The Implications in and for Canada of the IRS’s Final Section 482 Services Regulations

By Nathan Boidman
Overview
In principle, there ought to have been no need to write this article. The reasons are threefold. First, the principle underlying the tax rule governing cross-border intercompany transactions in Canada and the United States is the same: namely, intercompany prices are to be governed by the arm’s-length standard. In the United States, this is expressed in the regulations pursuant to section 482 of the Internal Revenue Code. In particular, Treas. Reg. § 1.482-1(b)(1) states, in part:

The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standards of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer . . . . The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer.

Canada’s standard is contained in the basic intercompany transfer pricing rule of section 247(2) of the Income Tax Act, which states:

Where a taxpayer or a partnership and a non-resident person with whom the taxpayer or the partnership, or a member of the partnership, does not deal at arm’s length (or a partnership of which the non-resident person is a member) are participants in a transaction or a series of transactions and

(a) the terms or conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm’s length . . . .

any amounts that, but for this section and section 245, would be determined for the purposes of the Act in respect of the taxpayer or the partnership for a taxation year or fiscal period shall be adjusted (in this section referred to as an “adjustment”) to the quantum or nature of the amounts that would have been determined if,

(c) where only paragraph (a) applies, the terms and conditions made or imposed in respect of the transaction or series, between the participants in the transaction or series had been those that would have been made between persons dealing at arm’s length . . . .

Second, credible recognition has been to the hegemony of facts and circumstances in applying the arm’s-length standard principle. This was seen some 47 years ago in a 1962 decision of the Tax Review Board of Canada in Hofert (involving sales of Christmas trees by a Canadian subsidiary to its U.S. parent), where the Tax Review Board stated that proper pricing is simply a matter of the particular facts and circumstances of the case. Some 30 years later, in September 1992, then-acting U.S. Treasury International Tax Counsel, James Mogle, in announcing that the U.S. Department of the Treasury and Internal Revenue Service were withdrawing from the proposed section 482 regulations (which had been issued in January of that year) the “comparable price method” (CPM) as a mandatory method, was quoted, as follows:

Mogle said he has “a few ideas” as to what might replace CPI, but gave no details. The right answer, he believes, is “a great deal more flexibility and broad principles from which you can then go to a fact and circumstances analysis.”

Thus, the arm’s-length principle is a matter to be determined according to the particular facts, ultimately, by a court and, per se, its determination should not be the object of any specific “rules.”

Unfortunately, in 1968, the United States started to ignore, overlook, or compromise this fact of legal life when the government issued the first set of regulations under section 482. The problem spread to other parts of the world with the issuance of the OECD’s 1979 “guidelines,” which were more or less a knockoff of the 1968 U.S. Regulations.

Third, again in principle, are not intercompany services basically susceptible to reasonably straightforward and uncontroversial treatment under the arm’s-length standard, in contrast to intercompany sales of proprietary products or intercompany licensing of proprietary intangibles, as transactions that do not necessarily involve high-value intangibles?

Notwithstanding these principles, there is a need to write this article for five reasons.

First, international intercompany transfer pricing has increasingly become distorted by a de-emphasis of the arm’s-length standard as a rule of law and growing emphasis of it as a mechanical apparatus to be sliced and diced and dealt with in modules, as though varying facts and circumstances never existed. Although this really started in 1968, it picked up steam some two decades later with the issuance by the U.S. Treasury and the IRS of the White Paper, written pursuant to the enactment in 1986 of the “super royalty” amendment to section 482. Any examination of that voluminous document shows a laboratory-like approach to dealing with the facts and circumstances, though it was with some substantial relief that one came to the conclusion that where more than one member of a group owned high-valued intangibles, the laboratory-like allocation method suggested by the White Paper came down to a profit-split, which is reality but a judgment call.

After that, the flurry of activity by the United States and other
countries (whose efforts have been galvanized around the work of the OECD) has more and more led to a disconnect between the essential nature of the arm’s-length standard, and the mechanical way in which legislators and administrators believe that they can try to deal with it. This unfortunate factor permeates all developments in transfer pricing including the new U.S. Services regulations under section 482.

The second reason is the almost paranoid fashion in which tax administrators view the activities of multinationals — the concern that transfer pricing is used as sword that seeks to manipulate prices in order to allocate profits in a fashion that reduces overall group tax. This leads to the constant, debilitating process, of trying to either fine tune or add radical elements to what at law is a principle that simply cannot be put into a nice, neat box. Therefore, there are the ongoing studies by the OECD of “business restructuring” and the “revelations” in recent proposals to revise Chapters I, II, and III of the OECD Guidelines. The nexus noted earlier between OECD and U.S. Regulations has been vividly brought to mind by the OECD proposals, which would essentially jettison the hegemony of “traditional” transactional methods over “profit-based” methods. The OECD’s September 9 release trumpets how experience since 1995 indicates that there should no longer be a bias toward (or a presumption in favor of) “the traditional methods” (based on pricing each transaction) over the “transactional profit methods” (which are not really pricing methods at all but rather tax authority techniques for evaluating the extent to which the “arm’s length pricing standard” has been met). As a result, the release states there should be “a standard whereby the selected transfer pricing method should be the ‘most appropriate method to the circumstances of the case.’” Is not that the U.S. 1994 “best method” rule?

The third reason is the vivid contrast between the approaches of Canada and the United States to legislatively applying the arm’s-length standard. For Canada, the matter is simple. The law is the standard and nothing but the standard. (See section 247(2)(a) of the Act.) There are no statutory regulations. Jurisprudence on services has simply confirmed the notion that it is all a question of the facts and circumstances of a particular case. There are a plethora of views, interpretations, and positions of the Canada Revenue Agency (CRA) on transfer pricing that simply do not make law. And yet, somewhat surprisingly, Canadian courts have suggested that the OECD materials (and, in particular, the OECD Model Treaty and the OECD Transfer Pricing Guidelines) are sources that a court may take into account in dealing with the particular issue before it.

The United States, on the other hand, has had regulations since 1968 and, with respect to “services,” there are the new July 31 final regulations which are voluminous (running to 158 pages) and detailed. This article focuses on the effect of those rules in and on Canada.

Fourth, there is the difficulty that the notion of “services” as used in a plain, generic, commercial context — that is to say, one person renders a service to another — in fact masks the range of factors that may arise under that term. In particular, this area of intercompany relations (as dealt with in the new regulations and that are addressed by the CRA in its writings and by the OECD in its musings) extend far beyond the notion of a consenting person with the ability to render a service in fact rendering that service to another consenting person with ability to contract and receive the service.

Included as well are the following factors and elements, which give this area much of its difficulty, complexity, and controversy. There is a question of the nature of the business deal and relationship where the arrangement is not simply a service by one person to another, or one member of the group to another, but rather a de facto or legal sharing of an employee. This may also raise the difficult question of “secondments,” the boundaries and full implications of which may be less than clear under contract or employment law, quite apart from the issues arising under tax law. Separately, there is the different question (in relation to the notion of intercompany services) whether a particular activity carried out by one corporation (generally, a parent) provides a service (with a monetary value) to another member (say, a subsidiary) as opposed to being carried out for the purposes and benefit of the parent. This, of course, is the issue of “shareholder” or stewardship or custodial activities. Then there is an added difficulty whether simple “cost” or cost plus a mark-up is involved. The determination of “cost” can be contentious and controversial (as seen in the separate “cost-sharing” case of Xilinx).

There is also the question whether certain arrangements constitute the provision of the service or something totally different — the best example of which is perhaps intercompany guarantees. In particular, proposed legislation in Canada and the final Services regulations punting on this question (and in a fashion that put into question whether a guarantee does in fact constitute the rendering of a service) is part of the specific issues addressed in this article.

