

2023 OSLER LEGAL OUTLOOK



## Transfer pricing proposals infuse Canada's tax laws with OECD concepts

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Canada's transfer pricing rules ensure that, for Canadian income tax purposes, the pricing of non-arm's length cross-border transactions adheres to the pricing that arm's length parties would have used in similar transactions. In cases decided over the last two decades, Canadian courts have consistently held that these rules operate so as to respect the legal underpinnings of the transactions undertaken by the parties, requiring only the elimination of price distortions arising from the non-arm's length relationship.

In [Budget 2021](#), the federal government announced that it intended to undertake a public consultation on Canada's transfer pricing rules because it was concerned about the guidance issued by the courts in one such decision, the [Cameco](#) case, from which the government's application for leave to appeal to the Supreme Court had been denied. The resulting [consultation paper](#) was released in June 2023 and included draft legislative amendments.

The proposals and related developments have significant implications for audits and disputes regarding the interpretation and application of the arm's length principle in Canada. If implemented as currently proposed, the draft amendments would introduce uncertainty and potentially harm Canadian competitiveness. Multinational groups should scrutinize their intercompany transactions and confirm that they are sufficiently prepared to defend their transfer pricing policies in light of the Organization for Economic Cooperation and Development (OECD) Base Erosion and Profit Shifting (BEPS) concepts reflected in the proposed amendments.

### The proposed amendments

The draft amendments in the consultation paper represent the first substantial rewrite of the transfer pricing rules in section 247 of the *Income Tax Act* (Act) since it was first enacted in 1997. The language and concepts are heavily influenced by changes to the transfer pricing guidance published by the OECD in its *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ([OECD Guidelines](#)) arising out of the BEPS project.

The consultation paper suggests that a "lack of detail in the current [rules] ... has led to an

overemphasis on intra-group contracts, rather than on the factual substance of transactions." The paper states that this has resulted in "outcomes in which the profit allocations between the Canadian and non-resident taxpayer were at odds with the economic contributions of the parties."

The proposed new rules, if enacted, will maintain the requirement that non-arm's length dealings be adjusted for tax purposes to the conditions that would have been established in comparable circumstances had the parties been dealing at arm's length. However, they differ from the current rules in the Act by establishing a new concept, which is the first step of the analytical framework. The new concept of a "delineated transaction or series" is to form the basis for comparison to arm's length conditions. The "delineated transaction or series" is to be determined by reference to "economically relevant characteristics." This concept is derived from the OECD Guidelines and is defined to include certain factors that emphasize the "actual conduct" of the parties in priority to the contractual terms of transactions. Once the "delineated transaction or series" has been established, its "conditions" (another newly and broadly defined term that includes "all information" in respect of the transaction or series) are to be scrutinized and adjusted to arm's length conditions.

The thrust of these new concepts and analytical framework is to broaden the facts and information that may be relevant to a transfer pricing analysis. The result is to cast doubt on the extent to which taxpayers can rely on legal documentation of transactions as forming the basis for the analysis.

The draft amendments also provide that a transaction or series can be disregarded and replaced with an alternative transaction or series if it would have been commercially irrational for parties dealing at arm's length to enter into the actual transaction or series and it prevents the determination of a transfer price. This amendment would replace the "recharacterization" branch of Canada's existing transfer pricing rules, which was the primary issue in the *Cameco* case. It would eliminate the requirement that a transaction or series be tax-driven before it can be disregarded.

In keeping with the recent trend of incorporating OECD guidance by reference into tax legislation, the draft amendments also include a proposed "consistency rule." This rule would require amounts determined under Canada's domestic transfer pricing rules to be consistent with amounts determined under the OECD Guidelines, unless the context requires otherwise.

While the draft amendments represent a significant re-write of Canada's transfer pricing rules, the changes are generally consistent with the approach currently taken by the Canada Revenue Agency (CRA) in auditing and assessing multinational groups. In our experience, the CRA has relied increasingly on BEPS concepts in its transfer pricing positions, which have been a focal point for CRA audit activity in recent years. We expect that the proposed changes, if enacted, will further embolden the CRA to intensify its scrutiny of cross-border intercompany pricing.

The transfer pricing consultation is taking place alongside other legislative developments. These include a parallel consultation regarding legislative amendments to the GAAR, which we discuss in our [A new era for the Canadian GAAR](#) article, as well as Canada's implementation of a global minimum tax. Other BEPS-related initiatives are also in process. These initiatives include anti-hybrid and excessive interest and financing expenses limitation (EIFEL) rules, as well as significant expansions to the tools and resources that are available to the CRA in auditing multinational groups.

Over the last several years, we have seen an expansion of the CRA's audit powers, successive monetary investments by the government in CRA audit and enforcement activity and a suite of new mandatory disclosure rules (MDR) that received royal assent on June 22, 2023. Among

other things, the MDR require disclosure in some situations of uncertain tax positions reflected in a group's consolidated financial statements. These requirements will result in routine annual disclosure to the CRA of a "road map" to certain transfer pricing and other tax positions that involve making complex judgments.

Together with these developments, the draft transfer pricing amendments will shape the scope and tone of audits for the foreseeable future, as well as the level of scrutiny that the CRA is likely to apply to arrangements between non-arm's length parties. If the proposed amendments are enacted as currently drafted, we expect the intensity of audit scrutiny and resulting tax controversies to persist and potentially increase. Multinational groups will need to consider their level of preparedness to educate the CRA about their business and intercompany practices and defend their transfer pricing policies in the context of the evolving landscape.

Taxpayers wanting to resolve or avoid transfer pricing controversies may seek bilateral and multilateral relief through the "competent authority" process under Canada's tax treaty network – for example, through an advance pricing arrangement (APA) that provides comfort for future fiscal periods. Unfortunately, the recent trend in the CRA's administration of these programs has been to restrict, rather than expand, access.

Earlier this year, the CRA released a draft updated information circular providing guidance regarding APAs, inviting comments from stakeholders on the first such update in more than 20 years. The draft circular would require taxpayers to submit more detailed information at the pre-filing stage of an APA, prior to acceptance into the program. It also includes an extensive list of reasons why the CRA may choose to reject an APA request even after receiving that detailed information, including where there is a disagreement between the CRA and the taxpayer regarding the most appropriate transfer pricing approach. One Canadian member of a multinational group recently applied for judicial review of the competent authority's decision not to accept them into the APA program. The application was made on the basis that the transactions proposed to be covered followed a restructuring, which represents another potential cause for rejection listed in the draft CRA circular.

If enacted, the proposals to amend the transfer pricing provisions introduced in the consultation paper are likely to put more pressure on the CRA to improve access to competent authority services like the APA program, as taxpayers place increased importance on certainty in a rapidly changing compliance environment.