Meritas Capability Webinar:

Essential Tax Strategies for US Businesses in Canada

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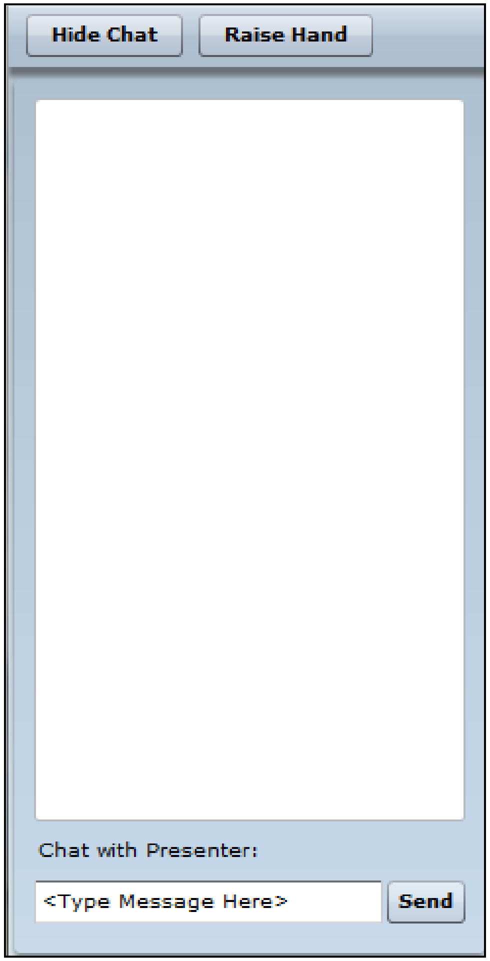

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Presenters

- Meritas Canada Tax Group - Members
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  - Harold Feder, Colin Green (BrazeauSeller.LLP - Ottawa, Ontario)
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  - Robert Korne, Marc-André Bélanger (BCF LLP - Montréal, Quebec)
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Overview

- This webinar is directed at U.S. solicitors and tax advisors with clients carrying on or proposing to commence business operations in Canada. The Meritas Canada Tax Group is made up of some 25 practicing Tax Lawyers representing all of Canada and its Provinces and Territories. If you have clients doing business in Canada and want to gain a better understanding of the key Canadian tax issues such U.S. enterprises face when establishing a base of operations in Canada, this program is for you.
- This short webinar program is intended as a checklist of key Canadian tax issues and planning opportunities that U.S. enterprises and their legal counsel should consider before establishing business operations in Canada. And for those of you with clients already doing business in Canada, we will identify key changes in the cross-border taxation of U.S. businesses and the strategic tax planning that can be undertaken to avoid the adverse consequences arising from these new tax rules.

Outline

- Taxation of US Employees/Contractors in Canada
- Selecting a Canadian Business Structure
- Financing Canadian Operations
- Transfer Pricing Canadian Perspective

Taxation of US Employees/Contractors in Canada: Issues and Solutions

Presented by: Colin Green, BrazeauSeller.LLP

US Employees/Contractors in Canada

- Many U.S. companies send employees or self-employed contractors to Canada to perform services.
- It is important to understand the key issues that accompany cross-border employees and contractors.

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US Employees/Contractors in Canada

Outline:

1. Federal income tax overview
2. U.S. contractors (paid by CAD or U.S. employers)
3. U.S. employees (paid by their U.S. employers)
4. Visa requirements

US Employees/Contractors in Canada

1. Federal income tax:

- US residents are subject to Canadian tax on the following types of income:
  - ***Employment income earned in Canada***
  - ***Income from carrying on business in Canada***
  - Gains realized from disposition of “taxable Canadian property”
  - Canadian source “passive” income
- Our focus here is on the first two.