Fifth, there is the almost quaint, perhaps uniquely U.S. approach to view some services as not needing to be charged at a market price or mark-up, but simply at cost. Inasmuch as Canada has no rules per se (apart from the ALS principle), the notion is not found within the four corners of the Income Tax Act. But it is one that has both been pondered by OECD as far back as 1984 (and deemed appropriate where there was no so-called entrepreneurial risk involved in rendering the services) and, as a matter of administrative practice and the influence of the OECD, adopted in practice by CRA and many other countries. While this should be viewed favorably by taxpayers, the matter can turn nasty and controversial where the components of cost can lead (as they have in some instances in Canada) to absurd claims by tax administrators for charges that would be far in excess of any arm’s-length price for the service.

Within the framework of the foregoing factors, this article examines key aspects of the final Services regulations in and for Canada.

Key Aspects of the Services Regulations from the Canadian Perspective

A. Overview: Basic Divergence under the 1968 Regulations

In principle, the most destabilizing aspect of the Canada-U.S. intercompany transfer pricing comparative is the disparate approaches to pricing services, which pits the 1968 U.S. “cost” approach (for many, if not all, situations) against the orthodox Canadian ALP approach. The IRS’s July 31, 2006, temporary Services regulations (which were slated to be effective in 2007) and now the final regulations serves to partially dissolve the conceptual mismatch in this area between the two countries because the Unit-
ed States has moved to an ALP approach. But the “Services Cost Method” (SCM) in the temporary and final regulations (which perpetuates pricing at cost in certain circumstances) will at least theoretically maintain an element of conceptual conflict. On the other hand, certain aspects of (1) relevant arrangements and (2) CRA administrative approach long ago provided for substantial convergence of the conceptually different regimes.

B. Ambit of the Ostensible Divergence under the 1968 Regulations

If the final regulations can be said to unify the U.S. and Canadian approaches to pricing services, to what extent was such a convergence necessary? The short answer is that, perhaps more in theory than in practice, the two systems have been totally different since the 1968 U.S. regulations were adopted.

Unlike the notion in the 1968 regulations of pricing intercompany services at cost (except in certain specified circumstances), Canada considered that there is no reason that pricing services should differ from pricing anything else, that is to say, at an ALP quite different from the cost of the service rendered. Several factors, however, tend to bridge the conceptual gap, and this can best be seen in bifurcating those factors into an inbound-outbound discussion.

1. Basic Factors and Inbound Bias/Predilection

In principle, the Canadian orthodox ALP approach meant either (1) a theoretical determination is made whether there is any service being provided that must be priced, and (2) if there is, it is priced on an ALP basis. Where the arrangement is only nominally a service by one party to the other, however, and hence more, in fact, a sharing of an activity (and its cost) then an ALP, in fact, becomes cost. The latter factor has often been caught up in CRA’s natural predilection to be alert to excessiveness or overcharges in inbound intercompany price, and this has spawned searches (by CRA) for factors justifying denying mark-ups and asserting cost-based approaches.

The inbound bias is facilitated by CRA’s challenging the taxpayer on a threshold factor whether the service itself is required by the Canadian recipient and whether it provides any particular benefit to the recipient. That, in turn, raises the issue whether a parent company’s activity is “stewardship or custodial” in nature — which therefore does not constitute or convey a service to any subsidiary. If that hurdle is overcome, CRA looks for reasons any mark-up over cost (profit margin) would not confirm with market realities. This, in concept, should be the case only where there is a shared employee-type dynamic at play rather than a spot-type service being performed.

The first version of the Information Circular (IC 87-2) spoke about this in terms of lack of entrepreneurial risk with respect to the underlying service (essentially mimicking language in a 1984 OECD study — see note 25), though that language does not appear in the present circular (IC 87-2R), which reflects the absence of it in the 1995 Revised OECD Guidelines.

2. Effect of Predilection on Outbound Services — CRA Hoisted on its Own Petard?

Naturally, where the service provider is Canadian, in respect of a foreign subsidiary, CRA would like to make its inbound predilections and biases somehow magically disappear and see all services as crown-jewel type activity, entailing a narrow view of what is in the interest of the Canadian parent, an expansive view of what is being performed for the foreign subsidiary, and a very generous view of the value of the services and mark-ups required. But CRA is, at times, inhibited by its inbound predilections and cannot keep a straight face without (reluctantly) accepting a cost-based approach for outbound services.

Sometimes the notions blend, as in a recent situation where CRA, with respect to an outbound service, contended that all-in “cost” (including stock-related compensation) of certain senior executives is an appropriate benchmark for alleged service provided, even though such cost bears no relationship to the type of prices that might be found in the market for similar services performed by such personnel.

C. Do The New U.S. Regulations Provide Complete Convergence?

The new U.S. approach should draw the two systems closer together, because the new regulations require a greater percentage of intercompany service arrangements to be priced at market and not at cost. While SCM will conceptually continue a conflict, since SCM will be restricted to services that either are simply shared activity or are very basic and commodity-like and deliver the least amount of value to the recipient — and where, as a practical matter, the cost may not be much less than the service’s worth, there may not be much room for real dispute with Canada.

In theory, the new U.S. approach with respect to those services that might or must be priced at market simply becomes an extended application of possible competing theories of proper transfer pricing methods in arriving at an arm’s length price, an area in which Canada has no rules and where only the trial judge will be able to determine what the “right” answer is.

The issues of imbedded intangibles should present no conceptual conflict between the two countries within the ambit of the essence of proper ALP pricing. CRA’s views respecting “bundled” transactions provide that platform.

Finally, it will be interesting to see how the new U.S. “business judgment” rule related to SCM will dovetail with CRA’s existing predilections to see or not see the basis for mark-up in intercompany services.

D. U.S. Outbound-Canada Inbound

1. Overview

With respect to those inbound prices from a U.S. parent to a Canadian subsidiary which may be priced under SCM, there is no reason, in concept, why CRA will oppose, that is to say, no different from those circumstances where under the 1968 regulations only a cost-based charge was required. In non-SCM cases, in theory there need not be conflict.

2. Straight Services

This section treats an activity carried out or performed by a U.S. member of a Canada-U.S. group (regardless of which is the parent) that results in a service being received or enjoyed by a Canadian member of the group where (1) if the service were not made available by the U.S. member, it would be purchased from a third party by the Canadian member and, as such, (2) it does not involve the sharing of an employee (or similar arrangement), nor an activity that is undertaken for the purposes and benefit of the

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U.S. member, that is, a “shareholder activity” (discussed below).

Viewed from the standpoint of comparative corporate tax rates, there should be a preference for, or bias toward, minimizing prices for intercompany services northbound to Canada, within a Canada-U.S. group. The standard U.S. federal corporate rate is 34 percent or 35 percent, and with state (or both state and city), corporate taxes (which are deductible for federal tax purposes), the effective overall U.S. corporate tax rate could be in the mid-40s percentage range. In Canada, on the other hand, the interrelated effects of the phasing-in by 2012 of a net federal corporate rate of 15 percent for profits also subject to provincial taxes (the federal rate in 2010 will be 18 percent) and the adoption by many provinces of an add-on rate in the 10-percent area means comparative effective overall Canadian corporate tax rates for 2010 mainly in the area of 28-30 percent, and by 2012 in the area of 25 percent.

Accordingly, at the extreme, based on present legislation, the highest U.S. effective overall rate — some 47 percent applicable to corporate profits earned in New York City — will be double the 23-percent effective overall rate payable in 2012 and subsequent years in New Brunswick. And the New York City rate will be almost double the 25-percent rate payable in Canada’s largest province, Ontario, starting in 2013.

That pricing preferences will be obviously facilitated where the SCM is available for northbound services. Leaving aside any issues respecting the determination of cost, prices based on the SCM should be welcomed by CRA. Here issues, if any, would presumably arise with the IRS, not the CRA, in the form of whether the SCM is, in fact, applicable. Where the SCM is not applicable and that pricing preference must be dealt with in the context of “normal” ALP pricing, two factors arise.

