the transaction to determine how the residual profits or losses would have been divided between independent enterprises.²²⁰

b. The Transactional Net Margin Method

The TNMM is determined by comparing the net profit margin in a transaction between associated enterprises with the net profit margin realized by independent enterprises from similar transactions.²²¹ As with the PSM, a functional analysis is required to determine whether controlled and uncontrolled transactions are comparable and what adjustments are necessary to obtain reliable results.²²² However, since the TNMM is applied to only one associated enterprise, it can produce absurd results.²²³ Many factors unrelated to transfer prices can affect net margins.²²⁴ For example, market share has a tremendous influence on a company's net profit margin.²²⁵ Where one company enjoys a sizeable advantage over its competitors, its transactions will be conducted in light of its competitive position. With respect to its competitive position in the market, all of the differences are likely to have a material effect on the profitability of the compared transactions.²²⁶

Because Revenue Canada takes the position that the TNMM should be used only as a method of last resort,²²⁷ tax practitioners would be wise to establish their transfer prices under one of the four methods mentioned above.²²⁸ By ordering the transfer pricing methods, Canada is sending a message to MNEs that it will not

218. See Hay et al., *supra* note 183, at 26.

219. See Levey & Shapiro, *supra* note 182, at 57 (explaining the two stages of a residual analysis).

220. 1995 OECD report, *supra* note 2, at ¶ 3.19.

221. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 41 (describing the TNMM and stating that the TNMM is only to be considered by taxpayers when the other recommended methods cannot be used or do not produce a reasonable estimate of an arm's length price or allocation).

222. See *id.* at ¶¶ 43-44 (discussing how Revenue Canada will apply the TNMM).

223. 1995 OECD report, *supra* note 2, at ¶ 3.31 (noting since many factors unrelated to transfer prices can affect net margins and can render the TNMM less reliable heightens the concerns over a one-sided analysis).

224. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 44 (recommending that taxpayers not rely solely on broad sources of industry profit data to try to satisfy the standards of comparability required to implement the TNMM).

225. See Hay et al., *supra* note 183, at 261.

226. See generally 1995 OECD report, *supra* note 2, at ¶¶ 1.31-1.35 (discussing why business strategies need to be considered in determining comparability for transfer pricing purposes).

227. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 24.

228. See Jack Bernstein, *Canada-U.S. Transfers of Technology: A Canadian Perspective*, 15 TAX NOTES INT'L 1693, 1701 (1997) (stating that taxpayers should ideally apply the CUP method in the transfers of technology between the U.S. and Canada).

accept the "best method" approach to setting arm's length prices.²²⁹ Under the current U.S. transfer pricing rules, MNEs are simply required to adopt the "best method" that provides the most reliable measure of the arm's length principle.²³⁰ In other words, the U.S. rules do not prioritize the methods but rather leave it up to the taxpayer to choose the best method under the facts and circumstances of the transaction.²³¹ As a result, U.S. MNEs preparing their transfer pricing documentation using the TNMM should be prepared to have their method challenged by Revenue Canada.²³²

As a practical matter, U.S. MNEs operating in Canada are forced to evaluate their transfer pricing data using both the U.S. and Canadian rules.²³³ While the methods are similar, a situation could arise where the IRS accepts one method and Revenue Canada accepts another.²³⁴ If Revenue Canada makes a downward adjustment, and the associated enterprise is unable to obtain a readjustment from Revenue Canada, the associated enterprise may have to seek relief by requesting competent authority assistance to avoid the possibility of double taxation.²³⁵ However, under this procedure there is no guarantee the taxpayer will avoid double taxation.²³⁶ The competent authority procedure is simply a mutual agreement between two countries that they will negotiate and attempt to resolve a dispute.²³⁷ Unfortunately the taxpayer does not get to participate in the competent authority negotiations, but is required to give the competent authorities all the information that is relevant for resolving the issue in a timely manner.²³⁸ Therefore, all MNEs operating in Canada should note that even if they determine the PSM or TNMM is appropriate, they must consider whether a traditional transaction method will produce the same results.²³⁹ A MNE that uses a transactional profit method when a traditional

229. See Treas. Reg. § 1.482-1(b)(1) (1994).

230. See generally Lester, *supra* note 41, at 292-94 (discussing the "best method" rule).

231. See Nolan, *supra* note 87, at 538-39 (noting that the U.S. does not apply a strict priority of methods, but does prefer the CUP method).

232. See Robert Turner, *Transfer Pricing Update—Canada's New Penalties and Paperwork*, 97 TAX NOTES INT'L 183-17 (Sept. 22, 1997), available in LEXIS, Taxana Library, TNI File (stating the bottom line for U.S. companies is that they can expect problems from Revenue Canada).

233. See Shapiro & Dodge, *supra* note 99.

234. See *id.*

235. See generally 1995 OECD report, *supra* note 2, at ch. IV(c) (discussing the mutual agreement procedure).

236. See Catherine Brown, *The U.S.-Canada Tax Treaty: Its Impact on Cross Border Transfer of Technology*, 9 TRANSNAT'L LAW. 79, 117 (1996) (stating there is no requirement that the competent authority procedure must resolve the dispute).

237. See generally Clark, *supra* note 63, at 1199-1200 (discussing the competent authority procedure in light of relief from double taxation).

238. See generally 1995 OECD report, *supra* note 2, at ¶¶ 4.57-4.59 (explaining the role the taxpayer can and must play when a taxpayer seeks relief under the competent authority procedure).

239. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 26 (requiring taxpayers to select the transfer pricing method that is the most appropriate to the particular facts and circumstances, and provides the highest degree of comparability).

transaction method can be employed will likely be exposed to a transfer pricing penalty.²⁴⁰

C. Penalty

Starting after 1998 Canada will impose a transfer pricing penalty on Canadian taxpayers that fail to make reasonable efforts to determine and employ an arm's length price or allocation.²⁴¹ The penalty will also be imposed on adjustments that are not qualifying cost contribution arrangements.²⁴² Because the penalty is imposed on the total adjustment, it poses a serious threat to MNEs carrying on large volumes of cross-border trade and could easily replace double taxation as the chief concern of MNEs operating in Canada.²⁴³ For instance, only where a MNE has made reasonable efforts to determine and use an arm's length price or allocation in connect with a transaction or series of transactions will a beneficial set-off be allowed.²⁴⁴ This means a taxpayer who enters into two or more cross-border transactions, in which a detrimental transfer pricing adjustment is made with respect to one or more of the transactions, will not be able to offset any beneficial adjustment against the detrimental adjustment unless the taxpayer has satisfied the arm's length principle with respect to the beneficial transfer pricing adjustment.²⁴⁵ Therefore, theoretically, an associated enterprise owing no taxes could still be subject to a transfer pricing penalty if the taxpayer fails to satisfy the arm's length principle with respect to any favorable proposed adjustment.²⁴⁶

1. Calculating the Penalty

While calculating the penalty is straightforward, the devil is in the details. Subsection 247(1) supplies no less than four definitions that are relevant for cal-

240. See Income Tax Act, R.S.C., § 247(3) (1998) (Can.).

241. See *id.* §§ 247(3) and 247(11)(3).

242. See *id.* § 247(1) (defining a qualifying cost contribution as an arrangement under which reasonable efforts are made by the participants in the arrangement to establish a basis for contributing to, and to contribute on that basis to, the cost of producing, developing or acquiring property, or acquiring or performing any services, in proportion to the benefits which each participant is reasonably expected to derive from the property or services, as the case may be, as a result of the arrangement); see also 1995 OECD report, *supra* note 2, at ¶ 8.3 (stating a cost contribution arrangement is used by business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights).

243. See Ernst & Young, *supra* note 45, at ¶ 30 (finding double tax relief is the single most important issue facing MNEs). The survey also found that 92% of Canadian respondents believe they will be subject to a transfer pricing examination during the next two years. *Id.* at ¶ 82.