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US Employees/Contractors in Canada

1. Federal income tax:

- U.S. companies that "carry on business" in Canada are subject to CAD tax (absent treaty exemption).
- If no Permanent Establishment ("P.E."), Article VII of the CAD-US Income Tax Convention Treaty provides for no tax (absent certain exceptions).
- Definition of P.E. in broad terms:
  - Key role of "fixed place of business"
  - Dependent agent P.E. (concludes contracts on behalf)
  - P.E. from Services: Single Individual Test: provide services through an individual who meets physical presence test (183 days in CAD) and gross revenue test (50% of individual's gross active revenue in CAD)
  - P.E. from Services: Enterprise Test: provide services for 183 days or more in 12 month period in connection to same project

US Employees/Contractors in Canada

1. Federal income tax:

- If a U.S. company does not have a P.E., it may still be subject to certain Canadian income tax filing and withholding requirements in respect of subcontractors and employees performing work in Canada.

US Employees/Contractors in Canada

2. US contractors working in Canada:

- ITA (s.153(1)(g)) and regulation (105(1)) provide for 15% withholding of fees, commissions, or other amounts paid to US persons for services provided in CAD.
- Payer is fully liable for tax owing, in addition to penalties and interest (even if non-resident)
- If services provided in US and in CAD, an apportionment may be made.

US Employees/Contractors in Canada

2. US contractors working in Canada (con’t):

- Note: regulation 105 withholding is not the end of the matter! The withholding is on account of U.S. contractor’s CAD income tax liability. The U.S. contractor must then file a CAD income tax return.
- Also possible to obtain a **waiver**. The waiver must be in place before payments made.

US Employees/Contractors in Canada

2. US contractors working in Canada (con’t):

- Example: U.S. company sends U.S. contractor to work in Canada (to provide services on their behalf), absent a waiver, the U.S. company is required to withhold and remit even though it has no presence in Canada.

US Employees/Contractors in Canada

3. US employees working in Canada:

- U.S. companies providing remuneration to U.S. employees (providing service in Canada) are subject <u>same</u> withholding and remittance requirements that CAD employers are subject to (unless a waiver is obtained) under Regulation 102. Employers must remit:
  - Income tax
  - CPP contributions
  - EI premiums (reciprocity agreement)

US Employees/Contractors in Canada

3. US employees working in Canada:

- Employers must remit:
  - Income tax
  - CPP contributions
  - EI premiums (reciprocity agreement)
- Employers must also do the following:
  - Prepare and submit waiver at least 30 days before employment in Canada begins
  - Prepare and submit Canadian information returns on same timeline as Canadian employers
  - Obtain Canadian individual tax numbers for each non-resident employee
  - apply for Certificate of Coverage from IRS re: CPP

US Employees/Contractors in Canada

3. US employees working in Canada (cont'):

- Note: regulation 102 withholding is not the end of the matter! The withholding is on account of U.S. employee's CAD income tax liability. The U.S. employee must then file a CAD income tax return and U.S. employer must still issue information slips.
- Note: payer is <u>fully liable</u> for tax owing, in addition to penalties and interest (even if non-resident)

US Employees/Contractors in Canada

3. US employees working in Canada (cont'):

- Also possible to obtain a **waiver**. The waiver must be in place before payments made (ideally, 30 days in advance of start of work or first payment) .

US Employees/Contractors in Canada

3. US employees working in Canada (cont'):

- Exemption under the Canada – US Treaty: Article XV provides for an exemption *if*
  - Total remuneration is under $10,000 (on calendar year basis), *or*
  - employee not present in Canada for 183 day period (in calendar year) *and* remuneration not borne by employer who is a CAD resident or P.E. (or fixed base) in Canada.
  - Note: should still apply for waiver to avoid withholding requirement

US Employees/Contractors in Canada

4. VISA requirements for working in Canada:

- Be aware of the potential requirement to obtain a Canadian work visa for more than "business visitors".
- Under NAFTA (U.S. and Mexican) business visitors may enter Canada to perform duties related to the business cycle (R and D, manufacture and production, marketing, sales, distribution, and service).
- Their primary source of remuneration and principal place of business <u>must</u> remain outside of Canada and Business Visitors cannot enter the Canadian labour market.
- Be aware of documents (letters, evidence, etc.) which may be required.