(a) Comparing the Methods

First, the basic question is whether the ALP pricing methods set out in Treas. Reg. §§ 1.482-9(c) to (h) conflict with Canadian requirements — (1) as a matter of law, the basic ALP principle, unadorned by any statutory or regulatory rules (but augmented by the uncertain role of OECD Guidelines), and (2) as a matter of non-binding CRA views and assessing practice, the combined effect of the approaches set out in IC-87-2R and in the OECD Guidelines. The section 482 regulations methods are: (1) the “comparable uncontrollable services price” (CUSP) method, (2) the “gross services margin” (GSM) method, (3) the “cost of services plus” method, (4) the “comparable profits” (CPM) method, (5) the “profit split” method, and (6) “unspecified methods. Overlaid on those methods are the rules for “contingent-payment contractual terms for services.”

Except possibly for the GSM method, there is nothing in the nomenclature of the six specified methods that should either be considered novel from the Canadian standpoint or raise concern or uncertainty of concept. The CUSP method is the holy grail of transfer pricing, and if found to the satisfaction of a court, it would normally govern in both Canada and the United States. In this respect, CRA’s views on comparables in relation to services are set out in paragraphs 160 and 161 of IC-87-2R, as follows:

160. Where a service is rendered by arm’s length parties or the service supplier, as part of its ordinary and recurring activities, renders the service for arm’s length parties, the price charged in those circumstances is a good indication of the arm’s length price. Thus, the CUP method should be used, assuming sufficient quality data for its application is available.

161. This presumes that:

- the services are substantially the same in terms of their nature and quality as well as the quantity or extent to which these services are provided;
- the markets are similar; and
- the services are provided on comparable terms.

Underlying those comments is a discussion at paragraphs 53-56 and 64-69 of IC-87-2R of the CUP method.

The GSM method appears to be a hybrid-type application to services of the “resale price” method traditionally used, in respect of intercompany sales of goods, as the second ranking “transactional” method. Although the concept makes basic sense and may be viewed as appropriate by a Canadian court, this approach is not, per se, seen in CRA’s discussion of intercompany services in IC-87-2R.

The “cost of services plus” method is both familiar in concept from a Canadian standpoint and specifically addressed by CRA in IC-87-2R in relation to services in the following terms in paragraph 162:

162. Where the CUP method cannot be applied, the taxpayer should consider the cost plus method. The cost plus method is appropriate where, after the appropriate functional analysis, the taxpayer can verify comparability (including the functions performed, the assets used, and the risks assumed) with uncontrolled transactions. The taxpayer must ensure that the costs incurred by the service supplier are substantially the same as those incurred in the comparable transactions. If not, appropriate adjustments must be made.

This language, however, must be read in light of the more detailed statement of this method in relation to both the sale of goods and provision of services set out in paragraphs 76-79 and 86 of IC-87-2R. In contrast to CRA’s simply and briefly worded views, the final U.S. Services regulations have seven pages of detailed “rules” and examples. That said, there is no apparent clear conflict between the real potential effects of the two approaches.

Neither the CPM nor profits split methods in the final regulations has any counterpart in the CRA’s views on services, set out in paragraphs 152-171 of IC-87-2R, though those methods (and the OECD counterpart to CPM, the “transactional net margin” method (TNMM), are treated in the Circular as part of the approaches generally available for pricing intercompany transactions. As set out in the final regulations, these two methods basically piggy-back their counterparts in respect of sale of goods in Treas. Reg. § 1.482-5, in respect of CPM, and Treas. Reg. § 1.482-6, in respect of profits splits. Therefore, no particular conflicts need arise in this area.

Finally, with respect to unspecified methods, the notion simply reflects the essential “facts and circumstances” nature of the ALP, which is part of its basic fabric and is acknowledged by CRA in
its Circular. In addition, in the context of a statement in the final regulations, it is interesting to consider recent OECD proposals to rewrite the Guidelines, which seems to be adopting “the best method” rule in the context of the following statement (in Treas. Reg. §1.482-9(h)):

As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm’s length result under the principles of the best method rule. See § 1.482-1(c).

Given the paucity of helpful case law in Canada respecting pricing for services and the absence of anything on the face of the six specified methods in the final regulations that necessarily conflicts with the notion underlying the ALP, there is no reason why a Canadian court would necessarily reject prices for inbound services based on those methods.

Would CRA, separately, see the matter differently and thus, ultimately, throw the matter into treaty-sponsored competent authority procedures, new treaty-based binding arbitration procedures (stemming from the Fifth Protocol to the treat-signed September 2007 and brought into force in December 2008), or litigation? That would not be a new or unusual possibility in Canada-U.S. transfer pricing matters. Canada-U.S. transfer pricing disputes, generally spawned by CRA assessing initiatives, have been seen frequently during the past 30 years (if not longer), and thus have predicated on pricing matters. Canada-U.S. transfer pricing disputes, generally spawned by CRA assessing initiatives, have been seen frequently during the past 30 years (if not longer), and thus have predated spinoff by CRA assessing initiatives, have been seen frequently during the past 30 years (if not longer).44

Hence, there is really no reason to think that the six U.S. pricing methods will particularly reduce or increase issues raised by CRA respecting pricing of Canada-U.S. intercompany services.

(b) The Effect of Tax Rate Arbitrage

If the clear tax rate arbitrage in favor of reducing U.S. income and increasing Canadian income spawns attempts to interpret and apply the six methods to minimize prices for northbound services, the result should be more disputes with the IRS and fewer with CRA. This is not an easy matter to forecast, however, because it has, in a way, been an evolving inversion — from a time when either there was a tax rate arbitrage in favor of the United States, little, or none at all. That, together with other factors, often saw pricing for northbound transactions on the high, not low, side — or at least, was seen that way by CRA. And in that context, it was the IRS that had modest or no concerns.

But given the previously discussed substantial corporate rate differential, a predilection to push the pricing envelope toward optimizing Canadian corporate profits should take hold. If it does, the respective positions and concerns should reverse, and it presumably will be the IRS, not CRA, that brings a jaundiced eye to examining Canada-US transfer pricing.

3. Shared Employees/Cost Sharing

The concept of shared-employees contemplates a situation with the following characteristics:

- neither member requires the full time of the one or more persons who are capable of meeting that requirement but together are prepared to commit to financing the engagement of the one or more relevant persons and to share their available time and efforts and share — pro rata — their costs;
- it is impractical for each member to hire, as its employee(s) the one or more persons on a part-time (or partial) basis and instead one member employs the relevant person(s) and, either as a matter of an explicit agreement or otherwise, that member makes available that person or persons to the other, and charges an aliquot or pro rata portion of the costs to the other, in such fashion as is a proxy for the overall results for each member, as though the person had been part-time employed by each member;
- the arrangement does not entail any sharing — or transfer — of other property or resources (such as valuable intangibles) between the parties and thereof does not raise the ubiquitous issues surrounding “cost sharing” arrangements related to developing proprietary intangibles;
- the arrangement does not entail a situation where one member has a core/constant need for the function and activity and would engage one or more full-time (or perhaps part-time) persons, while the other has no such need, but only an occasional need — one in respect of which the timing and duration is unpredictable — and would therefore enter into no full or part-time employee relationship, but instead would look to either another group member or to an outside service provider and purchase on a “spot”-market basis the required service-function-input.

How do the final regulations treat the foregoing situation where one member is a U.S. party and the other is a Canadian party? Does it matter which member is the “employer” of such “shared-employee”? Bearing in mind that in Canada there would be no specific applicable law, what are the views of CRA and would they conflict with the U.S. notions and approach? One would expect, having regard to the essence of the fundamental governing rule in both countries, the ALP, that both countries would see a non-controversial simple requirement — namely, that the costs of the employed person(s) be shared either pro rata to a pre-determined and agreed allocation, based on the reasonable expectation of the proportionate use to be made — or pro rata to the actual proportionate use made. Is that what the U.S. rules provide for?

The short answer is that it depends. The preamble to the final regulations states that there has been inclusion of “the shared services arrangement provision in the SCM Rules,” which is a shorthand reference to the notion that costs can properly be shared. The fine points, however, restrict the ambit. In particular, a U.S. member, as the employer of the shared employee, can charge the Canadian member, as user of the shared employee, a pro rata amount of the employee’s cost, as the ALP, only if the employee’s functions are a “specified covered service” (SCS) for purposes of SCM. If the activity fails to meet the SCS requirement or, if it does, it involves an “excluded service,” then neither the SCM nor the SSA (which allows sharing based on “reasonably anticipated benefits,” as
defining in paragraph (1)(3)(i) is applicable.

