Agenda

- Introduction
- Transfer Pricing Audits – Process and Practical Issues
- Transfer Pricing Appeals and Competent Authority Interaction
- Arbitration under the Canada-U.S. Tax Treaty
- OECD Update
- Case Law Update
Learning Objectives

- What to expect in a transfer pricing audit
- Factors to consider when preparing your dispute strategy
- Understand your options after the field audit
- Understand recent developments in the US and within the OECD
- Be aware of current transfer pricing case law
“Companies Dodge $60 Billion in Taxes Even Tea Party Condemns”
(www.bloomberg.com – May 16, 2010)
– “…a technique known as transfer pricing…carves an estimated $60 billion a year from the U.S. Treasury as it combines tax planning and alchemy.”
– “Transfer pricing is the corporate equivalent of the secret offshore accounts of individual tax dodgers,” said Senator Carl Levin…
– Senator Byron Dorgan calls transfer pricing “an unbelievable scandal.”

“Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes”
(www.bloomberg.com – October 21, 2010)
– “The tactics of Google and Facebook depend on ‘transfer pricing’, paper transactions among corporate subsidiaries that allow for allocating income to tax havens while attributing expenses to higher-tax countries.”
Canadian Transfer Pricing Landscape

- **Dramatically increased audit activity and re-assessments**
- **Revised T106 forms**
  - Renewed focus on financial transactions
- **Risk-weighted audit approach for large taxpayers**
- **Resources at CRA**
  - Approximately 340 auditors across Canadian Taxation Service Offices (TSO) focusing on transfer pricing
  - 30 auditors at CRA headquarters providing support
  - 20 economists in Ottawa supporting the field auditors
  - $7.9 million allocated to additional salaries of CRA auditors engaged in TP audits
- **Reassessments issued during CRA’s FY2010**
  - Approximately 1,200 files reassessed
  - $1.45 billion in taxes assessed
Canadian Transfer Pricing Landscape

• **Canadian companies as entrepreneurs**
  – CRA refuses to allow for routine returns locally, attributing super-profits to local subsidiary
  – CRA focus on functional interviews

• **Foreign distributors as service providers**
  – CRA allowing only a return on specific costs for foreign distributors

• **Reduction in Canadian functions, risks and profit**
  – Through changes in transfer pricing methodology or restructurings
  – If it reduces profits in Canada, it will be challenged

• **Royalties for trademarks and trade names**
  – CRA arguing that local selling efforts create value, not the brand (i.e. economic vs. legal ownership of intangible)
CRA Transfer Pricing Audit: Mapping out a Strategy
CRA Audit – Mapping out a Strategy

• **Access to treaty**
  – Treaty available?
  – Procedures for accessing treaty

• **Deadlines**
  – Notification to competent authority
    o Deadlines differ by treaty country

• **Waivers**
  – Should a year be kept open?
  – Consider restricted waiver – six months to withdraw

• **CRA powers**
  – Access to foreign-based information
  – Requirements
CRA Audit – Mapping out a Strategy

• **Pre-empt a written proposal where possible**
  – If CRA indicates the issue, push for dialogue/meetings
  – Goal is to get the best starting point

• **“Mandatory” referrals**
  – Intangible property will likely be referred to head office for review by economists
  – If you know there will be a referral, push for the referral report and an opportunity to rebut where possible

• **Strategy**
  – How far are you willing to pursue any issue?
  – Weaknesses?
  – Implications in other jurisdictions with similar transactions?
  – Weigh pros and cons of all options
  – Revisit F/S provision
CRA Audit – Dealing with Proposed Adjustments

• **Be consistent**
  – Your position was already set out in your documentation – reinforce it
  – Do not assume the auditor has read the documentation in detail

• **Plan for the end game**
  – Assume all correspondence will be read by CRA head office, appeals, competent authority, foreign tax jurisdiction, and a court of law
  – Set out legal, economic, and “prudent businessperson” arguments

• **Stick to the issues**
  – Narrow your focus to the one or two fundamental issues that CRA is relying on as the basis for its proposal (e.g., entrepreneurial entity, IP owner, value chain)

• **Get everyone to the table**
  – Insist on meetings with auditor, team leader, economist, supervisor
  – Gives you a chance to take control (e.g., presentation of facts to all)

• **Settlement?**
After the CRA Audit – The Long Haul

• **Know your options after the field audit**
  - Appeals
  - Competent authority (and Accelerated Competent Authority Procedure)
  - Arbitration
  - Litigation
  - Advance Pricing Arrangements

• **Explore your options early**
Appeals and Competent Authority
Interaction - Competent Authority and Objection Routes

• **Not available concurrently but either route is available on linear basis**

• **If you choose Competent Authority route first**
  – Unless waiver filed, file Notice of Objection (held in abeyance pending CA decision)
  – If CA decision accepted, Notice of Objection ends
  – If not, Notice of Objection proceeds (but no going back to CA)