US Employees/Contractors in Canada

Conclusions:

- In some instances, both a Regulation 102 and a Regulation 105 waiver may be required (example: if a U.S. company pays a U.S. worker).
- CRA increasingly reassessing taxpayers who fail to apply for waivers in advance . This can result in:
  - Penalties of 10% to 20% the withholding;
  - Interest at the prescribed rate; and
  - Additional penalties for failure to file or distribute a Form T4 (penalty a daily amount, with total from $100 to $7,500)

US Employees/Contractors in Canada

Best Practices:

- In entering the Canadian workplace, consult a tax professional.
- Apply for the requisite waivers early in the process.
- File all necessary tax returns (even if waivers have been obtained)

Selecting a Canadian Business Structure

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Selecting a Canadian Business Structure

Outline:

- Canadian Branch
- Canadian Subsidiary Company
- Unlimited Liability Company (“ULC”)
- US Owner of ULC
- US Owner of non ULC
- Comparison of ULC jurisdictions
- Partnership

Canadian Branch

- Not a separate legal entity – simply carrying on business in Canada through the US entity
- Advantages
  - If business will incur substantial losses in first years of operations, then can be deducted against income from other sources in the US entity
  - Branch may work where a flow-through structure is desirable for US tax purposes – but sometimes unlimited liability companies may be an alternative

Canadian Branch

- Disadvantages
  - Liability risk mixed with other activities of the US entity
  - Financial statements for the branch which include income earned in Canada must satisfy both Canada Revenue Agency ("CRA") and the U.S. Internal Revenue Service – allocation of expenses is sometimes difficult
  - Compliance obligations of a branch are sometimes more onerous – clearance certificate on disposition of property, withholding tax on amounts it receives from providing services in Canada
  - If you want to later use a Canadian corporation, may be adverse US and/or Canadian consequences

Canadian Branch

- Canadian operations of a branch will be subject to the following tax:
  - Canadian corporate income tax on the net income of the branch – range from 25% to 31%
  - Canadian withholding tax on property income earned by the branch
  - Branch tax at a rate of 25% of the net profits not reinvested in Canada, unless rate is reduced by Canada-US Treaty

Canadian Branch

- Branch tax charged on after tax income of branch operation, subject to a lifetime exemption for the first C$500,000 of Canadian income.
- Branch tax rate is 25% but rate is usually reduced under the Treaty to 5% for US corporations.
- Branch tax is effectively the equivalent of the 5% non-resident withholding tax which would be applicable under the Treaty if the US corporation carried on business in Canada through a subsidiary and repatriated earnings with a dividend.
- But – branch tax is imposed in year profit is earned as opposed to the time when dividends are declared

Canadian Branch

- In summary – both Canadian corporate tax and branch tax will apply to business income earned by a US corporation doing business in Canada as a branch
- US corporation would include all income earned in Canada for US federal income tax purposes and should be eligible for foreign tax credits for Canadian taxes paid

Canadian Subsidiary Corporation

- A corporation can be incorporated under the legislation of a particular province, or federally under the *Canada Business Corporations Act*.
- The provinces of British Columbia, Alberta and Nova Scotia allow "unlimited liability companies" which are often chosen for US tax purposes.

Canadian Subsidiary Corporation

- A corporation incorporated in Canada (including ULC's), will be a resident of Canada within the meaning of the ITA and will be subject to Canadian income tax (federal and provincial) on its worldwide income.
- Dividends paid by the Canadian subsidiary corporation to a qualifying US resident parent corporation, will be subject to Canadian withholding tax of 25% under the ITA (may be reduced by Treaty).