244. See Income Tax Act, R.S.C., § 247(3)(a)(iii) (1998) (Can.).

245. See generally Vincent, *supra* note 139 (discussing the setoff mechanism in § 247).

246. *Id.*

culating a transfer pricing penalty under subsection 247(3).²⁴⁷ Anyone attempting to compute Canada's transfer pricing penalty can easily become lost in the definitional phrases since the definitions are themselves computations.²⁴⁸ Luckily, the burden falls on Revenue Canada to make the necessary computations for determining whether a penalty will apply to a given transaction or series of transactions. Unfortunately for Canadian taxpayers, the burden falls on them to justify their transfer pricing practices.²⁴⁹

The penalty provision imposes a flat ten percent penalty on the total of a taxpayer's "modified" transfer pricing capital adjustment and transfer pricing income adjustment²⁵⁰ for the taxable year where the "modified adjustment amount," exceeds the lesser of ten percent of the taxpayer's gross revenue for the year and US\$5,000,000.²⁵¹ The taxpayer's modified adjustment amount is reached by first computing the taxpayer's transfer pricing capital adjustment amount. Where the related transaction involved non-depreciable property or an eligible capital expenditure, this amount is determined by decreasing the taxpayer's cost of the non-depreciable property or eligible capital expenditure by three-quarters of the total adjustment amount.²⁵² However, where the property transferred is depreciable property, the transfer pricing capital adjustment amount is all of the reductions made under subsection 247(2) to the taxpayer's cost of the depreciable assets.²⁵³ If the taxpayer is a member of partnership, a second computation must be made.²⁵⁴

The computation for determining a member of a partnership's transfer pricing capital adjustment is similar to computing a non-partnership's transfer pricing capital adjustment. The only difference is that the partner's transfer pricing capital adjustment is based on the partner's share of income or loss of the partnership for the period that is the total income or loss of the partnership for the period.²⁵⁵ For example, assume a Canadian taxpayer is a member of a partnership that purchases

247. See Income Tax Act, R.S.C., § 247(1) (1998) (Can.) (setting forth the four principle definitions which are: (1) transfer pricing capital adjustment, (2) transfer pricing income adjustment, (3) transfer pricing capital setoff adjustment and (4) transfer pricing income setoff adjustment).

248. See generally *id.* (defining transfer pricing capital adjustment).

249. See Borraccia, *supra* note 77, at 467-68 (stating that in a transfer pricing dispute, the Minister's facts are assumed correct and the burden is on the taxpayer to rebut this assumption at the time of the assessment).

250. See generally Income Tax Act, R.S.C., § 247(3) (1998) (Can.). The "modified" transfer pricing capital adjustment and transfer pricing income adjustment, or simply the "modified adjustment amount," is determined by subtracting from the total of the transfer pricing capital adjustment and the transfer pricing income adjustment any portion of such adjustments that relate to a transaction where the taxpayer has made reasonable efforts to determine an arm's length price or that relate to a qualifying cost contribution arrangement. *Id.* In addition, any transfer pricing capital setoff adjustment or transfer pricing income setoff adjustment that relates to a qualifying cost contribution, or where the taxpayer has made reasonable efforts, is subtracted from the total of the transfer pricing capital and income adjustment. *Id.*

251. See *id.*

252. See *id.* (defining transfer pricing capital adjustment at (a)(i)).

253. See *id.* (defining transfer pricing capital adjustment at (a)(ii)).

254. See *id.* (defining transfer pricing capital adjustment at (b)).

255. See *id.* (defining transfer pricing capital adjustment at (iii)-(iv)).

a non-depreciable asset in a cross-border transaction with an associate enterprise. If Revenue Canada makes a downward adjustment to this asset, then the partner's transfer pricing adjustment is equal to the partner's portion of three-fourths of the total downward adjustment.²⁵⁶ With one exception, the same rule applies where the asset is depreciable. Where the asset is depreciable, the partner's transfer pricing capital adjustment is equal to the full amount of the partner's share of the downward adjustment.²⁵⁷ However, where the income and loss of the partnership is zero, the partnership is deemed to have US\$1,000,000 in income for determining the taxpayer's share of the partnership's income.²⁵⁸

The second determination that must be made to reach a taxpayer's modified adjustment amount is to calculate the taxpayer's transfer pricing income adjustment.²⁵⁹ This figure is obtained by adding all amounts by which the taxpayer's income would increase for the year or all amounts by which a loss for a year would decrease, assuming the decrease was the only adjustment made under subsection 247(2).²⁶⁰ After this figure has been determined, the next step is to add the taxpayer's transfer pricing capital and income adjustments.²⁶¹ Once this amount is determined it is reduced to the extent that the taxpayer's transfer pricing capital and income adjustments can reasonably be characterized as relating to a qualifying cost contribution arrangement or by the amount of any adjustment relating to a transaction for which the taxpayer has made a reasonable attempt to determine an arm's length price or allocation.²⁶²

Finally, to reach the modified adjustment amount, the total of a taxpayer's transfer pricing capital and income adjustments are further reduced by the total of a taxpayer's transfer pricing capital set-off adjustment²⁶³ and transfer pricing income set-off adjustment.²⁶⁴ These two amounts are subtracted from the total of the taxpayer's transfer pricing capital and income adjustments that can reasonably relate to a qualifying cost contribution arrangement or by the amount of any adjustment relating to a transaction for which the taxpayer has made a reasonable attempt to determine an arm's length price or allocation.²⁶⁵ As the last sentence affirms, a set-off will only apply to a beneficial adjustment where the taxpayer has made reasonable efforts to determine and use an arm's length price or allocation.²⁶⁶

256. See Income Tax Act, R.S.C., § 247(1) (1998) (Can.) (defining transfer pricing capital adjustment at (b)(i)).

257. See *id.* (defining transfer pricing capital adjustment at (b)(ii)).

258. See *id.* (defining transfer pricing capital adjustment at (iv)).

259. *Id.*

260. See *id.* (defining transfer pricing income adjustment).

261. *Id.* § 247(3)(a)(i)(A)-(B).

262. See Income Tax Act, R.S.C., § 247(3)(ii) (1998) (Can.).

263. See *id.* § 247(1) (defining transfer pricing capital setoff adjustment).

264. See *id.* (defining transfer pricing income setoff adjustment).

265. *Id.* § 247(3)(iii).

266. See generally Vincent, *supra* note 139 (discussing how Revenue Canada will apply the setoff mechanism in §247).

For a simple illustration of how Revenue Canada will apply the penalty, assume a Canadian subsidiary of a Chinese MNE, with gross revenue of US\$60 million for the taxable year 2001, enters into four transactions (A, B, C and D) with the parent in 2001. Transactions A and B are purchases of depreciable assets made for US\$10 and US\$5 million, respectfully, in which Revenue Canada makes a downward adjustment of US\$5 million and US\$3 million. Transaction C is a qualified contribution arrangement where Revenue Canada makes a downward adjustment of US\$2 million, and transaction D is a non-depreciable asset purchased for US\$6 million in which Revenue Canada makes a US\$2 million beneficial adjustment.²⁶⁷ Further assume that the taxpayer did not properly document transactions A and B. Moreover, transaction D was determined under the profit split method and Revenue Canada later found the cost plus method to provide a higher degree of comparability. Using these facts, Table 1 shows that the taxpayer is liable for a transfer pricing penalty equal to US\$1 million.

Table 1	Transfer Pricing Penalty Calculation				
Transactions	A	B	C	D	
Proposed Downward Adjustment	\$5,000,000	\$3,000,000	\$2,000,000		Total Proposed Adjustments \$12,000,000
Proposed Upward Adjustment				\$2,000,000	
Qualifying Cost Contribution Arrangement	n/a	n/a	(\$2,000,000)	n/a	(\$2,000,000)
Reasonable Efforts	\$0	\$0	\$0	\$0	\$0
Modified Adjustment Amount				\$10,000,000	
Compare Modified Adjustment to the Lesser of \$5,000,000 and 10 Percent of Gross Revenue: 10 Percent of \$60,000,000 Equals \$6,000,000.				\$5,000,000 Penalty Applies Because \$10,000,000 > \$5,000,000	
Penalty: \$10,000,000 multiplied by 10 Percent			Total Penalty: \$1,000,000		

267. Since transaction D is a non-depreciable asset, for purposes of Table 1, assume the \$2 million is three-fourths of the total transfer pricing adjustment.

