Respecting the Dualistic Nature of Canada's Two Transfer Pricing Rules: A Tax Policy and Legal Analysis

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Analysis

Respecting the Dualistic Nature of Canada's Two Transfer Pricing Rules: A Tax Policy and Legal Analysis

The authors argue that the Canada Revenue Agency routinely relies on its basic transfer pricing rule—found in paragraph 247(2)(a) and (c) of the Income Tax Act—to recharacterize transactions, thereby circumventing the provisions of the Act that govern recharacterization—paragraphs 247(2)(b) and (d). This practice, they contend, ignores both the exceptional nature of the recharacterizaton rule and the dualistic nature of the country's transfer pricing regime.

By Brian Bloom and François Vincent

The Canadian Income Tax Act's transfer pricing regime is a dualistic one. Paragraphs 247(2)(a) and (c) of the Act house a fairly standard, garden-variety transfer pricing rule. That rule's basic function is to reprice transactions as structured by taxpayers. Conversely, paragraphs 247(2)(b) and (d) of the Act contain an ''exceptional'' transfer pricing rule. In certain exceptional circumstances, described in detail below, the rule first restructures or recharacterizes transactions and then prices the recharacterized transactions.

Despite the manifest duality of this regime and the exceptional nature of the recharacterization rule, it appears that the CRA routinely relies on the authority of the rule in paragraphs 247(2)(a) and (c) to recharacterize transactions, thereby circumventing the strict conditions under which paragraphs 247(2)(b) and (d) can apply and, somewhat perversely, transforming the exception into the rule.

Like the rule, this article is divided into two parts. The first part considers the merits of the CRA's position by undertaking a detailed examination of the tax policy underlying the Act's transfer pricing rules. The second analyzes the CRA's position in relation to an actual case, modified as necessary to protect taxpayer confidentiality.

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A. Tax Policy Analysis

1. Transfer Pricing Rules

When cross-border transactions occur between persons who do not deal with each other at arm's length (controlled transactions), the absence of market forces, coupled with the incentive to minimize global taxes that is created by disparities in the different jurisdictions' effective tax rates, casts doubt on whether the parties' pricing of the controlled transactions produces the right starting point for measuring their income and, thus, whether an appropriate amount of taxable income has been allocated to each taxpayer's home jurisdiction.

Transfer pricing rules are intended to dispel that doubt and reproduce the right starting point for measuring a taxpayer's (and the taxpayer's jurisdiction's) income derived from controlled transactions by establishing an unbiased economic standard by which controlled transactions are required to be priced.[1] To minimize economic double taxation, and thereby remove impediments to international trade and investment, that standard should be one that has broad international acceptance.

Fortunately, such a standard—the arm's-length standard—exists, and has been explicitly adopted by Canada. By adopting the arm's-length standard, Canada's transfer pricing rules also promote horizontal equity and protect the tax base from erosion through pric-

[1] *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD 2010, para. 1.14.

ing manipulation.[2] However, the Act's transfer pricing rules are intended to act as a shield, not a sword. They are not intended to raise revenue—although that may be a consequence of their application, particularly where a multinational enterprise has sought to employ controlled transactions as a means to unduly reduce a member's taxable income that would otherwise be allocable to Canada.[3]

a. Part XVI.1 of the Act

Part XVI.1 of the Act, which replaced former subsections 69(2) and (3) for taxation years beginning after 1997, contains the rules, notably in subsection 247(2), for pricing controlled transactions. As will become apparent, those rules were heavily influenced by the 1995 Organization for Economic Cooperation and Development guidelines, which reaffirmed the OECD's endorsement of the arm's-length principle as the standard-bearer in international transfer pricing matters.

The main objective in introducing new Part XVI.1 was to enshrine the arm's-length principle into the Act's transfer pricing rules, thereby leaving no doubt as to the standard by which the Act prices, and thus measures a taxpayer's income from, controlled transactions.[4] A secondary objective was to provide the CRA with the tools it needed to confirm whether that standard was being observed by requiring taxpayers to contemporaneously document their controlled transactions and the methods used to establish arm's-length prices. After all, taxpayers are presumed to know their businesses and their industries best.[5]

To ensure taxpayers had the proper incentive to compute their transfer prices in accordance with the arm's-length principle and to document their transfer pricing, a penalty was introduced. The penalty also was intended to serve as a counterweight to the perceived bias created by the U.S. transfer pricing penalties—a sensible precaution given the considerable volume of related-party trade between the two countries. Conspicuously absent from the transfer pricing rules, however, is a U.S.-style accuracy-related or ''transactional'' penalty.[6] This is because Finance and the CRA perceived transfer pricing as being more art than science,[7] and thus it followed that a taxpayer's obligation to determine an arm's-length price should be one of means, not result.

As noted, under Part XVI.1, the standard selected for pricing controlled transactions is that established by the arm's-length principle: for tax purposes, the prices employed in controlled transactions should be those that would have been employed had the non-arm's-length parties been dealing with each other at arm's length when concluding those transactions.

Taken literally, the arm's-length principle establishes an unattainable goal, as—failing the existence of a Star Trek-like holographic simulator or a quantum leap in game theory computer modeling—it is not possible to determine how the actual parties to the transaction would have priced the transaction had they been unrelated.

As a practical matter, the lofty goals of the arm's-length principle are achieved through a comparison; that is, by benchmarking the terms and conditions—in particular, the price—of controlled transactions against those observed in the same or similar transactions occurring between arm's-length parties in the same or similar circumstances, known as ''comparables.'' This results in an approximation of the prices that would have been used in, and thus the income that would have arisen from, the controlled transactions had the parties to them been dealing with each other at arm's length when concluding them.

The basic scheme of Part XVI.1 is to have taxpayers search for comparables for their controlled transactions, to contemporaneously document that search and their transfer pricing analysis, and to price those transactions in accordance with those comparables, making necessary adjustments to reflect any material differences between the controlled and uncontrolled transactions that could affect their pricing.[8] The basic operating premise underlying this scheme is that comparables generally will be available with which to price the controlled transactions and will be used for this purpose.

While it may be possible to achieve an arm's-length price in the absence of comparables, through the use of valuation techniques, and the law does not expressly stipulate that comparables or any particular transfer pricing method must be used for this purpose, the pri-

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[2] The Supplementary Information to the 1997 federal budget states the following in this regard: ''This [arm's-length] standard protects the tax base against the shifting of income that can potentially occur from the discretionary determination of transfer prices on transactions made between related parties situated in different countries. The international adherence by all industrialized countries to a common standard also prevents the double taxation of profits of multinational enterprises by two or more tax jurisdictions and, consequently, promotes international trade.''

[3] This view appears to be shared by the Tax Court of Canada, which stated in paragraph 152 of *Alberta Printed Circuits Ltd. v. R.*, 2011 D.T.C. 1177:

> The underlying policy concern behind the transfer pricing rules is, of course, leakage from the Federal Treasury due to profits being shifted from one country to another or, expressed in more conventional terms, the object is to ensure that parties not at arm's length report substantially the same amount of income in the jurisdiction in which they are located as would parties dealing at arm's length.

[4] The Supplementary Information to the 1997 federal budget states that one of the government's objectives in proposing changes to the Act's transfer pricing rules was ''to harmonize the standard contained in section 69 of the Act with the arm's length principle as defined in the [1995] revised OECD Guidelines.''

[5] Another objective was to formally recognize the existing practice among many CRA transfer pricing auditors of allowing downward adjustments to income or other amounts to offset proposed upward adjustments. On their face, former subsections 69(2) and (3) did not authorize downward adjustments, and the CRA itself had not formalized the practice. Subsection 247(10) statutorily authorizes this practice.

[6] The United States' transactional penalty, found in Internal Revenue Code Section 6662, potentially applies where the transfer price used for a particular controlled transaction exceeds 200 percent or is less than 50 percent of the ''correct'' transfer price for that transaction, as established by the IRS.

[7] See IC 87-2R at para. 34.

[8] Subsection 247(2) applies to both ''taxpayers'' and ''partnerships'' because it was not clear whether a partnership would be treated as a taxpayer for *all* purposes of Part XVI.1, which part can result in adjustments to more than just ''income,'' and because the new documentation requirements and penalties made it imperative that the transfer pricing rules be unequivocal as to when transactions involving partnerships were subject to them.

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macy of comparables as a means of establishing an arm's-length price is a necessary consequence of the adoption of the arm's-length principle and is the basic operating premise underlying Part XVI.1 of the Act. As stated in the OECD guidelines, a ''comparability analysis'' is at the heart of the application of the arm's-length principle.[9] Indeed, like their inspiration, Article 9 of the OECD's *Model Tax Convention on Income and on Capital*,[10] the rules in subsection 247(2) posit an arm's-length result as between two or more undefined parties, thereby suggesting that a comparison is the preferred course for satisfying the arm's-length standard.

b. 'In the Circumstances'

In this regard, one rather notable omission that distinguishes subsection 247(2) from its predecessors is the lack of any explicit reference to the price that would have been used ''in the circumstances'' had the parties to the controlled transaction been dealing with each other at arm's length.

The importance of comparing the circumstances material to the pricing of a controlled transaction with those of a (putative) comparable transaction was recognized 50 years ago in *J. Hofert Ltd. v. Minister of National Revenue*,[11] a transfer pricing case that considered whether a Canadian subsidiary had, contrary to subsection 17.(2) of the 1952 Income Tax Act, sold Christmas trees to its U.S. parent at a price that was less than fair market value. The Minister claimed that the Canadian subsidiary's higher-priced consignment sales of identical trees to arm's-length Canadian retailers constituted a comparable for the sales to the U.S. parent, despite the fact that the latter sales were final, conducted at the wholesale (not the retail) level and involved quantities that were between seven and 10 times greater than the Canadian sales.

The court at paragraph 5 of the opinion stated:

> What the respondent says is that because trees were sold in Canada at an ascertained price—although in circumstances entirely different from those that prevailed where the American purchaser was concerned—that price, whatever it turned out to be, should have governed sales to J. Hofert Company across the American border. This impresses me as being an unrealistic approach that should not be entertained.

The reason for the lack of a specific reference to ''in the circumstances'' in subsection 247(2), the authors submit, is that the quoted words are implicit in the comparative exercise mandated by the explicit adoption of the arm's-length principle in subsection 247(2).

More specifically, the evaluation of whether an uncontrolled transaction or taxpayer is a valid comparable for a controlled transaction or taxpayer is based on an examination of several comparability factors—in particular, the nature of the property or services transacted; the terms of the transactions; the functions, assets, and risks of the parties to the transactions; their business strategies; and the larger economic and geographic environments in which the transactions occur.[12] In short, the comparative exercise necessarily involves an analysis of the circumstances in which the controlled and uncontrolled transactions take place.

Indeed, the contemporaneous documentation provision in subsection 247(4) requires taxpayers to provide a description of most of the above-listed factors precisely because they are relevant to the inquiry under subsection 247(2). It is noteworthy that Article 9 of the OECD Model Tax Convention contains no explicit reference to the circumstances in which such transactions take place, but those circumstances plainly are relevant to the determination of an arm's-length price under the OECD guidelines.[13] This fact is noted in the Supplementary Information to the 1997 federal budget:

> The [OECD] guidelines offer practical guidance for both taxpayers and tax administrations with regard to methods that can be used to determine whether prices on transactions undertaken by related parties situated in different countries are in accordance with the ''arm's length principle''. This principle rests on a comparison of the conditions observed between independent parties *in similar circumstances* entering into similar transactions. [Emphasis added.]