Canadian Subsidiary Corporation

- Most US entities doing business in Canada will be subject to a reduced withholding rate:
  - must own 10% or more of the voting stock of the Canadian corporation
  - Canadian withholding tax rate is reduced from 25% to 5% under the Treaty
  - Article IV(7)(b) of the Treaty has the effect of denying treaty benefits on dividends paid by a ULC to US shareholders, but techniques have developed that can result in the same treaty benefits

Canadian Subsidiary Corporation

- Corporate income tax is levied by both the federal and provincial governments, and varies according to the nature of the corporation's business, its residency status and affiliations
- Federal corporate tax rate is 15%
- Provincial tax rates vary significantly
- Combined federal/provincial rates range from 25% to 31% for US controlled Canadian subsidiary corporations

Unlimited Liability Company

- A ULC is a unique type of corporation that can be incorporated in Alberta, British Columbia and Nova Scotia.
- Characteristics
  - Separate legal entity
  - Shareholders have unlimited liability exposure (but not the same exposure in each province)
  - Can be treated as a look-through for US tax purposes
  - Regarded as a corporation for Canadian tax purposes and taxed in Canada on that basis

Unlimited Liability Company

- Often used by US entities carrying on business in Canada because of their hybrid nature
- Usually recommend a blocker company between US parent and ULC because of liability concerns for shareholders of ULC

Unlimited Liability Company

- Simple example 1:
  - US individual carries on a Canadian business through an S-corp that owns the shares of a ULC
  - S-corp is blocker company
  - ULC pays
    - Canadian corporate tax on business income at rate ranging from 25%-31%
    - Reduced Canadian withholding tax of 5% on dividends paid to S-corp – when PUC increase technique is used
  - US individual pays
    - US tax on the income of ULC (because both S-corp and ULC would be treated as fiscally transparent in US)
    - Full foreign tax credit in US for both Canadian corporate tax and withholding tax

Unlimited Liability Company

- Simple example 2
  - US C-corporation carries on a Canadian business through ownership of a ULC
  - May have a 2nd US C-corporation as blocker company
  - ULC pays
    - Canadian corporate tax on business income at rate ranging from 25%-31%
    - Reduced Canadian withholding tax of 5% on dividends paid to C-corp – when PUC increase technique is used
  - US C-corporation pays
    - US tax on the income of ULC (because ULC is treated as fiscally transparent in US, and both US C-corps can file on a consolidated basis)
    - Full foreign tax credit in US for both Canadian corporate tax and withholding tax

US Owner of ULC – Limited Liability Company

- Using a US LLC as the entity that carries on business in Canada through a branch or owns the shares in a Canadian subsidiary corporation has problems because of how Canada Revenue Agency has interpreted the Treaty

US Owner of ULC – Limited Liability Company

- CRA has historically taken the position that a fiscally transparent LLC is not entitled to treaty benefits because it is not a resident of the US for the purposes of the Treaty
- Treaty changed on February 1, 2009, to allow the benefits of the treaty to be available in connection with income, profit, or gain paid to or derived by a fiscally transparent US LLC with one or more US resident members by treating such members as having derived the amount for the purposes of the Treaty.

US Owner of ULC – Limited Liability Company

- Complications in practice because although US shareholders of USLLC may get benefits, Canada still treats USLLC as only taxpayer.
- Canada does not treat USLLC as though it did not exist, substituting shareholders for the USLLC as the taxpayer

US Owner of ULC – Limited Liability Company

- USLLC must file a Canadian tax return in which it claims the benefit of Article 4(6) and must supply documentation to support the claim that is based on the identity of the USLLC's shareholders
- If shareholders are not corporations that are entitled to treaty benefits, then reduced treaty rate on dividends will not apply

US Owner of ULC – Limited Liability Company

- In practice it may be difficult for a Canadian resident payer to evaluate the treatment of a payment to the USLLC on the fictitious assumption that it was received directly by the USLLC member.
- If the Canadian resident payer has mistakenly withheld the reduced treaty rate, the payer will be liable for unremitted withholding.

