Canada’s TPM-15 and TPM-16: Throwing Sand in the BEPS Gears

The author argues recent transfer pricing memoranda issued by the Canada Revenue Agency on low-value services and the use of multiple-year data ignore relevant guidance developed by the Organization for Economic Cooperation and Development under its project to combat base erosion—and further that the TPM on multiple-year data places the CRA firmly at odds with U.S. regulations.

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The Canada Revenue Agency Jan. 29 released two memoranda on transfer pricing: TPM-15, on intragroup services and Section 247 of the Canada Income Tax Act, and TPM-16, on the role of multiple-year data in transfer pricing analyses.

In Canada, the Transfer Pricing Memoranda (TPM) series provides supplementary guidance to Information Circular 87-2R on international transfer pricing. As a whole, they define and help deepen the understanding of the administrative position of the CRA on transfer pricing for the application of Section 247 of the Canadian Income Tax Act.

TPM-15 and TPM-16 raised eyebrows with both their content and the timing of their release. This article highlights the most perplexing features of the memoranda.

TPM-15: Intragroup Services

TPM-15 states in the first paragraph that it is meant to “clarify the CRA’s policy on several audit and tax issues commonly encountered during the audit of intragroup services.” As such, it purportedly provides supplementary guidance on Part 6 of Information Circular IC 87-2R, initially released Sept. 27, 1999.

To set things in context, IC 87-2R, Part 6, basically summarizes the content of Chapter 7 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as drafted in 1995 (and subsequently reprinted in the July 2010 edition). Aside from its general penchant for the comparable uncontrolled price (CUP) method and its explicitly stated preference for the use of a direct approach for the com-
The stated purpose of TPM-16, on the role of multiple-year data in transfer pricing analyses, is “to provide guidance and direction on the use of multiple year data in determining the arm’s length price in transfer pricing cases.”
The CRA has had a fairly contentious relationship with multiple-year data and statistical tools in general since at least 2003, when it released a paper on that topic by Ronald Simkover, the chief economist in its International Tax Operations Department.6 At the time, the CRA, as stated in the paper, already was claiming that “statistical tools do not improve the comparability of any of the selected comparable independent transaction.” As for multiple-year data, the CRA denied any potential use of that information to establish the arm’s-length nature of a transaction. Arm’s-length parties should in fact “set their prices on an ongoing basis” for transfer pricing purposes, according to the CRA. The compliance costs involved, it would seem, are irrelevant.

TPM-16 provides additional guidance on paragraph 51 of IC 87-2R stating that “taxpayers, in applying the recommended methods and taking into account the effects on profits due to product life cycles and short-term economic conditions, should consider multiple year data for the taxpayer; and the arm’s length party as a comparable.” The memo also reminisces on Simkover’s paper abundantly, although never mentioning it by name.

TPM-16 establishes a clear distinction between the use of multiple-year data to account for the degree of comparability of the economic characteristics of a transaction and its use to identify an arm’s-length price or range. TPM-16 somewhat brings into line the administrative policy of the CRA pertaining to the use of multiple-year data with the guidance found in Chapter 3 of the OECD transfer pricing guidelines.

From that perspective, the update is a welcome addition to TPM-14,7 which discussed significant changes made to the OECD guidelines in 2010.

TPM-14, issued in 2012, stated simply that “the CRA endorses the application of the arm’s-length principle and the 2010 version of the Guidelines for the administration of the Income Tax Act regarding transfer pricing matters.”

Paragraph 5 of TPM-16, meanwhile, explicitly states that “the use of multiple years of data may be appropriate and beneficial during the comparability analysis stage of a transfer pricing analysis.” Things get a little more blurry from that point on. Paragraph 9 of TPM-16 states forcefully that “the determination of arm’s length prices used in related party transactions for Canadian taxpayers should be established for each individual tax year using the results obtained from comparable transactions in the relevant tax year.” As such, the CRA maintains its long-standing position that “since comparability cannot be expressed in numbers, it is not possible to apply a statistical tool to arm’s length data to improve the comparability of the underlying transactions or to improve our understanding of the comparability,” as stated in paragraph 20.