2. Soundness of the Penalty Provision

It is important to recognize the ten percent penalty applies to the total of the modified adjustment amount and not just a percentage of the tax actually collected.²⁶⁸ The difference in the base to which the penalty applies dramatically increases the Canadian transfer pricing penalty over the U.S. penalty that applies to the additional tax imposed on the adjustment.²⁶⁹ Moreover, since beneficial set-offs can only be reduced where the taxpayer can show that reasonable efforts have been made to determine and use an arm's length price or allocation, and where the Revenue Minister considers a beneficial adjustment appropriate,²⁷⁰ the penalty could apply to Canadian companies or partnerships that have no income tax liability in Canada even after a transfer pricing adjustment.²⁷¹ Therefore, subsection 247(2) exceeds the U.S. penalty provision, considered by many to be the most onerous in the world.²⁷² Although an exodus from Canada by MNEs is not going to happen, the effect will be to restrict the competitiveness of MNEs operating in Canada.²⁷³

Furthermore, Canadian taxpayers are not able to deduct the interest assessed on the transfer pricing adjustment.²⁷⁴ This in effect increases the effective transfer pricing penalty over the U.S. transfer pricing penalty that allows taxpayers to deduct the interest produced by the penalty.²⁷⁵ For small and medium sized associated enterprises operating in Canada, interest payments will be a heavy burden to carry.²⁷⁶ When the penalty amount and the interest are added together, the actual Canadian penalty in a typical case is approximately seventy percent higher than the U.S. transfer pricing penalty amount.²⁷⁷ Clearly, Canada's sizeable transfer pricing penalty goes beyond the recommendations in the 1995 OECD report because the report discourages overly harsh penalties since such penalties lead to a form of non-compliance by intimidating associated enterprises into under-reporting income in

268. See generally Shapiro & Dodge, *supra* note 99, at 35-42 (comparing the U.S. transfer pricing penalty with the transfer pricing penalty in § 247).

269. See generally Nolan, *supra* note 87, at 547 (discussing the U.S. transfer pricing penalty and stating the U.S. penalty is based on the underpayment of tax due).

270. See Income Tax Act, R.S.C., § 247(10) (1998) (Can.).

271. See generally Wilkie, *supra* note 61 (noting the inequity inherent in the penalty provision).

272. See Kayfetz & Helzel, *supra* note 7, at 208 (asserting the U.S. transfer pricing penalties are the most severe of all countries).

273. See generally Menyasz & Hirani, *supra* note 59 (noting accounting firms have voiced concerns that tightening Canada's transfer pricing rules would affect the competitiveness of Canadian corporations).

274. See Shapiro & Dodge, *supra* note 99, at ¶ 38 (stating Canadian taxpayers are effectively subject to an additional penalty because neither the interest assessed on the transfer pricing adjustment nor the penalty paid are deductible for Canadian tax purposes).

275. See I.R.C. § 163 (1997).

276. See generally Menyasz & Hirani, *supra* note 59 (addressing the competitiveness of Canadian corporations in light of § 247).

277. Shapiro & Dodge, *supra* note 99, at ¶ 42.

other jurisdictions.²⁷⁸ The irony here is that Canada has taken a page out of the U.S. transfer pricing play book and is now the "great intimidator" of MNEs.²⁷⁹

3. Penalty Review Board

Canadian taxpayers receiving a reassessment as a result of a transfer pricing adjustment can seek relief from Revenue Canada by either filing a notice of objection or, if applicable, under the competent authority procedure.²⁸⁰ Where Canada has a bilateral tax treaty making the competent authority procedure available to taxpayers, this procedure should first be exhausted.²⁸¹ As a practical matter, the competent authority procedure is less costly than litigation and can produce the same results.²⁸² Moreover, if the Canadian taxpayer is a U.S. subsidiary, there is a good chance the dispute can be satisfactorily settled because the IRS and Revenue Canada have a good track record for resolving competent authority cases.²⁸³ However, in the event the competent authority procedure is not available, the taxpayer has no choice but to file a notice of objection and seek relief from the Appeals Branch of Revenue Canada, and ultimately, in the Canadian courts.²⁸⁴

While the competent authority procedure should first be pursued, a taxpayer receiving a reassessment should immediately file a notice of objection with Revenue Canada.²⁸⁵ This ensures that if the competent authorities are unable to reach a settlement or a fair settlement, the taxpayer can still seek relief from the Appeals Branch.²⁸⁶ Should the appeals board decide against a taxpayer, the next step would be for a taxpayer to file an appeal in the Canadian Tax Court.²⁸⁷ At this point it should be remembered that the taxpayer must carry the burden of proof.²⁸⁸ In

278. See 1995 OECD report, *supra* note 2, at ¶ 4.26 (encouraging OECD member countries not to enact overly harsh transfer pricing penalty systems).

279. See generally TM III, *supra* note 19 (stating Revenue Canada sees the United States fisc as an aggressor rather than a victim of transfer pricing abuses between U.S. based MNEs and Canadian subsidiaries).

280. See Kingissepp Part I, *supra* note 79, at 322-23 (noting the competent authority procedure when available should first be pursued).

281. *Id.*

282. See generally Tax Management Portfolios, *Transfer Pricing: Foreign Rules and Practice Outside of Europe*, 897 TM VII (1997) (stating in light of costs and delays associated with Canadian court proceedings, a Canadian taxpayer may seek relief from double taxation through the Canadian competent authority procedure).

283. *Id.*

284. See Andrew H. Kingissepp, *Strategies for Appealing Canadian Transfer Pricing Adjustments: Part II*, 6 J. INT'L TAX'N 353, 355 (1995) [hereinafter Kingissepp Part II] (discussing the strategic considerations a taxpayer must consider when appealing a transfer pricing assessment from Revenue Canada).

285. See Kingissepp Part I, *supra* note 79, at 326 (stating the notices of objections should comply in all material respects with Bill C-70 requirements).

286. See Tax Management Portfolios, *Transfer Pricing: Foreign Rules and Practice Outside of Europe*, 897 TM VI (1997) (noting where the Appeals Branch of Revenue Canada maintains an assessment, the taxpayer is entitled to bring an action in the Tax Court of Canada pursuant to § 169 of the Income Tax Act).

287. *Id.*

288. See Kingissepp Part II, *supra* note 284, at 355 (noting the taxpayer generally has the burden of disproving assumptions of fact made by the Minister or his officials at the time the reassessment was made).

cases where the dispute revolves around the transfer pricing method, the taxpayer must rely on expert witnesses to show Revenue Canada's price is inappropriate.²⁸⁹ Since choosing a transfer pricing method is not an exact science, the strength of a taxpayer's argument lies in the strength of the taxpayer's expert witnesses.²⁹⁰ In any event, a taxpayer and her tax practitioner must weigh important legal considerations when considering whether to navigate through the appeals process.

D. Contemporaneous Documentation

Taxpayer compliance in Canada is based on the self-assessment system.²⁹¹ When a taxpayer tries to take advantage of this system, and later becomes the focus of an audit, Revenue Canada requires that the taxpayer produce documents supporting the position taken.²⁹² With respect to transfer pricing documentation, Canadian taxpayers are now expected to go to great lengths to prepare or obtain written materials demonstrating that their transfer prices satisfy the arm's length principle.²⁹³ Canada requires associated enterprises to contemporaneously prepare a non-exclusive list of documents that readily demonstrate to Revenue Canada that the taxpayer is actively reviewing its transfer pricing practices and polices.²⁹⁴ The starting point for considering Canada's transfer pricing documentation requirements is subsection 247(4). This subsection is Revenue Canada's latest weapon for ensuring that taxpayers engaging in cross-border transactions with related parties document their transfer pricing transactions in accordance with the 1995 OECD report.²⁹⁵

289. See Borraccia, *supra* note 77, at 468 (stating Revenue Canada will attempt to support its assessment through cross-examination of the taxpayer's witnesses).

290. See Kingissepp Part II, *supra* note 284, at 358-59 (asserting if the taxpayer's transfer pricing case is likely headed for court, the strength of the taxpayer's case likely will depend heavily on the effectiveness of the taxpayer's experts). At a minimum, the taxpayer's expert should be very knowledgeable in that particular area, and be widely recognized as one of the leaders in the field. *Id.*

291. See Revenue Canada, Homepage (visited Feb. 12, 1998), <<http://www.re.gc.ca>> (noting each year Canada provides taxpayers with tax return forms). It is the responsibility of the taxpayer to secure the proper tax return form and properly prepare the form before returning it to Revenue Canada. *Id.* In fact, to help facilitate taxpayer compliance, Revenue Canada has made it possible for taxpayer to download tax return forms via the Internet. *Id.*

292. See generally Przynski & Mikhail, *supra* note 54, at 941 (discussing how the production of documents in a transfer pricing dispute helps Revenue Canada resolve the conflict).