Thus, in the authors' view, it is a distinction without a difference.

c. In Which Circumstances?

The same conclusion was reached by the Federal Court of Appeal in *General Electric Capital Canada Inc. v. R.*:[14]

> The concept underlying subsection 69(2) and paragraphs 247(2)(a) and (c) is simple. The task in any given case is to ascertain the price that would have been paid in the same circumstances if the parties had been dealing at arm's length. This involves taking into account all the circumstances which bear on the price whether they arise from the relationship or otherwise.[15]

Paragraph 55 of the appeals court's decision in *General Electric* further elaborates by noting that price-distorting factors attributable to the community of interest that exists between related persons should be excluded from the analysis. The question raised by *General Electric* is whether a parent's ''implicit support'' of its subsidiary is such a factor. More generally, the question is how one identifies such price-distorting factors.

The specific issue before the *General Electric* courts was whether fees paid by a Canadian subsidiary (GECAN) to its U.S. parent (GECUS) for guaranteeing its

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[9] OECD guidelines, para. 1.6.

[10] In *Alberta Printed Circuits*, the court comments, at paragraph 149, that paragraphs 247(2)(a) and (c), like former subsection 69(2), are analogous to article 9(1) of the OECD Model Convention.

[11] 1962 Carswell Nat 62 (T.A.B.).

[12] OECD guidelines, para. 1.36.

[13] According to the guidelines, the arm's-length principle seeks to adjust profits by reference to the conditions that would have obtained between independent enterprises ''in comparable transactions and comparable circumstances (i.e., in ''comparable uncontrolled transactions'')'' (para. 1.6).

[14] *General Electric Capital Canada Inc. v. R.*, 2011 D.T.C. 5011 (FCA), affirming *General Electric Capital Canada Inc. v. R.*, 2010 D.T.C. 1007 (TCC).

[15] *General Electric*, FCA, para. 54.

debts exceeded the fees that would have been paid if the parties had dealt with each other at arm's length.

The Minister's position was that an arm's-length party in GECAN's circumstances would not have paid any amount for GECUS's explicit guarantee, as it conferred no economic benefit on GECAN. The Minister argued that GECAN's credit rating already was on par with that of GECUS, as, in evaluating GECAN's creditworthiness, GECAN's (arm's-length) lenders would have recognized and relied upon the fact that GECUS had a strong economic incentive to support GECAN in times of financial difficulty. This (implicit) support was attributable to the fact that GECAN was a ''core'' subsidiary whose failure would have jeopardized GECUS's reputation and sterling credit rating, resulting in incremental borrowing costs to GECUS that would have exceeded the costs of its financial support.

The taxpayer's position was that the notion of implicit support had no place in a transfer pricing analysis, since it derived from the familial relationship between parent and subsidiary.

The Tax Court found that GECAN, in fact, benefitted from its parent's explicit guarantee but that such benefit was attenuated by the existence of its parent's implicit support. As a legal matter, implicit support was a circumstance that could be considered because it was not rooted in the parties' non-arm's-length relationship and it had ''nothing to do with the *exercise* of *de facto* or *de jure* control which defines a non-arm's length relationship.''[16] In other words, implicit support was simply a fact that existed independently of whether one of the parties could exercise control over the other party and did not emanate from the exercise of that control.

As a factual matter, implicit support was relevant because it was well-known in the marketplace that GE and GECUS prized their AAA credit ratings and would feel economically compelled to preserve them. These initial determinations by the Tax Court culminated in the following important question of fact:

> The question . . . becomes how successful this negotiating approach would be, having regard to all of the other relevant facts and circumstances, some obviously countervailing [to the relevance of implicit support], that would be taken into account in arm's length negotiations [between persons in the same circumstances as GECUS and GECAN].[17]

Thus, the Tax Court's legal and factual analysis can, the authors submit, be distilled into the following question: All other things being equal, what would have been the guarantee fee negotiated between a party in the same circumstances as GECUS and a party in the same circumstances as GECAN if the former party did not exercise *de jure* or *de facto* control over the latter party?

Considered this way, it seems that the only factors that should be excluded from the analysis are:

- factors that arm's-length parties would not consider relevant in their negotiations, and
- terms and conditions of the controlled transaction that are the product of one party's exercise of, or ability to exercise, control over the other party.

The latter (price-distorting) factor is discussed further below.

Interestingly, the above question was never fully answered by the judge, as the evidence before him failed to indicate how adjustments could be made to account for material differences in the situation of an insurer or other professional guarantor on the one hand and GECUS's situation on the other.[18] This is why the Tax Court judge preferred the (one-sided) yield method, described below, over the insurance method.[19] Another material difference between an insurer and GECUS for which adjustments may be difficult to make is the fact that an insurer is able to spread its risk over a very large number of contracts. This factor would cause a person in GECUS's circumstances to seek a higher fee than would an insurer.

The Federal Court of Appeal agreed with the Tax Court's determinations and stated at paragraph 55 of its decision that ''all the factors [other than the abovementioned price-distorting ones] which an arm's length person in the same circumstances as [GECAN] would consider relevant should be taken into account.''

In reaching its decision, the Federal Court of Appeal commented as follows on the relevance of implicit support: ''In the present case, it is common ground that in the context of the yield method, implicit support is a factor which an arm's length person would find relevant in pricing the guarantee.''[20]

The yield method accepted by the courts in *General Electric* seeks to measure the enhancement in credit rating, and thus the benefit in terms of decreased borrowing costs, afforded to a debtor by an explicit guarantee. Thus, while this yield method (arguably) determines the maximum or ceiling price that an arm's-length person, in GECAN's circumstances, would have been willing to pay for GECUS's guarantee, it does not establish what an arm's-length guarantor, in GECUS's circumstances, would have been willing to receive for the provision of the guarantee. In short, the yield method does not establish an equilibrium or market price for the guarantee as between the parties.

While the notion of implicit support may, as noted by the Federal Court of Appeal, be relevant to the application of the yield method, the authors respectfully note that it is not the method that authorizes the use of the notion; rather, as pointed out by the Tax Court judge, the notion's relevance ultimately turns on whether and to what extent two (hypothetical) parties that deal with each other at arm's length would recognize, when negotiating the price of the guarantee, that GECUS would, in the circumstances, be economically compelled to support GECAN in times of financial distress. In short, the relevance of implicit support should be assessed from the perspectives of both (hypothetical) parties to the transaction.

Indeed, the recognition of implicit support by a ratings agency does not, in the authors' view, automatically translate into the recognition of implicit support by an insurer or other professional guarantor that has actual capital at risk. As observed by the Tax Court judge in *General Electric*, much of this notion's significance would be lost in translation:

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[16] *General Electric*, TCC, para. 199 (emphasis added).
[17] *General Electric*, TCC, para. 201.
[18] *General Electric*, TCC, at paras. 254 and 257.
[19] See TCC, para. 304.
[20] *General Electric* at para. 56.

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> [L]ogically, a third-party insurer would attach very little worth to the ''implicit support'' of GECUS because if it was called upon to execute its guarantee of the Appellant's debt it would be expected to pay up.[21]

While the authors' analysis of the decisions in *General Electric* does not dispute the relevance of implicit support in the determination of an arm's-length price in that case, a different view exists. *General Electric* raises particularly difficult issues in relation to the notion of implicit support because both the (purported) implicit guarantee as well as the explicit guarantee emanate from the same entity, GECUS.[22]

The struggle, in *General Electric*, to compute an arm's-length price for a routine transaction exposes the not inconsiderable gap, discussed further below, between the theory of the arm's-length principle—which, as noted, presupposes the general availability of comparables to price controlled transactions—and the practice of that principle, which teaches us that comparables often are hard to find. Absent any reliable comparables for the guarantee, the Tax Court selected a method that, on the facts, suggested that the fee paid by GECAN did not exceed an arm's-length price,[23] thereby judiciously bridging the gap between theory and practice in this difficult case.

d. A Commercial Context

Article 9 of the OECD Model Tax Convention is concerned with the pricing of ''commercial'' and ''financial'' transactions, and the OECD guidance on Article 9 and the arm's-length principle is aimed at those kinds of transactions. Accordingly, Part XVI.1, the authors assert, is not intended to apply to transactions that take place outside of a commercial context—such as cross-border gifts between siblings—despite the fact that, on its face, subsection 247(2) makes no distinction between commercial and personal transactions.[24]

In any case, Finance had been assured by the CRA that the transfer pricing rules would be applied only in a commercial setting.

Nevertheless, to ensure that the opening words of subsection 247(8) did not result in subsection 247(2) being considered to occupy the entire field of controlled transactions, Finance added the language ''if subsection [247](2) is applied to adjust the amount'' to subsection 247(8).

As the authors have said previously, this wording was intended to clarify that, despite the opening words of subsection 247(8), CRA auditors retained the authority and, indeed, should continue to adjust transactions made outside the commercial context using the rules in subsection 69(1), thus avoiding the unintended application of the subsection 247(3) penalty, the subsection 247(4) documentation requirements, and *Information Circular* IC 87-2R in this noncommercial context.[25]

e. A Transactional Focus

Subsection 247(2) is the legislative embodiment of the arm's-length principle in Canada. The plain focus of that provision is on transactions because the arm's-length principle seeks to establish a separate or single taxpayer's income based on an evaluation of the (actual) controlled transactions entered into by that taxpayer. The basis for this transactional focus is explained by the OECD guidelines as follows:

> [T]he arm's length principle follows the approach of treating members of an MNE [multinational enterprise] group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the transactions between those members.[26]

This contrasts with a global formulary apportionment regime, which allocates to each member of a multinational entity, and thus to the member's country of residence, a fraction of the multinational's global income from uncontrolled transactions based on some weighing of factors considered to reflect the member's economically significant contributions to the earning of that income, without any reference to the member's actual controlled transactions. A domestic example of such a regime exists under Regulation 400, which deals with the allocation of the taxable income of a corporation among Canada's provinces.

The transfer pricing rules' transactional focus also is a function of the fact that they are accessory to the Act's rules that compute income and those rules essentially are transactional—that is, they measure a particular taxpayer's income transaction-by-transaction. Thus, in theory, subsection 247(2) seeks to establish an arm's-length price or result for each controlled transaction entered into by a taxpayer. IC 87-2R, which provides guidance on subsection 247(2), states at paragraph 36 that ''to arrive at the most precise approximation of an arm's length price or allocation, the arm's length principle should ideally be applied on a transaction-by-transaction basis.'' Similar language is found in paragraph 3.9 of the OECD guidelines.

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[21] TCC, para. 255.

[22] For a more detailed discussion of this point, see Vincent, *Transfer Pricing in Canada 2011 Edition*, Carswell, at pp. 164-165. Also see Boidman, Nathan, ''Pricing Canada-U.S. Guarantees After GE Capital: Still Evolving,'' 19 *Transfer Pricing Report* 1042, 2/10/11.

