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What Multinationals Need to Know About Canada Revenue Agency's Two New Transfer Pricing Memoranda, TPM-15 And TPM-16: Onerous Canadian Transfer Pricing Documentation Required

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INTRODUCTION

The Canada Revenue Agency (CRA) released two new transfer pricing memoranda on January 29, 2015: (1) TPM-15 dealing with intra-group services; and (2) TPM-16 dealing with multiple-year data in transfer pricing analyses.

While the memoranda clarify CRA's policy on several tax and audit issues for intra-group services and provide guidance on the use of multiple-year data, the memoranda seem to take a different and more onerous approach to transfer pricing than do the United States — Canada's major trading partner — and the Organisation for Economic Co-operation and Development (OECD). CRA issued TPM-15 after the OECD published draft revisions to its guidance on intra-group services as part of the Base Erosion and Profit Shifting (BEPS) Project, but before completion of the OECD consultation period.

CRA's focus in TPM-15 and TPM-16 on detailed transfer pricing documentation for each intra-group service and the requirement to provide data on relevant year comparables (rather than multiple-year averages) suggests that transfer pricing documentation in the United States and other countries may not be sufficient to avoid the imposition of Canadian transfer pricing penalties for the failure to prepare adequate contemporaneous documentation.

TPM-15 — INTRA-GROUP SERVICES

Intra-group services are services performed for the benefit of an entity within a multinational enterprise (MNE) group by either the parent or a subsidiary within the MNE group.[1] Such intra-group services include a wide range of services, such as technical, management, administrative, financial, or marketing services.

There are two main issues with intra-group services: (1) whether intra-group services have in fact been provided; and (2) what amount, if any, should be

[*] Thank you to Richard Tremblay for his helpful guidance and suggestions.

[1] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (July 22, 2010), online: OECD <www.oecd.org>, at ¶7.1 [2010 Guidelines].

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charged for such services in accordance with the arm's-length principle.[2]

Determining Whether Intra-Group Services Have Been Provided

TPM-15 suggests that services charged to a Canadian company by a foreign non-arm's-length entity should be verifiable from a review of the Canadian company's records. TPM-15 further indicates that "a formal contract or invoicing system alone are not sufficient evidence of the existence of a service for which a charge is justified"[3] because there have been instances where in fact no services were provided despite the existence of contracts for service fees. Conversely, a Canadian company may be providing services to foreign non-arm's-length entities and not billing for services provided.[4]

TPM-15 recommends that CRA auditors establish facts to properly evaluate the charge for intra-group services, which requires that a benefit to the user be established and the rationale for the service be explained from the point of view of the service provider and the user.[5] In addition, direct and indirect charges should be separately identified and allocation keys and mark-ups should be explained and justified where there is an allocation of costs.[6]

The CRA confirms that intra-group services can be charged using the direct charge method (CRA's preferred method) or the indirect charge method. The direct charge method is used when similar services are provided to arm's-length parties or the service can be separately identified and quantified.[7] However, there are situations where the direct charge method cannot be used, such as where a service has been provided to a number of non-arm's-length parties and the value to each entity cannot be determined. In that case, the indirect charge method can be used to absorb or charge centralized service costs. As long as the indirect charge results in an allocation that is commensurate with the expected benefit, the indirect charge method will be considered appropriate, except where the services are a main business activity of the service provider and are also provided to third parties — in which case, the direct method would be more appropriate. Thus, the indirect charge method is likely appropriate where: (1) the direct charge method is difficult to apply because there are no or few comparative services that the entity provides to third parties; (2) the proportionate benefit received by each entity can only be estimated and not precisely quantified; and (3) the recordkeeping required to separately track or identify the benefit received by each entity is onerous in relation to the activity itself.[8]

In order for a CRA auditor to determine that intra-group services have in fact been provided, "it is necessary to identify the nature and extent of the transaction and then to perform a functional analysis of the parties involved."[9] If an arm's-length party would not have paid an outside enterprise to perform the service or would not have performed the service itself, then the charge for such a service would not normally be justified under the arm's-length principle.[10]

With respect to allocating costs, the CRA indicated that: (1) no shareholder or custodial costs (in relation to activities undertaken by a parent because of its ownership in a subsidiary) should be allocated to subsidiaries;[11] (2) no specific non-Canadian entity costs should be allocated to Canadian entities; (3) no specific Canadian entity costs should be allocated to non-Canadian entities; and (4) the remaining common corporate costs should be allocated by means of an arm's-length charge.