293. See generally Tower, *supra* note 100 (listing the categories of documents that taxpayers must prepare to justify their transfer prices).

294. Income Tax Act, R.S.C., § 247(4)(a)(i)-(vi) (1998) (Can.).

295. See Press Release 97-076, *supra* note 11 (stating the proposed documentation requirements adhere to the 1995 OECD report).

1. Statutory Requirements

Subsection 247(4) requires MNEs to document their transfer pricing based on the arm's length principle with information available at the time of the determination.²⁹⁶ This type of documentation is commonly referred to as contemporaneous documentation because the taxpayer must gather and analyze all the information that is reasonably available at the time the transfer pricing transaction occurred.²⁹⁷ By requiring taxpayers to document their transfer pricing transactions contemporaneously, taxpayers must determine before the transaction is consummated whether their transfer pricing is appropriate for tax purposes.²⁹⁸ Under subsection 247(4), this means taxpayers must include in their documentation at least six different categories of information.

Chief among these requirements is the duty to prepare a functional analysis.²⁹⁹ A functional analysis seeks to identify the principal functions performed by each party by taking into account all the functions performed and risks undertaken by the parties to a transaction.³⁰⁰ Because a functional analysis is the starting point for many of Revenue Canada's transfer pricing audits,³⁰¹ requiring MNEs to prepare a functional analysis minimizes the use of hindsight and helps Revenue Canada properly assess whether the taxpayer's transfer pricing satisfies the arm's length principle.³⁰² This type of analysis is especially useful for determining a party's share in a cost contribution arrangement (CCA), because a functional analysis provides an auditor with an overall view of the transfer pricing transaction from the taxpayer's viewpoint.³⁰³ Since the value of each participant's contribution to a CCA is supposed to be equal to the benefit each party expects to derive from the arrangement, analyzing the functions and risks between the parties can determine to some extent the degree of allocation.³⁰⁴

296. *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 82.

297. *See* 1995 OECD report, *supra* note 2, at ¶ 1.6.

298. *See generally* Turner, *supra* note 232 (noting the significance of the contemporaneous documentation requirements).

299. Income Tax Act, R.S.C., § 247(4)(a)(vi) (1998) (Can.) (stating a description of "the functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction" must be prepared).

300. *See generally* 1995 OECD report, *supra* note 2, at ¶¶ 1.20-1.27 (discussing the purpose and function of a functional analysis).

301. *See Transfer Pricing: Canadian Auditors Seek U.S. Affiliate's Section 6662 Studies, Officials Say*, 1997 DAILY TAX REP. 51 d7 (1997), available in WL 1997 DTR 51 d7 (describing how Revenue Canada's auditors are seeking the functional analysis prepared by U.S. affiliates to help determine whether a Canadian taxpayer's transfer pricing adheres to the arm's length principle).

302. *See* Przysuski & Mikhail, *supra* note 54, at 941 (stating documentation in support of the CUP method needs to be based on information reasonably available at the time of the transfer price determination so as to preclude the use of hindsight).

303. *See* Income Tax Act, R.S.C., § 247(1) (1998) (Can.) (defining cost contribution arrangement).

304. *See Draft Information Circular 87-2R*, *supra* note 19, at ¶ 49 (discussing what must transpire for a CCA to satisfy the arm's length principle).

Along with a functional analysis, subsection 247(4) requires taxpayers to prepare a complete and accurate description of the terms and conditions of the transaction and how they relate to the terms and conditions of other transactions between the associated enterprises.³⁰⁵ This necessarily requires taxpayers to prepare documentation describing the property or services to which the transaction relates,³⁰⁶ to explain the identity of the parties, and to explain the parties' relationship at the time the transaction was entered into.³⁰⁷ Since these three requirements are common to all transfer pricing transactions, associated enterprises will find preparing this information routine.³⁰⁸ However, the documentation requirements do not end here. MNEs are also expected to prepare documents describing the data used to determine whether the transfer pricing method being employed satisfies the arm's length principle.³⁰⁹ This requires taxpayers to explain and defend why they chose to base their transfer prices on the particular information.³¹⁰ In preparing documentation to show how the transfer pricing method has been determined, tax practitioners need to analyze and consider fully each transfer pricing method and show that the method being used provides the highest degree of comparability between controlled and uncontrolled transactions.³¹¹ If a transactional profit method is used, this will be the taxpayer's best opportunity to persuade Revenue Canada that its transfer pricing method is consistent with transactional conditions in the open market.³¹² Therefore, since documentation is a taxpayer's first line of defense against a transfer pricing adjustment, a taxpayer should fully explain to Revenue Canada why their data is applicable to the method being used.

Finally, taxpayers must prepare documentation describing any assumptions or business strategies or policies that influenced the setting of prices.³¹³ Business strategies may include factors bearing upon a taxpayer's market position.³¹⁴ For example, a taxpayer seeking to increase its market share might temporarily charge an associated enterprise a price that is lower than the price charged for the same product in an uncontrolled transaction. The idea is that the current reduction will lead to higher profits in the future. Where this is the case, a taxpayer with a market

305. Income Tax Act, R.S.C., § 247(4)(a)(ii) (1998) (Can.).

306. *Id.* § 247(4)(a)(i).

307. *Id.* § 247(4)(a)(iii).

308. See 1995 OECD report, *supra* note 2, at ¶ 5.16 (stating there are certain features common to any transfer pricing inquiry).

309. Income Tax Act, R.S.C., § 247(4)(a)(v) (1998) (Can.).

310. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 82.

311. *Id.* at ¶ 25 (stating the CUP method will provide the highest degree of comparability than any of the other recommended methods).

312. See *generally id.* at ¶ 24 (stating Revenue Canada prefers the traditional transaction methods over the transactional profit methods).

313. Income Tax Act, R.S.C., § 247(4)(vi) (1998) (Can.).

314. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 16 (explaining business strategies are factors that can affect comparability, as they influence the price that arm's length parties would charge for a product).

penetration strategy needs fully to disclose this information to Revenue Canada.³¹⁵ If the business strategy is plausible and can be characterized as a transaction that an independent enterprise would accept, Revenue Canada is unlikely to make a downward adjustment.³¹⁶ However, failure to inform Revenue Canada of this strategy or satisfy any of the documentation requirements can lead to a penalty.³¹⁷

a. Reasonable Efforts

As an incentive for MNEs to take the contemporaneous documentation requirements seriously, subsection 247(4) is tied to the penalty provision in subsection 247(3).³¹⁸ A taxpayer is deemed to have failed to make reasonable efforts to determine and use an arm's length price or allocation unless the taxpayer satisfies the documentation requirements in subsection 247(4).³¹⁹ In other words, a taxpayer's transfer pricing income adjustment and transfer pricing capital adjustment will not be reduced for determining the penalty under subsection 247(3) unless the documentation requirements have been met.³²⁰ Similarly, unless the documentation requirements are met, the taxpayer's transfer pricing income set-off adjustment and transfer pricing capital set-off adjustment will not reduce the taxpayer's transfer pricing income and capital adjustments.³²¹ Therefore, even though the documentation requirements will increase a MNEs compliance burden, it is critical the taxpayer prepares enough documentation to meet the requirements of subsection 247(4).³²² However, a transfer pricing penalty can still be encountered where a taxpayer does not adhere to the reporting requirements.³²³

315. See generally 1995 OECD report, *supra* note 2, at ¶¶ 1.31-1.35 (discussing when business strategies can be taken into account when determining the comparability of controlled and uncontrolled transactions).

316. See generally Vincent, *supra* note 139 (stating if the transaction has a bona fide business purpose, the transaction is unlikely to be recharacterized).

317. See Income Tax Act, R.S.C., § 247(4)(a)(i)-(vi) (1998) (Can.) (requiring taxpayers to prepare a list of documents or fall victim to the penalty in § 247(3)).

318. *Id.* § 247(4).

319. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 78 (stating that whether a taxpayer has made reasonable efforts to determine and use arm's length prices or allocations is a question of fact). If a taxpayer takes all reasonable steps to ensure its transfer pricing is in conformity with the arm's length principle, then the taxpayer is deemed to have made reasonable efforts with respect to the penalty in § 247(3). *Id.* See generally Schwinn, *supra* note 46 (reporting that Revenue Canada considers applying a transfer pricing penalty where the taxpayer does not properly prepare documentation and utilized a transfer pricing method).

320. Income Tax Act, R.S.C., § 247(4) (1998) (Can.).

321. *Id.*

322. See Shapiro & Dodge, *supra* note 99, at ¶ 43 (asserting that Canadian taxpayers must develop a transfer pricing policy to have meaningful documentation).

323. Income Tax Act, R.S.C., § 247(4)(b) (1998) (Can.).

b. Reporting Requirements

The rule deeming a taxpayer not to have made a reasonable effort extends to two reporting requirements.³²⁴ First, a taxpayer is deemed not to have made reasonable efforts under subsection 247(4) unless the taxpayer has assembled all the required documents within the taxpayer's documentation-due date.³²⁵ In the case of a partnership, all the documentation must be compiled by the day on which a return is required to be filed by the partnership.³²⁶ All other taxpayers are required to assemble such documentation by the person's filing due date for the year.³²⁷ This means that even if a MNE has satisfied the arm's length principle with respect to a transfer pricing method, the MNE can still be deemed to have failed to meet the arm's length principle if all the documentation has not been timely compiled.³²⁸

Second, the deeming rule applies if a taxpayer fails to provide Revenue Canada the proper transfer pricing documents within three months of a written request.³²⁹ While this rule is easy to understand, MNEs should not assume that Revenue Canada will wait until the end of the year to make a document request.³³⁰ For example, assume a corporate taxpayer's tax return is due on December 31, 2001, and on February 1, 2001, the taxpayer purchases a fixed asset from an associated enterprise in New Zealand. Under subsection 247(4)(a) the taxpayer must have completed and prepared all transfer pricing documents by December 31, 2001, to avoid the deeming rule.³³¹ However, Revenue Canada could make a written request for documentation with respect to this transaction on March 1, 2001.³³² This would then require the taxpayer to obtain or prepare documents providing a complete and accurate description of the transaction to Revenue Canada by June 1, 2001. Therefore, because it takes time to compile and analyze transfer pricing information, documenting their transactions contemporaneously is important for MNEs.³³³

324. See generally Vincent, *supra* note 139 (discussing the reporting requirements).

325. See Income Tax Act, R.S.C., § 247(1) (1998) (Can.) (defining documentation-due date)

326. See *id.* (explaining that subsection (b) under documentation-due date states with respect to "a partnership, [the documents are due] the day on or before which a return is required by section 229 of the Income Tax Regulations...or would be required to be so filed if that section applied to the partnership").

327. See *id.* (defining documentation-due date at subsection (a)).

328. See generally *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 82 (explaining under what circumstances the deeming rule will apply).

329. See Income Tax Act, R.S.C., § 247(4)(c) (1998) (Can.).

330. See generally *Draft Information Circular 87-2R*, *supra* note 19, at ¶¶ 80-90 (implying there is no provision in § 247 that requires Revenue Canada to wait until the taxpayer's documentation-due date before making a written request for documents).

331. See Income Tax Act, R.S.C., § 247(4)(c) (1998) (Can.).

332. *Id.*

333. See generally Inland Revenue, *supra* note 111, at ¶¶ 290-301 (discussing the importance of determining transfer prices at the time the transaction is entered into).

2. Compliance Burden

The 1995 OECD report recommends that tax authorities take great care to balance the need for documents against the cost and administrative burden to taxpayers.³³⁴ Generally, this means that tax authorities should not expect taxpayers to prepare or obtain documents beyond the minimum needed to make a reasonable assessment of whether the taxpayer's transfer pricing satisfies the arm's length principle.³³⁵ While Information Circular 87-2R accepts this axiom,³³⁶ it is clear subsection 247(4) is heavily balanced in favor of Revenue Canada.³³⁷ Since the documentation requirements in subsection 247(4) are not merely guidance on what documents should be prepared or obtained, but a prescriptive list of documents that must be complete and accurate in all material respects,³³⁸ MNEs will have to expend substantial amounts of money to ensure their documents satisfy Revenue Canada.³³⁹

According to Information Circular 87-2R, taxpayers need to prepare or obtain documents in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of similar complexity and importance.³⁴⁰ Depending on the facts and circumstances of the transaction, this means that taxpayers may have to prepare documents beyond those listed in subsection 247(4).³⁴¹ While considering whether the prudent business management test is met, a prudent businessperson needs to balance compliance costs with the significance of the transaction to the taxpayer's business.³⁴² Where Revenue Canada determines a businessperson did not act like a prudent businessperson an adjustment is sure to follow. Permitting Revenue Canada to determine when a businessperson is acting like a businessperson is a burden that MNEs can

334. See 1995 OECD report, *supra* note 2, at ¶¶ 5.6-5.15 (cautioning tax administrations to ensure that taxpayers do not incur extraordinary expenses to secure documents).

335. *Id.* at ¶ 5.7 (stating the taxpayer should be expected to have prepared or obtained such documents only if they are indispensable for a reasonable assessment of whether the transfer pricing satisfies the arm's length principle and can be obtained or prepared by the taxpayer without a disproportionately high cost being incurred).

336. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 80 (stating the documents required to be obtained or prepared are those pursuant to principles of prudent business management).

337. See generally *Menyaszc & Hirani*, *supra* note 59 (quoting Steven Hannes, a partner with Fulbright & Jaworski in Washington, D.C., as stating that subsection 247(4) goes very far in requiring MNEs to reveal the underlying facts of their transactions).

338. Income Tax Act, R.S.C., § 247(4) (1998) (Can.).

339. See generally *O'Conner & Shapiro*, *supra* note 58 (stating documentation requirements are expected to significantly increase Canadian multinationals' compliance burden).

340. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 80; see generally *Wilkie*, *supra* note 61 (discussing the contemporaneous documentation requirements along with the prudent business management principle).

341. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 84 (asserting that the list of documents required to be prepared under § 247(4) is not intended to be an exhaustive list of documents necessary to substantiate that the taxpayer's transfer pricing is in accordance with the arm's length principle). The list in § 247(4) is also not exhaustive with respect to determining whether a taxpayer has made reasonable efforts to determine an arm's length price or allocation. *Id.*

342. *Id.* at ¶ 80.

scarcely afford.³⁴³ Accordingly, because professional fees for work on transfer pricing disputes with Revenue Canada can be enormous, MNEs should hire professionals to prepare their transfer pricing documentation to insure they have made reasonable efforts in preparing their documentation. Therefore, the only winners under subsection 247(4) are accountants, lawyers, valuation experts and other professionals.

One benefit of having professionals prepare documentation is that such actions will assist taxpayers in filing correct tax returns.³⁴⁴ This is an important point because Revenue Canada determines whether the taxpayer's transfer prices satisfy the arm's length principle even if the documentation is incomplete.³⁴⁵ Having professionals prepare documentation, therefore, is likely to save the business from a transfer pricing adjustment and penalty.³⁴⁶ This is especially true where the transaction between associated enterprises involves intangible property, intra-group services or a cost contribution arrangement.³⁴⁷

V. SPECIAL CONSIDERATIONS

Establishing transfer pricing in transactions involving intangible property, intra-group services and cost contribution arrangements raises several controversial transfer pricing issues.³⁴⁸ These types of transactions are highly complex and have special characteristics that complicate the search for comparables.³⁴⁹ Applying the arm's length principle to these transactions requires tax authorities and associated enterprises to gather and analyze complex sets of data that can only approximate the

343. See generally Toulou, *supra* note 57 (reporting tax experts consider § 247 as giving Revenue Canada a great deal of leeway in questioning pricing practices and business arrangements).

344. See 1995 OECD report, *supra* note 2, at ¶ 5.4.

345. See Przynski & Mikhail, *supra* note 54, at 941 (stating inadequate record keeping may give rise to a reassessment wherein doubt is resolved in favor of Revenue Canada).