Therefore, two distinct employee-sharing situations arise, distinguished by the SCS factor. Assume a U.S. parent and Canadian subsidiary each need half the time of one full-time bookkeeper. They agree that U.S. parent will be the “employer” and pay the BK, say, $50K a year and that Canco will pay $25K to UScO. Revenue Procedure 2007-13 lists the activities of a bookkeeper as a specified covered service. That satisfies the SSA requirements (with SCM at core of that) and, therefore, the cost sharing will be accepted.

But if both companies also need half the time of a nuclear physicist to carry on their separate research programs and U.S. parent again employs the party, pays the party $1MM a year, and recovers $500K from Canco, will that be accepted? It may not because that will not be a qualified SSA, because it either is not covered by 2007-13 or, even if it, is it is disqualified from SCM as an “excluded activity.” Therefore, the IRS could try to use any of the six other pricing methods to allocate to U.S. parent an amount greater than the $500K.

Obviously, in the second scenario, the issue would be avoided if each corporation hired its own nuclear physicist and there was no cross-corporate dealing. But would that also be the result if they share one person, alternate use of person on a monthly basis, directly employed the person (on a monthly basis), and pay the person so that there is no intercompany transaction or payment?

In Canada, the view (reasonably by a court) would likely reflect the basic principles suggested above, which are at the essence of CRA’s brief comments on the matter in IC-87-2R. As part of that is paragraph 7.36 of the OECD Guidelines, which reads:

7.36 When an associated enterprise is acting only as an agent or intermediary in the provision of services, it is important in applying the cost-plus method that the return or mark-up be appropriate for the performance of an agency function rather than for the performance of the services themselves. In such a case, it may not be appropriate to determine arm’s length pricing as a mark-up on the cost of the services but rather on the costs of the agency function itself, or alternatively, depending on the type of comparable data being used, the mark-up on the cost of services should be lower than would be appropriate for the performance of the services themselves. For example, an associated enterprise may incur the costs of renting advertising space on behalf of group members, costs that the group members would have incurred directly had they been independent. In such a case, it may well be appropriate to pass on these costs to the group recipients without a mark-up, and to apply a mark-up only to the costs incurred by the intermediary in performing its agency function.

The bottom line is that the implied requirement to do more than share costs of shared-employees who do not fit Revenue Procedure 2007-13 and the SCM could clearly conflict with the ALP or lead to uncertainty and disputes between Canada and the United States.

E. Canada Outbound — U.S. Inbound

1. Overview

In outbound Canadian parent-U.S. subsidiary arrange-ments, as a matter of theory, there apparently need not be any conflicts because (as Notice 2007-5 confirms) SCM is not mandatory. As well, as noted above, the pre-existing Canadian situation often sees CRA accepting cost as a basis for an outbound charge as well as an inbound charge.

2. Straight Services

This section addresses and treats an activity carried out or performed by a Canadian member of a Canada-U.S. group (regardless of which is the parent) that results in a service being received or enjoyed by a U.S. member of the group where (1) if the service were not made available by the Canadian member, it would be purchased from a third party by the U.S. member and, as such, (2) it does not involve the sharing of an employee (or similar arrangement), nor an activity undertaken for the purposes and benefit of the Canadian member, that is to say, it is a “shareholder activity” (discussed above).

As previously explained, comparative tax rates should raise a preference or bias to minimize prices for intercompany services northbound to Canada within a Canada-U.S. group. It necessarily follows that that same rate differential reverses the preference or bias for pricing southbound (Canada to United States) intercompany services to one of seeking to maximize prices for southbound services.

The final regulations will affect any such bias or preference in six distinct ways. First, CRA will be happy. Second, the IRS will be unhappy. Third, the clear choice (provided by the final regulations) of not adopting SCM means the road will be clear to seek ALP prices for any type of straight service, a choice that would normally be expected to produce prices in excess of cost. Fourth, the obverse of the effects discussed in respect of the restrictive ambit of SSAs could even see mark-up claimed for employee-sharing arrangements. Fifth, the obverse of the effects of the restrictive view in the final regulations of “shareholder activity” could be seen to provide wider latitude than may otherwise seem appropriate to make charges to U.S. subsidiaries for Canadian parent company activity. Sixth, and finally, the detailed “methods” may or may not be seen to provide latitude to push the envelope on the quantum of prices determined.

3. Shared or Employees/Cost Sharing

The discussion of shared employees (which relates to the relevant employee being engaged by a U.S. member and then shared with a Canadian member) applies equally where the roles of the two group members is reversed and the employee (on the books of the Canadian member and made available to the U.S. member) is one whose activities consists of specified covered services (SCS). Where the activities do not constitute SCS, however, the analysis potentially differs in that it is unlikely that CRA would see a requirement that the amount to be charged to the U.S. member exceed cost (whereas in the northbound case that might be asserted by the IRS) and there does not appear to be any particular reason the IRS would object to such cost-based pricing to the U.S. member.

F. The “Shareholder (Stewardship) Activity” Factor in Canada-U.S. Groups

The issue whether an activity by a parent corporation is undertaken for its own purposes and benefit and does not constitute a service conveyed to a subsidiary (so that there is no basis to charge
a fee or allocate a cost, related thereto, to a subsidiary), or instead is, in whole or in part, the contrary is a contentious matter in both countries. The final regulations denote the first case as constituting a situation where the activity meets the regulations’ requirement of being a “shareholder activity,” whereas the administrative views of CRA, as expressed in IT-87-2R, do not utilize that, or any other, identifying terminology. This is in contrast to the initial version of IC-87-2, which invoked the notions of “custodian” and “stewardship” activities and costs. The OECD 1995 Guidelines (on which CRA relies) does use the U.S. terminology (in paragraph 7.9) in relation to an activity which, it states “would not justify a charge to the recipient companies.” The Guidelines state:

It may be referred to as a “shareholder activity,” distinguishable from the broader term “stewardship activity” used in the 1979 Report. Stewardship activities covered a range of activities by a shareholder that may include the provision of services to other group members, for example services that would be provided by a co-coordinating centre. These latter types of non-shareholder activities could include detailed planning services for particular operations, emergency management or technical advice (trouble shooting), or in some cases, assistance in day-to-day management.

Paragraph 7.10 provides three examples of what “will constitute shareholder activities, under the standards set forth in paragraph 7.6.” They are activities relating to the (1) corporate governance of the parent, (2) financial statement reporting of the parent, and (3) the raising of capital used to acquire subsidiaries. The “standards set forth paragraph 7.6” are, as follows:

7.6 Under the arm’s length principle, the question whether an intra-group service has been rendered when an activity is performed for one or more group members by another group member should depend on whether the activity provides a respective group member with economic or commercial value to enhance its commercial position. This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself. If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm’s length principle.

The latter standards are reflected in CRA’s IC-87-2R paragraph 154-156.48

The final regulations reflect similar principles, though controversy has raged since the temporary regulations were issued in 2006. Both the principles and the controversy are neatly summarized by the preamble to the final regulations, which reads, in part:

Paragraphs (I)(3)(ii) through (v) provide guidelines that indicate the presence or absence of a benefit. Section 1.482-9T(I) (3)(iv) of the 2006 temporary regulations provides that an activity is a shareholder activity if the sole effect of that activity is either to protect the renderer’s capital investment in the recipient or in other members of the controlled group, or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, or both.

The Treasury Department and the IRS received comments on shareholder activities. Some commentators asserted that the “sole effect” language is too restrictive and that the language should be replaced by a “primary effect” standard. . . .