• **If Notice of Objection process chosen first**
  – Notice of Objection filed and Appeals Branch review undertaken
  – If Notice of Objection decision accepted and double tax remains, CA will only present the issue
  – If not accepted, taxpayer can pursue appeal to Tax Court or start CA process
  – If Tax Court decision results in double tax, the CA will only present the issue
Competent Authority vs. Notice of Objection

• **Competent Authority (CA) application** is usual route for relief from double taxation

• **But Notice of Objection route** can be used:
  – To keep tax year open for reassessment
  – For non-treaty jurisdictions
  – When double tax at issue is low
  – When reassessment is seriously flawed
  – If you want to test your position with CRA Appeals
  – If you believe foreign competent authority will agree with CRA Appeals
  – If you want to work with the domestic Appeals functions
  – In case CA process does not provide satisfaction
CRA Appeals – Settlement and Mediation

- **Settlement and Mediation Policies** – external CRA website
- **Applicable to all files, including transfer pricing**
- **Settlement policy**
  - Settlement preferred over litigation
  - Taxpayer initiated “without prejudice” proposal
  - Most suitable for factual disputes
- **Mediation policy**
  - Traditional Notice of Objection process undertaken first, then held in abeyance
  - Propose mediation to Chief of Appeals (terms and conditions negotiated)
  - If successful, implemented as resolution of notice of objection
Competent Authority Process

• Available under MAP of a treaty between two countries

• Lengthy process compared to Appeals

• Less latitude to take unilateral action due to treaty partner’s involvement

• CA assistance does not cover interest or penalties

• Excellent resolution of double-tax
  - 2009-2010 CRA MAP Report: 95% of cases obtained full double tax relief

• Accelerated Competent Authority Procedure (ACAP)
  - Request CA assistance for subsequent filed tax years for same issue
  - Make ACAP request at the same time as the related MAP request
Arbitration
Arbitration - Overview

• Latest protocol to Canada-US Income Tax Convention includes new paragraphs 6 and 7 of Article XXVI, introducing mandatory “baseball-style” arbitration.
  - The first arbitration cases between Canada and the United States started on December 15, 2010

• CRA published:
  – Memorandum of Understanding Between The Competent Authorities of Canada and the United States of America
  – Arbitration Board Operating Guidelines – Canada-United States

• Filing of complete MAP request with both competent authorities
  – Filing date is known as “commencement date” if CAs confirm within 30 days that a complete MAP request has been received

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Arbitration Process

- For APAs, the commencement date will be the earlier of:
  - i. the day on which the CAs have exchanged their initial negotiating position, or
  - ii. two years after the day on which a complete APA is received (confirmation should be received within 60 days from the CAs)

- If taxpayers aim to have arbitration start on second anniversary of commencement date, as two-year mark after commencement date approaches, taxpayers and their advisors should complete notarized confidentiality statement and submit it to CAs

- If CAs have not resolved case within two-year mark (TYM) of commencement date, arbitration should automatically begin at TYM unless
  - Tax returns were not filed with at least one of the two Contracting States
  - The CAs have agreed before TYM that case is not suitable for arbitration; or
  - A notarized confidentiality agreement has not been filed by the taxpayers involved

- Each competent authority must appoint an arbitrator within 60 days of the TYM.

- Arbitrators must agree within 60 days on a third arbitrator, who will also chair the arbitration board

- Proposed resolutions are exchanged and presented to arbitration board, which picks one position
OECD Developments
OECD Developments

• Revisions to Chapters I – III
  – More guidance on comparability and the application of transactional profit methods
  – Transition from hierarchy of methods to most appropriate method
  – Additional terminology formally adopted
  – CRA will adopt the new OECD position on hierarchy of methods

• Chapter IX – Transfer Pricing Aspects of Business Restructurings

• Next focus area – Intangible property
Case Law Update
Significant Transfer Pricing Cases

Canada

- **GE Capital Canada** – Guarantee fees and implicit support
- **GlaxoSmithKline** – Appropriateness of CUP versus overall result
- **1143132 Ontario** – Importance of raising arguments at the appropriate time
- **Cameco Corporation** – Willingness of CRA to present alternative positions to support its field audit findings

United States

- **Veritas** – Valuation of buy-in payment and Cost Sharing Agreements (CSA)
- **Xilinx** – Inclusion of stock-based compensation costs in cost pool under a CSA

Australia

- **SNF** – Importance of comparable transactions even when there is not perfect information available
Transfer Pricing Cases

- **Canada – GE Capital**
  - $136 million adjustment related to guarantee fee charged by US parent to Canadian subsidiary for explicit guarantee of third-party loans during the 1996-2000 taxation years
  - Tax Court of Canada (TCC) ruled that implicit support should be taken into consideration but that guarantee fee charged was still adequate
  - CRA appeal dismissed by Federal Court of Appeal (FCA) on December 15, 2010