346. See generally Ernst & Young, *Ernst & Young 1995 Transfer Pricing Documentation Survey*, 96 TAX NOTES TODAY 162-77 (Aug. 19, 1996), available in LEXIS, Taxana Library, TNT File (finding that 76% of the MNEs employing transfer pricing professionals were satisfied with their documentation). Of the MNEs surveyed, 62% utilized external economists/tax advisors. *Id.* Given the increased number of business units subject to § 247 and the amount of money at stake, it seems evident that the role transfer pricing professionals play will only increase. *Id.*

347. See Marc M. Levey & Lawrence W. Shapiro, *OECD Transfer Pricing Draft Targets Excessive Documentation*, 6 J. INT'L TAX 'N 244 (1995) (discussing the 1995 OECD's report's documentation on the transfer or intangible property, intra-group services and cost contribution arrangements).

348. See generally Donald Watkins & Robert Spindler, *Letter to Canada's Chief of International Taxation and Market Analysis from Joint Committee on Taxation of Canadian Bar Association and Canadian Institute of Chartered Accountants Concerning Part II of OECD Discussion Draft on Guidelines for Transfer Pricing*, 96 TAX NOTES INT'L 145-32 (Jul. 26, 1996), available in LEXIS, Taxana Library, TNI File (discussing the special considerations for intangible property, intra-group services and cost contribution arrangements from a Canadian perspective).

349. See 1995 OECD report, *supra* note 2, at ¶ 6.13 (discussing the application of the arm's length principle to the transfer of intangible property).

arm's length principle.³⁵⁰ In establishing arm's length pricing, therefore, the only solution is to have cooperation between tax authorities and MNEs.³⁵¹ No where is this truer than where the transaction involves the transfer of intangible property.³⁵²

A. Intangible Property

Information Circular 87-2R recognizes that there may be problems applying the arm's length principle to intangible property because of the difficulty and uncertainty encountered with attributing an arm's length value to such transfers.³⁵³ Since intangible property is often unique to a particular business and may have considerable value, but relatively no book value on the company's balance sheets, applying the CUP method to determine an arm's length price for the sale or licences of the intangible may not be possible because of the lack of comparable transactions.³⁵⁴ Nevertheless, where the same or comparable property has been sold or licensed to arm's length parties, or where the business controlling the intangible property has received genuine offers from independent enterprises for the intangible, Information Circular 87-2R recommends taxpayers use the CUP method to determine an arm's length price or allocation.³⁵⁵

In cases involving highly valuable or unique intangible property, the traditional transaction methods may be impossible to apply, and a taxpayer may have to resort to a transactional profit method.³⁵⁶ Where this situation arises, Information Circular 87-2R recommends that taxpayers employ the profit split method.³⁵⁷ When using the profit split method, taxpayers must remember that using hindsight in determining the value or expected profit to be received from the intangible property is not appropriate.³⁵⁸ Moreover, when valuing the intangible property, Information Circular 87-2R cautions taxpayers to pay close attention to the terms and conditions that independent enterprises would expect to protect their respective positions.³⁵⁹

350. See generally Watkins & Spindler, *supra* note 348 (recommending that Canada remain flexible with respect to applying the arm's length principle to transactions involving intangible property, intra group services and cost contribution arrangements).

351. *Id.* (maintaining cooperation between taxpayers and tax authorities is the only sensible means for resolving transfer pricing issues).

352. See Arnold & McDonnell, *supra* note 71, at 908 (stating that some of the most difficult transfer pricing problems relate to the pricing of transactions involving intangible property).

353. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 58 (asserting that transfers of intangible property raises specific issues associated with the difficulty of attributing an arm's length value to such transfers).

354. See Levey & Shapiro, *supra* note 347, at 245.

355. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 59.

356. See 1995 OECD report, *supra* note 2, at ¶¶ 6.28-6.35 (discussing the application of the arm's length principle when valuation is highly uncertain at the time of the transaction).

357. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 60.

358. See 1995 OECD report, *supra* note 2, at ¶ 2.33.

359. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 63; Marc M. Levey & Salvador M. Borraccia, *Draft Amendments to Canadian Transfer Pricing Rules Tighten Taxpayers' Compliance Burden*, 8 J. INT'L TAX 498 (1997), available in LEXIS, Lawrev Library, Allrev File (describing when a party would be expected to protect

For example, if the intangible property is highly valuable or unique, and cannot be easily valued, it is likely the independent enterprise selling or leasing the intangible property would insist upon a short term agreement and a price adjustment clause to protect its interests.³⁶⁰ Where these terms and conditions are missing from a controlled transaction, Revenue Canada will determine the value based on such factors.³⁶¹ Moreover, the value of the intangible property can have a bearing on establishing an arm's length price for intra-group services.³⁶²

B. Intra-Group Services

Intra-group services are often linked to arrangements for transferring intangible property.³⁶³ For example, an associated enterprise receiving an intangible under a know-how contract may need the contract to contain a service clause that requires the associated enterprise transferring the intangible to provide highly skilled personnel to assist in the commercial activity.³⁶⁴ Since under the arm's length principle it is necessary to determine whether the services performed are services for which a charge is justified, intangible property that is highly valuable or unique may require high service charges.³⁶⁵ However, where the intangible property is not unique and an independent entity can perform the service activity, Revenue Canada is more likely to scrutinize the intra-group service charge.³⁶⁶

After it is determined that an intra-group service charge is justified, the next step is to determine whether the amount charged is in accordance with the arm's length principle.³⁶⁷ This first requires identifying the amount being charged for the services. There are two methods for determining such a charge: (1) the direct charge

their interests under Information Circular 87-2R).

360. See 1995 OECD report, *supra* note 2, at ¶ 6.30 (discussing what measures an independent enterprise would likely take when anticipated benefits alone do not provide adequate protection against the risks posed by valuing intangible property).

361. See Income Tax Act, R.S.C., § 247(2)(a) (1998) (Can.) (allowing Revenue Canada to adjust the pricing of the amounts to the quantum or nature that would have been determined if the terms and conditions were those that would have been determined between persons dealing at arm's length).

362. See Carlson et al., *supra* note 172, at 344 (noting it may be appropriate to apply separate transfer pricing methods to services and property when they are provided together).

363. See Jack Bernstein, *Canada-U.S. Transfers of Technology: A Canadian Perspective*, 15 TAX NOTES INT'L 1693, 1699 (1997) (noting that it is common for service fees to be part of the transfer of technology).

364. See 1995 OECD report, *supra* note 2, at ¶ 7.3 (recognizing that intra-group arrangements for rendering services are sometimes linked to arrangements for transferring goods or intangible property).

365. See Levey & Shapiro, *supra* note 347, at 245 (stating applying the arm's length principle to controlled transactions involving the transfer of unique intangible property may be difficult because the associated enterprises might structure the transaction in a way that unrelated companies would not contemplate).

366. See generally Purdy & Zanchelli, *supra* note 46, at 398 (discussing Canada's stepped up scrutiny of management fees).

367. *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 68 (stating where a charge for services is justified, the amount charged should be in accordance with the arm's length principle).

method and (2) the indirect-charge method.³⁶⁸ Revenue Canada prefers the direct charge method because it allows the service performed and the basis for the payment to be clearly identified.³⁶⁹ Where, however, the same service has been performed for many non-arm's length parties and the service rendered cannot be directly attributable to each party, the indirect-charge method must be used.³⁷⁰ Once service charges have been identified, the last step is to employ a transfer pricing method.

In applying the arm's length principle to intra-group services, Information Circular 87-2R and the 1995 OECD report recommend the CUP method.³⁷¹ The CUP method is appropriate where comparable services are provided between independent enterprises or where the associated enterprise has provided the services to an independent enterprise in comparable circumstances.³⁷² Lacking comparables, the circular recommends that the CPM be considered.³⁷³ Only in exceptional cases, for example where the CUP and CPM cannot be applied, should a taxpayer rely on a transactional profit method.³⁷⁴

C. Cost Contribution Arrangements

Cost contribution arrangements present a special challenge to Revenue Canada and taxpayers because the traditional transfer pricing questions, i.e., the transfer of property or services, do not arise.³⁷⁵ The distinguishing feature between a CCA and ordinary intra-group transfers is that participants in a CCA make contributions to a joint activity where the compensation intended by the participants is the expected benefit to each from the pooling of resources and skills.³⁷⁶ Typically, these types of arrangements include research and development (R&D) arrangements and arrange-

368. See generally 1995 OECD report, *supra* note 2, at ¶¶ 7.19-7.28 (discussing the application of the direct and indirect-charge methods).

369. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 75 (noting Revenue Canada's preference of the direct charge method over the indirect charge method).

370. See *id.* at ¶ 76 (asserting where an indirect allocation is used, it should result in a charge that is comparable to that which independent enterprises would accept).

371. See generally Levey & Borraccia, *supra* note 359 (discussing how Information Circular 87-2R treats intra-group services).

372. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 69 (noting where a service is rendered by arm's length parties or the service provider renders the service for arm's length parties, the price charged in those circumstances is a good indication of the arm's length price).

373. *Id.* at ¶ 70.

374. See 1995 OECD report, *supra* note 2, at ¶ 3.1.

375. See Levey & Shapiro, *supra* note 347, at 247 (noting the complexity surrounding cost contribution arrangements).

376. See *OECD Summary of Revised Guidelines on Cost Contribution Arrangements*, 191 DAILY TAX REP. L-2 (1997), available in WL 191 DTR L-2 [hereinafter *OECD Summary*] (stating that a CCA is a contractual arrangement rather than necessarily a distinct juridical entity or permanent establishment of all the participants).

ments for the joint development of intangible property.³⁷⁷ In fact, a common type of CCA is an agreement for the R&D of intangible property.³⁷⁸

To apply the arm's length principle to a CCA, it is necessary to examine whether each participant expects benefits.³⁷⁹ Information Circular 87-2R maintains that only participants having a reasonable expectation of exploiting or using the results from the CCA can be considered participants.³⁸⁰ For example, the participants may choose to carry-out part of the CCA activity in a separate company. Even though this separate company may be a subsidiary of one participant, if this separate company only performs a service without any reasonable expectation to benefit from the results of the CCA, then the separate company is not a participant to the CCA.³⁸¹

Once the expectation of mutual benefit has been determined, the arm's length principle requires the calculation of each participant's contribution to the arrangement.³⁸² The value of each participant's contribution is determined by comparing what independent enterprises in comparable circumstances would assign to that contribution.³⁸³ Since the amount of each participant's contribution is unlikely to be determined in a straightforward manner, except where the contribution is made in cash, this determination must be resolved on a case-by-case basis.³⁸⁴ Where, however, the contribution is services or associated operating cost, Revenue Canada considers the arm's length value to be the cost to the provider.³⁸⁵ In the event a participant's contribution is not equal to the expected benefit, a balancing payment may be required to adjust the participants' proportionate share of contributions.³⁸⁶

377. See generally Turner, *supra* note 232 (stating that under § 247, a cost contribution arrangement applies to a broader range of activities and services, and not just the traditional shared development of new products and ideas); see also *OECD Releases Cost Contribution Arrangements Under Transfer Pricing Guidelines*, 97 TAX NOTES INT'L 190-20 (1997), available in LEXIS, Taxana Library, TNI File (asserting that cost contribution arrangements are most frequently used in the research and development area, but can also be used by business enterprises to share costs and risks of developing, producing or obtaining any assets, services or rights).

378. See generally *OECD Summary*, *supra* note 376 (noting that CCAs are not confined to the development of intangible property and include arrangements for the sharing of costs and risks for developing or acquiring other types of property and services).

379. See 1995 OECD report, *supra* note 2, at ¶ 8.10 (stating that a party may not be considered a participant if the party does not have a reasonable expectation that it will benefit from the CCA activity).

380. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 49 (stating that the expectation of mutual benefit is fundamental).

381. See Bernstein, *supra* note 228, at 1707 (discussing the requirement of reasonable expectation).

382. See Albertina M. Fernandez, *The Week In Review, October 6, 1997*, 97 TAX NOTES INT'L 193-11 (1997), available in LEXIS, Taxana Library, TNI File.

383. See 1995 OECD report, *supra* note 2, at ¶ 8.8 (discussing how to apply the arm's length principle in relation to a CCA).

384. See Levey & Shapiro, *supra* note 347, at 247-48 (noting the arm's length principle attempts to determine whether the allocation reflects the relative benefits inuring to the parties which is not very easy when the property is in-kind).

385. *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 50.

386. See generally *OECD Summary*, *supra* note 376 (stating a balancing payment should be treated as an addition to the costs of payer and as a reimbursement, and therefore a reduction, of costs to the recipient).

Finally, the arm's length principle requires a determination of whether the allocation is appropriate. This means it must be determined whether each participant's proportionate share of the overall contributions is consistent with the participant's proportionate share of the overall expected benefits.³⁸⁷ Since there is no universal rule to determine each participant's share of the benefits, Information Circular 87-2R supports the use of an allocation key as an indirect measure to estimate the additional income to be derived from the arrangement.³⁸⁸ The appropriateness of a particular allocation key will depend on the nature of the CCA activity and the relationship between the allocation key and the expected benefits.³⁸⁹ Moreover, to help Revenue Canada determine whether the allocation key and the CCA overall satisfy the arm's length principle, Information Circular 87-2R requires that taxpayers prepare additional documentation.³⁹⁰

The additional documentation requirements in Information Circular 87-2R relating to CCAs must be prepared or obtained in the same manner as the documents required to be prepared under subsection 247(4).³⁹¹ Among the list of documents concerning a CCA that must be prepared are the procedures for entering or withdrawing from the CCA and the policies and procedures governing balancing payments.³⁹² This requires a taxpayer to document any material changes to the CCA.³⁹³ While all these documentation requirements can be mind-numbing, one way a taxpayer can navigate through many of the highly technical transfer pricing rules is to enter into an Advanced Pricing Agreement (APA) with Revenue Canada.³⁹⁴

387. See 1995 OECD report, *supra* note 2, at ¶ 8.19 (discussing whether a participant's allocation is appropriate).

388. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶¶ 52-53 (discussing an allocation key which seeks to reflect the participants' proportionate shares of the expected benefits); see, e.g., 1995 OECD report, *supra* note 2, at ¶ 8.19 (stating the possibilities for allocation keys include sales, units used, produced, or sold, gross or operating profit, the number of employees, capital invested, and so forth).

389. See Levey & Shapiro, *supra* note 347, at 248 (stating that in a written cost contribution arrangement, the terms and conditions should be defined precisely and the participants should be able to demonstrate that the terms have been or will be carried out in practice).

390. See generally Levey & Borraccia, *supra* note 359 (listing the nine areas of documentation Information Circular 87-2R indicates taxpayers need to document for a cost contribution arrangement).

391. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 86 (stating the documentation requirements also apply to CCAs and must include additional information).

392. See *id.* (providing a list of nine areas CCA documentation must address).

393. *Id.* at ¶ 87.

394. See Ernst & Young, *supra* note 45, at 69 (finding 14% of respondents report having used an APA and 36% would consider using an APA in the future). The survey also discovered that Canadian and United States companies are most likely to utilize an APA in the future, with 57% and 50%, respectively, responding affirmatively. *Id.*

VI. ADVANCED PRICING AGREEMENTS

An APA is an agreement between the taxpayer and Revenue Canada to determine in advance the appropriate transfer pricing methodology, and how that methodology is to be applied to specific cross-border transactions between associated enterprises.³⁹⁵ The APA process in Canada has been in effect since 1993 and provides taxpayers with an alternative for resolving intercompany transfer pricing issues.³⁹⁶ Once a taxpayer and Revenue Canada enter into an APA, the APA is considered binding on both parties.³⁹⁷ If the taxpayer complies with the APA's terms, Revenue Canada considers the methodology being used to satisfy the arm's length principle.³⁹⁸ Therefore, the APA offers Canadian taxpayers the opportunity to resolve potential transfer pricing disputes while reaching an understanding with Revenue Canada that if the taxpayer adheres to the terms and conditions of the APA, the taxpayer's transfer pricing method will not be challenged.³⁹⁹ Considering the onerous penalty provision in subsection 247(3), taxpayers should find the APA very attractive.⁴⁰⁰

By using the APA process, taxpayers can reduce their chances of receiving a transfer pricing penalty.⁴⁰¹ For example, the penalty in subsection 247(3) applies when a taxpayer fails to use a transfer pricing method that provides the highest degree of comparability when compared to other methods.⁴⁰² When an APA exists between a taxpayer and Revenue Canada, the transfer pricing method will already be established. Therefore, assuming the taxpayer uses the method agreed upon in the APA, the taxpayer is considered to have satisfied the arm's length principle with

395. See Arnold & McDonnell, *supra* note 71, at 908.

396. See *Transfer Pricing: Revenue Canada Processing Multilateral APA Involving Five Tax Jurisdictions*, 1996 DAILY TAX REP. 97 d4 (1996), available in WL 1996 97 d4 (noting that as of March 1996, Canada's APA program had 35 pending APAs and up to seven finalized APAs).

