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## Transfer Pricing in Canada: The Transfer Pricing Penalties

### Legislation

Since 1997, Canada's transfer pricing rules have been included in section 247 of the Canadian *Income Tax Act* (ITA). They are complemented by sections 233.1 ITA, 233.3 ITA, 233.4 ITA, and 233.8 ITA, as applicable.

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The Canadian transfer pricing rules are managed by the Canada Revenue Agency (CRA). In the province of Quebec, the Agence du revenu du Quebec also does transfer pricing compliance audit.

Section 233.1 ITA prescribes the filing of an information return containing the prescribed information (Form T106) for non-arm's length transactions with non-residents when the total amount of the controlled transactions exceeds \$1,000,000.

Subsection 233.8(3) ITA prescribes the filing of the country-by-country report containing the prescribed information (form RC4649) where the total amount of the consolidated group revenues is equal or above 750 million Euros.

Specific penalties apply for failure to comply with these reporting requirements. Other penalties prescribed in the Canadian *Income Tax Act* may apply in specific situations.

Following the production of the contemporaneous documentation by the taxpayer as per subsection 247(4) ITA and subsequent transfer pricing adjustments as per subsection 247(2) ITA (when applicable), subsection 247(3) ITA prescribes the liability to a transfer pricing penalty when there is a lack of reasonable efforts in the determination of any arm's length price.

### T106 reporting penalties

The Canadian *Income Tax Act* prescribes numerous penalties for failure to comply with the reporting obligations of non-arm's length transactions with non-residents as highlighted in the *T106* form's instructions.

Penalties may result from late filing, failure to file and filing which contains false information or omission.

In case of late filing (filing after the due date), subsection 162(7) ITA applies. One penalty for late filing may be assessed by the CRA for each T106 form, as applicable. The penalty is equal to \$25 per day of failure to file up to a maximum of 100 days (i.e., a maximum of \$2,500). A minimum penalty of \$100 does apply in case of late filing for each T106 form, as applicable.

In case of failure to file, subsection 162(10) ITA applies. One penalty for failure to file may be assessed the CRA for each T106 form, as applicable. This penalty is assessed where a “reporting person or partnership knowingly, or under circumstances amounting to gross negligence, fails to file or fails to comply with a request by the Canada Revenue Agency (CRA) for T106 documentation.”

In the first case, the minimum penalty is \$500. The penalty for failure to file is applicable for up to 24 months of failure to file a T106 form that is, \$12,000 for each failure to comply. The penalty that may arise from the application of subsection 162(7) ITA [late filing] is subtracted from that amount, as applicable.

With regard to subsection 162(10) ITA, the T106 form’s instruction adds: “where the CRA has served a demand to file T106 documentation [as per section 233 ITA], the minimum penalty is \$1,000 per month, to a maximum of \$24,000 for each failure to comply.” The penalty that may arise from the application of subsection 162(7) ITA [late filing] is also subtracted from that amount, as applicable.

A third penalty related to the reporting obligation concerns the filing of a false statement or omission in a T106 form. One penalty for false statement or omission may be assessed by the CRA for each T106 form as applicable under subsection 163(2.4) ITA. In that case, the penalty is \$24,000 for each T106 form, as applicable.

### **RC4649 reporting penalties**

Prescribed form *RC4649, Country-by-Country Report* is required to file the country-by-country report in Canada. The Canadian *Income Tax Act* prescribes numerous penalties for failure to comply with the reporting obligations of non-arm's length transactions with non-residents.

The instructions in guidance *RC4651 Guidance on Country-by-Country Reporting in Canada* indicates that “subsection 162(5) of the Act provides a penalty for the failure of any person to provide any information required on a prescribed form made pursuant to the Act or the Regulations. The penalty for the failure to provide the information is \$100 and is applicable to each such failure. [...] Subsection 162(7) of the Act provides a penalty for the failure to file an information return as and when required by the Act and for the failure to comply with a duty or obligation imposed under the Act or the Regulations. The penalty is equal to \$25 per day of default, subject to a \$100 minimum and a \$2,500 maximum.”

Additional penalties may be levied in situation of gross negligence and failure to file in a timely fashion or following a request from the CRA to file. With respect to subsection 162(10) ITA, the minimum penalty is \$1,000 per month, to a maximum of \$24,000 for each failure to comply.

### **Transfer pricing penalties**

Subsection 247(3) ITA prescribes the liability to a transfer pricing penalty when there is a lack of reasonable efforts in the determination of any arm's length price.

Such a penalty may ensue when the CRA makes one or more transfer pricing adjustments,

- whereas the “terms or conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm's length” as per paragraph 247(2)(a) ITA; or
- under paragraph 247(2)(b) ITA in the case where a transaction exists only to obtain a tax benefit.

However, paragraph 247(3)(b) ITA indicates that a transfer pricing penalty is not applicable,

- when the total amount of the net transfer pricing adjustments does not exceed 10% of the taxpayer's gross revenue for the year as computed in accordance with the *Income Tax Act*; or
- when the total amount of the net transfer pricing adjustments does not exceed \$5,000,000.