- **Canada – GlaxoSmithKline**
  - $51.5 million adjustment related to product sold from a Swiss affiliate to the Canadian taxpayer during taxation years 1990-1993
  - TCC ruled that license agreement not relevant in the application of subsection 69(2) based on Supreme Court of Canada (SCC) decision in Singleton
  - FCA referred case back to TCC for redetermination of the substantive issues
  - CRA sought leave to appeal to SCC, which was allowed (along with taxpayer's application for leave to cross-appeal) on March 24, 2011
Transfer Pricing Cases

• Canada – 1143132 Ontario
  – Transactions between Canadian parent and Barbados subsidiary reassessed under subsection 247(2)
  – Agreed statement of facts filed with TCC acknowledged that transfer prices did not meet the arm’s length principle
  – Although not included in its reasons for appeal, taxpayer argued that Barbados subsidiary was resident in Canada based on mind and management principles
  – TCC noted that nothing in taxpayer’s appeal suggested that residence was an issue, and therefore decided that proper procedures were not followed, and dismissed the appeal

• Canada – Cameco Corporation
  – Deals with pricing of uranium transactions with Swiss affiliate during 2003
  – CRA reassessed on a particular basis during the audit, yet raised new arguments in its filed pleadings which discussed “recharacterization”, “sham”, and “indirect transfers of income”
  – In an interim decision dealing with motions to strike portions of the Crown’s pleadings and to strike an affidavit filed the taxpayer, the court stated that neither party “has displayed any great effort to grease the wheel that operates the appeal process”.
Transfer Pricing Cases

• **United States – Veritas**
  – $1.55 billion valuation difference between IRS and taxpayer for buy-in payment under a CSA
  – Tax Court rejected fundamental aspects of IRS’s approach
  – IRS did not appeal but does not acquiesce to Tax Court’s result or reasoning
  – 2009 Cost Sharing Regs codifies IRS approach in Veritas

• **United States – Xilinx**
  – Case focused on whether cost of employee stock options (ESOs) should be shared between Xilinx US and Irish subsidiary – 1997 to 1999
  – 2003 – Stock-based compensation specifically included in costs to be allocated under a CSA in US Cost Sharing Regs.
  – Tax Court ruled for taxpayer – proposed adjustment violated arm’s length standard
  – IRS has recently acquiesced in the result but not the reasoning of decision – mooted by 2003 amendments to Cost Sharing Regs.
Transfer Pricing Cases

• **Australia – SNF (Australia) Pty Ltd**
  
  – The court upheld transfer prices based on comparable arm’s length transactions that occurred in foreign markets, since the Australian uncontrolled transactions were too small to support application of the CUP method
  
  – Taxpayer argued that losses were due to other commercial reasons, including intense competition and poor management
  
  – Federal Court of Australia confirmed importance of comparable transactions even when there is not perfect information available
  
  – “All that the taxpayer needs to put before the Court is sufficient evidence to demonstrate true comparability”
Contact Us

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Customs Valuation - 2011

AGENDA

• GATT Valuation
  – Review six methods
  – Emphasis on transaction value method
  – Treatment of related party imports; Proof of arms length pricing

• Subsequent proceeds – post importation payments and fees
  – CBSA policy July 2009

• CBSA audit approach
  – New in 2010
GATT Valuation
GATT Valuation

• **Transaction Value**
  • Price paid/payable when the goods are sold for export to a purchaser in Canada plus certain specified adjustments

• **Transaction Value of identical or similar goods**
  • Customs value based on the value applied on a different import transaction covering identical or similar goods

• **Deductive Value**
  • Resale value in country of importation less certain costs incurred including SG&A or commission earned

• **Computed Value**
  • The costs of manufacturing plus a reasonable profit

• **Residual Method**
  • Any other reasonable method, usually a modified version of the above methods
Transaction Value

- **Sale for export**
  - Cannot use for no-charge shipments, consignment w/o sale, tolling operations w/o sale

- **To a “purchaser in Canada”**
  - Resident
  - PE and carries on business
  - Non Resident Importer provided no prior agreement to sell to a resident

- **Price paid or payable (PPOP)**
  - All payments made or to be made directly or indirectly to or for the benefit of the vendor

- **Related parties – price cannot be influenced by the relationship**
  - CBSA will in most cases accept a tax transfer price study to support pricing is at arms length
  - CBSA will examine all payments to determine whether the payment can be added as a legislated addition or part of the PPOP or must be excluded from the customs value
Transaction Value