[23] One perhaps may infer this from the fact that the fee paid by GECAN was significantly lower than the benefit it was found to have received from the explicit guarantee in terms of reduced borrowing costs.

[24] Finance had contemplated expressly limiting subsection 247(2) to ''commercial'' transactions but feared that any such limitation could be exploited by taxpayers. For example, if a controlled transaction that consisted of the performance by an individual of personal services for payment, whether *qua* employee or independent contractor, were, for whatever reason, not to have been classified as a ''commercial'' or ''financial'' transaction, then it would have been outside of the scope of both subsections 69(1) and 247(2). Finance wanted to avoid any such gap in the legislative scheme and, indeed, the definition ''transfer price,'' in subsection 247(1), actually refers to ''services (including services provided as an employee . . .).''

[25] Vincent and Bloom, ''Subsection 247(2) Versus Subsection 69(1) of the Income Tax Act,'' Vol. XIII, No. 3 *International Tax Planning* (Federated Press), 940-48 (2006); and '' 'Fair Value' Is Not 'Arm's Length': Applying and Interpreting Subsection 69(1) and 247(2) of the Canadian Income Tax Act,'' 15 *Transfer Pricing Report* 550, 11/22/06.

[26] OECD guidelines, para. 1.6.

f. 'Series of Transactions'

While the ideal may be to apply the arm's-length principle on a transaction-by-transaction basis, the OECD guidelines note that situations often occur in which separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis.[27] For example, in a highly-integrated multinational enterprise, unfinished or semi-finished goods may be transformed serially by several members of the group. The absence of markets for such goods may make them extremely difficult to price or evaluate individually. In these situations, it may be preferable to use the (ultimate) price of or income from the series, for which there may be comparables, as the starting point for determining the price of or allocating income to the individual transactions that make up the series. The use of the ''series'' concept in subsection 247(2), coupled with the definition of ''arm's length allocation'' in subsection 247(1), ensure that taxpayers and tax administrators have the latitude to do so.

Another reason for referring to a ''series of transactions'' in subsection 247(2) was to address the government's concern that related taxpayers—those that, by definition, do not deal with each other at arm's length—could interpose a third party (commonly known as an accommodation party) in their controlled transactions and then claim that the transfer pricing rules do not apply because the participants in each of the back-to-back transactions dealt with each other at arm's length. Whether a third party deals at arm's length with taxpayers for whom it acts as an accommodation party,[28] the overall ''series of transactions'' nevertheless would include participants that were related to each other, putting to rest this concern.

g. Transfer Pricing Methods

Because of the highly fact-specific nature of transfer pricing and the widely acknowledged difficulty of finding purely transactional comparables or comparable uncontrolled prices (CUPs), subsection 247(2) does not prescribe any particular method for determining an arm's-length price. The transfer pricing rules even expressly contemplate the use of profit-based methods through the definition ''arm's length allocation'' in the penalty and documentation provisions in subsections 247(3) and (4). Thus, subject to the one caveat below, the transfer pricing rules adopt a results-oriented approach in this regard.[29]

Profit-based methods involve a comparison of the results of a tested party with those of a functionally similar uncontrolled party, and, under the arm's-length principle, are an indirect way of establishing an arm's-length price for controlled transactions.[30] The development and widespread use and acceptance of profit methods, which effectively shift the focus of the comparability exercise away from transactions and onto the taxpayers who carry them out, is a practical solution to the dearth of genuine transactional comparables. (In the view of some, this comparables shortage is the Achilles heel of the arm's-length principle, with its fundamentally transactional approach.)

In short, profit methods seek to bridge the not inconsiderable gap between the theory and practice of transfer pricing under a regime governed by the arm's-length principle.

Whatever transfer pricing method is selected, though, in order to satisfy the arm's-length principle and thus the requirements of subsection 247(2), its ultimate aim, at least in theory, should be to establish an approximation of an arm's-length price or an arm's-length allocation for a taxpayer's controlled transaction or group of controlled transactions where such transactions are ''bundled'' in accordance with the OECD guidelines.[31]

It is worth emphasizing that a method's ultimate objective should be to price actual controlled transactions, not to impute industry averages to taxpayers based on what are supposedly comparable taxpayers without regard to those transactions. Otherwise, a profit-based method could be difficult to distinguish, conceptually, from a formulary apportionment method, which, as noted, is not an acceptable transfer pricing method under the transaction-based standard adopted by Canada's transfer pricing rules. Indeed, it is this conceptual distinction that, arguably, caused the OECD to reject the United States' comparable profits method (CPM) but to accept the similar transactional net margin method (TNMM).

2. Tax Policy Considerations: Paragraphs 247(2)(a) and (c)

a. Scope, General Comments

Paragraphs 247(2)(a) and (c) contain the Act's normal, everyday transfer pricing rule. That rule's basic function, one that fits hand-in-glove with the manner in which the Act operates, is to price the actual controlled transactions entered into by non-arm's-length parties in accordance with the arm's-length principle. Indeed, the reason one makes comparability adjustments to the prices or results of uncontrolled transactions is to reflect differences in their terms and the terms of the actual controlled transactions. Therefore, the question normally asked by those paragraphs is the following one: Assuming all of the (non-price) terms and conditions remain constant, what would have been the price or results of the controlled transaction had it been concluded by persons dealing at arm's length with each other?[32]

This *ceteris paribus* approach is a function of the fact that the Act, consistent with the arm's-length principle, generally respects taxpayers' legal relationships, and the transfer pricing rules are a part of the Act.

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[27] OECD guidelines, para. 3.9.

[28] See, in this regard, *Special Risks Holding Inc.—Placements Risques Spéciaux Inc. v. R.*, 84 D.T.C. 6505 (Federal Court—Trial Division).

[29] As stated in the Supplementary Information to the 1997 federal budget, one of the objectives in amending the Act's transfer pricing rules was to ''ensure that, in selecting the most appropriate pricing method, all the various methods described in the OECD guidelines are available to taxpayers.''

[30] The OECD guidelines refer to the CUP method as providing a ''direct'' estimate of the price the parties would have agreed on had they resorted directly to a market alternative to the controlled transaction.

[31] See the discussion on ''series of transactions'' above and paras. 3.9 to 3.12 of the OECD guidelines.

[32] Of course, this essentially is the question asked by former subsections 69(2) and (3).

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That said, sometimes a term or condition of a controlled transaction that is material to its price has no arm's-length analogue and clearly is one that arm's-length parties would not contemplate. In that case, paragraphs 247(2)(a) and (c)—which adjust amounts for controlled transactions by positing that all of the terms and conditions of the controlled transactions, and not just their price, were arm's-length—appear to be broad enough to effectively permit the CRA to assume that the overtly non-arm's-length term in question conforms more closely to the corresponding terms of uncontrolled comparable transactions, or does not exist.

In the authors' view, the CRA was intended to have this authority because one generally cannot disassociate the price of a transaction from, for example, its terms of payment.[33] Moreover, an arm's-length price or result cannot be achieved by adjusting the prices or results of arm's-length comparables to reflect what are plainly the non-arm's-length terms of a controlled transaction, but only by the effective adjustment of those non-arm's-length terms, where they are material to the price or results of the controlled transaction.

Consider the following example: A foreign parent (FP) hires its Canadian subsidiary (Cansub) to perform engineering services for it and agrees, in writing, to not seek indemnification from Cansub, under *any* circumstances, for losses incurred by it as a result of Cansub's work. Due to this covenant, Cansub charges FP less for its services than it charges third parties for the same services. All of Cansub's contracts with third parties include indemnities. Assuming that FP's covenant is enforceable by Cansub,[34] should it be taken into account in establishing an arm's-length price for Cansub's services under paragraphs 247(2)(a) and (c)?

In the absence of any evidence that arm's-length parties would have agreed to such a covenant in similar circumstances, FP's covenant probably should be disregarded when computing an arm's-length price for the services under those paragraphs, as it appears to arise solely by reason of FP's ability to exercise control over Cansub. More specifically, FP's control over Cansub may serve as a proxy for an indemnity, since it effectively provides FP with a means of indemnifying itself without having to resort to a lawsuit in the event Cansub performs substandard work. An arm's-length party, by contrast, would have no such alternative recourses available to it, and thus it would insist on some form of contractual indemnity. If the covenant is the product solely of FP's ability to exercise control over Cansub and has no arm's-length analogues, then, consistent with the decisions in *General Electric*, it should not—and, based on the design of paragraphs 247(2)(a) and (c), need not—be taken into account in computing an arm's-length price for Cansub's services under those paragraphs.

b. A Side Note on Former Subsections 69(2) and (3)

While the Courts in *General Electric* did not distinguish between paragraphs 247(2)(a) and (c) and former subsections 69(2) and (3), at least two substantive differences between those provisions appear to exist:

- the limited authority described above in relation to the non-price terms of a controlled transaction, and
- the express possibility of effecting downward transfer pricing adjustments.

Interestingly, the decision of the Australian Federal Court in *SNF (Australia) Pty Ltd v Comr.*,[35] suggests there may be another substantive difference between former subsections 69(2) and (3) and paragraphs 247(2)(a) and (c). The court noted that, in contrast to the Australian transfer pricing rules, former subsections 69(2) and (3) posited an arm's-length price as between the actual parties to the controlled transaction rather than as between undefined arm's-length persons (as in the case of paragraphs 247(2)(a) and (c)) who had concluded the same transaction as the actual parties. According to the court, this distinction may have meant that one could not satisfy those subsections by merely demonstrating that the price selected for a controlled transaction did not exceed an arm's-length price but only by the determination of the specific, solitary arm's-length price applicable to that transaction.[36]

In the FP and Cansub example, the CRA's authority to disregard the covenant constitutes a minor deviation from the *ceteris paribus* approach in order to prevent terms and conditions that spring exclusively from one party's control over another party (or the control exercised over both parties by another party) from biasing, or—in the words of the Federal Court of Appeal in *General Electric*—distorting, the price that otherwise would have prevailed if the parties had been dealing at arm's length with each other.

For the avoidance of doubt, this limited authority applies only to the terms and conditions that clothe an underlying transaction and not to the nature of the underlying transaction itself, and would not permit the CRA to use the rule in paragraphs 247(2)(a) and (c) to recharacterize a transaction. On the contrary, one of the secondary reasons for introducing a dedicated recharacterization rule was precisely to forestall any argument that, since the language of Article 9 of the OECD Model Convention is considered to be sufficiently broad to permit recharacterization,[37] the rule in paragraphs 247(2)(a) and (c), which is noticeably inspired by Article 9,[38] also would permit it.

The above-described authority nevertheless should be used sparingly and only in clear-cut cases, such as the one set out above, given that it conflicts with the ba-

[33] See discussion in OECD guidelines, para. 9.165.

[34] The example also assumes that the covenant is not a sham.

[35] [2011] FCAFC 74. See 20 *Transfer Pricing Report* 103, 108; 6/2/11.

[36] See, in particular, paragraphs 123, 128 and 129 of the decision.)

[37] OECD guidelines, para. 1.66.

