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Tax Alert – Canada

Department of Finance consultation on Canada's transfer pricing rules - Detailed summary

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On 6 June 2023, the Department of Finance released a consultation paper titled *Consultation on Reforming and Modernizing Canada's Transfer Pricing Rules* (the consultation paper), which follows through on the commitment made in the 2021 federal budget to review these rules. The consultation paper includes draft revisions to section 247 of the *Income Tax Act* (the Act), as well as potential administrative measures. Interested stakeholders are invited to provide comments by 28 July 2023.

In this Tax Alert, we provide a summary of the key points of the consultation paper.

Following the Crown's loss in the *Cameco* case at both the Tax Court of Canada and Federal Court of Appeal,¹ the government committed to a review of the transfer pricing rules in Canada. The consultation paper represents the Department of Finance's opening foray into potential legislative amendments and revised administrative measures applicable to transfer pricing in Canada. It also raises certain streamlined pricing approaches as topics for further discussion.

The consultation paper sets out a series of 23 questions with regards to specific elements of the proposals. Draft legislative amendments to implement certain proposed measures are included in Appendix A of the consultation paper.

¹ *Cameco Corporation v. The Queen*, 2018 TCC 195; aff'd 2020 FCA 112. Also, see EY Tax Alert 2020 Issue No. 40, [Federal Court of Appeal rejects Crown appeal in Cameco transfer pricing case](#).

Proposed legislation

The main legislative proposal concerns possible amendments to the transfer pricing adjustment rules in section 247 of the Act. These potential changes are intended to provide greater clarity on the application of the arm's length principle in Canada, in part by attempting to better align the language in the provision with that published in the Organisation for Economic Co-operation and Development (OECD) *Transfer Pricing Guidelines*.²

New definitions are proposed. In particular, the term "economically relevant characteristics" is added, which is intended to delineate all of the information ("conditions", with its own interpretive rule) that should be taken into account when setting and analyzing prices in intercompany transactions, with an emphasis on the functions and actual conduct of the parties, to determine the "delineated transaction". This is a much broader undertaking than the existing transfer pricing legislation currently imposes.

Thereafter, as a first element, for purposes of making a transfer pricing adjustment, a comparison is required of the conditions of the delineated transaction to the conditions that would have been included had the parties been dealing at arm's length in comparable circumstances. Where the conditions from this comparison differ, the taxpayer's reported income or expense amount (referred to as the "initial amount") may be adjusted to the quantum or nature that would have been determined if arm's length conditions had applied.

The second element of the proposed legislative changes introduces new "non-recognition and replacement" provisions to replace the current "recharacterization" provisions in paragraphs 247(b) and (d) of the Act. Non-recognition will apply where, taking into consideration the perspectives of the participants and the options realistically available to them at the time of entering into the transaction, it is determined that:

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

² OECD *Transfer Pricing Guidelines* refers to the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.

Where the non-recognition and replacement rule is determined by the Canada Revenue Agency (CRA) to apply, then "...the delineated transaction or series is to be disregarded and replaced with an alternative transaction or series that comports as closely as possible with the facts of the delineated transaction or series while achieving an expected result that, had the participants been dealing at arm's length in comparable circumstances, would have been commercially rational".³

This non-recognition and replacement feature appears to be largely directed at addressing difficulties experienced by the Crown in supporting its recharacterization position in the *Cameco* case. Throughout the consultation paper, several references to the *Cameco* case are discussed to explain the Department of Finance's tax policy concerns with respect to the current rules, and to illustrate how the proposed non-recognition and replacement rule could have operated in similar circumstances.

Third, the consultation paper also proposes to insert a consistency provision indicating that the Canadian transfer pricing rules are to be applied in a manner so as to achieve consistency with the OECD *Transfer Pricing Guidelines*.⁴ An embedded caveat of "unless the context otherwise requires" provides the CRA with leeway in interpretation. Whether the application of the OECD *Transfer Pricing Guidelines* is to be made using a static or an ambulatory approach to future changes to the guidelines is left open for stakeholder input and later determination.

Administrative measures

The consultation paper invites stakeholders to provide input on administrative matters connected to transfer pricing, such as documentation and penalty provisions, and the possibility of adopting more modern or simplified approaches in specific situations.

The consultation paper notes that these measures are intended to reduce transfer pricing disputes, ease compliance burdens and allow the CRA to focus its resources on transactions that pose a higher risk of base erosion.

Administrative measures considered in the consultation paper include the following potentially significant developments:

- ▶ **Increased penalty thresholds:** Under the current rules, the transfer pricing penalty provisions employ both an absolute threshold – an adjustment of more than \$5 million – and a relative threshold – an adjustment greater than 10% of the taxpayer's revenue. A penalty will potentially apply if the adjustment amount is more than the *lesser* of the two threshold amounts. The consultation paper proposes to increase the absolute threshold from \$5 million to \$10 million, as this amount has not been increased since its introduction in 1997, but to leave the 10% of revenue relative threshold unchanged.

³ Proposed paragraph 247(1.3)(b) of the Act.

⁴ As provided for in proposed subsection 247(2.03).