TPM-15 defines "corporate group costs" to mean "centralized costs of intra-group services that are not shareholder costs and that are not for services pro-

[2] TPM-15 ¶¶5 and 16 refer to 2010 Guidelines ¶7.5.

[3] TPM-15 ¶7.

[4] TPM-15 ¶6 refers to 2010 Guidelines ¶7.18 : ". . . the absence of payments or contractual agreements does not automatically lead to the conclusion that no intra-group services have been rendered."

[5] TPM-15 ¶8.

[6] *Id.* ¶9.

[7] TPM-15 ¶11 indicates that the CRA's position is consistent with 2010 Guidelines ¶7.20: "In certain cases, the arrangements made for the charging of intra-group services can be readily identified. These cases are where the MNE group uses a direct charge method, i.e., where the associated enterprises are charged for specific services." The 2010 Guidelines ¶7.21 states, "An MNE group should often be able to adopt direct charging arrangements, particularly where services similar to those rendered to associated enterprises are also rendered to independent parties."

[8] TPM-15 ¶15 refers to the 2010 Guidelines ¶7.21 and ¶7.24.

[9] TPM-15 ¶18.

[10] TPM-15 ¶21 refers to 2010 Guidelines ¶7.6: "If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's-length principle."

[11] Examples of shareholder costs include costs of issuing shares, share transfer expenses, expenses of meetings of shareholders, costs relating to reporting requirements of the parent (such as for a prospectus), filing of tax returns, and maintaining shareholder records, and costs of managerial activities, such as legal costs, director's fees, and other fees. Each cost should be analyzed to determine if the charge is really a shareholder cost or whether it has specific benefit to any other entity. Disclosure costs required under Sarbanes-Oxley may overlap with Canadian reporting requirements and therefore compliance with the former may result in a benefit to another entity and be allocated accordingly.

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vided and charged for directly between entities.''[12] The CRA's position on allocating corporate group costs to a Canadian entity is that, where the direct charge method is not applicable: (1) the allocation must be made by means of an arm's-length charge; (2) the allocation should be based on a comprehensive review of the group actual costs (not budgeted costs) carried out in advance of the allocation; (3) the basis for allocation used must be explicit, definable, and available for examination by CRA auditors; and (4) the allocation basis should result in costs being shared in proportion to the benefits received.

The selection of an allocation key should consider ''the nature and likely use of the service.''[13] In addition, CRA auditors should refrain from accepting the proportion of sales revenues as a single allocation basis (as it can lead to wide fluctuations) and instead it may be preferable to implement a multiple allocation basis for intra-group services to better reflect the benefits likely to be received.[14] Hence, while sales may be an allocation key for advertising expenditures, time spent may be an allocation key for data processing, and number of employees may be an allocation key for human resource costs, better matching costs to the benefits likely to be received.