[38] As with Article 9 of the Model Convention, subsection 247(2) refers to terms or conditions that are ''imposed,'' in addition to ''made,'' in a transaction because it deals exclusively with transactions entered into between non-arm's-length persons. Frequently, such transactions involve a directing mind that dictates or ''imposes'' the terms of the bargain, including any conditions related thereto, on the other party or parties to the transaction. Thus, to forestall any argument that the ''making'' of the terms and conditions of a transaction is exclusively a collaborative process, subsection 247(2), like Article 9, refers as well to terms or conditions that are ''imposed'' in the transaction. Similarly, the word ''conditions,'' in this context, is not used in the narrow legal sense of a contractual term the non-performance of which permits the beneficiary-party to renounce the agreement but, rather, in the broad sense in which it is used in article 9 of the OECD Model Convention.

sic way in which the Act applies to transactions and can create uncertainty, unpredictability, and unfairness for taxpayers, as their transfer pricing reassessment invariably becomes, to a certain degree, disconnected from the facts. As a practical matter, given the broad spectrum of (non-price) terms and conditions witnessed in arm's-length transactions, and the heavy reliance on profit methods in determining arm's-length prices, this type of adjustment rarely should be seen in practice. The line between the (effective) modification of the price and other terms and conditions of a controlled transaction that are material to its price—which is something that appears to be authorized under paragraphs 247(2)(a) and (c) in the above-described limited circumstances—and the recharacterization of that transaction—which is something that is not authorized under those paragraphs—is discussed in detail below.

c. Package Deals

''Package deals'' consist of (otherwise) discrete transactions that one of the parties has bound or ''stapled'' together with the intention that all of the transactions must occur in order for any one of them to occur.[39] For example, a franchisor may be willing to franchise or license its business operating methods, name, and trademarks to another, conditional upon the franchisee entering into a separate contract to purchase its inventory exclusively from the franchisor (or a related party).[40] This type of arrangement is made or imposed in both arm's-length and non-arm's-length dealings and, in this instance, serves to protect the franchisor's goodwill by giving it control over the quality of the franchisee's products. In deciding whether to enter into the franchise, an arm's-length franchisee would, the authors submit, view the stapled transactions as a single, package deal and would evaluate the costs and benefits of the arrangement as a whole. Thus, in establishing transfer prices for each of the stapled transactions in this type of arrangement, the correct starting point for the comparability analysis generally is the entire arrangement between the parties; that is, comparables should be sought for the entire arrangement in order to evaluate whether the total consideration paid for the individual transactions was arm's-length in the circumstances.

The comparison mandated by the arm's-length principle implicitly drives one to this conclusion by virtue of its inquiry into how an arm's-length (business) person would have behaved in similar circumstances, the key question being: Would he or she have evaluated the transactions individually or, rather, as a package deal? Typically, the answer will be ''as a package deal,'' and the language of paragraph 247(2)(a), which, as noted, considers all the terms and conditions of a transaction, arrangement, or series, explicitly accommodates this holistic approach.

d. 'Quantum and Nature'

Some of the uncertainty surrounding the scope and role of paragraphs 247(2)(a) and (c) may be attributable to the use of the expression ''quantum and nature'' in the midamble of subsection 247(2), which allows for the application of those paragraphs to result in an adjustment to both the quantity and the nature of an amount otherwise determined under the Act in respect of a taxpayer. The reason for this is explained next.

As noted, subsection 247(2) operates by adjusting amounts otherwise determined under the Act in respect of a taxpayer. In some cases, it may suffice to simply increase or decrease the quantum of an amount so determined—for example, by increasing a taxpayer's business income from $100 to $200. In other cases, however, it may be necessary to not only re-quantify an amount but to replace it with another type of amount—for example, by reducing a taxpayer's capital gain[41] from $100 to zero and correspondingly increasing the taxpayer's business income from zero to $100. Thus, in the latter case, an amount otherwise determined in respect of a taxpayer, a $100 capital gain, has been adjusted both in terms of its quantum and its nature. The authority to adjust the nature of an amount is important because, while ''a buck is a buck is a buck''[42] is a laudable tax policy, it is not really the way the Act operates: the nature of the buck can be quite significant in establishing the tax consequences of a transaction to a taxpayer.

While the theoretical importance of properly characterizing an amount can be seen in the above example, in the transfer pricing context its practical significance often is seen in circumstances where a single contract between controlled taxpayers houses two or more bundles of rights and obligations that are recognized as distinct legal agreements. The contract may need to be ''unbundled'' into its component legal parts in order to determine whether the transaction gives rise to tax under, most notably, Part XIII of the Act.

For example, a contract may contain both an agreement to license intellectual property and an agreement to further develop that intellectual property, all for a single monthly fee. The CRA may decide to leave the contract in its bundled form and simply adjust the quantum of the fee (or the taxpayers' business income) to reflect an arm's-length fee. Alternatively, the CRA may decide to ''unbundle'' the contract into its component legal parts—a license of intellectual property and a service agreement—and to price each of these agreements separately. In so doing, the CRA invariably will need to adjust not only the quantum of the fee recipient's business income but the specific nature of the amounts that comprise that income into, in this case, license fees and

[39] This is the type of situation dealt with in *GlaxoSmithKline v. R.*, 2010 D.T.C. 7053 (FCA), reversing 2008 D.T.C. 3957 (TCC); leave to appeal to the Supreme Court granted March 24, 2011, and arguments were heard in January. See 20 *Transfer Pricing Report* 808, 1/26/12.

[40] The fact that the franchise may be entered into with one party and the stapled purchase of goods with another party who is related to the first party should not change the transfer pricing issue or the resolution of that issue.

[41] Of course, the transfer pricing rules apply to both controlled transactions that are on income account and controlled transactions that are on capital account.

[42] This was the catch phrase that was used to distill the thinking behind the 1966 Report of the Royal Commission on Taxation, commonly known as the ''Carter Commission'' report.

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services fees, which adjustment may result in tax under Part XIII of the Act for the recipient-licensor and, consequently, a withholding obligation on the payer-licensee.[43]

Thus, in substance, the word ''nature,'' as used in relation to paragraphs 247(2)(a) and (c), mirrors the role of section 68 under Part I of the Act, by ensuring that amounts are allocated as needed between different types of property and different types of legal agreements, the difference being that section 68 allocates amounts based on a ''reasonableness'' standard, while subsection 247(2) allocates amounts based on the arm's-length standard. That is not to say that, in many if not most cases, the same allocation of amounts would not be achieved under the two standards. However, that is not the point. The point is that the same result may not necessarily be achieved under these two competing standards and thus, partly for this reason, the application of section 68 is excluded where subsection 247(2) is applied to adjust (the nature of) an amount.[44]

Finally, in connection with the earlier discussion on package deals, it is not uncommon for one of the parties to an otherwise arm's-length package deal to be indifferent to the manner in which the total consideration is allocated among the deal's individual transactions and to accommodate the other party in this particular respect. In that case, while the overall arrangement still may serve as a valid comparable for establishing the total amount of consideration that should have been paid in a similar controlled arrangement, the allocation of such consideration by the parties should not be used to benchmark the prices of the controlled arrangement's individual transactions, assuming their pricing is relevant to the computation of tax under the Act.

Indeed, in applying section 68, the courts have shown greater deference to the parties' allocation in circumstances where they have opposing interests in this regard or where there is actual evidence of hard bargaining over the allocation of the total price.[45]

In circumstances where the aggregate consideration appears to be arm's-length but the allocation of that consideration appears to be tax-driven, how does one allocate the aggregate consideration among the individual transactions? The authors tentatively suggest that one proceed by analogy to the manner in which transfer pricing methods are customarily applied, which is by first attributing an arm's-length return to the simpler party—the party that does not own valuable intangibles, have complex functions or assume significant risks—and then attributing the residual profits to the more complex party.[46] Thus, by analogy, one should consider allocating the consideration first to the least complex transaction—taking into account the assets used, functions performed, and risks assumed by the parties to that transaction in relation to that transaction, as well as the availability of reliable comparative data for that transaction—and then allocating the remaining consideration to the other, more complex transactions, for which there is less reliable comparative data. In this way, as in transfer pricing matters more generally, the prospect for error is minimized.

The authors would add that, having concluded a package deal consisting of, for example, a license agreement authorizing one party to use the other party's patents and trademarks to manufacture and distribute branded products and a second, stapled agreement to purchase the raw materials for the manufacture of those products exclusively from the licensor, the parties may not then effectively disavow those transactions by allocating all of the consideration to the purchase price of the raw materials on the basis that no license would have been required (other than, perhaps, an ancillary one), if the purchaser had, instead, acquired the finished, branded product from the licensor-cum-vendor.

As discussed next, this would, in effect, constitute the recharacterization of the stapled transactions—something only tax authorities, not taxpayers, are authorized to do and, even then, only in exceptional circumstances.

3. Tax Policy Considerations: Paragraphs 247(2)(b) and (d)

a. Recharacterization in General

As discussed, while the words ''quantum or nature'' serve two statutory masters, their primary allegiance is to the recharacterization rule contained in paragraphs 247(2)(b) and (d). But why introduce a recharacterization rule in the first place? After all, such a rule is not a necessary part of a transfer pricing regime and conflicts with the basic approach to taxation under the Act. The reason, the authors submit, is that, in certain exceptional circumstances, a controlled transaction plainly provides the wrong starting point for measuring a taxpayer's income and thus its mere repricing does not bring the taxpayer or the tax administrator any closer to an arm's-length result.

Rather, to approach such a result, one needs to first recreate the starting point. This involves the rejection of the controlled transaction as structured by the taxpayer and its replacement with a hypothetical alternative transaction, a practice commonly referred to as the recharacterization of the controlled transaction.

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[43] The use of the words ''for the purposes of this Act'' in subsection 247(2) is intended to permit adjustments to the quantum or nature of amounts otherwise determined ''in respect of a taxpayer'' under all parts of the Act, including Part XIII. One such amount, in the authors' view, is the amount paid by a taxpayer to a nonresident person for the purposes of (for example) Part XIII's charging provision in subsection 212(1).

[44] This point has been explained in the relation to subsection 69(1) of the Act, although the explanation applies equally to section 68. See Vincent and Bloom, '' 'Fair Value' Is Not 'Arm's Length': Applying and Interpreting Subsections 69(1) and 247(2) of the Canadian Income Tax Act,'' 15 *Transfer Pricing Report* 550, 11/22/06.

[45] The Federal Court of Appeal recently stated the following on this point in *Transalta Corporation v. Her Majesty The Queen*:

> An allocation agreed between the parties to an arm's length transaction is an important factor to consider for the purpose of section 68 of the Act. However, the weight to be given to such an agreement will vary according to the circumstances. An agreement where the parties have strong divergent interests concerning the allocation will be given considerable weight, while an agreement where one of the parties is indifferent, or where both parties' interests are aligned as regards the allocation, will be given less weight: *R.L. Petersen v. The Minister of National Revenue* (1987), 88 D.T.C. 1040 at pp. 1046-1047. (2012 FCA 20, at para. 77).