The Treasury Department and the IRS believe that the “sole effect” language is appropriate. The “primary effect” language in the 2003 proposed regulations could inappropriately include activities that are not true shareholder activities and may even consist of substantial activities that are non-shareholder activities.49

There would appear to be an equivalence between paragraph 7.6 of OECD, paragraphs 154-158 of IC-87-2 and Treas. Reg. § 1.482-9(l) (3)(i), which reads, as follows:

(3) Benefit—(i) In general. An activity is considered to provide a benefit to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient’s commercial position, or that may reasonably be anticipated to do so. An activity is generally considered to confer a benefit if, taking into account the facts and circumstances, an uncontrolled taxpayer in circumstances comparable to those of the recipient would be willing to pay an uncontrolled party to perform the same or similar activity on either a fixed or contingent-payment basis, or if the recipient otherwise would have performed for itself the same activity or a similar activity. A benefit may result to the owner of intangible property if the renderer engages in an activity that is reasonably anticipated to result in an increase in the value of that intangible property. Paragraphs (l)(3)(ii) through (v) of this section provide guidelines that indicate the presence or absence of a benefit for the activities in the controlled services transaction.

The difficulty in the Canada-U.S. context is the threshold divergence of approach. The Act has no rule other than the ALS principle and CRA (and OECD) have a few simply-stated views.

The final regulations are replete with rules and examples, with the latter numbering 21 and running several pages in the official release. For all the detail and all the examples, however, the final provide no particular assistance in many situations that may commonly arise, so all that one remains with (as it should be) are the basic facts and circumstances constituting the ALP.50

For example, a company was faced with a proposed adjustment by CRA to add a service fee to its income under sections 247(2)(a) in the following circumstance:

- Canco is widely-held, publicly-traded, with a group of operating
U.S. subsidiaries that engage senior executive-level personnel.

- The U.S. subsidiaries prepare and operate in accordance with detailed operational and financial budgets.
- Senior executives of Canco analyze the U.S. operational and financial budgets and prepare reports therefore for the sole purpose of informing the CEO, CFO, and the board of directors.
- These reports are not provided to nor discussed with the U.S. subsidiaries and therefore do not entail or result in any advice or other input being conveyed to the U.S. subsidiaries.
- CRA’s initial position was that the activities resulted in valuable services to the U.S. subsidiaries and commanded a charge of a fee, consisting of the costs of the Canadian personnel involved plus an appropriate profit mark-up.
- CRA subsequently withdrew its initiative when confronted with the sheer matter of the facts which did not entail either the rendering of any service to the U.S. subsidiary or otherwise conveying any benefit to the U.S. subsidiaries.
- There is no reason the answer would be any different under section 482 of the Code, under the original 1968 regulations, the 2003 proposed regulations, the 2006 temporary regulations, or the final rules.

Pure logic in relation to the ALP/ALS produces the right answer: Nobody has to be assisted by “rules” couched in terms of “sole effect” or “solely for the benefit of.” Conversely, if there were something more than “solely for” in the foregoing example, business logic would dictate a different answer. For example if, in that situation, senior management of Canco used its analysis of U.S. subsidiary’s operating and financial budget to provide any feedback intended to be assessed and perhaps acted upon with the objective of increasing bottom-line profit, there would arise a different dynamic in terms of analyzing a cross-border intercompany service arrangement. That added factor would raise the possibility that there should be recognized an intercompany (Canco to its U.S. subsidiary) service. And the proper final determination would turn on assessing each element of the dynamic: Does U.S. subsidiary wish to have advice from its parent? Or, instead, is it being foisted upon it? Is the advice actually adopted and acted upon? If so, does it produce any measurable benefits to the U.S. subsidiaries? Is the dynamic comparable to one that may have been effectuated with a third-party business consultant?

All of these (and others that could arise) are questions of fact and circumstances for which there are no pre-packaged answers. No amount of “rules” writing (such as in the final regulations) can anticipate and answer all the questions, let alone the “right” answers. In fact, the 21 examples in the regulations go no further than answer whether there is simply no service/benefit being conveyed or the contrary without, in the latter case, taking the matter further. For example, of the 21 examples, the closest (but not necessarily truly pertinent) to the foregoing appears to be example 6, which deals with a situation where the activities of the parent could be seen to be largely “duplicative” but at the same time “confer” a benefit.

At the end of the day, whether it is a Canadian parent-U.S. subsidiary or the converse situation, the question of determining whether a particular activity by a particular parent results in a service (with a benefit) to the cross-border subsidiary — one for which there should be a fee charged in order to comply with the ALS of either country (leaving aside whether the SCM election may apply from the U.S. perspective) — will turn on assessing, in a reasonable, logic-based manner, the particular facts and circumstances. Moreover, it appears that only circumstances where a true conflict could arise is if the IRS seeks to consider that one of the 21 examples governs the situation and the result is one that does not comport with the ALS, logically applied.

G. The Special Case of Guarantees

1. Pre-Existing Situation

Intercompany guarantees, and pricing them, is a black hole in Canada-U.S. inter-company pricing arrangements, and it is not clear whether certain pending legislative developments and pending court cases in Canada and the final regulations will unify the approach of the two countries.

There had been no problem with an inbound (northbound) guarantee (that is to say, a guarantee by U.S. parent of the debt of the Canadian subsidiary). Under the 1968 regulations and certain case law, it appeared well settled from a U.S. perspective that no charge was required to be made by the guaranteeing U.S. parent to the guaranteed Canadian subsidiary. Of course, CRA liked it that way. But when U.S. groups have chosen to charge fees, disputes have arisen, which are now before the Canadian courts.

In an outbound (southbound) situation, a Canadian parent guarantee of a U.S. subsidiary, the potential for controversy has existed and led to an initiative, acceded to by the Canadian Department of Finance, to amend section 247 to coordinate the pre-existing U.S. approach and Canadian transfer pricing rules. Pursuant to a comfort letter issued on March 11, 2003, section 247 is to be amended by adding section 247(7.1) to except, from arm’s-length pricing standards, guarantees by a Canadian parent of certain debt of a foreign subsidiary (which therefore require no charge or fee). Presumably, the IRS will be happy with that result. (Cross-border guarantees by a subsidiary of its foreign parent’s debt potentially raise Canadian issues that will not be resolved by proposed section 247(7.1)).

2. Under the Final Regulations?

What of a U.S. parent guarantee to a Canadian subsidiary under the final regulations? Will a fee have to be charged? Both the 2006 temporary regulations and 2009 final rules have deferred dealing with that question. If a guarantee fee becomes a requirement, it should be accepted in principle by CRA, given its predilection to consider a guarantee to be a service that is to be priced at some market amount. The proposed amendment to section 247 would arguably provide conceptual support for the notion that, in general, a guarantee is a transaction that has to be compensated by a fee priced in some fashion in the market.

In general, therefore, the results of the proposed change in Canada (to section 247(7.1)) and possible future U.S. regulations may narrow conceptual gaps between the approaches of the two countries and as a practical matter eliminate any issues on southbound guarantees (previously a potential source of dispute), but now raise them on northbound guarantees, previously an area where dispute would not have necessarily had to arise because the 1968
regulations did not require that a guarantee be compensated.

Other Matters and Concluding Comments
There are Canadian tax issues, apart from those arising under transfer price rules (i.e., section 247(2) of the Act), which may apply to those northbound services performed in Canada (for a Canadian member of a group), by employees or other representatives of a U.S. member of the group. These are beyond the scope of this article, but may be briefly noted as follows:

- The U.S. member would engage nexus to the Canadian tax system, as “carrying on business in Canada,” but normally would be expected to be exempt from Canadian tax under the combined effects of the permanent establishment (Article V) and business profits (Article VII) of the Treaty. There are, however, the potential issues under the new “services PE” rules of Article V(9) added by the Fifth Protocol.
- Even if there is exemption from Canadian tax, hassles may arise under advance withholding tax rules of section 105 of the Income Tax Regulations (and in the case of Quebec, similar requirements under its tax statutes).
- Substantive and procedural (e.g., withholding) employee-related tax rules would apply to U.S. employees or other representatives of the U.S. member, and the substantive effects may not necessarily be eliminated by the rules of Article XV of the Treaty.
- Canadian, federal, provincial, or harmonized (e.g., federal and provincial) goods and services tax (GST) or more traditional sales tax may apply, though in a commercial context they are supposed to impose no net burden.