TPM-15 also addressed two categories of duplicate costs: (1) services already performed internally or purchased elsewhere; and (2) multiple charges for the same service (double dipping). With respect to the first category of duplicate costs, TPM-15 emphasizes that there should be no intra-group service fee for activities undertaken by one entity that merely duplicate a service that another entity is performing for itself, or that is being performed for the other entity by a third party. As a result, costs allocated to a Canadian entity where the Canadian entity is self-sufficient are not allowable, but costs for which the assistance of the foreign entity is necessary or beneficial are allowable.[15] Duplicate costs are not chargeable unless there is a valid business reason, which must include a functional analysis of the Canadian recipient of the service that demonstrates the Canadian entity received a benefit from the intra-group service.[16] With respect to the second category of duplicate costs, as a result of CRA's concern about double dipping of expenses (such as the deduction of both foreign director's fees and service fees where the foreign director is employed by the entity supplying the services to the Canadian company), TPM-15 suggests that a CRA auditor should review in detail the services provided and the services charged under the service fee to ensure that there is no duplication of charges for the same services.[17] As well, royalty payments and interest expense should be unbundled and analyzed separately and not be included in service fees. TPM-15 recommends that CRA auditors consider the form that an arm's-length consideration would take had the transaction occurred between independent enterprises dealing at arm's-length to ensure that the remuneration was not already built into the compensation. For example, for financial services, remuneration would generally be built into the spread and no further service fee would be charged.[18]

Finally, intra-group service fees may include expenses that are not deductible for Canadian tax purposes, such as where the expenses are not incurred by a Canadian entity for the purpose of gaining or producing income. TPM-15 highlights many provisions of the Canadian *Income Tax Act* that restrict or disallow certain expenses. Where a lump-sum fee is charged for a bundle of services without details of the individual type of expenses, the CRA suggests that CRA auditors look through the lump-sum fee to determine if the charges included are otherwise deductible for tax purposes by reviewing each individual item included in the fee. Where the fee contains non-deductible items but in total reflects an arm's-length price, the CRA's position is that the Canadian *Income Tax Act* prohibits the deduction of the portion reflecting the non-deductible element. In such a case, there may be no recourse for the resulting double taxation even though the amounts are arm's-length amounts, unless there is taxation not in accordance with a treaty.

Valuing Intra-Group Services

Once it is determined that a charge for a service is warranted, the next issue is determining the arm's-length value of the service. With respect to valuation of intra-group services, TPM-15 provides that valuation should be determined by considering the perspective of both the provider and the recipient, and by looking at the cost of the service and what an arm's-length party would be willing to pay in comparable circumstances.[19] As many intra-group services are priced on a cost plus basis (because comparable uncontrolled prices may not be available), TPM-15 suggests that mark-ups are situationally dependent (and not automatic) and must be justified by reference to

[12] TPM-15 ¶30.
[13] *Id.* ¶35.
[14] *Id.* ¶36.
[15] *Id.* ¶38.
[16] *Id.* ¶39.
[17] *Id.* ¶40.
[18] *Id.* ¶41.
[19] TPM-15 ¶55 refers to 2010 Guidelines ¶7.29.

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arm's-length support as well as detailed functional analysis.[20]

Key Questions Asked by CRA Auditors

TPM-15 suggests that CRA auditors ask the following key questions in analyzing intra-group services: (1) Do the services provide a benefit for the recipient entity for which it would be willing to pay an arm's-length party? (2) Is a charge being made for a service that the recipient entity already performs for itself or purchases from a third party? (3) Does the service charge represent a double dip because the entity has already been charged for the activity in another expense category? (4) Is the expense one for which a deduction is specifically disallowed under Canadian income tax rules?

CONTRASTING TPM-15 TO THE 'SIMPLIFIED APPROACH' IN THE 2014 OECD SERVICES DRAFT AND TO REG. §1.482-9[21]

On November 3, 2014, the OECD provided its public discussion draft of proposed modifications to Chapter VII of the Transfer Pricing Guidelines relating to low-value-adding intra-group services (2014 OECD Services Draft). The 2014 OECD Services Draft suggests a simplified transfer pricing approach for low-value-adding intra-group services. The simplified approach recognizes that the arm's-length price for low-value-adding intra-group services is closely related to costs, allocates the costs of providing each category of such services to the MNE group that benefits from the services, and applies the same mark-up for all categories of services.

