
FineAnswers

Answers to questions on tax and finance

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What is transfer pricing and why is it important?

Transfer prices are the prices at which services, tangible property and intangible property are traded across international borders between related parties (as defined in IC-872R). Transfer pricing is important because a change in the transfer price would affect the profits of the Canadian business subject to tax in Canada. Revenue Canada can, under section 247 of the Income Tax, adjust the pricing if it thinks that the transfer price would be different from a price agreed between two unrelated (arms length) parties. The price adjustment could have an adverse tax effect on the Canadian business entity.

What methods of calculation of the transfer price are acceptable to Revenue Canada?

In its recent circular IC87-2R, which came out on the 27th of September 1999 Revenue Canada explains in details methods acceptable to it which are based on the OECD (Organization for Economic Co-operation and Development) guidelines. Adoption of these methods make it more likely that a Canadian company will not face an adjustment or face one adjustment by Canada and a different adjustment by the other country.

What are the methods outlined in the OECD guidelines?

You can find the details together with examples in the above-mentioned

information circular. They briefly fall into the following categories

1) Traditional transaction methods.

-The comparable uncontrolled price (CUP) method.

Adopts as the transfer price the price used by an arms length party in a similar transaction.

-The resale price method.

Uses the arms length resale price of the product less an arms length commission / expense to arrive at the transfer price.

-The cost plus method.

Compares a selling price using a *cost + overhead + profits* method arrived at in dealing with an arms length party to the *actual cost + overhead* to arrive at the mark-up %. The mark-up so calculated plus total actual transfer cost will result in the transfer price.

2) Transactional profit methods.

-The profit split method.

As it is apparent the total profit of the transaction made between the non-arms length parties is allocated on a fair basis to each of the parties. Profits are usually calculated before taxes and interest and some cases gross profit is used. The allocation will depend on such factors as functions performed, assets used and risks assumed by each of them,

- in other words, each of their contribution.
- The transactional net margin method. Determines an arms length net profit margin and applies that to the total cost of the transaction and calculates the notional net profit. Adding this notional net profit to the total cost gives the transfer price.

The above is in a summary form and details should be reviewed in the Revenue Canada information circular.

Why should the method of calculating transfer pricing be documented?

Because Revenue Canada imposes a 10% penalty on the adverse adjustment of the transfer price to a maximum of \$5,000,000, if appropriate documentation does not exist showing that a reasonable effort was made to arrive at an arms length transfer price (a price unrelated parties would have agreed to for same transaction).

What is included in the documentation?

Subsection 247(4) of the Income Tax Act gives a brief detail of what documentation should be kept. The following is a summary of the type of information that should appear in the documents.

- 1) Description of the product and service to which the transaction relates.
- 2) All terms and conditions of the transaction.
- 3) The identity of the parties to the transaction and their relationship to each other at the time the transaction was entered into.
- 4) The functions, assets and risks attributed to each of the parties to this transaction.
- 5) The method used in determining the transfer price.
- 6) Assumption, strategies and policies that affect the calculation of the transfer price.

When should such documentation be in place?

Subsection 247(1) provides that the documentation should be in place at the same time tax returns of the business is to be filed (*documentation due date*) and should be made available to the Minister within three months of receiving notice. This provision applies to taxation years beginning in 1998. Therefore fiscal years ending 31st of December 1998 and later will fall in this category. Also short fiscal years beginning and ending in 1998 will also be caught.

How would documentation apply to transactions entered into many years ago?

Transactions entered into before September 11, 1997 will be exempt from this requirement. Therefore exports and imports sales made in fiscal years beginning in 1998; but contracted before September 11, 1997 are excluded from the requirement for keeping transfer-pricing documentation.

Please note that the information above is of a general nature, please consult with your professional tax advisor