Returning to transfer pricing rules in respect of Canada-U.S. cross border intercompany services, the foregoing discussion makes the following clear:

- In many, but not all, respects, the final regulations will see the principles underlying the transfer pricing rules of the two countries for cross border services draw closer together. This particularly stems from the new restrictions on (but not total abolition of) the use of cost-based pricing.
- The partial continuance of cost-based prices (under SCM), the choice that can be made whether or not to use SCM and comparative Canadian-U.S. corporate tax rates should see effective efforts made to minimize prices for northbound services and maximize them for southbound services.
- There appears to be nothing in the six methods (beyond SCM) for pricing services that necessarily conflict with Canadian law.
- In the case of shared employees, the final regulations may promote dispute between the two countries.
- In the case of parent company activities, there is nothing in the final regulations that necessarily conflicts with the relevant Canadian law, even though the U.S. regulations contain pages and pages of “rules,” whereas the Canadian approach is really simply to use the ALP (possibly buttressed in non-mechanical or specific way by OECD musings in the form of the 1995 OECD Guidelines).

- Finally, in the potentially controversial area of cross-border guarantees, the story will not really be told unless and until the United States issues specific regulations, Canada enacts proposed section 247(7.1), and pending litigation has been completed.

In summary, the two countries are driving from different ends of the spectrum. The United States is trying to depart from the notion of services being charged at cost toward services being charged at whatever arm’s-length pricing theology would provide. Canada often drives from the latter theology toward where the service is inbound to Canada, finding reasons why the arm’s-length price is cost. At what point do these two different initiatives intersect and arrive at a consensus will be but one of the interesting points to focus on as Canada-U.S. matters under the final regulations proceed.

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POSTSCRIPT
Subsequent to completing the article and submitting it for publication, two relevant developments arose.

First, the Tax Court of Canada has rendered its opinion in the case involving General Electric Capital Canada Inc., which is referred to in note 53 and the related text and which entails a dispute over the deductibility of certain guarantee fees paid by that company to its U.S. parent. In a taxpayer-favorable decision dated December 4, 2009, the court found that, as a matter of fact, guarantees provided by the U.S. parent operated to reduce the borrowing costs to the Canadian subsidiary by well over 100 basis points (per dollar of borrowing). As a result, and in the overall factual context, the fee paid of 100 basis points (per dollar of debt guaranteed) met the requirements of comprising an arm’s-length price. The court rejected evidence put forward by the Government that the Canadian subsidiary’s borrowing costs would have been no greater had guarantees not been provided by the US parent.

Second, with respect to the suggestion that U.S. courts might not slavishly follow mechanical approaches in the section 482 regulations that depart from or conflict with the essential nature of the arm’s-length principle (see, for example, at note 7 and related text), note should be made of the decision in early December in Veritas Software Corp. & Subsidiaries v. Commissioner, 133 T.C. No. 14 (filed December 10, 2009). In this case involving the proper pricing of “buy-in” obligations under a cost-sharing arrangement, the U.S. Tax Court rejected Government theories contained in the regulations that the court considered to invalidly (arbitrarily, capriciously, and unreasonably) reject and override pricing that, the court found, accorded with third-party comparables.

2. This foundational “rule” in the regulations, however, did take somewhat of a beating in the recent decision by the U.S. Court of Appeals for the Ninth Circuit in Xilinix Inc. v. Commissioner, 567 F.3d 482 (9th Cir. 2009), which reversed the Tax Court. (The taxpayer in Xilinix has petitioned for a rehearing. Xilinix Inc. v. Commissioner, Nos. 06-74246 and 06-74269 (9th Cir. filed August 12, 2009). In that case, the court held that a mechanical rule in the regulations overrode the basic arm’s-length standard otherwise required by section 482.


4. Like the situation in the United States, the rules of section 247 apply only to certain affiliated parties and in Canada it is those who “do not deal at arm’s length.” See section 251(1) of the Act, which deems “related” persons (i.e., parent and subsidiary or sister corporations) to not deal at arm’s length, and leaves open the possibility that, based on all of the facts and circumstances, unrelated parties also do not deal at arm’s length. The concept of related persons is based on the notion of legal control. See Interpretation Bulletin IT-6484: Corporations: Association and Control; Buckerfield’s Ltd. v. MNR, 64 DTC 5301 (ECC); Duha Printers (Western) Ltd. v. The Queen, 98 DTC 6334 (SCC). With respect to the second notion (factual non-arm’s length), for the high-water mark on this concept see the Supreme Court in Swiss Bank Corp. v. Minister of National Revenue, 72 DTC 6471 (SCC), which appears to have chosen among competing theories (controlling mind, acting in concert, de facto control, and separate economic interests) the singularly economic-based concept of whether the parties to the transactions had separate economic interests with respect to the transaction (which would provide a market discipline for proper pricing). In transfer pricing, this was found where two 50-percent shareholders of a corporation each charged equal fees for rendering services, i.e., fees proportionate to the shareholdings. See Windsor Plastic Products Ltd. v. The Queen, 87 DTC 7171 (F.C.T.D.). The courts, however, often still revert to the other concepts (controlling mind, etc.). See William J. McNichol v. The Queen, 97 DTC 111 (TCC); MNR v. Sheldon’s Engineering Ltd., 55 DTC 1110 (SCC); MNR v. T.R. Merritt Estate, 69 DTC 5159 (SCC); Noranda Mines v. The Queen, 87 DTC 379.

5. This applies to any transaction or event, including the sale of goods, provision of services, or the licensing or rental of intangibles or tangibles, though the requirement with respect to intercompany financings is less clear. For an overview of the Canadian approach to transfer pricing, see Nathan Boidman, “Recent Developments on Canada’s Pricing Guidelines” in IRS History, BNA DAILY TAX REPORT No. 176 (September 12, 2006) See also “The Transfer Pricing Tempest—Implications of Glaxo-SmithKline’s Mammoth IRS Settlement,” Staffor Legal Teleconference Presentations (October 24, 2006). Other Canadian court decisions respecting transfer pricing have involved offshore/low tax jurisdiction elements. See Indalex Ltd. v. The Queen, 86 DTC 6039 (F.C.T.D.) and 88 DTC 6053 (F.C.A.), Dominion Bridge Co. Ltd. v. The Queen, 75 DTC 5150 (F.C.T.D.) and 77 DTC 5367 (F.C.A.), Spur Oil v. The Queen, 80 DTC 6105 (F.C.T.D.) and 81 DTC 5168 (F.C.A.), Irving Oil Ltd. v. The Queen, 88 DTC 6138 (F.C.T.D.) and 91 DTC 5106 (F.C.A.). There was another decision involving a Canada-U.S. multinational, but not in the context of tax law but in a minority shareholder oppression claim in Ford Motor Co. of Canada, Ltd. v. Ontario Municipal Employees Retirement Board and the persons set out in Schedules A and B, 2004 DTC 6224; Ford Motor Co. of Canada Ltd. v. Ontario Municipal Employees Retirement Board and Ontario Municipal Employees Retirement Board v. Ford Motor Co. of Canada Ltd., Ct. of Appeal for Ontario, Nos. C41312 and C41450, appeals affirmed, dismissed in part January 6, 1966. See Tamu N. Wright, “Ontario Appeal Court Affirms Determination Ford’s Transfer Pricing System Was Improper,” 14 BNA Tax Management, TRANSFER PRICING REPORT (February 1, 2006).


7. That addition reads, as follows: “In the case of any transfer (or license) of intangible property (within the meaning of section 936(b)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.”