Paragraph 247(3)(a) ITA specifies that the transfer pricing penalty will not apply when the taxpayer has made reasonable efforts to determine and document the arm's length price(s) of its controlled transaction(s) exposed to transfer pricing adjustments. This rule applies even if the total amount of the net transfer pricing adjustments exceeds the limits prescribed in paragraph 247(3)(b) ITA.

In short, when the taxpayer can demonstrate reasonable efforts, there is no transfer pricing penalty applicable under subsection 247(3) ITA.

When the penalty applies, it is equal to 10% of the total amount of the net transfer pricing adjustments which relate to controlled transactions where there was no reasonable effort made by the taxpayer.

Paragraph 176 of Information Circular *IC 87-2R International Transfer Pricing* illustrates the calculations of the transfer pricing penalty as follows:

- **UT** is defined as the total of all upward adjustments (whether on account of income or capital) under subsection 247(2), whether or not the taxpayer has made reasonable efforts to comply with the arm's length principle.
- **UR** is defined as the total of all upward adjustments (whether on account of income or capital) under subsection 247(2), which relate to transactions for which the taxpayer has made reasonable efforts to determine and use arm's length prices or allocations.
- **DR** is defined as the total of all downward adjustments (whether on account of income or capital) under subsection 247(2) on transactions for which the taxpayer has made reasonable efforts to determine and use arm's length prices or allocations.

**Penalty Threshold Calculation:**

The penalty under subsection 247(3) applies if, for a particular taxation year:

- **(UT minus UR minus DR) is greater** than (the lesser of \$5,000,000 and 10% of the taxpayer's gross revenue for that particular tax year).

If not, there is no penalty under subsection 247(3).

If so, the amount of the penalty is calculated separately and the amount of the penalty is not reduced by the threshold.

**Penalty Calculation:**

- **10% × (UT minus UR minus DR)."**

**Administrative position**

In Transfer Pricing Memorandum *TPM-09 Reasonable efforts under section 247 of the Income Tax Act* released on September 18, 2006, the CRA indicated that "reasonable efforts" 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. What is reasonable is based on what a reasonable business person in the taxpayer's circumstances would do, having regard to the complexity and importance of the transfer pricing issues that arise in the taxpayer's case."

In Canada, the International Tax Auditor must assess if the taxpayer has made reasonable efforts for an eventual application of the transfer pricing penalty. However, to ensure a reliable application of the transfer pricing penalty prescribed by subsection 247(3) ITA, the national Transfer Pricing Review Committee (TPRC) has the ultimate mandate of determining whether reasonable efforts have been made.

Transfer Pricing Memorandum *TPM-13 Referrals to the Transfer Pricing Review Committee* explains:

"Taxpayers must be made aware of any transactions that may be subject to a subsection 247(3) [ITA] penalty. This should be done through a draft penalty referral report provided to the taxpayer with the proposal letter.

The draft penalty referral report provides taxpayers with an opportunity to submit any additional information they want the TPRC to consider. After the report is issued, the taxpayer will be given a reasonable time (generally 30 days) to make representations with respect to the potential application of subsection 247(3). This will be the taxpayer's only opportunity to submit additional information for the TPRC's consideration.

Once representations with respect to the penalty proposal are received from the taxpayer, the auditor will include these representations along with his or her comments in the penalty referral report.

The completed penalty referral report will then be forwarded to the Secretariat of the TPRC to be prepared for presentation to the TPRC. Referrals to the TPRC will first be assigned to an IASS [International Advisory Services Sections] case officer within the ITD [International Tax Division]. The case officer will review the referral to ensure that sufficient information has been provided by the auditor to proceed with a formal presentation to the TPRC. After the review by the IASS case officer, the auditor will forward a copy of the formal penalty referral report to the taxpayer immediately before it is presented to the TPRC.

The chairperson of the TPRC will decide whether reasonable efforts were made by the taxpayer. The decision and reasons for the decision will be communicated by memorandum to the Assistant Director of Audit (ADA) of the tax services office (TSO) that is responsible for the file. The memorandum will be issued within 45 days of receipt of a referral that contains all the information necessary to allow the TPRC to make a recommendation to the chairperson. The TPRC review will be limited to a determination of whether transfer pricing penalties are applicable to the transfer pricing adjustments raised. The TPRC's role is not to question or review the adjustments that gave rise to the penalty referral. The TSO will be responsible for informing the taxpayer of the decision and the reasons for the decision."

### **Canadian tax courts**

In *Marzen Artistic Aluminum Ltd. v. The Queen*, 2014 TCC 194, the Tax Court of Canada confirmed that in the presence of reasonable efforts a transfer pricing penalty does not apply. In its analysis the Court examined subparagraph 247(4)(a)(i)-(vi) ITA separately to determine if reasonable efforts had been made by the taxpayer. This approach of the court was not altered by the Federal Court of Appeal in *Marzen Artistic Aluminum Ltd. v. Canada*, 2016 FCA 34.

### **Conclusion**

To ensure that you are fully compliant with the Canadian transfer pricing rules, it may be time to review the transfer pricing policies and procedures of your company. Other business processes may also need to be reconsidered, revised or modified to produce strong operational transfer pricing processes in the MNE group.



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