



Transfer Pricing Documentation Requirements

Michael Friedman, Partner

Todd A. Miller, Partner

*Presented at:
Federated Press – 8th Understanding Canada/U.S. Transfer Pricing Course
Toronto, Ontario
November 5, 2012*

Agenda

- Contemporaneous Documentation: An Overview
- Statutory Requirement for Contemporaneous Documentation
- Transfer Pricing Preparation Process
- Key Areas of CRA Review
- Common Errors/Pitfalls

Contemporaneous Documentation: An Overview

What is “Contemporaneous Documentation”?

Why do you need to create and maintain it?

- Protection from penalties
- Management of tax risk
- Basis for audit responses
- Inter-affiliate coordination
- Strategic/Operational planning
- Institutional memory
- Future sale transactions



Statutory Requirement for Contemporaneous Documentation

(i) History

- Prior to the introduction of section 247 of the *Income Tax Act* (Canada) (the “Act”), transfer pricing requirements were largely governed by former subsections 69(2)/(3) of the Act.

Former subsections 69(2)/(3)	Section 247
<ul style="list-style-type: none">• “Reasonable amount in the circumstances” test• Informal documentation requirements	<ul style="list-style-type: none">• Comparative “Arm’s Length” test for each “transaction”• 247(2) – Transfer pricing “adjustments” (capital/income/setoff)• 247(3) – Imposes transfer pricing penalty• 247(4) – Contemporaneous documentation requirement to avoid penalties

Statutory Requirement for Contemporaneous Documentation

(ii) Penalty Provision – Subsection 247(3) of the Act (excluding QCCAs)

- Penalty of 10% of:
 - the total transfer pricing income and capital adjustments for the year
 - minus**
 - the total transfer pricing income and capital adjustments and the total transfer pricing income and capital setoff adjustments relating to transactions in respect of which “reasonable efforts” have been made to determine and use arm’s length transfer prices or allocations (the “**Penalty Base**”)
- Penalty applies where the Penalty Base exceeds the lesser of 10% of the taxpayer’s adjusted gross revenues and \$5 million

Statutory Requirement for Contemporaneous Documentation

(ii) Penalty Provision – Subsection 247(3) of the Act (cont'd)

- CRA: The penalty imposed under subsection 247(3) is intended to be a compliance penalty.
 - If a taxpayer made **reasonable efforts** to use arm's length transfer prices, the penalty will not apply.
- CRA: “A reasonable effort means the degree of effort that an independent and competent person engaged in the same line of business or endeavour would exercise under similar circumstances”.

Statutory Requirement for Contemporaneous Documentation

(iii) “Reasonable Efforts” Deeming Rule

- Unless a taxpayer prepares documentation containing the items listed in paragraph 247(4)(a) of the Act by the relevant “documentation-due date”, the taxpayer is deemed not to have made reasonable efforts to determine and use arm’s length transfer prices or allocations.
- Under subsection 247(4), the taxpayer must also:
 - update contemporaneous documentation for subsequent taxation years or fiscal periods to account for material changes; and
 - provide contemporaneous documentation to the Minister of National Revenue within three months of a written request served personally or by registered or certified mail.

Statutory Requirement for Contemporaneous Documentation

(iii) “Reasonable Efforts” Deeming Rule (cont’d)

- Documentation must provide an accurate and complete description of:
 - i. the property or services to which the subject transaction relates;
 - ii. the terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the same parties;
 - iii. the identity of the participants to the transaction and their relationship to each other at the time the transaction was entered into;
 - iv. the risks the participants assumed, the functions they performed and the property they used or contributed in respect of the transaction;
 - v. the data and methods considered and the analysis performed to determine the transfer prices (or relevant allocations/contributions) in respect of the transaction; and
 - vi. the assumptions, strategies and policies that influenced the determination of the transfer prices (or relevant allocations/contributions) in respect of the transaction.