• **Additions:**
  - Packing costs (product packaging)
  - Commissions and brokerage (selling commissions, commodity brokerage)
  - Assists:
    - Materials, parts, equipment and tooling
    - Engineering, development and artwork undertaken outside the country of importation
  - Royalties and license fees (condition of sale)
  - Subsequent proceeds from the resale, use or disposal of the imported goods
  - Transportation and insurance to the place of direct shipment

• **Deductions:**
  - Cost for installation, construction etc. after importation
  - Canadian duty and taxes included in the price
  - Transportation from the place of direct shipment to Canada
Subsequent Proceeds: Post Importation Payments
Subsequent Proceeds: Post Importation Payments

- **Legislation: Customs Act**

48. (1) Subject to subsections (6) and (7), the value for duty of goods is the transaction value of the goods if the goods are sold for export to Canada to a purchaser in Canada and the price paid or payable for the goods can be determined and ……

(c) where any part of the proceeds of any subsequent resale, disposal or use of the goods by the purchaser thereof is to accrue, directly or indirectly, to the vendor, the price paid or payable for the goods includes the value of that part of the proceeds or such price is adjusted in accordance with subparagraph (5)(a)(v); …
Subsequent Proceeds: Post Importation Payments

- **Historical Policy:**
  - CBSA rarely questioned management fees
  - R&D costs were allowed to be split between research (non-dutiable unless work resulted in an import) and development costs, which are generally dutiable
  - Costs for marketing rarely questioned
  - No clear expectations from importers on what was required as proof
Subsequent Proceeds: Post Importation Payments

CBSA Policy: Memorandum D13-4-13, July 8, 2009

• Subsequent proceeds are subject to the following two conditions:
  – The payments accrue directly or indirectly to the vendor of the goods
  – The payments are based on, or a result of, the resale, disposal, or use of the goods in Canada

• In addition, if the payment does not meet the above then the CBSA will apply the definition of “Price Paid or Payable”
Subsequent Proceeds: Post Importation Payments

- When establishing the value for duty of imported goods under the transaction value method, there are several kinds of post-importation payments that must be examined:

  (a) any payments based on the resale of the goods that cannot be related by the importer to services received;

  (b) management or administration fees;

  (c) contributions to research and development;

  (d) contributions for worldwide marketing or promotion;

  (e) overhead expenses related to the manufacturing of the goods but not captured in the selling price and recovered after the importation of goods;

  (f) interest on deferred payments; and

  (g) other payments made after importation
Subsequent Proceeds: Post Importation Payments

- **When are fees excluded from duty (includes GST)?**
  - The services must have been rendered for the operation of the business in Canada
  - The amount of the charge must be in accordance with an arm’s length charge
  - The services provided are justified for the operation of the business in Canada.
  - Payments such as dividends are excluded from the customs value
  - The service is not specified as an addition in the legislation
Subsequent Proceeds: Post Importation Payments

• Importers must be able to provide the CBSA with documents that verify:
  – The nature of the services for which payment is made
  – The basis on which the payment is made (options for cost allocations)
  – That actual services are provided

• Our experience is that most companies do not have sufficient proof to support inter-company fees.
Subsequent Proceeds: Post Importation Payments

• CBSA expects the declared value to be correct:
  – 90 days to correct from date of having reason to believe there was an error (over 90 days VDP applies)
  – Reason to believe includes date of; debit/credit note, invoice, journal entry etc.
  – Also, in almost all cases price decreases after import are not allowed

• Importers should undertake a valuation review to determine whether they are affected by this new policy

• Valuation reviews can be done in conjunction with a transfer price study
Also refer to:

- **Trade Matters Summer 2009 Edition Canada**
  - Customs Fact: Duty Surprise for Importers of Goods from Related Companies
- **Customs memorandum D13-4-13, July 2009**
Canada Border Services Agency: Valuation Audit Approach
CBSA Valuation Audit Approach

• Valuation audits are typically complex, lengthy and intrusive.
• The CBSA may request the following documents for the year under review:
  – Audited financial statements, detailed adjusted trial balance, including account descriptions and zero balance accounts
  – Reconciliation of the cost of goods sold reported on the financial statements to the adjusted trial balance; the importer must be able to identify the imported and non-imported goods
  – Identification of the General Ledger account numbers where the purchases of imported goods and the corresponding payables are recorded
CBSA Valuation Audit Approach


- Copies of transfer price studies and agreements, as well as copies of any management fee/intercompany fee agreements and royalty/licence agreements.

- Source documents for transactional testing to verify value declared versus amount paid to the vendor.
CBSA Valuation Audit Approach

Importers not prepared for a CBSA valuation audit can expect:

- Fairly long process – 6 to 12 months
- Assessment for GST and duty, if applicable, plus interest
- Penalties can be assessed - $25,000.00 per issue maximum first level (escalates on subsequent infractions)
- Additional assessment for up to four years in certain cases
- Appeals generally take more than 1 year