Under the 2014 OECD Services Draft, the MNE group can elect for application of the simplified methodology and prepare documentation, including the description of low-value-adding intra-group services provided, the rationale for the provision of each category of services, a description of benefits of each category of services, and a justification of the selected allocation keys. Services that would likely meet the definition of low-value-adding services include accounting, human resources, information technology, internal and external communications, legal services, and activities with regard to tax obligations.[22] The 2014 OECD Services Draft suggests that the same mark-up should be used for all low-value-adding services and that the mark-up selected should be no less than 2% of the relevant cost and should be no greater than 5% of the relevant cost.[23]

Reg. §1.482-9 identifies methods for determining taxable income in connection with a controlled services transaction. Specifically, the U.S. services cost method can be used by taxpayers for either specific covered services (similar to the 2014 OECD Services Draft) or low margin covered services where the median comparable markup on total services costs is less than or equal to 7%.

Based on TPM-15, the CRA suggests that extensive transfer pricing documentation is required for each service and not each category of services, even in the context of low-value-adding intra-group services. In essence, under TPM-15, there is no simplified approach. This can be particularly problematic where a U.S. parent has relied on the U.S. services cost method, which is not recognized by the CRA.

TPM-16 — ROLE OF MULTIPLE-YEAR DATA IN TRANSFER PRICING ANALYSES

TPM-16 provides that the determination of arm's-length prices used in related-party transactions for Canadian taxpayers should be established for each individual taxation year using the results obtained from comparable transactions in the relevant taxation year. That is, the transfer pricing analysis should be determined on a year-by-year basis, looking at controlled transactions that were undertaken in the year. TPM-16 indicates that taxpayers should not average results over multiple years for the purpose of substantiating transfer prices.

Multiple-Year Data Only To Be Used for Comparability Purposes

Multiple-year data are, according to TPM-16, useful only when selecting or rejecting comparables, but not when determining the points of a range to be used.[24] However, the CRA accepts that in the Advance Pricing Arrangement (APA) context, the averaging of historical outcomes of comparable transactions may form part of the transfer pricing analysis with respect to establishing reasonable expectations of outcomes in future years.[25]

The claimed rationale in TPM-16 for only using multiple-year data for comparability purposes is that

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[20] TPM-15 ¶62.

[21] All "Reg. §" references herein are to sections of the regulations under the U.S. Internal Revenue Code, as amended.

[22] 2014 OECD Services Draft, ¶7.48.

[23] 2014 OECD Services Draft, ¶7.57.

[24] TPM-16 ¶9.

[25] *Id.* ¶10.

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some of the relevant economic circumstances (such as business cycles, product life cycles, useful life of capital, business strategies) may assist in accepting or rejecting a potential comparable transaction but that actual year data must then be evaluated.[26] According to the CRA, multiple-year data should only be used to increase the breadth or depth of the understanding of the characteristics of the controlled transaction. Multiple-year data are more than the observed financial outcomes but also include information from companies engaged in potentially comparable transactions, information on how unrelated parties involved in similar transactions interact, information on facts that arm's-length parties take into account, and the impact of changes in the industry.

While multiple-year data are useful to select or reject comparables, TPM-16 emphasizes that it will be the data observed in each individual year (which are derived from comparable transactions undertaken in that year) that "will be of greatest value" when determining the arm's-length transfer price. Similarly, statistical tools (which apply only to numbers and not qualitative analysis) generally are of no use to improve comparability or to improve the CRA's understanding of the comparability.[27]

TPM-16 suggests that while there are many comparability factors to consider, the most important is the date of the transaction and the data derived from the taxable year under evaluation.

Use of Multiple-Year Data and Statistical Tools

TPM-16 explains that the use of multiple-year data (for comparability purposes) is different from the application of statistical tools (for testing prices for the transaction under review). CRA's position is that the use of a range, which describes the highest and lowest points within a set of observed outcomes, is an acceptable use of a statistical tool, as long as the range is not across multiple years.[28]

CRA highlights that the use of interquartile ranges should not be used to assess comparability as such a statistical tool is not based on the consideration of economic characteristics of the transaction.