Statutory Requirement for Contemporaneous Documentation

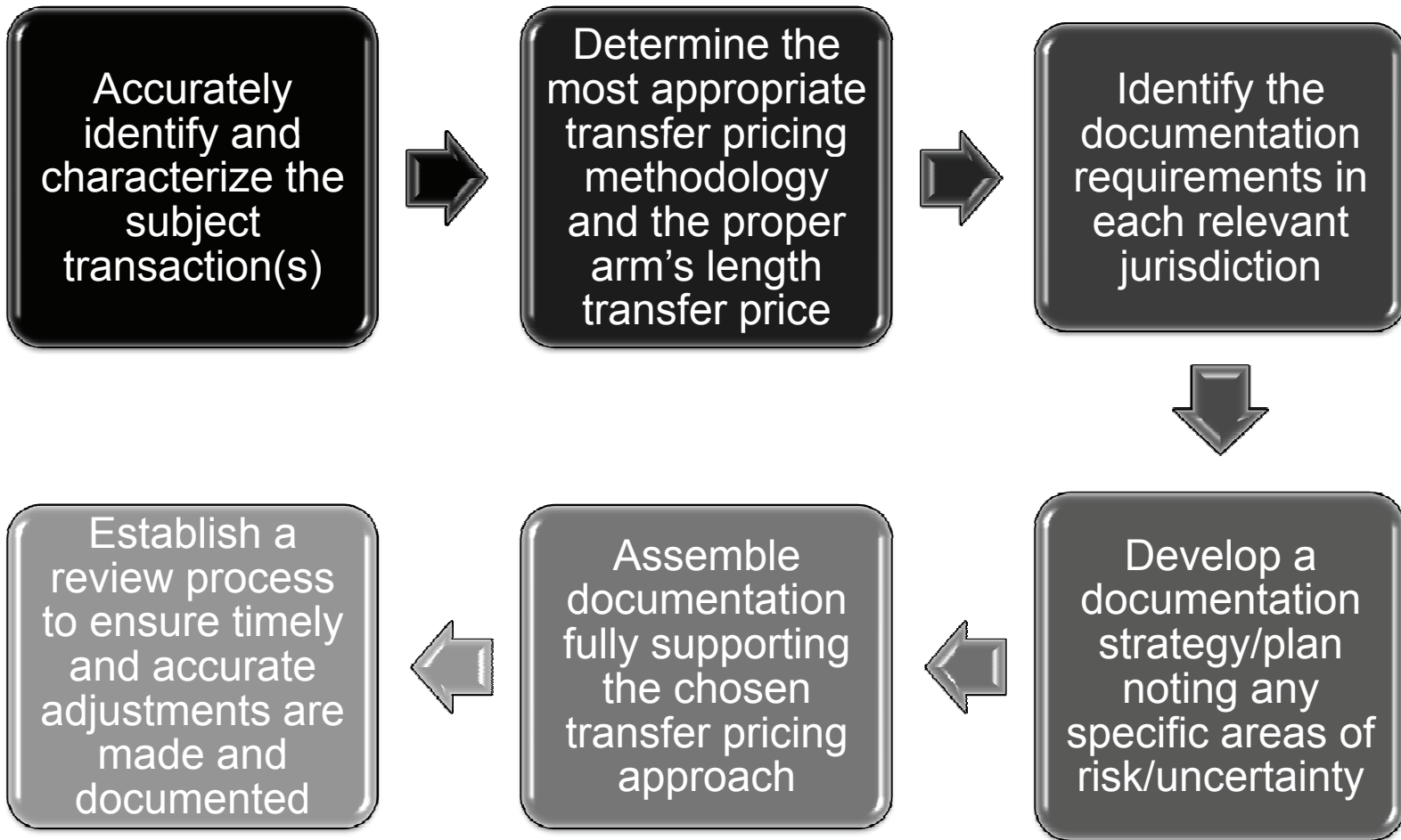
(iii) “Reasonable Efforts” Deeming Rule (cont’d)

- CRA: The documentation list set out in paragraph 247(4)(a) is not exhaustive; compliance with the list does not preclude a finding that the taxpayer has not made reasonable efforts to determine arm’s length transfer prices.
- CRA: A taxpayer will be deemed not to have made reasonable efforts if contemporaneous documentation is not received within three months of the taxpayer’s receipt of a written request.
- Part 7 of IC 87-2R sets out certain of the CRA’s expectations with respect to contemporaneous documentation practices.
See <http://www.cra-arc.gc.ca/E/pub/tp/ic87-2r/ic87-2r-e.pdf>

Canadian Transfer Pricing Statistics

- As suggested in recent private sector reports:
 - The CRA has reportedly levied approximately \$300 million in penalties pursuant to subsection 247(3).
 - As of March, 2012, 295 potential 247(3) penalty assessments have been referred to the CRA's Transfer Pricing Review Committee (the "TPRC"), with the Committee recommending penalty assessments in 151 of those cases.
 - In fiscal 2010-2011 alone, the TPRC considered 34 penalty referrals and recommended that penalties be levied in 21 of those cases (62%).
- *GlaxoSmithKline* – Minister's SCC Leave Application

Transfer Pricing Preparation Process



Transfer Pricing Preparation Process

Developing a Documentation Strategy:

- ***Description/Characterization of the transaction***
 - Define what type of product or service is being transferred/delivered
- ***Functional Analysis***
 - Describe the functions and risks associated with the transaction and the property owned by each transaction participant
- ***Industry overview***
 - Conduct analysis of industry-specific data and statistics
- ***Determine the most appropriate transfer pricing methodology***
 - Information Circular 87-2R provides an overview of methodologies
- ***Economic/Financial Analysis***
 - Assess the financial performance of each transaction participant
 - Consider comparable companies and/or transactions to identify appropriate pricing adjustments

Sources of Data

■ Internal Sources

- Past transfer pricing studies
- Intercompany invoices, agreements, correspondence
- Accounting records
- Business plans and organizational charts showing the relationship between parties to the transaction
- Functional analyses describing the functions and risks of each related party
- Financial analyses documenting the economic circumstances associated with the transaction
- Tenured management/personnel
- Foreign-based information



Sources of Data

■ External Sources

- Commercial/Public Databases (e.g., EdgarStat, ONESOURCE Transfer Pricing, SEDAR)
 - Note potential lack of data specific to Canadian companies.
 - Be aware of differences in accounting systems when dealing with some international companies.
- Industry Data
- Trade Journals

Note that various characteristics can influence comparability among transactions. These include:

- *Contractual terms and conditions;*
- *Descriptions of goods or services; and*
- *Risks assumed and functions performed by the parties.*

PATA Model Documentation Package

- The former Pacific Association of Tax Administrators (“PATA”) released a documentation package to help taxpayers meet the transfer pricing documentation requirements imposed by member nations. The package can be found at:
<http://www.cra-arc.gc.ca/tx/nrsdnts/cmmn/trns/pt-eng.pdf>
- Elements of the PATA documentation package include reports pertaining to:
 - Organizational structure;
 - Nature of the business;
 - Controlled transactions;
 - Assumptions, strategies and policies; and
 - Comparability, functional and risk analysis.

Key Areas of CRA Review

CRA Standard Audit Protocol

- Requests for contemporaneous documentation must be issued when conducting a transfer pricing audit.
- Requests for contemporaneous documentation can be issued by letter or query sheet. A sample audit query sheet can be found at:
<http://www.cra-arc.gc.ca/tx/nrsdnts/cmmn/trns/nxb-eng.pdf>
- Taxpayers must submit documentation within the three month period provided in paragraph 247(4)(c) or they will be deemed to not to have made reasonable efforts to determine arm's length transfer prices.
- See *Transfer Pricing Memorandum 05 – Contemporaneous Documentation*
<http://www.cra-arc.gc.ca/tx/nrsdnts/cmmn/trns/tpm05-eng.html>

Key Areas of CRA Review

CRA Transfer Pricing Red Flags

- Persistent Losses/Profitability Variances
- Intangibles and Royalties
- Bundled Supplies
- Contract Manufacturing Arrangements
- Intragroup Services
- Business Reorganizations, IP Migrations
- Management or Guarantee Fees
- Transactions involving low tax jurisdictions
- Overlapping Transactions (commissions, reimbursements)
- T106 reporting issues
- Changes in transfer pricing methodologies



Common Errors/Pitfalls

- Insufficient/incomplete contemporaneous documentation
- Inappropriate use of comparables/methodologies
- Failure to update contemporaneous documentation
- Failure to provide contemporaneous documentation within 3 months of a written request
- Failure to appreciate jurisdictional differences
- No organizational agreements in writing
- No inter-affiliate coordination/consistency
- Compromise of legal privilege
- Lack of continuity of personnel
- T106 reporting errors



Concluding Comments

Effective transfer pricing documentation practices entail:

- Advance planning and co-ordination
- Rigorous and well-organized document preparation
- Disciplined monitoring and reassessment
- Proactive responses to audit inquiries



Questions?



Cautionary Note

The foregoing commentary is summary in nature and does not address all of the issues and considerations that may be relevant under any particular set of circumstances.

The statements and material presented herein do not represent legal or tax advice.

No transactions should be executed on the basis of the foregoing statements and commentary.

Formal legal, tax, and accounting advice should be obtained prior to making any investment or executing any transaction.

Transfer Pricing Documentation Requirements



Michael Friedman, Partner
michael.friedman@mcmillan.ca
d 416.865.7914 | f 416.865.7048

Todd A. Miller, Partner
todd.miller@mcmillan.ca
d 416.865.7058 | f 416.865.7048

McMillan LLP
181 Bay Street, Suite 4400
Toronto, ON M5J 2T3