[46] OECD guidelines, para. 3.18. This method is applied in *Alberta Printed Circuits* at para. 215-220.

b. 'Authority' to Recharacterize Transactions

The OECD guidelines state that there are two circumstances where it may, exceptionally, be appropriate for tax administrators to recharacterize controlled transactions:

> In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute transactions for them. . . . However, there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction.[47]

The OECD guidelines served as the Department of Finance's ''authority'' for introducing the recharacterization rule in paragraphs 247(2)(b) and (d). More precisely, but for the above statement in the guidelines, paragraphs 247(2)(b) and (d) would not have been enacted. Accordingly, paragraphs 247(2)(b) and (d) are not intended to apply in circumstances that are not identified in the OECD guidelines.[48]

c. First Circumstance

The first such circumstance arises where the economic substance of a transaction differs from its legal form. The example provided in the OECD guidelines is the making of a loan by a taxpayer to a non-arm's-length person where, having regard to the economic situation of the borrower, the loan appears to be an economic substitute for equity or share capital. Another example of this first circumstance (albeit outside of the transfer pricing context) is provided by *Her Majesty the Queen v. Imperial Oil Limited*.[49] In that case, the taxpayer lent money to a non-bank subsidiary of a bank on the strength of the bank's loan guarantee. The taxpayer lent the money in this manner, rather than directly to the bank, because a loan to a bank would not have given rise to an investment allowance for capital tax purposes. Therefore, while the transaction's legal form was a loan to a subsidiary of a bank, its economic substance arguably was a loan to a bank.

Still another example is provided by the fact pattern in *Shell Canada Ltd. v. R.*,[50] discussed in detail in the legal analysis section of this article. In this case, the Minister sought to telescope a New Zealand dollar loan that had been coupled with a currency forward into a single U.S. dollar loan on the basis that the legal form of the transactions did not reflect their economic reality. The authors understand that the incorporation of such a test into the transfer pricing rules was considered by Finance and rejected for a number of reasons.

The main reason for eschewing an economic substance test in the transfer pricing context was that it conflicted with the way Canada taxed more generally under the Act. In other words, since such a test generally was inappropriate when applying the other provisions of the Act, including those provisions that compute a taxpayer's income, then it similarly was inappropriate for the transfer pricing rules, which were intended to be accessory to those other provisions of the Act. This reasoning is the key to understanding why Finance rejected the aforementioned first circumstance but, as will be explained below, incorporated the second circumstance described in the OECD guidelines into the transfer pricing rules.

Another reason for rejecting an economic substance test was to avoid fuelling the uncertainty that already pervaded this area of the law due to, as discussed, a paucity of genuine transactional comparables, or CUPs, and the inherent difficulty in adjusting for differences between the tested transactions and parties and their (imperfect) comparables. Finance also was concerned about the possibility that this uncertainty would not be confined to the transfer pricing rules but would spread to the Act's other substantive provisions that can apply to controlled transactions, particularly those that dealt with debts, such as the thin capitalization rules. The effect of this contagion, it was feared, would be to rewrite those substantive rules based on an invisible standard that permeated them when they applied—but only when they applied—to controlled transactions. As previously stated, the transfer pricing rules were not intended to interfere with the tax policy and integrity of the Act's other income-modifying rules:[51]

> [T]he practical effect of treating the transfer pricing rules and the income-modifying Rules as overlapping is to overwrite the latter rules with a different, competing standard, when (but only when) the affected debt transactions involve non-arm's length non-residents. For example, . . . the prescribed rate of interest benchmark found in subsection 17(1) or section 80.4 would, in those circumstances, be supplanted by a different standard, such as an arm's length interest rate or the greater of an arm's length interest rate and the prescribed interest rate, and the fixed debt-to-equity ratio stipulated in subsection 18(4) would be superseded by a variable arm's length debt-to-

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[47] OECD guidelines, paras. 1.64 and 1.65.

[48] The predecessor to the 1995 OECD guidelines, the OECD's 1979 report entitled ''Transfer Pricing and Multinational Enterprises,'' states the following with respect to the recharacterization of transactions:

> In general, the approach which is adopted in this report to the adjustment of transfer prices for tax purposes is to recognize the actual transactions as the starting point for the tax assessment and not, in other than exceptional cases, to disregard them or substitute other transactions for them [para. 23].

The 1979 report does not elaborate on the exceptional circumstances in which an actual transaction does not provide the right starting point for a tax assessment. New Chapter IX of the 2010 OECD guidelines does elaborate on those circumstances in the context of so-called business restructurings. However, as that chapter did not exist at the time new Part XVI.1 of the Act was being formulated, the authors make only passing mention of it in this article, notably to address a particularly ill-founded statement therein that may have contributed to the CRA's misguided approach in the case discussed in the legal analysis section of this article.

[49] 2004 D.T.C. 6044 (FCA), affirming 2002 D.T.C. 1954 (TCC).

[50] [1999] 3 S.C.R. 622.

[51] By ''income-modifying rule'' the authors mean a rule that alters the facts—whether expressly, as in the case of a rule that imputes interest or other income where none occurs, or implicitly, as in the case of subsection 18(4), which effectively treats excess debt as equity—in determining the tax results of a transaction.

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> equity ratio, which could be higher or lower than 2-to-1 depending on the situation of the particular resident borrower. Conceivably, the thin capitalization rule in subsection 18(4) could be thrust into the role of a statutory ''transmission'', compelled to periodically vary its gearing ratio to suit the changing conditions of the particular borrower. Clearly, this was not Parliament's intent in enacting the transfer pricing rules.[52]

Yet another reason for rejecting an economic substance test was because, at least at the time, Finance felt that considerations of economic substance more properly resided within the general anti-avoidance rule (GAAR) where relevant to the ''misuse or abuse'' analysis mandated by subsection 245(4). This has been previously explained as follows:

> More specifically, it was felt that the types of transactions described by the first circumstance should *not* be recharacterized, unless they constituted a misuse of the provisions of the Act or an abuse of the Act when read as a whole within the meaning of subsection 245(4) (the ''misuse or abuse'' tests). Indeed, to apply the transfer pricing rules in this ''substance versus form'' context would usurp the role of the GAAR and render subsection 245(4) virtually meaningless in those situations (but only those situations) where the transaction or series involves a non-arm's length nonresident. Plainly, this was not the result sought by Finance in enacting paragraph 247(2)(b).[53]

Lastly, an economic substance test, in effect, restructures a transaction or series in a way that evinces its (non-tax) commercial or economic objectives, while paragraph 247(2)(b) generally does not apply to transactions or series that have (non-tax) commercial or economic objectives. In other words, the two tests target different types of transactions.

Thus, transactions contemplated by the first circumstance articulated by the OECD at paragraph 1.65 of the OECD guidelines are not intended to come within the ambit of paragraph 247(2)(b).

d. Second Circumstance

The second circumstance identified by the OECD guidelines occurs where ''the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.''[54]

The second circumstance thus has two components.

First, the transaction must be one that, when viewed as a whole, would not have been one that would have been entered into by independent enterprises behaving in a commercially rational manner. In other words, the transaction must be one that is manifestly contrary to the commercial interests of the relevant party. Secondly, the transaction must have been structured in this commercially irrational manner in order to impede the tax authorities' ability to determine an arm's-length price under ''normal'' transfer pricing rules or to achieve some other tax benefit for the party.[55] The application of normal transfer pricing rules is impeded because there are no arm's-length comparables upon which to base a transfer pricing assessment.

Paragraph 247(2)(b) is intended to apply to transactions contemplated by the second circumstance and, more particularly, the two conditions of subparagraphs 247(2)(b)(i) and (ii) are intended to parallel the second circumstance's two components. A closer inspection of paragraph 247(2)(b)'s language will make this plain.

With respect to paragraph 247(2)(b)'s opening words, the references in the OECD guidelines to the arrangements viewed ''in their totality'' or the ''totality of the terms'' of the transaction were translated into legal language as the ''transaction'' *simpliciter*, in contrast to the ''terms or conditions'' of the transaction, which is the expression used in the ''normal'' transfer pricing rule in paragraphs 247(2)(a) and (c).

The condition in subparagraph 247(2)(b)(i) is intended to denote the result of a commercially irrational transaction—namely, the failure of the operating premise, as there are no arm's-length comparables against which to benchmark the controlled transaction:[56]

> (b) the transaction or series
>
> (i) would not have been entered into between persons dealing at arm's length . . .

It is this failure that, in turn, impedes the operation of the ''normal'' transfer pricing rules in paragraphs 247(2)(a) and (c).

The condition in subparagraph 247(2)(b)(ii) is intended to mirror the second circumstance's second component. It establishes whether paragraphs 247(2)(a) and (c)'s effectiveness has been impeded by design—that is, for tax purposes—or whether it is the product of something else, such as the fact that the members of a multinational enterprise may, for genuine commercial reasons, enter into controlled transactions that have no arm's-length analogues:

> (b) the transaction or series . . .
>
> (ii) can reasonably be considered not to have been entered into primarily for *bona fide* purposes other than to obtain a tax benefit.

The specific purpose of paragraph 247(2)(b), therefore, is to ensure that the revised Canadian transfer pricing rules in section 247 of the Act can be applied in an effective manner to irrational transactions for which no arm's-length comparables exist, where the particular form of the transaction thwarts the effective application

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[52] Bloom, ''A Policy of Disengagement: How Subsection 247(2) Relates to the Act's Income-Modifying Rules,'' 1957 *Tax Topics* (CCH) 1-4 (9/10/09).

[53] Bloom, ''Paragraph 247(2)(b) Demystified,'' 1783 *Tax Topics* (CCH) 1-5 (5/11/06).

[54] OECD guidelines, para. 1.65.

[55] Paragraph 1.66 of the OECD guidelines notes that, in both the first and second circumstances, the transaction may have been structured by the taxpayer to avoid or minimize tax.

[56] Of course, the mere absence of comparables for a particular transaction does not mean that that transaction is necessarily irrational from a commercial point of view. As stated in paragraph 9.172 of the 2010 OECD guidelines' chapter on business restructurings, ''the mere fact that an associated enterprise arrangement is not seen between independent enterprises does not in itself mean that it is not arm's length nor commercially rational (see paragraph 1.11).''

of such rules to the relevant party and was selected for this reason or to achieve some other tax benefit. While the ''primary'' transfer pricing rule in paragraphs 247(2)(a) and (c) could, in theory, apply in those types of situations, Finance may have feared that the resulting adjustments would be too arbitrary to serve as the basis for a transfer pricing assessment, and that such an approach effectively would be playing into the hands of the taxpayer.

That said, Finance understood that the recharacterization of a real controlled transaction into a notional uncontrolled transaction could lead to equally arbitrary results, and thus that it would be improper to use the recharacterization power in circumstances other than the one exceptional circumstance identified as the second circumstance authorizing recharacterization in the OECD guidelines.

In evaluating the utility of a dedicated recharacterization rule, Finance considered how GAAR's misuse or abuse tests would apply in the second circumstance generally, and, in particular, in the example given in the OECD guidelines of a current sale by a taxpayer for a lump sum amount of all future intellectual property (as opposed to existing intellectual property) developed by the taxpayer in a future period.

Finance concluded that the misuse test probably was irrelevant, since no specific provision of the Act was being misused. Although the abuse test was thought to be relevant, it probably did not apply either, since, based on the *Stubart* case,[57] and as attested to by the very existence of section 245, the Act did not contain a general scheme against transactions that lacked a commercial rationale.[58] Nevertheless, it was decided that, as a matter of tax policy, the CRA should not need to rely on GAAR (whether or not applicable) in this case, as it should be able to recharacterize such a transaction, if structured in this manner to specifically thwart the application of the normal transfer pricing rules or to achieve some other tax benefit.