397. See Brian J. Arnold, *Revenue Canada to Provide Advance Pricing Agreement Service*, 12 TAX NOTES INT'L 726, 727 (1993) (discussing the binding effect of the APA on Revenue Canada and the taxpayer).

398. See DEPARTMENT OF FINANCE CANADA, INTERNATIONAL TRANSFER PRICING: ADVANCED PRICING AGREEMENTS (APA), ¶ 3 (Information Circular 94-4, Dec. 30, 1994) [hereinafter ADVANCED PRICING AGREEMENTS]. This circular provides an overview of the advanced pricing agreement in Canada. *Id.* at ¶ 2. It illuminates the main features of the program and sets out the basic requirements taxpayers must meet to obtain an APA. *Id.*

399. See William Innes & Janice McCart, *Transfer-Pricing Disputes: Access to and Disclosure of Information*, 43 CAN. TAX J. 821, 859 (1995) (stating that APAs are, in effect, a mechanism to resolve transfer pricing disputes before they arise and a process in which extensive information may be produced).

400. See Steven Grodnitzky, *Revenue Canada Grapples with Transfer Pricing Comments*, 15 TAX NOTES INT'L 1836, 1837 (1997) (reporting in light of the new transfer pricing rules, Revenue Canada expects an increase in requests for APAs).

401. See Tax Management Portfolios, *Foreign Income Transfer Pricing: Alternative Practical Strategies Detailed Analysis*, III. Factors to Consider in Deciding Whether to Seek an APA, 890 TM III (1997) [hereinafter *Detailed Analysis*] (stating the primary benefit of seeking an APA is to obtain certainty of result with respect to a defined set of transactions).

402. See *Draft Information Circular 87-2R*, *supra* note 19, at ¶ 79 (stating Revenue Canada considers the making of reasonable efforts requires the application of a recommended method by the taxpayer).

respect to the methodology and no penalty will follow from applying the method.⁴⁰³ Moreover, since the method has been settled in advance, the taxpayer does not have to compare the methods to determine which method produces the highest degree of comparability.⁴⁰⁴ As imagined, this can substantially reduce the amount of data and analysis needed to meet the documentation requirements.⁴⁰⁵

Although taxpayers entering into APAs must still comply with the contemporaneous documentation requirements, the APA allows taxpayers to streamline their documentation.⁴⁰⁶ Since taxpayers must initiate the APA process, the burden is on the taxpayer to convince Revenue Canada to accept their APA proposal.⁴⁰⁷ To meet this burden taxpayers must prepare a detailed explanation and analysis of each method, and set out why the proposed method provides the most reliable measure of the arm's length principle.⁴⁰⁸ In other words, applying for an APA requires the taxpayer to meet the contemporaneous documentation requirements in subsection 247(4).⁴⁰⁹ Therefore, if Revenue Canada accepts the APA proposal, the taxpayer only has to focus on one transfer pricing method and will know what details and specific information Revenue Canada wants to satisfy the contemporaneous documentation requirements.⁴¹⁰

Given the breadth of section 247, taxpayers with high amounts of cross-border intercompany trade may want to seek an APA.⁴¹¹ If costs of seeking an APA are a problem, the APA can be limited to one or two goods or services.⁴¹² There is no requirement that an APA must cover all the goods and services transferred by an associated enterprise.⁴¹³ Nonetheless, it remains to be seen how Revenue Canada

403. See *ADVANCED PRICING AGREEMENTS*, *supra* note 398, at ¶ 3 (stating a APA prospectively confirms an appropriate transfer pricing method, and its application, to specific cross-border non-arm's length transactions for a specified term).

404. See generally *Levey & Borraaccia*, *supra* note 359 (discussing the ranking of transfer pricing methods in the preferred order that Revenue Canada expects).

405. See generally *Blake M. Murray & Andrew H. Kingissepp*, *Canada Proposes Rigorous New Transfer Pricing Rules*, 8 J. INT'L TAX 490 (1997), *electronic version* (explaining the data and analysis needed to satisfy the penalty provision in subsection 247(3)).

406. See *Arnold*, *supra* note 397, at 727 (noting once the APA is entered into Revenue Canada will consider itself bound and the taxpayer will only need to concentrate on the transfer pricing method agreed upon).

407. See *ADVANCED PRICING AGREEMENTS*, *supra* note 398, at ¶ 15 (discussing how a taxpayer can request one or more pre-filing meetings with Revenue Canada to explore the suitability of an APA).

408. See *Innes & McCart*, *supra* note 399, at 859 (asserting that if a Canadian taxpayer chooses to seek an APA, extensive information must be provided to Revenue Canada).

409. See *Snyder*, *supra* note 5, at 1066-67 (noting that the taxpayer must comply with the terms of the APA for the APA to have any affect).

410. See generally *Detailed Analysis*, *supra* note 401 (discussing the cost of seeking an APA).

411. See generally *Turner*, *supra* note 232 (stating he expects more taxpayers will seek comfort on their transfer pricing policies through Canada's APA process).

412. See generally *Detailed Analysis*, *supra* note 401 (stating that a significant part of the expenses a taxpayer will incur result from the need to collect and analyze a significant volume of data to support the transfer pricing method).

413. See *ADVANCED PRICING AGREEMENTS*, *supra* note 398, at ¶ 3 (stating that the APA prospectively confirms an appropriate transfer pricing method and its application to specific cross-border non-arm's length transactions for a specific term).

will respond to an APA request in light of section 247. If Revenue Canada's approach to section 247 is inflexible, this may enhance the attractiveness of an APA, particularly in complex situations.⁴¹⁴

VII. CONCLUSION

Overall, section 247 and Information Circular 87-2R facilitate the effective administration of taxation of international transactions. Section 247 affirms Canada's commitment to the internationally recognized arm's length principle and endorses the 1995 OECD report.⁴¹⁵ For taxpayers familiar with the OECD's work on transfer pricing, the provisions in section 247 and Information Circular 87-2R should not come as a surprise. Canada has long recognized that the governance of MNEs requires continuity among the international community.⁴¹⁶ Since Canada has based its transfer pricing laws on the 1995 OECD report, taxpayers can use the report as a Rosetta Stone to navigate through much of the complexity that plagues transfer pricing issues.

With respect to MNEs, Canada's transfer pricing rules are not welcome news.⁴¹⁷ The transfer pricing penalty is overly harsh and can be easily triggered. Moreover, the penalty is not proportionate to the offense.⁴¹⁸ To make matters even worse, the contemporaneous documentation requirements place a heavy burden on MNEs.⁴¹⁹ However, if there is a light at the end of the tunnel for MNEs, it is that more countries will follow Canada's lead. While this may sound contradictory, it is actual complementary because the more countries that follow Canada's lead and adopt the recommendations in the 1995 OECD report, the closer MNEs will be to an international tax system that can efficiently administer the taxation of international transactions.

414. See generally Turner, *supra* note 232 (noting that inflexibility will lead to taxpayers seeking APAs).

415. See generally Murray & Kingissepp, *supra* note 405 (stating that § 247 may end up being inconsistent with the 1995 OECD report, even though Canada's new transfer pricing rules purport to follow this report).

416. See generally Arnold & McDonnell, *supra* note 71, at 902 (reporting that all the participants agree transfer pricing is a global issue).

417. See generally Menyasz & Hirani, *supra* note 59 (stating that MNEs are concerned the new transfer pricing rules will have a negative effect on the competitiveness of Canadian companies).

418. See 1995 OECD report, *supra* note 2, at ¶ 4.27 (recommending that OECD member countries ensure their transfer pricing penalty system is proportionate to the offense).

419. See generally Levey & Borraçcia, *supra* note 359 (stating that Canada's requirement that MNEs prepare or obtain complete and accurate documentation is overly burdensome).