8. In Canada there has been only one court decision (Hofert) respecting a straightforward transfer pricing issue between the Canadian unit of a multinational and a unit based in another high tax jurisdiction such as the United States. (Central Canada Forest Products Ltd. v. MNR., 52 DTC 359, also involving Canada and the United States, is of limited value.) And it seems that there has been no such decision by a U.S. court. All other Canadian and U.S. decisions seem to have involved in one way or another, tax-flavored transfer pricing arrangements generally involving units of the multi-national operating in less than a high-tax environment. (But there now is pending Canada-U.S. transfer price litigation in both countries.) For example, see the 2008 decision of the Tax Court of Canada in Glaxo (GlaxoSmithKline Inc. v. The Queen, 2008 TCC 324, 2008 DTC 3957), in which the court upheld most of Canada Revenue Agency downward adjustments of prices paid by Glaxo Canada to a Swiss affiliate for the pharmaceutical ingredient for Zantac. The taxpayer’s appeal to the Federal Court of Appeal is now pending. U.S. observers may wish to compare this litigation to the U.S.-Glaxo settlement. “GlaxoSmithKline to Pay $3.4 Billion to Settle Largest Dispute in IRS History.” BNA DAILY TAX REPORT No. 176 (September 12, 2006) See also “The Transfer Pricing Tempest—Implications of Glaxo-SmithKline’s Mammoth IRS Settlement,” Stafford Legal Teleconference Presentations (October 24, 2006). Other Canadian court decisions respecting transfer pricing have involved offshore/low tax jurisdiction elements. See Indalex Ltd. v. The Queen, 86 DTC 6039 (F.C.T.D.) and 88 DTC 6053 (F.C.A.), Dominion Bridge Co. Ltd. v. The Queen, 75 DTC 5150 (F.C.T.D.) and 77 DTC 5367 (F.C.A.), Spur Oil v. The Queen, 80 DTC 6105 (F.C.T.D.) and 81 DTC 5168 (F.C.A.), Irving Oil Ltd. v. The Queen, 88 DTC 6138 (F.C.T.D.) and 91 DTC 5106 (F.C.A.). There was another decision involving a Canada-U.S. multinational, but not in the context of tax law but in a minority shareholder oppression claim in Ford Motor Co. of Canada, Ltd. v. Ontario Municipal Employees Retirement Board and the persons set out in Schedules A and B, 2004 DTC 6224; Ford Motor Co. of Canada Ltd. v. Ontario Municipal Employees Retirement Board and Ontario Municipal Employees Retirement Board v. Ford Motor Co. of Canada Ltd., Ct. of Appeal for Ontario, Nos. C41312 and C41450, appeals affirmed, dismissed in part January 6, 1966. See Tamu N. Wright, “Ontario Appeal Court Affirms Determination Ford’s Transfer Pricing System Was Improper,” 14 BNA Tax Management, TRANSFER PRICING REPORT (February 1, 2006).


11. That addition reads, as follows: “In the case of any transfer (or license) of intangible property (within the meaning of section 936(b)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.”


13. OECD, Transfer Pricing Aspects of Business Restructurings (September 18, 2008).

14. OECD, OECD releases a proposed revision of Chapters 1-111 of the Transfer Pricing Guidelines (September 9, 2009).

15. In 1994, after eight years of arduous work, the United States revised its 1968 transfer pricing “rules” (i.e., “regulations made under 482”) having mechanical-like effects.
with the so-called Best Method Rule. That means taxpayers should select and use the transfer pricing setting method that is the most appropriate in the circumstances. Does that mean that, without being told, taxpayers would use the worst method or more inferior method? Or is that not a “blinding glimpse of the obvious,” an expression attributed to Ross Johnson (the Canadian Prairie accountant who rose to and was President and CEO of RJR Nabisco at the time of its takeover by Kohlberg Kravis Roberts & Co.) in Barbarians at the Gate — The Fall of RJR Nabisco by Bryan Burrough and John Helyar?

16. In Canada, regulations may be written by the government (and approved through “orders-in-council”) when specifically provided for the in the Act.


18. Chief Justice Rip can be seen to have followed the Guidelines as expressed by Canadian courts. See Income Tax Information Circular—IC-87-2R (September 27, 1999) (International Transfer Pricing), which essentially is a regurgitation of the OECD transfer pricing guidelines. Through IC-87-2R, CRA seeks to impose on the Canadian tax system a “hierarchy” of “transfer pricing methods,” based on the OECD guidelines, which ostensibly differ from the “best method” approach of the 1994 U.S. regulations. Both countries start with comparable uncontrolled prices (CUPs), with the United States quickly going to profit-based methods (CPM) whereas CRA advocates sticking with pre-1994 U.S.-style transaction-based methods. And CRA prefers the OECD-spawned “transactional net margin” method instead of its close cousin, the U.S. CPM method, though IC-87-2R reluctantly concedes a role for CPM in appropriate cases.

19. A.W.C. Parsons, et al. v. MNR, (1983) (F.C.T.D.) 83 DTC 5329 (“An Interpretation Bulletin is precisely what it is stated to be. It is nothing more than some departmental officer’s interpretation of subsections 159(2) and (3) of the Act and has no legal effect whatsoever other than it is directed to employees of the Department responsible for assessing taxpayers who will follow it without question. The limit of their discretion is to do what they are told.”).

20. In Canada, international agreements affecting taxation (e.g., tax treaties) require parliamentary enactment in order to take effect. Why should OECD pronouncements be any different?

21. In the recent decision of the Tax Court of Canada in Glaxo — see note 8 — Chief Justice Rip can be seen to have followed the Guidelines as though they were baked statutorily into the Income Tax Act.


23. The Fifth Protocol makes changes to article XV of the Canada-U.S. Treaty that may exacerbate the issues.

24. See note 2 supra.


27. See Temp. & Treas. Reg. § 1.482-9(b).

28. Under the 1968 regulations, the cost safe harbor applied to “non-integrated services” (Treas. Reg. § 1.482-2(b)(3)) with the latter notion relating to relatively narrow circumstances.

29. Perhaps the only Canadian court decision fully on point (i.e., dealing with services) involved a low-tax jurisdiction, which was decided on its own particular facts and simply confirmed that ALP (whether for a service — or anything else) is determined by a Canadian court based on its appreciation of the particular facts and circumstances — which include looking at the context established by prior-year factors. Safety Boss Ltd. v. The Queen, 2000 DTC 1767 (T.C.C.).

30. See paragraph 155 and 156 of the Circular, which sets out CRA’s views whether a service in fact has been rendered.

31. Paragraphs 165 through 171 indirectly deal (and in a rather confusing way) with shared service arrangements, which essentially involve developing proper principles to share costs.

32. Is this similar to issues in the United States respecting cost contribution arrangements and the new SCM rule? Tax Executives Institute (see note 33) observed that requiring stock-based compensation conflicted with the Tax Court decision (since reversed) in Xilinx. TEI was concerned about the “staggering amount of work” involved with certain types of calculations respecting stock-based compensation.

33. Revenue Procedure 2007-13, 2007-3 I.R.B. 295, contains a revised and expanded list of specified covered services for SCM, that is to say, services eligible to be priced at cost. The original list in Announcement 2006-50 had designated 48 activities or tasks while the new publication designates more than 100 tasks. A submission by Tax Executives Institute to the IRS, dated November 21, 2006, respecting the temporary regulations, and one of November 15 recommending an expanded list of SCM activities were reflected in Revenue Procedure 2007-13. See “IRS Postpones Temporary Services Rules Except for ‘Business Judgment Provision’,” BNA DAILY TAX REPORT No. 245, at GG-2 (December 21, 2006).

34. The SCM method does not apply if the same services are rendered at a mark-up of greater than seven percent to third parties. Similarly, it does not apply to manufacturing, production, extraction, constructing, reselling, distributing, research development engineering, and financial transactions, including guarantees, insurance, and re-insurance.

35. In this respect, a factual finding of the Tax Court of Canada will be overturned by an appeal court (the Federal Court of Appeal) only if there has been an error in law, including a “palpable error” in appreciation of facts or a fundamental error in thinking or analysis.

36. See TPM-06, Bundled Transactions (May 16, 2005), and paragraphs 36-43 of IC-87-2R.

37. That rule, under Treas. Reg. § 1.482-9(b)(5), requires (in order for SCM to apply) that the taxpayer “reasonably concludes in its business judgment that the service does not contribute significantly to key competitive advantages, core capabilities or fundamental risks of success or failure in one or more trades or businesses of the controlled group.” The reasonableness of the conclusion will be assessed on “all the facts and circumstances.”