US Owner of ULC – S Corporation

- See simple example 1 on earlier slide
- Exceptionally, because Canada has historically accepted that an S corporation is itself resident in the United States for purposes of the Convention, Canada will allow benefits under the Convention to the S corporation in its own right.
- Difference between how CRA treats LLC's and S-corporations is hard to understand…

US Owner of ULC – US C Corporation

- C corporation may own the shares of a ULC as noted earlier in simple example 2, but there may not be significantly different tax liability than if the C corporation owns shares of a non-ULC Canadian corporation.

US Owner of Non-ULC

- If a US C corporation owns a Canadian corporation that is not a ULC, indirect foreign taxes may sometimes be claimed in the US to get a similar overall tax result as if the C corporation owned the ULC.
- If a fiscally transparent S corporation, LLC or partnership owned by US residents owns the shares of the Canadian corporation that is not a ULC, the Canadian profits will be taxed first in Canada and then in the US upon repatriation via dividends. No credit will be available in the US to the individual owners of the S-corp, LLC or partnership for taxes paid in Canada.

Comparison of ULC Jurisdictions

	Nova Scotia Unlimited Liability Company "NSULC"	Alberta Unlimited Liability Corporation "ABULC"	British Columbia Unlimited Liability Corporation "BCULC"
Cost of Incorporating	Incorporation fee of $1,050.60, and an ongoing annual filing fee, of $1,050.60.	Incorporation fee of $250 and an ongoing annual filing fee of $30.	Incorporation fee of $1,000, and an ongoing annual filing fee of $45.
Shareholder Liability	Shareholders are not co-debtors or guarantors of the obligations of the NSULC and only become liable for any deficiency on the part of the NSULC upon the winding –up of the Corporation.	Articles of the ABULC must include an express statement that the liability of each of its shareholders "for any liability, act or default of the unlimited liability corporation is unlimited in extent and joint and several in nature." Accordingly, a creditor of an ABULC will have a direct claim against all shareholders without having to seek recourse against the ABULC or having it wound-up.	Like the NSULC, shareholders have no direct liability to creditors of the BCULC and can only become liable to contribute to the BCULC to cover debts and liabilities on liquidation and are jointly and severally liable for payment to the BCULC's debts and liabilities on dissolution.

Comparison of ULC Jurisdictions

	Nova Scotia Unlimited Liability Company "NSULC"	Alberta Unlimited Liability Corporation "ABULC"	British Columbia Unlimited Liability Corporation "BCULC"
Statutory Limits to Liability of Former Shareholders	No liability unless court holds that existing shareholders are unable to satisfy the obligations of the unlimited company. No liability to contribute to a deficiency upon liquidation if it ceased to be a shareholder one year or more before the wind-up. No liability for any debt or liability of the NSULC arising from contracts entered into after it ceased to be a shareholder.	Only liable for liabilities that were incurred while a shareholder, and any action must be brought within two years of ceasing to be a shareholder.	No liability unless existing shareholders are unable to satisfy the debts and liabilities of the BCULC, and even then no liability: 1) for any debt or liability that arose after the former shareholder ceased to be shareholder; 2) on a liquidation of the BCULC, if the former shareholder ceased to be a shareholder one year or more before the commencement of the liquidation; or 3) on or after dissolution of the BCULC, effected without liquidation, if the former shareholder ceased to be a shareholder one year or more before the date of dissolution.

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Comparison of ULC Jurisdictions