Thus, in short, it was felt that the economic substance test denoted by the OECD guidelines' first circumstance actually created the wrong starting point for computing a taxpayer's income, since (perceived) economic realities generally do not supplant legal relationships under the Canadian system of taxation, but that recharacterization was warranted in the second circumstance because tax-driven transactions that were manifestly contrary to a taxpayer's commercial interests clearly provided the wrong starting point for the computation of a taxpayer's income and were practically impossible to price.

e. A Side Note on IT-96R6

Significantly, when the CRA revised Interpretation Bulletin IT-96R6, it chose to not apply GAAR in the circumstances described in paragraph 17 thereof:

> When a taxpayer grants an option to a person with whom it does not deal at arm's length on capital account to acquire securities of another entity, section 69 may be applied to the disposition of the securities if the price of the option and the exercise price are materially less than the fair market value of the securities otherwise determined at the time of the exercise of the option. *The application of section 69 will most often apply when the taxpayer has granted a non-arm's length ''non-commercial option''*. A *''non-commercial option'' is one into which arm's length parties would not consider entering*. For example, this type of option may involve an unrealistically long option period, a low option price, or an exercise price that does not fully recognize expected future events (e.g., inflation, zoning change, market trends) that affect the value of assets owned by the corporation whose securities are being optioned and thus which affect the price of the optioned securities over the option period.'' [Emphasis added.]

The CRA's explanation of the changes made to paragraph 17 (former paragraph 11) of the interpretation bulletin states that this paragraph was revised specifically to reflect the CRA's position that section 69, rather than subsection 245(2), is the relevant provision in the circumstances. Note also the similarity between the CRA's administrative commercial rationality standard, as emphasized above, and the wording of subparagraph 247(2)(b)(i).

f. When is the CRA Recharacterizing a Transaction?

Moving from policy to practice, the question becomes: When must the CRA satisfy the conditions of paragraph 247(2)(b) in reassessing a taxpayer? The answer to this question, the authors submit, is that, generally, the CRA must satisfy those conditions when it is not merely seeking to price a controlled transaction—which, as explained, may include making (effective) modifications to some of its (non-price) terms and conditions in order to be able to compute an arm's-length price for the underlying transaction. Rather, the CRA must satisfy the conditions of paragraph 247(2)(b) when seeking to substitute a different type of transaction for the actual transaction and to price that different type of transaction. The key element, in this regard, is the type or legal classification of the transaction (for example, sale, license, lease, loan, or service) employed by the CRA to reassess the taxpayer. Where a taxpayer's income (or other amount) is adjusted based on a different type of transaction, whether actual or hypothetical, this generally indicates that the CRA has rejected the actual controlled transaction in its totality, if the alternative transaction logically implies a change in the facts as between the parties.

This can best be understood by considering a few examples.

g. Examples

Example 1: License Versus Service

- NRco, a nonresident corporation, develops intellectual property at its own risk and licenses the IP to Canco, a resident subsidiary, for a royalty based on Canco's Canadian sales.

[57] *Stubart Investments Ltd. v. The Queen*, 84 D.T.C. 6305 (SCC).

[58] Different from the approach of the Supreme Court of Canada in *Canada Trustco Mortgage Co. v. R.*, 2005 D.T.C. 5523, Finance approached the misuse or abuse tests in subsection 245(4) on the assumption that they were two distinct tests. A detailed discussion of subsection 245(4) is beyond the scope of this article. See section e. in this regard.

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- The CRA reassesses Canco by ''pricing'' the royalty on the assumption that NRco is rendering a research and development service to Canco for a cost-plus type fee.
- Thus:
  1. Canco's income (or other amount determined under the Act) is adjusted based on a different type of legal arrangement—a service rather than a license, and
  2. the adjustment logically assumes that Canco owns the IP and has hired NRco to service Canco's IP, which is contrary to the actual facts.
- In the authors' view, this constitutes the recharacterization of the license transaction.

Example 2: Sale Versus License[59]

- Canco, a resident corporation, sells all of its intellectual property (IP) to Forsub, a nonresident subsidiary, for a lump sum.
- The CRA reassesses Canco to adjust its income as though the IP had not been sold to Forsub but licensed to it for a royalty based on Forsub's foreign sales.
- Thus:
  1. Canco's income is adjusted based on a license agreement rather than a sale agreement, and
  2. the adjustment logically assumes that Canco retains ownership of the IP, which is contrary to the facts.
- In the authors' view, this constitutes the recharacterization of the sale transaction.

Example 3: Lease Versus Sale

- Aco leases equipment to its subsidiary, Bco; the term of the lease is coextensive with the useful life of the equipment and Bco has a nominal purchase option.[60]
- The CRA reassesses and prices the lease payments by comparing their net present value to the sale price of the same type of equipment in an uncontrolled transaction. The reassessment contains adjustments to reflect factual differences in the controlled and uncontrolled transactions, but none of these differences are material to the pricing of the lease payments.
- Thus:
  1. the CRA is employing a different type of legal transaction to price the actual transaction, but
  2. the CRA's reassessment does not assume facts material to the pricing of the actual transaction that are different from the actual facts.
- In this case, the CRA is merely seeking to price the controlled transaction by reference to a transaction that is comparable from an economic point of view. This is suggested by the high degree of comparability between the controlled and uncontrolled transactions, the use of a net present value method as a mathematical device to compare a stream of payments to a lump-sum amount, and the CRA's attempt to account for minor differences in the transactions, all of which evince an intention to use the (different type of) uncontrolled transaction merely as a means of determining an arm's-length price for the actual controlled transaction. In short, all of these factors combined make it clear that the CRA is simply engaged in a comparability or pricing analysis, and is not seeking to recharacterize the controlled transaction. As the CRA is not recharacterizing the actual transaction, it may proceed under the authority of paragraphs 247(2)(a) and (c) to make the adjustment.

Example 4: Lease Versus Sale

- The facts are the same as in Example 3 except that the CRA reassesses Aco by including the full net present value or sale price of the equipment in Aco's income in the year the lease is entered into.
- Thus:
  1. the CRA has adjusted Aco's income based on a different type of legal agreement, and
  2. the reassessment or adjustment assumes that the lessee, Bco, owns the equipment and that the lessor, Aco, does not, which is contrary to the facts.
- In the authors' view, this constitutes the recharacterization of the controlled transaction and the CRA could not make the adjustment under the authority of paragraphs 247(2)(a) and (c). Moreover, the CRA could not rely on paragraphs 247(2)(b) and (d) to make such an adjustment, as this would amount to the importation of an economic substance test, in the sense of the first circumstance contemplated by the OECD guidelines, into the transfer pricing rules.

The foregoing examples are intended to illustrate the two indicia that will generally be present where the CRA is recharacterizing a transaction:

1. An adjustment to a taxpayer's income or other amount determined under the Act based on a different type of legal transaction than the controlled transaction—or what amounts to the same thing based on the results of taxpayers that engage in such different types of transactions.
2. An adjustment that assumes a state of facts, as between the parties to the controlled transaction, that differs from the actual state of facts in a manner that can materially affect the pricing of the controlled transaction. Any assumptions that posit a material reallocation of functions, assets, or risks as between the parties to the controlled transaction would, in the authors' view, have such an impact.

Together, these generally indicate that the CRA is not attempting to price a controlled transaction or to measure the profits from it but has rejected it and effectively replaced it with an alternative transaction. This generally constitutes the recharacterization of the controlled transaction and can only be achieved under the authority of paragraphs 247(2)(b) and (d), which, as explained, are intended to recharacterize only those transactions that come within the ambit of the second circumstance described in the OECD guidelines.

h. An Exceptional Rule

Since the rule contained in paragraphs 247(2)(a) and (c) is intended to serve as the Act's ''normal'' or ''everyday'' transfer pricing rule, then it follows that the recharacterization rule contained in paragraphs 247(2)(b)

[59] For a discussion of the circumstances where paragraph 247(2)(b) could apply to a sale of intellectual property, see Bloom, ''Paragraph 247(2)(b) Demystified,'' note 29, at p. 3.

[60] It is assumed, for these purposes, that the transaction would be classified as a lease at law.

and (d) is an ''unusual'' or ''exceptional'' rule.[61] It is an exceptional rule for several reasons.

Firstly, the circumstances in which it can apply are inherently exceptional, as it essentially contemplates a situation where the application of the pricing rule produces results that are even more arbitrary than the application of the recharacterization rule due to the fact that the controlled transaction is not commercially rational.

Secondly, the recharacterization rule conflicts with the basic scheme of the transfer pricing rules in the sense that taxpayers cannot document alternative transactions, which suggests that the transfer pricing penalty may be unavoidable in these situations and, yet, the penalty was, in part, intended to serve as encouragement for taxpayers to document their controlled transactions, which documentation (if accurate and complete) would, in turn, shelter them from the penalty.

Thirdly, it is difficult to envisage how issues of double taxation can be resolved under the mutual agreement procedure (MAP) of Canada's tax treaties when the competent authorities of the two contracting states do not share the same starting point for their analysis. Indeed, according to paragraph 27 of Information Circular 71-17R5, the Canadian competent authority will not negotiate anti-avoidance cases under the MAP, where the CRA's reassessments are based on section 245 or a specific anti-avoidance provision of the Act.

More generally, a recharacterization rule conflicts with the basic scheme of the Act, which taxes based on what taxpayers did, not what they could have done. Of course, taxpayers cannot self-assess on the basis of hypothetical, alternative transactions.

Finally, as discussed, the transfer pricing rules are not intended to be the primary basis on which a taxpayer's tax liability is determined; rather they are intended to be accessory to the Act's other rules that determine that liability. However, that is not the effect of a recharacterization rule, which essentially wipes the Act's slate clean and itself establishes (some or all of) the rules by which a taxpayer's liability under the Act is to be computed.

For all of these reasons, the recharacterization rule in paragraph 247(2)(b) and (d) is an exceptional or abnormal one and, thus, to employ the normal transfer pricing rules in paragraphs 247(2)(a) and (c) to effectively recharacterize transactions would turn the integrated scheme of the transfer pricing rules, the Act, and the MAP provisions of Canada's tax treaties on its head.

Unfortunately, despite the negative ramifications of using paragraph 247(2)(a) and (c) to recharacterize transactions, despite the fact that transfer pricing rules are basically intended to price (actual) controlled transactions, despite the clear guidance provided by the OECD that recharacterization is an exceptional remedy, despite the apparent symmetry between the OECD guidelines' second circumstance and the conditions of paragraph 247(2)(b), and despite the juxtaposition of paragraphs 247(2)(a) and (c) with what is an overt recharacterization rule in paragraphs 247(2)(b) and (d), that appears to be precisely what the CRA is doing, as discussed next.

[61] ''The word ''exceptional'' in this context is similar in meaning to ''rare'' or ''unusual.'' It reflects that in most cases it is expected that the arm's-length principle under Article 9 can be satisfied by determining arm's-length pricing for the arrangement as actually undertaken and structured. (OECD guidelines, para. 9.168.)