CONTRASTING TPM-16 TO REG. §1.482-1

In the United States, the Internal Revenue Service (IRS) specifically permits the use of interquartile ranges in the determination of comparables in the arm's-length range. Reg. §1.482-1(e)(2)(iii)(B) and §1.482-1(e)(2)(iii)(C) allow taxpayers to use the interquartile range as an acceptable statistical method to establish an arm's-length range of results. That is, the statistical methods are used to increase the reliability of the transfer pricing analysis.

In addition, Reg. §1.482-1(f)(2)(iii)(D) specifically allows for the application of methods using multiple-year averages. The IRS allows a taxpayer to use a comparison of the average result over a multiple-year period with the average results of uncontrolled comparables over the same period where it reduces the effect of short-term variations unrelated to transfer pricing. Arguably, the U.S. approach recognizes that perfect data are usually not available — thus the need for a more practical approach.

Based on TPM-16, the unusual result is that U.S. transfer pricing documentation based on interquartile ranges or multiple-year averages may not be accepted by the CRA as being sufficient for Canadian transfer pricing documentation purposes, and the CRA could impose transfer pricing penalties.

CONCLUSION: MULTINATIONALS MUST PREPARE MORE ONEROUS TRANSFER PRICING DOCUMENTATION FOR CANADA

CRA's release of the new TPM-15 (before final resolution of intra-group services in the OECD's BEPS project) suggests that service fees are and will continue to be a significant area of inquiry for CRA auditors. The CRA suggests that, despite the 2014 OECD Services Draft, a significant amount of disclosure of domestic and foreign-based information is required, even for routine intra-group services.

TPM-16 provides that while multiple-year data may be useful when selecting or rejecting comparables, transfer prices for a given year should be determined based on the results of a single year of data from each of the comparable transactions. The focus on yearly data may actually not be practical, especially when it is difficult to determine in comparable databases whether a comparable transaction continues into a current taxation year. Other comparability fac-

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[26] TPM-16 ¶15 suggests that 2010 Guidelines ¶3.75–¶3.79 discuss the use of multiple years of data in the form of information relevant to a comparability analysis and do not promote averaging multiple years of numerical data to establish comparability.

[27] TPM-16 ¶20.

[28] This is the first time that the CRA has explicitly accepted the use of a range, likely because of the Supreme Court of Canada's explicit acceptance of a transfer pricing range in *Canada v. GlaxoSmithKline Inc.*, 2012 SCC 52 at ¶61.

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tors may actually be more relevant than the date of the transaction.[29]

Based on TPM-15 and TPM-16, the CRA articulates a clear need for any multinational to provide detailed and justified support for intra-group services and the bases for comparability of controlled transactions to avoid Canadian transfer pricing penalties.[30] TPM-15 and TPM-16 suggest that comprehensive transfer pricing documentation must be prepared based on relevant year-by-year data and that transfer pricing documentation prepared in other countries (including the United States) may not be sufficient to meet CRA requirements.

For example, a Canadian subsidiary of a U.S. parent will likely not be able to use the U.S. parent's transfer pricing documentation where the documentation is based on multiple-year averages or the services cost method, even though that documentation is compliant with the U.S. Internal Revenue Code and accepted by the IRS. Reliance by the Canadian subsidiary on the U.S. transfer pricing documentation may be considered by the CRA to be insufficient for Canadian transfer pricing purposes, resulting in the imposition of harsh transfer pricing penalties. Hence, multinationals need to be cognizant that U.S. or multi-jurisdictional transfer pricing reports may not be accepted as adequate for Canadian transfer pricing documentation purposes.

Despite efforts for greater simplicity and consistency across countries (for example, through the 2014 OECD Services Draft), transfer pricing appears to be becoming even more complex as there are still significant differences between countries (including the Canadian and U.S. tax authorities), resulting in the need for different transfer pricing documentation to meet the differing country needs. In order to avoid the imposition of Canadian transfer pricing penalties, multinationals are facing higher compliance costs to prepare more onerous documentation for Canada.

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[29] For example, in the context of royalties, the nature of the intangible property being licensed is arguably more relevant than the date of the license or royalty payment.

[30] However, a reasonable transfer pricing range may be sufficient in court.

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