	Nova Scotia Unlimited Liability Company "NSULC"	Alberta Unlimited Liability Corporation "ABULC"	British Columbia Unlimited Liability Corporation "BCULC"
Directors Residence	No residency requirement	At least 25% of directors must be resident in Canada.	No residency requirement
Director's Liability	The NSCA does not deal extensively with directors' liability, so the common law test for directors' liability that generally applies. There is an obligation on directors to exercise a degree of skill reasonably expected form a person of his/her knowledge and skill. Under Nova Scotia law, directors have no statutory liability for employee's unpaid wages. Instead, unpaid wages owed to employees can be protected by a lien on the employer's assets. The NSCA does not impose any limitation on the scope of indemnification that an NSULC can provide to its directors.	The ABCA provides for an objective test with respect to the duty of care required of directors and imposes liability for directors in respect of a broad range of corporate acts. Under the ABCA and Alberta employment standards legislation, directors have a statutory liability for up to six months' unpaid wages owed to employees. The ABCA limits the scope of director's indemnity to specifically enumerated matters.	The BCBCA also provides for an objective test with respect to the duty of care required of directors and imposes liability for directors in respect of a broad range of corporate acts. The BCBCA limits the scope of director's indemnity to specifically enumerated matters. The liability of directors for unpaid wages is not addressed in the statute.

Comparison of ULC Jurisdictions

	Nova Scotia Unlimited Liability Company "NSULC"	Alberta Unlimited Liability Corporation "ABULC"	British Columbia Unlimited Liability Corporation "BCULC"
Dividends	No statutorily enforced solvency tests restricting the declaration of dividends. However, NSULCs are subject to regular common law rules for such declarations.	An ABULC must satisfy a statutory insolvency test before declaring a dividend.	A BCULC must satisfy a statutory insolvency test before declaring a dividend.
Return of Capital	An NSULC can return paid up capital to its shareholders with 2/3* approval of shareholders, or pursuant to its articles of association (generally by shareholder's resolution). This action is not subject to any statutory solvency test. *For companies incorporated before June 1, 2008, ¾ approval is necessary instead of 2/3 (unless ¾ of shareholders have approved that all future special resolutions will be 2/3)	An ABULC can return paid up capital with 2/3 approval of shareholders and the satisfaction of a solvency test. The ABULC cannot return paid-up capital if there are reasonable grounds for believing that the corporation is, or would after the reduction be, unable to pay its liabilities as they become due, or the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities.	A BCULC can return paid up capital with 2/3 approval of shareholders and the satisfaction of solvency test. A BCULC cannot return paid-up capital if there are reasonable grounds for believing that the company's realizable value of the company's assets would, after the return, be less than the aggregate of its liabilities.

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Partnership

- May be entered into by a foreign corporation, directly or through a subsidiary, if it wishes to establish a business arrangement with another entity.
- Would take the form of a general partnership or limited partnership
- Each province has its own legislation governing partnerships

Partnership

- Income or loss of business is calculated at the partnership level as if partnership were a separate person, but the resulting net income or loss flows through to the partners and taxable in their hands.
- Partnerships themselves are not taxable entities for Canadian income tax purposes

Partnership

- May be appropriate if the business is expected to generate losses in its early years, as the partnership structure would allow each partner to take advantages of such losses. The amount of losses available to a limited partner is limited to the amount which it has “at risk” in the partnership.

Financing Canadian Operations

Presented by: Robert Korne – BCF LLP
Marc-André Bélanger – BCF LLP

March 14, 2013

Financing Canadian Operations

1. Debt vs. Equity
2. Deductibility of Interest
3. Canadian Withholding Tax
4. Use of Canadian Disregarded Entity
5. Canada-US Double-Dip Financing Structure
6. Canadian Refundable R&D Tax Credits

Financing Canadian Operations

1. Debt vs. Equity

- Legal form over substance;
- Equity invested in a Canadian corporation;
  - Repayment of equity to non-resident shareholders - without Canadian tax consequences, subject to the new Canadian foreign affiliate dumping rules

Financing Canadian Operations

2. Deductibility of Interest

- Fixed or participating interest;
- Use and purpose of financing;
- If non-arm's length, payment before end of the second year after the year of the interest deduction;
  - Election to pay the Cdn withholding tax to preserve the interest deduction;
- Leveraged buy-out;
  - Bump of capital assets including foreign affiliates;
- Transfer pricing analysis required to determine reasonable interest rate.