B. Legal Analysis

1. Facts and Assumptions

The authors' analysis of the CRA's current approach is based on the following facts drawn directly from an actual case that has been sanitized to protect taxpayer confidentiality.

- Canco is a corporation resident in Canada and a member of a multinational enterprise, GlobalMNE. Canco manufactures specialty widgets. To manufacture these widgets, Canco must be authorized to use certain intellectual property, IP1, which it does not own and did not develop. Canco's only business is the manufacture and distribution of specialty widgets. Canco sells a large part of its widget production to a related company resident in the United States, USco, and distributes the rest to arm's-length persons in Canada.
- Foreignco is a non-resident corporation that is a member of GlobalMNE. Foreignco's only business is the performance of research and development (R&D) at its own cost and risk and the licensing of the resulting intellectual property, if any. Foreignco (and predecessor corporations none of which were ever residents of Canada) developed certain intellectual property, namely IP1, IP2 and IP3. Foreignco licenses IP1 to Canco and IP2 to another member of GlobalMNE but cannot license IP3. All licenses are documented.
- Under the license agreement, Canco pays a royalty to Foreignco for the use of IP1 (and any improvements thereto) calculated as a percentage of Canco's sales.
- Canco's license of IP1 is non-exclusive and non-transferable, and for the territory of ''Canada.'' It is for a 10-year period, and is renewable from year to year thereafter.
- Under the license, Foreignco agrees to provide ancillary services, such as assistance with setup and troubleshooting, to Canco at no additional charge.
- Foreignco is not in the business of providing such ancillary services or of improving intellectual property that it does not own and license out.
- Canco has borne none of the risks or costs related to the development of any intellectual property owned by Foreignco. Such risks are significant, as Foreignco has a team of scientists performing R&D on a full-time basis and not all of the resulting intellectual property can be licensed (as in the case of IP3).
- There are no realistic alternatives available to Canco to access IP1 or equivalent intellectual property.
- Canco, USco and Foreignco do not deal at arm's length with each other for the purposes of the Act.

2. The CRA's Position

During an audit of the royalty paid by Canco to Foreignco, the CRA's International Tax Division (ITD) took the following positions:

- ''The ITD continues to recommend that a royalty is not an appropriate form of compensation for the R&D services provided by [Foreignco], because it does not match the economic substance of the transaction.''

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■ ''The transaction in question is the provision by [Foreignco] of R&D services and technical support to [Canco].''

■ ''The ITD has not attempted to suggest (a) this transaction would never occur at arm's length and that (b) it is primarily for [the MNE] to obtain a tax benefit. Rather, the ITD has proposed to alter the method of compensation for such a transaction, which would clearly fall under section 247(2)(a). That is, the ITD has proposed that the terms and conditions would need to be changed to reflect the benefit received by [Canco]. The ITD recognizes the existence of the R&D efforts from [Foreignco] and in no way has attempted to ignore them, but does challenge the value of such services.''

■ ''It is the ongoing nature of the indefinitely defined series of transactions and the business interaction between [USco], [Canco] and [Foreignco] that presents an economic substance more similar to an ongoing provision of intercompany services.''

Thus, in auditing a transaction—namely, Foreignco's licensing of IP1 to Canco—the CRA effectively replaced that transaction with a different type of transaction—namely, a hypothetical service agreement upon which a markup on the annual cost of R&D performed by Foreignco is charged to Canco—and disregarded the payment of a royalty calculated as a percentage of Canco's sales. Significantly, in doing so, the CRA specifically avoided relying on paragraphs 247(2)(b) and (d) and insisted, instead, that its reassessments were based on paragraphs 247(2)(a) and (c).

3. Issues and Legal Framework

The issues raised by the case are:

■ Is the CRA authorized to reassess Canco in this manner pursuant to paragraphs 247(2)(a) and (c)?

■ If not, are paragraphs 247(2)(b) and (d) applicable in the circumstances?

In the authors' view, the CRA's positions in this case demonstrate a fundamental misunderstanding of the legal principles applicable to Part XVI.1 of the Act. The analysis and assessment of transfer prices by the CRA should not be performed in a vacuum, but are intended to be subject to the same legal principles according to which the other parts of the Act are administered and interpreted.

In Canada, this analysis generally consists of a two-step process. First, one determines the rights and obligations of the relevant party or parties under private law principles and, then, one applies the relevant rules of the Act, as interpreted by the case law, to the legal relationships and transactions so determined.

a. Parties' Rights and Obligations

At law, the transaction entered into between Canco and Foreignco is a license and is evidenced by a license agreement. The terms and conditions setting forth the rights and obligations of the parties to this agreement are premised on the fact that Foreignco is the owner of IP1 and that Canco is not. Indeed, were it otherwise, the agreement would serve no purpose and would be legally ineffective. The agreement evinces Canco's desire and need to have access to IP1 and Foreignco's willingness to grant such access in return for the payment by Canco of a royalty. The agreement also provides that Canco will receive certain ancillary services related to the use of IP1 and will have access to improvements to IP1, if any, at no additional charge.

More specifically, Canco's rights consist of the right to use IP1 and any improvements, as well as the right to receive certain ancillary services if needed. In return for these rights, Canco is obligated to pay a royalty to Foreignco. Foreignco's rights consist of the right to receive a royalty from Canco for the use of IP1, and to withhold access to IP1 and to any related improvements and services, if Canco does not pay the agreed upon royalty. In return for these rights, Foreignco is obliged to give Canco access to IP1 and its improvements, as well as to provide certain ancillary services where needed by Canco.

Thus, as Foreignco is the owner of IP1, the ''bottom line'' is that Canco would not be authorized to use IP1 to manufacture its widgets, or to benefit from the ancillary services and the improvements to IP1, if it were not willing to pay a royalty to Foreignco for the use of IP1.

b. Applicable Law

It is a well-settled principle of Canadian tax law that ''economic realities'' do not trump legal rights and obligations.[62] This was stated emphatically by the Supreme Court of Canada in *Shell Canada Ltd. v. R.*[63]

Shell Canada involved a financing transaction commonly known as ''kiwi loans.'' Briefly, Shell Canada needed US$100 million of general financing. In order to minimize the after-tax cost of the financing, rather than borrow US$100 million at a 9.1 percent interest rate, Shell Canada borrowed the equivalent of US$100 million in New Zealand currency (NZ$150 million) for a term of 5 years at an interest rate of 15.4 percent. The higher interest rate reflected the fact that the New Zealand dollar was a weak currency and was expected to depreciate in value relative to the U.S. dollar over the term of the loan.

Shell Canada exchanged the NZ$150 million for US $100 million and then entered into a forward exchange contract, which allowed it to exchange the relevant amount of U.S. dollars for New Zealand dollars at the dates specified for payment of the interest and principal on the New Zealand dollar-denominated loan. By structuring the transaction in this manner, Shell Canada had an increased (fully deductible) interest cost (15.4 percent versus 9.1 percent if it had borrowed directly in U.S. dollars) but a compensatory foreign exchange gain (only half of which was taxable) on the ultimate repayment of the principal of the loan and exchange of principal under the forward contract. Thus, the combined effect of the New Zealand dollar borrowing and forward contract (aside from the tax benefits) was the economic equivalent of a direct borrowing by Shell Canada of US$100 million.

The Supreme Court was asked to disallow the deduction of the portion of the interest that exceeded 9.1 percent based on the ''economic realities'' of the transaction. This approach does not alter a party's actual legal rights and obligations; rather, it seeks to determine the tax effects of the transactions by disregarding those legal rights and obligations for tax purposes only, and substituting other rights and obligations or transactions for them based on the perceived economic substance of

[62] See note 22 above (Vincent at 297).
[63] See note 50 above.

the actual transactions. In *Shell Canada*, the (successful) application of this theory meant that Shell Canada would be treated, for tax purposes, as having borrowed US$100 million at the rate of 9.1 percent.

In reaching its conclusion, the Supreme Court stated that an economic realities approach had no application in Canadian tax law and that such an approach constituted an unauthorized recharacterization of *bona fide* legal relationships:

> This Court has repeatedly held that courts must be sensitive to the economic realities of a particular transaction rather than being bound to what first appears to be its legal form . . . But there are at least two *caveats* to this rule. First, *this Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's bona fide legal relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases*. Recharacterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect.[64] [Emphasis added.]

This statement by the Supreme Court is clearly not limited to the facts before the Court in *Shell*.[65]

Thus, the notion that there is some form of ''economic substance'' or ''economic ownership'' test in Canadian tax law is erroneous. Absent a sham or a specific provision of the Act to the contrary, legal relationships must be respected.

As discussed earlier in this article, the transfer pricing rules indeed contain a specific provision to the contrary, and it is housed in paragraphs 247(2)(b) and (d). Paragraphs 247(2)(b) and (d) can be used to recharacterize transactions if, but only if, certain strict conditions are satisfied. Similarly, the CRA can invoke section 245 of the Act or prove the existence of a sham in order to recharacterize a transaction. However, absent the allegation of and supporting evidence for the application of such provisions or the sham doctrine, the CRA's role is confined to the application of the various provisions of the Act to the legally enforceable rights and obligations of the parties as established by the parties.

The legal relationship between Foreignco and Canco is that of licensor-licensee. The license agreements were entered into for *bona fide* purposes other than to obtain a tax benefit: Foreignco owns intellectual property and Canco needs to be authorized to use that property in order to manufacture its widgets. Furthermore, the licensing of intellectual property is a commonplace transaction between arm's-length persons. Consequently, the CRA would not be able to recharacterize the licensing transaction under section 245 or paragraphs 247(2)(b) and (d) of the Act.

Similarly, there is simply no factual basis or evidence to suggest that the licensing agreement is a sham, as Canco and Foreignco's course of conduct corresponds perfectly with their (apparent) legal rights and obligations thereunder.[66]

Thus, the CRA's assertion that ''a royalty is not an appropriate form of compensation for the R&D services provided by [Foreignco], because it does not match the economic substance of the transaction,'' and its claim that it is not recharacterizing the license but, rather, merely altering ''the method of compensation for such a transaction'' are legally (and fiscally) incorrect. Each of these positions rests on a manufactured relationship between Foreignco and Canco, one which (wrongly) posits that Foreignco is a service provider to Canco, rather than a licensor of IP1.

In short, in transfer pricing matters, as in other tax matters governed by the Act, there exists a legal framework within which the CRA is required to operate. Under that legal framework, the CRA is not entitled to disregard the *bona fide* legal relationships established by taxpayers on the basis of some economic argument or on the pretext of performing a valuation analysis.

c. What is 'Recharacterization'?

The CRA apparently takes the view that paragraph 247(2)(c) authorizes it to effectively adjust the ''terms and conditions'' of a transaction without any limit, except for the one imposed by the arm's-length standard itself. Therefore, according to the CRA, a license agreement may, for example, be treated as an R&D services agreement without recourse to paragraphs 247(2)(b) and (d).

''Recharacterization'' is not defined for the purposes of Part XVI.1 of the Act and, indeed, subsection 247(2) does not actually use that terminology.

As noted above, the Supreme Court considered that the CRA's reliance on economic realities to disregard taxpayers' *bona fide* legal relationships in *Shell Canada* constituted the recharacterization of the transactions in that case. In addition, certain nonbinding (but persuasive) materials, such as IC 87-2R and the OECD guidelines, provide some guidance as to what the CRA and the OECD consider to be the recharacterization of a transaction.