- ▶ **Adoption of elements of the OECD Master File/Local File documentation model:** The consultation paper proposes to require the filing of an OECD Master File report in prescribed form by larger multinational enterprise (MNE) groups already subject to country-by-country reporting requirements upon receipt of a request from the CRA. In addition, the government is proposing that Canadian documentation requirements be brought in line with those set out in Chapter V (Documentation) of the OECD *Transfer Pricing Guidelines* (i.e., Local File documentation requirements).
- ▶ **Simplified documentation requirements for lower-value transactions and smaller taxpayers:** The consultation paper indicates that the government recognizes that documentation requirements impose a burden on taxpayers, highlighting the need to balance timely and reliable transfer pricing documentation and the cost of providing that documentation. The government recognizes that relief from the compliance burden could be provided by allowing more streamlined documentation requirements for lower-risk transactions and taxpayers. Therefore, the consultation paper considers the introduction of provisions that would satisfy documentation requirements for certain types of transactions via an annual reporting schedule, which would detail, *inter alia*, the nature and magnitudes of the specified transactions, the methods used and the arm's length conditions determined.

Streamlined pricing approaches

The consultation paper raises certain streamlined pricing approaches for consideration and stakeholder input without indicating a clear directional intent of the government to adopt these approaches.

- ▶ **Low-value-adding intra-group services:** It is noted that, in line with the OECD *Transfer Pricing Guidelines*, a number of jurisdictions have adopted an approach whereby a safe-harbour mark-up of 5% is considered an acceptable arm's length return for such services. Different implementation approaches are identified, and the potential for a dollar limitation is posited.
- ▶ **Standardized returns for distribution services:** The consultation paper notes that distributors that perform relatively routine activities and earn commensurate returns pose relatively low base erosion risk; as such, allowing a safe harbour return could reduce their compliance burden. Challenges are noted in defining the applicable scope of activities, and the potential need for a dollar limitation is again noted.
- ▶ **Intra-group loan conditions:** It is noted that a wide number of features can be observed in intra-group loans, that documenting the arm's length nature of interest rates on such loans can place a significant burden on taxpayers, and that challenging such arrangements can be difficult and resource intensive. Limiting acceptable loan conditions, including limiting the loan term (to five years), using the credit rating of the MNE group as a whole to price intra-group financial transactions, and removing subordination features and embedded options are discussed.

Consultation process

An invitation for stakeholder comments sets a closing date of 28 July 2023. Commentators are requested to advise whether they consent to disclosure of their submission in whole or in part.

EY teams will review the consultation paper in detail and will provide comments to the Department of Finance.

Takeaways

The substantive elements of Canada's transfer pricing rules have not been revised since their original introduction in 1997. The Department of Finance's consultation paper provides an opportunity for stakeholders to have input on this very important component of Canadian tax law.

While the intention of the Department of Finance is to reduce uncertainty in the interpretation of the transfer pricing rules in Canada, the proposed legislative revisions may create additional avenues of uncertainty and broaden the current landscape for Canadian transfer pricing disputes. In particular, the focus on "economically relevant characteristics", the interpretation of which is inherently subjective, may inevitably lead to more frequent and broader disputes. This could, in turn, increase the need for more effective dispute resolution mechanisms, a topic that is not addressed in the consultation paper.

The timing and potential application date of revised legislative proposals resulting from the consultation process are uncertain. Nonetheless, given the recurring nature of transfer pricing, taxpayers should review their current transactions and documentation in light of the directional intentions indicated by the government's proposals and consider whether proactive changes and/or improvements are warranted.

Furthermore, the administrative measures discussed in the consultation paper, which are intended to reduce compliance and administrative burdens, are worthy of serious consideration as part of the overall re-framing of the Canadian transfer pricing environment. However, it is not clear that the measures under consideration as currently framed are wholly consistent with the legislative proposals and will actually achieve the stated objectives.

Learn more

To view the full Department of Finance consultation paper, visit:

[Consultation on Reforming and Modernizing Canada's Transfer Pricing Rules - Canada.ca.](#)

For more information, please contact your EY or EY Law advisor or one of the following professionals:

Toronto

Marlon Alfred

+1 416 932 5151 | marlon.alfred@ca.ey.com

Andrew Clarkson

+1 416 943 2146 | andrew.clarkson@ca.ey.com

Tara Di Rosa

+1 416 943 2671 | tara.dirosa@ca.ey.com

Matthew Sambrook

+1 416 943 2080 | matthew.sambrook@ca.ey.com

Caton Walker

+1 416 943 5240 | caton.walker@ca.ey.com

Andrei Tarassov

+1 416 943 2546 | andrei.tarassov@ca.ey.com

Ottawa

Rene Fleming

+1 613 598 4406 | rene.fleming@ca.ey.com

Paul Mulvihill

+1 613 598 4339 | paul.f.mulvihill@ca.ey.com

Tony Wark

+1 613 598 4322 | tony.wark@ca.ey.com

Kevin O'Reilley

+1 613 598 4892 | kevin.oreilley@ca.ey.com

Quebec and Atlantic Canada

Wael Tfaily

+1 514 879 6695 | wael.tfaily@ca.ey.com

Alfred Zorzi

+1 514 874 4365 | alfred.zorzi@ca.ey.com

Hélène Vaudrin

+1 514 874 4661 | helene.vaudrin@ca.ey.com

British Columbia

Tina Berthaudin

+1 604 891 8207 | tina.berthaudin@ca.ey.com

Greg Noble

+1 604 891 8221 | greg.noble@ca.ey.com

Adrian Tan

+1 604 891 8318 | adrian.tan@ca.ey.com

Prairies

Andreas Ottosson

+1 403 592 9966 | andreas.ottosson@ca.ey.com

EY Law

Daniel Sandler

+1 416 943 4434 | daniel.sandler@ca.ey.com

Angelo Nikolakakis

+1 514 879 2862 | angelo.nikolakakis@ca.ey.com

David Robertson

+1 403 206 5474 | david.d.robertson@ca.ey.com

Roger Taylor

+1 613 598 4315 | roger.taylor@ca.ey.com

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