Financing Canadian Operations

2. Deductibility of Interest

- Thin capitalization rules;
  - Portion of interest deduction denied if debt-equity ratio not satisfied;
  - Debt-equity ratio – monthly computations;
  - Old rule: debt-equity ratio of 2:1;
  - New rule: debt-equity ratio of 1.5:1;
  - Relevant debt: 25% non-resident shareholder debt;
  - Foreign parent’s guarantee of debt not relevant to determine the debt portion.

Financing Canadian Operations

2. Deductibility of Interest

- Thin capitalization rules:
  - No consideration given to taxable income;
  - Applicable to partnership having corporate partners;
  - Not applicable to Canadian trust;
  - Deemed dividend on a portion of the interest not deductible under the thin capitalization rules;
  - Canadian withholding tax on deemed dividend.

Financing Canadian Operations

3. Canadian Withholding Tax

- No Canadian withholding tax on fixed interest paid on arm’s length debt;
- Participating debt interest;
  - Convertible debentures
    - Private vs. publicly-traded company context;
- Canada-United States Income Tax Treaty;
  - Limitation on benefits must be considered;
  - No Canadian withholding tax on fixed interest (arm’s length or not);
  - Canadian withholding tax of 15% on participating debt interest;
    - Different definition under the treaty.

Financing Canadian Operations

4. Use of Canadian Disregarded Entity

- Canada-United States Income Tax Treaty:
  - Article IV(7) and Canadian unlimited liability company (ULC);
    - Fixed (or participating) interest paid by a Canadian ULC to sole US shareholder (i.e. corporation for Canadian income tax purposes and a disregarded entity for US tax purposes)
      - 25% Canadian withholding tax.

Financing Canadian Operations

4. Use of Canadian Disregarded Entity

- Canada-United States Income Tax Treaty
  - Article IV(7) and Canadian ULC;
    - Fixed interest paid by a Canadian ULC having two or more shareholders (i.e. corporation for Canadian income tax purposes and a partnership for US tax purposes);
      - 0% Canadian withholding tax (because no different treatment for Canadian and US tax purposes);
    - Interest paid by Canadian ULC to US grand-parent shareholder;
    - Interest paid to an intermediary foreign holding company.

Financing Canadian Operations

5. Canada-US Double-Dip Financing Structure

- Impact of the 5th Protocol of the Canada-United Income Tax Treaty;

  - Old structure: hybrid entity financing structure;
  - New structure: hybrid instrument financing structure (because of Article IV(7));
    - Forward subscription agreement and secured loan: debt for Canadian tax purposes and equity for US tax purposes
      - Canada: interest deduction on the secured loan (1.5:1 debt-equity ratio);
      - United States: interest deduction on the external debt.

Financing Canadian Operations

6. Canadian Refundable R&D Tax Credits

- Attractive source of Canadian financing;
- Refundable tax credit rates:
    - Canadian-controlled private corporation (CCPC) status & asset and income tests
        - Federal: maximum of 35% of certain R&D expenses;
        - Quebec: maximum of 37.5% of salaries of R&D employees or 50% of R&D subcontracts;
    - Structures to maintain CCPC status;
    - Potential benefit of refundable R&D tax credits even if majority of Canadian operating entity is non-resident owned.

Transfer Pricing
Canadian Perspective

Presented by: Scott A. Murtha, Boughton Law, Vancouver

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Transfer Pricing Canadian Context

Outline:

- Context
- South-North Perspective
- Main Elements
- Comparability Analysis
- Adjustments
- Reasonable Efforts
- Contemporaneous Documentation
- Compliance vs. Accuracy
- Methodology
- Common Law
- Case Study

Transfer Pricing: Context

- “Transfer Pricing” is the practice of establishing “arm’s length” prices for related party cross-border transaction
- Organisation for Economic Co-operation and Development (“OECD”) issued the first part of its revised Transfer Pricing Guidelines for Multinational Enterprises in 1995, which were updated in 2010
- Canada has adopted the Guidelines into the Income Tax Act (Canada) (the “Act”) at section 247 as of 1998.