38. Bear in mind, however, the CRA predilection with respect to inbound parent company services, where CRA looks for “stewardship” factors, as...
would be viewed as not delivering a service to a Canadian subsidiary. 

39. In 2010, the rates in oil-rich Alberta and Canada’s two largest Provinces, Ontario and Quebec, will be respectively, 28, 30 and 29.9 percent. By 2012-2013, those rates will be 25, 25, and 26 percent, and in New Brunswick there will be the lowest corporate rate in North America, 23 percent.

40. In concept, the best and priority situation — one hardly ever given heed or attention — is where intercompany prices have actually been established by “hard bargaining.  See Nathan Boidman, Nicasio del Castillo, Gary M. Thomas, et al., 897 T.M., Transfer Pricing: Foreign Rules and Practice Outside of Europe.

41. For CRA’s views on the resale price method, see paragraphs 56-58 and 70-75 of IC-87-2R.

42. In a way, paragraphs 163, 164 and 165 are relevant to both this approach to arm’s-length prices and to the separate discussion of shared employees. They read, in part, as follows:

163. Arm’s length service suppliers would usually expect to recover their costs plus an element of profit. However, in determining an arm’s length charge for service, one must also take into account the economic alternatives available to the recipient of the service. Often, the price the recipient is willing to pay for the service does not exceed the cost of supply to the service supplier. [The Circular then gives an example discussing arrangements that are administrative or ancillary in nature.]

164. Determining whether a mark-up is appropriate and, where applicable, the quantum of the mark-up, requires careful consideration of factors such as:

• the nature of the activity;
• the significance of the activity to the group;
• the relative efficiency of the service supplier; and
• any advantage that the activity creates for the group.

165. As discussed in paragraph 7.36 of the OECD Guidelines, it is important to distinguish between the situation of:

• a taxpayer who renders services for the other members of a group; and
• a taxpayer who acts solely as an agent on behalf of the group to acquire services from an arm’s length party.

43. Paragraphs 47-63 (overview), 90-95 and 106-119 deal with CPM/TNMM and paragraphs 96 to 105 deal with profit splits.

44. Until recent years, most were routinely resolved through competent authority.

45. The developments include the 1986 U.S. enactment of super royalty, the 1994 U.S. section 482 regulations and concomitant U.S. enactment of transfer price-related penalties and contemporaneous documentary requirements, the advent of APAs in both countries, the 1998 re-enactment of Canada’s ALP and first enactment of its own version of transfer price-related penalties and documentation requirements, both the 1979 and 1995 OECD Guidelines, CRA’s original 1987 IC-87-2 and update, IC-872R in 1999, and the 2006 temporary section 482 Services regulations.

46. “Shared service arrangements” (SSA) are dealt with in Treas. Reg. § 1.482-9(b)(7). See also Treas. Reg. §§1.482-9(j) (Total Services Costs) and (k) (Allocation or Costs).

47. But issues respecting cost could arise and lead to claims by CRA for cost-based prices that exceed market prices. This can particularly arise where highly paid senior executives are involved.

48. It is likely that the “comments” referred to were those of TEI which, in a letter of November 27, 2007, wrote:

TEI recommends that paragraph (iv) be clarified because there are few activities that literally meet the “sole effect” criterion. Consider, for example, the activities of an audit committee of a public company’s board of directors, which is charged with ensuring that the internal controls of the company are adequate and effective. Such oversight arguably benefits the operations of the subsidiaries of the public company, but the primary reason for the activity is to meet the regulatory requirements applicable to the parent corporation. TEI therefore recommends that “sole” effect be changed to “primary” effect. In the alternative, TEI recommends that paragraph (iv) be changed to provide that a shareholder activity shall be considered to have such a sole effect if the only benefits provided to other controlled group members are either (i) indirect or remote, or (ii) duplicative. For example, this would cover the circumstance where a parent corporation engages an auditing firm to prepare annual reports for its public shareholders. As part of the engagement, the firm provides comments with respect to certain accounting processes of the controlled group members. These comments are incorporated in the group’s accounting system and allow for certain minimal efficiencies that would be considered indirect or remote. Accordingly, this activity is considered a shareholder activity.

49. Although the first recommendation was not followed, the second group seemingly was. See note 50 infra.

50. The detailed rules are (1) the definition of a “controlled services transaction” in paragraph (l)(1) — as an activity “that results in a benefit…to one or more other members of the controlled group”; (2) the definition of “activity” in paragraph (l)(2); (3) the exclusion in paragraph (l)(3)(ii) for benefits that are sufficiently “indirect or remote”; (4) the exclusion in paragraph (l)(3)(iii) for “duplicative activities”; (5) the exclusion in paragraph (l)(3)(iv) for “shareholder activities” (as described above) involving “the sole effect” thereof as being “either to protect the renderer’s capital investment in the recipient…or to facilitate compliance by the renderer with reporting, legal or regulatory requirements”; (6) the notion, in paragraph (l)(3)(v) that benefits of having status as a member of a group may be ignored; and (7) the notion in paragraph (l)(4) that transactions may be bifurcated (“disaggregation”) to determine how to best apply the ALP.

51.  

52. An outbound guarantee fee is deemed to be interest for purposes of Canadian withholding taxes (which, in general, apply to interest paid to affiliated non-residents). That rule (section 214(15)), together with provisions of Article XI of the Canada-U.S. treaty, as they read prior to the September 2007 Fifth Protocol, permitted a 10-percent tax on guarantee fees paid to a U.S. person. But the Fifth Protocol now provides an exemption in Art. XXIII(4).

54. The main requirements are, loosely speaking, that (1) there be a written agreement, (2) the guaranteed party essentially be a controlled subsidiary, and (3) the guaranteed obligation be related to an active business carried on by the guaranteed subsidiary.

55. This also involves section 15(1) shareholder benefit issues.

56. The preamble to the 2006 Temporary Regulations under the heading: “Controlled Services Transactions (d) Guarantees, including financial guarantees” states:

The proposed regulations appear to have created confusion on the part of some taxpayers regarding the appropriate characterization of financial guarantees for tax purposes. The provision of a financial guarantee does not constitute a service for purposes of determining the source of the guarantee fees. See Centel Communications, Inc. v. Commissioner, 920 F.2d 1335 (7th Cir. 1990); Bank of America v. United States, 680 F.2d 142 (Cl. Ct. 1980). Nevertheless, some taxpayers have suggested that guarantees are services that could qualify for the cost safe harbour and that the provision of a guarantee has no cost. This position would mean that in effect guarantees are uniformly non-compensatory. The Treasury Department and the IRS do not agree with this uniform no-charge rule for guarantees. As a result, financial transactions, including guarantees, are explicitly excluded from eligibility for the SCM by § 1.482-9(b)(4)(viii), however, no inference is intended that financial transactions (including guarantees) would otherwise be considered the provision of services for transfer pricing purposes. The Treasury Department and the IRS intend to issue future guidance regarding financial guarantees. Interestingly, in January 2007, Steven Musher, IRS Associate Chief Counsel (International) predicted that the final rules would address sourcing and pricing of guarantees. See “International Taxes: Hicks, Musher Outline Guidance, Tax Treaties,” BNA DAILY TAX REPORT No. 14, at G-3 (January 23, 2007). Almost three years later, there still has been no action on this matter.

57. The Canadian jurisprudence that has involved guarantee fees has not specifically and conclusively addressed that question, as it was either assumed away or it was not relevant to the issues before the courts. For a discussion of those cases and this overall matter, see Nathan Boidman, “Canada Announces Safe Harbour Respecting Certain-Inter Company Guarantees,” 32 TAX MANAGEMENT INTERNATIONAL JOURNAL 606 (November 14, 2003).

58. An added element of potential dispute respecting guarantee fees paid to a Canadian parent stems from U.S. case law on deductibility of such fees. For a discussion, see Nathan Boidman, supra note 57.