Paragraph 22 of TPM-16 goes further, stating that “the proper use of multiple year data and the application of statistical tools are different issues.”

In paragraph 16 of TPM-16, the CRA interprets the term “data” as found in paragraphs 3.75 through 3.79 of the OECD guidelines as “more than the observed financial outcomes as reflected in the income statements or selected profit level indicators.” In a nutshell, “data” encompasses the whole OECD comparability analysis, not the simple use of financial information.

According to paragraph 22 of the memorandum, “it is clear that statistical tools do not meet the necessary criteria to be able to improve a comparability analysis.”

This indicates that the conceptual rift between the unsubstantiated CRA administrative policy and the guidance found in Regs. §1.482-1(e)(2)(B) and (C) of the U.S. transfer pricing regulations remains largely unchanged. Under the U.S. rules, the “reliability” of the transfer pricing analysis is indeed increased through the proper use of statistical methods.

Paragraphs 23-27 of TPM-16 thus expand on the CRA views regarding the use and distinction of statistical tools and multiple-year data for transfer pricing purposes. Paragraph 23 on the use of the average or the median has the hallmarks of Simkover’s paper. The former refers to averages and medians as providing “a single-point descriptor,” while the latter terms them “measures of central tendencies.” Both statements add strictly nothing to the matter at hand.

Paragraph 24 of the memorandum states that “a single point description may be necessary when determining the price that is most appropriate to be used.” The author dares to suggest that a single point is, in fact, absolutely mandatory for the actual and practical pricing of any cross-border transaction at any time—whether it is the average, median or any other statistical measure. In fact, a single point also will find its relevance for any notice of assessment or reassessment issued by the CRA.

Elsewhere, the memorandum appears to open the door, at least slightly, to using the interquartile range. Paragraph 26, while not referring directly to the interquartile range, suggests that its use is conceivable, although on a year-by-year basis. On the actual relevance of the arm’s-length range for transfer pricing compliance purposes in Canada, paragraph 28 of TPM-16 may give renewed comfort with the statement that “the CRA will not make a transfer pricing adjustment if the price or margin of a transaction is within the arm’s length range”—that is, in accordance with paragraph 3.60 of the July 2010 OECD guidelines. Paragraph 29 then reiterates that multiple-year data is valuable in the context of the comparability analysis, although it states that “taxpayers should not average results over multiple years for the purpose of substantiating their transfer prices in an audit context.”

The last sentence of TPM-16 states that multiple-year averages may, however, play a role in the context of an advance pricing agreement. Appendix A then embarks on a short theoretical quest in which, once again, a distinction between the use of “multiple year data” and the use of “statistical tools” pushes the envelope pointlessly. The “distinction” made in Appendix A between “descriptive statistical tools” and “inferential statistical tools” is unsettling; this recurrent policy statement on the alleged inadequacies and potential misuses of the interquartile range, the author contends, illustrates the ever-enduring inability of the CRA to properly reconcile the practical realities of transfer pricing with its conceptual limitations and theoretical shortcomings, especially in the particular setting of a transfer pricing audit or litigation.

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6 Available at 12 Transfer Pricing Report 271, 8/6/03.
7 Available at 21 Transfer Pricing Report 831, 12/13/12.


**Conclusion**

Now more than ever, proper transfer pricing documentation is becoming critical in Canada. If nothing else, TPM-15 on intragroup services and Section 247 of the Income Tax Act, given its lack of reference to any type of safe harbor, is a harsh reminder of that fact.

The guidance on multiple-year data found in TPM-16, meanwhile, will require those documenting cross-border transactions between Canada and the U.S. to keep dealing with the CRA’s eccentricities relating to the use of statistical tools in transfer pricing.