Transfer Pricing: South – North Perspective

- The United States has Transfer Pricing legislation of its own and the application of this can differ from stated Canadian policy
- This presentation is focussed on the basics of transfer pricing for a US-based attorney advising a US corporation (likely a parent) with an operating Canadian subsidiary

Transfer Pricing: Main Elements

- Applicable to prices of: services, tangible property, and intangible property as these are offered, sold or traded across international borders between related parties;
- Treats parties not dealing at arm's length as if they operate as separate entities;
- Comparison of "controlled transactions" with "uncontrolled transactions" on a case-by-case basis

Transfer Pricing: Comparability Analysis

- In the course of an audit, the CRA will conduct a “comparability analysis” to discern the true “transfer price” for a transaction or series of transactions;
- This will include understanding the controlled transactions by measuring them against “reliable comparables”
- No set process in the legislation, but CRA uses the process set out in TPM-14

Transfer Pricing: Adjustments

- The CRA has authority under ss.247(2) to make adjustments if the transfer prices for the controlled transaction(s):
  - "would not have been entered into between persons dealing at arm's length, and
  - can <u>reasonably</u> be considered not to have been entered into <u>primarily</u> for *bona fide* purposes other than to obtain a tax benefit."

Transfer Pricing: Reasonable Efforts

- Compliance is not an option!
- 10% penalty is imposed if a taxpayer has not made “reasonable efforts” to <u>determine</u> and <u>use</u> arm’s length transfer prices.
- Evidence of reasonable efforts is usually set out in a written agreement between the parties

Transfer Pricing: Contemporaneous Documentation

- A taxpayer is required to reply to a CRA request for documentation within 3 months of the request being served;
- The documentation must include "complete and accurate" information sufficient to demonstrate that the property or services sold or offered cross-border reflects a reasonable attempt to arrive at a proper transfer price

Transfer Pricing: Compliance vs. Accuracy

- An important distinction is that the *penalty provisions* for transfer pricing focus on the efforts made to determine and use an arm’s length transfer price;
- However, even where a penalty is not applied an adjustment can occur if the transfer price is ultimately determined to be incorrect.

Transfer Pricing: Methodology

- The OECD Guidelines used to mandate a strict hierarchy of methods, which was relaxed (but not abandoned) in the 2010 amendments in favour of "the most appropriate method to the circumstances of the case";
- Traditional transaction methods are preferred over transactional profit methods;

Transfer Pricing: Common Law

- A significant decision was rendered by the Supreme Court of Canada in October of 2012;
- The SCC noted that the generic comparators CRA used in its original analysis did not reflect the economic and business reality of the taxpayer;
- “Transfer Pricing is not an exact science” and comparables will almost certainly not be identical in every case

Transfer Pricing: Case Study

- US Engineering Corporation (USCo) expands into Canada through the acquisition of Vancouver firm (Vanco) in 2007;
- Secures contracts with Canadian arm of BigOil Corporation;
- Back office support in the form of computer design and technical performed in US; site visits and installation performed in Canada;

Transfer Pricing: Case Study *(cont'd)*

- Vanco leases large office space and hires many engineers;
- Economic crash leads to loss of major contracts;
- Vanco stuck with lease;
- Functional analysis focussed on profitability of Vanco as compared to long-established US-based engineering firms;

Transfer Pricing: Case Study *(cont'd)*

- Audit defense focussed on:
  - Existing Services Agreement (which was basic but sound);
  - Attacking the comparables and the drain on profitability caused by the lease;
  - Establishing activity was reasonable under the circumstances;

Transfer Pricing: Case Study *(cont'd)*

- Assessment Vacated on Grounds:
  - Existing Services Agreement was appropriate and contemporaneous documentation was sound;
  - Further to SCC case, use of "comparables" by CRA did not account for economic factors outside the control of Vanco (or USCo);
  - Drain on profits of Vanco was reasonable under the circumstances;

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