IC 87-2R is intended to provide the CRA's general views on transfer pricing matters and guidance with respect to the interpretation and application of section 247 of the Act.[67] With regard to recharacterization, it states the following:

> 44. There are instances where it is necessary to recharacterize a transaction for tax purposes; however, as indicated in the OECD Guidelines, those instances are limited. The OECD Guidelines identify two exceptional situations where the recharacterization of a transaction would be considered (see paragraph 1.37 of the OECD Guidelines).
>
> 45. Paragraph 247(2)(*b*) of the Act, which provides the authority to recharacterize a transaction, states that a transaction can be recharacterized only after meeting the following two conditions:
>
> - the transaction or series must be one that would not have been entered into between persons dealing at arm's length; and

[64] *Ibid.*, at paragraph 39.

[65] See also the subsequent Supreme Court of Canada decision in *Singleton v. R.*, [2001] 2 S.C.R. 1046.

[66] For the meaning of ''sham'' in Canadian law, see, for example, *M.N.R. v. Cameron*, [1974] S.C.R. 1062 (SCC).

[67] See paragraphs 1 and 3 of IC 87-2R.

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- it can be reasonable to consider that the transaction or series of transactions was not entered into primarily for *bona fide* purposes other than to obtain a tax benefit.

As stated at paragraph 45 of IC 87-2R, the CRA's view, at the time the circular was drafted, was that *the* authority to recharacterize a controlled transaction rested within paragraph 247(2)(b).[68] That was also Finance's view at the time. If it had been felt that no such authority was needed or that such authority rested elsewhere, IC 87-2R would have said so.

Paragraph 44 of IC 87-2R states that the CRA believes that recharacterization should occur only in limited circumstances and refers specifically to the two exceptional circumstances then found at paragraph 1.37 of the OECD guidelines, now renumbered as paragraph 1.65.

The OECD guidelines discuss recharacterization in general terms at paragraphs 1.64 to 1.69.[69] The OECD refers, alternately, to the disregarding of actual transactions, to the substitution of alternative transactions for actual transactions, and to the restructuring of legitimate business transactions. As discussed in the first part of this article, the OECD articulates, at paragraph 1.65, two particular circumstances where it may, exceptionally, be both appropriate and legitimate for a tax authority to consider the recharacterization of a transaction:

- where the economic substance of the transaction differs from its form; and
- where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate price.

An example of each of the above circumstances is provided. The first involves an investment in an associated enterprise in the form of interest-bearing debt when, having regard to the economic circumstances of the borrowing company, the investment would not have been structured in this manner by arm's-length parties. The example states that a tax authority may be justified in treating the investment, instead, as a subscription of capital. The second involves the sale, under a long-term contract and for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract. The example suggests that this transaction might be recharacterized as a continuing research agreement.

In the present case, the CRA's reassessments are based on the ITD's view that the economic substance of the licensing transaction is that of the provision of services. According to the ITD, ''a royalty is not an appropriate form of compensation . . . because it does not match the economic substance of the transaction,'' and ''the transaction in question is the provision by [Foreignco] of R&D services.''

Thus, one would have thought that the CRA's approach, in this case, would fall squarely within the parameters of the first circumstance described by paragraph 1.65 of the OECD guidelines—that ''the economic substance of a transaction differs from its form.''

Nevertheless, the CRA insists that treating a transaction as though it were a completely different type of transaction, on the basis that the economic substance of the transaction differs from its form, does not constitute recharacterization, even where it implicitly assumes facts that are different from the actual facts—that is, that Canco owns IP1, when it does not. As demonstrated in the first part of this article, the CRA's position is clearly wrong and its actions in fact constitute the recharacterization of the licensing transaction, in the sense articulated by the first circumstance of the OECD guidelines.[70]

If one agrees that the treatment of a sale of intangible property as, for example, a license agreement plainly constitutes the recharacterization of the sale transaction, as described by paragraph 1.65 of the OECD guidelines, and that the CRA would, therefore, be required to invoke paragraphs 247(2)(b) and (d) to effect such a recharacterization, as suggested by paragraph 44 of IC 87-2R, then what is the substantive difference between that particular brand of recharacterization and the treatment, in the present case, of the license of IP1 as the provision of services? The authors submit that there is none.

From a legal perspective, if paragraphs 247(2)(b) and (d) are applied to recharacterize the sale of intellectual property as a license of such property, the sale nonetheless takes place. In other words, the legal owner of the intellectual property, after the application of paragraph 247(2)(d) to the sale transaction, is the purchaser. However, for income tax purposes, that ownership is not recognized and, instead, the vendor is presumed to continue to own the intellectual property.

Similarly, when the CRA treats Foreignco's license of IP1 to Canco as, instead, the provision of R&D services to Canco, the legal owner of IP1 remains Foreignco; however, for tax purposes, that ownership is disregarded, as Canco is presumed to have the right to use IP1 to manufacture its specialty widgets without a license from Foreignco. In brief, the CRA's approach necessarily assumes that, contrary to the actual facts, Canco owns IP1 and Foreignco does not. Thus, the effect of the CRA's approach, in terms of the ownership of intellectual property, is the same as in the above-described case involving the treatment of a sale of intellectual property as a license, an action that manifestly constitutes the recharacterization of the sale transaction under the OECD guidelines and, thus, IC 87-2R.

d. The CRA's Approach Renders Recourse to 247(2)(b) and (d) Superfluous

The CRA's approach is premised on an ability to disregard the transaction undertaken by Canco and For-

[68] The decision of the Tax Court of Canada in *General Electric Canada Company v. The Queen*, 2011 TCC 564, rendered Dec. 19, 2011, deals in part with the potential application of paragraphs 247(2)(b) and (d) but, because it is an interlocutory decision resulting from a motion to strike certain paragraphs of the Crown's pleadings, it does not provide an in-depth analysis or reach any conclusions with respect to the interpretation of those provisions.

[69] As noted, new Chapter IX of the 2010 OECD guidelines provides specific guidance for situations involving so-called business restructurings.

[70] As demonstrated in this part of the article, the CRA's actions also constitute the recharacterization of the license of IP1 under the principles of *Shell Canada*.

eignco (the licensing of intellectual property) and substituting, in its place, another transaction (the provision of R&D services). The CRA seems to think that the authority for this approach is rooted in paragraphs 247(2)(a) and (c) of the Act.

It appears to the authors that the only way one could reach this conclusion would be to read subsection 247(2) and its midamble as if paragraphs 247(2)(b) and (d) did not exist at all. More specifically, one would have to focus exclusively on the words ''any amounts that . . . would be determined for the purposes of this Act in respect of the taxpayer . . . for a taxation year . . . shall be adjusted . . . to the quantum or *nature* of the amounts.'' Perhaps the CRA interprets these words as authorizing it to adjust the ''nature'' of amounts without having to consider whether such an adjustment effectively recasts the underlying transaction as a different type of transaction or whether the conditions of paragraph 247(2)(b) have first been satisfied.

However, such an interpretation of subsection 247(2) would clearly be ill-founded in law, as it would turn a blind eye to the existence of paragraphs 247(2)(b) and (d) and dismiss the context and purpose of the enactment of these paragraphs within Part XVI.1 of the Act, as described in the first part of this article. Surely, not even the CRA would contend that the narrow exception to the *ceteris paribus* approach the authors describe would permit it to recast transactions when that is manifestly the function of neighboring paragraphs (b) and (d).

Moreover, an interpretation of subsection 247(2) that would allow the CRA to use paragraphs 247(2)(a) and (c) to treat a licensing transaction as if it were the provision of services would render paragraphs 247(2)(b) and (d) superfluous. Indeed, if the CRA can recharacterize a transaction simply by adjusting the ''nature'' of amounts under paragraphs 247(2)(a) and (c), then recourse to the specific recharacterization provisions of section 247 and compliance with the conditions of paragraph 247(2)(b) become unnecessary. Clearly, this approach would constitute an unauthorized and unprincipled unification of Canada's dualistic transfer pricing regime.

Lastly, the authors note paragraph 9.60 of new Chapter IX of the OECD guidelines dealing with business restructurings, which may have contributed to the thinking behind the CRA's approach in this case:

> Thus, in applying the arm's length principle, a tax administration evaluates each transaction as structured by the taxpayer, unless such transaction is not recognized in accordance with the guidance at paragraph 1.65. However, alternative structures realistically available are considered in evaluating whether the terms of the controlled transaction (particularly pricing) would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. If a more profitable structure could have been adopted, but the economic substance of the taxpayer's structure does not differ from its form and the structure is not commercially irrational such that it would practically impede a tax administration from determining an appropriate transfer price, the transaction is not disregarded. *However, the consideration in the controlled transaction may be adjusted by reference to the profits that could have been obtained in the alternative structure, since independent enterprises will only enter into a transaction if they see no alternative that is clearly more attractive*. [Emphasis added.]

As demonstrated herein, the type of adjustment described by the last sentence of the above-quoted paragraph constitutes the recharacterization of a transaction under the Act and thus can be made only under a recharacterization rule, such as the one contained in section 245 or paragraphs 247(2)(b) and (d), or the sham doctrine, and cannot be made under paragraphs 247(2)(a) and (c) of the Act.[71]

C. Conclusion

As shown, the CRA is not able to rely on paragraphs 247(2)(a) and (c) of the Act to treat a given transaction as though it were a completely different one, and the provisions of the Act and legal doctrine under which such an approach is possible do not apply in this case.

With, perhaps, one notable exception, Finance's approach to new Part XVI.1 of the Act was a minimalist one: draft only that which needed to be anchored in the law, and let the 1995 OECD guidelines and IC 87-2R guide taxpayers in their ''everyday'' transfer pricing analysis. As transfer pricing is a fact-dependent exercise that relies heavily on good judgment and common sense,[72] this approach had much to recommend it. Whether or not one thinks that Finance strayed from this approach in proposing a recharacterization rule, the point is that the success (or failure) of what is essentially a principles-based legislative scheme depends primarily upon a principled administration of that scheme by those entrusted with that task. As demonstrated, the use of paragraphs 247(2)(a) and (c) to recharacterize transactions conflicts with the tax policy and legal principles upon which Canada's dualistic transfer pricing regime was built, and, frustratingly for those who were involved in fashioning the government's approach to new Part XVI.1, is anything but a principled administration of the transfer pricing rules.

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[71] The inherent contradiction contained in paragraph 9.60 above—no doubt the product of the OECD's efforts to build a consensus among its member states—serves as a good example of why one should be cautious when transposing the OECD's guidance, particularly guidance published after the enactment of Part XVI.1, onto Canada's transfer pricing regime. That guidance is useful only to the extent that it is persuasive and does not conflict with Canadian tax policy and law. The last sentence of paragraph 9.60 is in direct conflict with Canadian tax policy and law and thus is irrelevant to the application of the transfer pricing rules. In any event, even within the OECD guidelines, these comments are confined to situations involving business restructurings and would not apply to ongoing transactions.

[72] As stated by the Tax Court in *General Electric*, ''In the final analysis, transfer pricing is largely a question of facts and circumstances coupled with a high dose of common sense'' (para. 273).

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