

## TAX LAW BULLETIN

December 2007

### YOUR GUIDE TO THE TRANSFER PRICING IMPACT OF THE NEW CANADA-US PROTOCOL

(First published in *TP Week*, “Your guide to the transfer pricing impact of the new Canada-US Protocol” (Nov. 22, 2007), online: *TP Week - Transfer Pricing Weekly News from the International Tax Review* <http://www.tpweek.com/Article.aspx?ArticleID=1698014>.)

The *Income Tax Act* (Canada) contains an extensive set of transfer pricing rules designed to ensure that cross-border transactions entered into between Canadian taxpayers and non-residents with which they do not deal at arm’s length are priced on an arm’s length basis. Not surprisingly, difficulties frequently arise when the Canada Revenue Agency (the “CRA”) applies these transfer pricing rules in a manner that is inconsistent with the assessing position adopted by a foreign revenue authority. Such conflicts are contemplated and, at least to a certain degree, addressed in most of the income tax treaties to which Canada is a party, including the *Canada-United States Income Tax Convention*.

On September 21, 2007, the Canadian and United States governments released the text of the fifth protocol to the treaty. The protocol introduces a number of substantive changes to the treaty, including certain measures that may significantly impact the transfer pricing practices of Canadian enterprises that transact business with related US parties.

### BINDING ARBITRATION

Of particular note and in contrast to Canada’s other tax treaties, the protocol will introduce a binding arbitration process that may be triggered when the relevant Canadian and US revenue authorities (the “competent authorities”) are unable to resolve certain conflicting assessments that may lead to double taxation. While not all disputes will be eligible to be resolved by the new arbitration provision, the governments have agreed that disputes relating to the pricing of transactions between related persons will generally qualify. (However, a matter that otherwise qualifies for arbitration may not be eligible to be arbitrated if both the Canadian and US authorities agree, before the date on which arbitration would otherwise commence, that the issue is not suitable for arbitration.) Where the binding arbitration process has been triggered, the competent authorities will be required to submit their proposed resolution of the dispute to the appointed arbitration board. The arbitration board must resolve the matter by selecting one of the two proposals tabled by the competent authorities and may not devise an alternate resolution (the so-called baseball arbitration approach).

The taxpayer whose affairs are the subject of an arbitration proceeding maintains an effective veto over the arbitration process since proceedings may not commence unless the taxpayer agrees not to publicly disclose any information received during the course of the arbitration, other than the outcome of the dispute. In addition, the taxpayer is not required to accept the outcome of the arbitration and may ultimately seek an alternative resolution through the applicable domestic appeal process.

The new binding arbitration measures introduced by the protocol should have positive implications for both the manner in which the Canadian and US revenue authorities audit the transfer pricing practices of domestic taxpayers and, more broadly, the general approach such authorities take to resolving transfer pricing disputes. For example, since a transfer pricing dispute may ultimately be put before an arbitration board for binding resolution, the competent authorities may begin to develop more reasoned or pragmatic assessing positions at the early stages of a transfer pricing review. The negotiation styles adopted by the competent authorities may also be altered in so far as a pending arbitration may discourage blue sky bargaining and motivate the adoption of more conciliatory approaches to the resolution of transfer pricing disputes. Tax directors of multi-national enterprises should remain cognisant of the new binding arbitration provisions that are set to be introduced by the protocol and factor the potential availability of binding arbitration into their negotiation strategy when addressing certain transfer pricing issues with the Canadian and US revenue authorities.

## OTHER CHANGES IN THE PROTOCOL

A number of other changes introduced by the protocol will have an impact on transfer pricing policy and practice. For instance, the Protocol signals the commitment of the contracting states to the principles enunciated in the OECD Transfer Pricing Guidelines. Specifically, in an annex to the protocol, the governments provided that, in applying article VII of the treaty: “the principles of the OECD Transfer Pricing Guidelines shall apply for purposes of determining the profits attributable to a permanent establishment”. The protocol also introduces certain enhancements to article XXVII of the treaty relating to the exchange of information between the Canadian and US governments, which may have implications for the identification of transfer pricing issues and related audit practices.

The release of the protocol will not only impact the transfer pricing practices of Canadian and US residents that execute cross-border transactions, it may also signal the Canadian government’s inclination to introduce comparable provisions when negotiating/re-negotiating other tax treaties in the future. Tax directors would, therefore, be well advised to closely monitor the application of the protocol to obtain a better sense of the future trends that may guide Canadian tax policy, particularly as they relate to transfer pricing.

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*The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.*

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