

Competent Authority Program Reports Reveal Transfer Pricing Trends

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Multinational enterprises (“MNEs”) are increasingly subject to scrutiny from tax authorities as to whether transactions entered into between members of an MNE are in accordance with arm’s length terms and conditions. In Canada, the advance pricing arrangement (“APA”) program and a significant part of the mutual agreement procedure (“MAP”) program are intended to deal with these transfer pricing issues. Where a tax authority disagrees with an MNE’s transfer pricing, the resulting reassessment allocating increased profits to its jurisdiction can lead to double taxation of a portion of the MNE’s profit unless a corresponding reduction is made to the profits originally reported for tax purposes in another jurisdiction. The MAP permits a taxpayer to request assistance from the competent authorities of the jurisdictions involved so that the necessary adjustments can be made to avoid double taxation resulting from a reassessment. Canada’s tax treaties generally provide for a MAP similar to Article 25 of the OECD Model Tax Convention. APAs provide another way to deal with transfer pricing issues but on a prospective basis. MNEs volunteer to submit detailed information regarding particular related party cross-border transactions and engage the Canada Revenue Agency (the “CRA”) and other relevant jurisdictions to review, negotiate and, ideally, reach an agreement with each other about the appropriate methodologies that should apply in determining transfer prices for such transactions over an agreed period of time. This bilateral (or in some cases, multilateral) agreement is known as an APA. As the CRA and tax authorities around the world continue to focus on transfer pricing as an important area for international tax audit, the efficient functioning of the MAP and APA programs is critical for MNEs with a presence in Canada.

For several years, the Competent Authority Services Division of the CRA has released annual reports summarizing the APA and MAP programs. Typically these reports have been released at least six months after the CRA’s fiscal period (which ends on March

31st) but, this year, the CRA released the two 2010 reports in mid-July.

The stated purpose of these reports is to increase awareness and provide more transparency regarding how these programs operate and how they are impacted by current events, and to describe any changes to the programs. Both reports rely heavily on statistics to show the types of issues that the Competent Authority Services Division is dealing with, and the processes that Canada and its treaty partners use to ensure that MNEs that participate in cross-border transactions are taxed in accordance with applicable tax treaties.

MAP Program Report

The MAP program report issued by the CRA for the fiscal year ending March 31, 2010, states that the Competent Authority Services Division accepted 75 new transfer pricing cases and completed 54 transfer pricing cases that were already part of its inventory. The number of completed transfer pricing cases is consistent with the previous year (53 cases), which was a major improvement from the fiscal year ended March 31, 2008 (28 cases). Nevertheless, the inventory of unresolved transfer pricing cases that have been accepted by the CRA steadily continues to grow (129 cases in 2008, 156 cases in 2009 and 184 cases in 2010). According to the MAP program report, nearly 81% of the completed negotiable MAP cases (including transfer pricing cases) result from CRA-initiated audit adjustments. This shows that the Competent Authority Services Division is facing an ongoing challenge to keep up with audit adjustments being pursued by the CRA’s international tax auditors. This may provide some explanation for the continued expansion of the Competent Authority Services Division. According to the 2010 MAP program report, the Competent Authority Services Division increased its workforce by more than 20%, growing from 44 employees on March 31, 2009 to 53 employees one year later.

One area of significant improvement revealed by the 2010 MAP program report is the notable drop in the number of negotiated MAP cases where there was no relief or only partial relief from double taxation resulting from an audit adjustment. According to the 2010 MAP program report, 95% of the completed negotiated MAP cases received full relief from double taxation. This is the highest success rate since the CRA began producing its annual MAP program reports in 2004. This is a substantial improvement from last year when 89% of the completed negotiated MAP cases provided full relief from double taxation. The fiscal year ended March 31, 2005, had the poorest record, with only 80% of the completed negotiated MAP cases providing the MNE with full relief from double taxation.

Another important improvement relates to the average time for completion of a negotiable MAP case. In the 2010 MAP program report, the average time to complete a MAP case resulting from a CRA-initiated adjustment was 22.73 months. This represents progress from the previous year's results, where, on average, it took 28.14 months to complete a MAP case that was initiated as a result of a CRA adjustment. This also brings the average time below the CRA's 24-month target completion time. Foreign initiated adjustments continue to take much longer for completion (30.53 months on average) but, again, there was meaningful advancement from last year (37.71 months).

For the first time, the CRA's MAP program report has not included a geographic breakdown of the cases it has completed. In the past, at least two-thirds of cases involved the United States. With the introduction of the mandatory arbitration provisions contained in the *Fifth Protocol to the Canada-U.S. Income Tax Convention*, the Canadian and U.S. competent authorities have significant incentive to resolve their negotiable MAP cases within 24 months of acceptance. No explanation was given for the exclusion of this information from the 2010 MAP program report.

The MAP program reports also contain useful information as to which industries were involved in completed negotiable MAP cases. This information may allow one to make certain inferences about the industries on which the CRA's international auditors have focused their attention in recent years. For example, the computer and electronics industry is typically at or near the top of the list showing the number of completed negotiated MAP cases. This was true again this year with 13 of 60 completed negotiated MAP cases. After two quiet years in the automotive and transportation equipment industry, it tied the computer industry in the top spot with 13 completed negotiated cases. There are some conspicuous absences from this year's industry list, as well. For many years, the Canadian health industry appeared to have been a focus for the CRA's international tax auditors, but during the last fiscal period none of the completed MAP cases related to

that industry. Another industry that does not appear on this list of completed MAP cases is the finance and insurance industry. Perhaps the absence of these two industries from the list of completed MAP cases is related to the two recent transfer pricing court decisions in *GlaxoSmithKline* (health) and *GE Capital Canada* (finance). The CRA may have delayed consideration of MAP cases in its inventory while awaiting the outcome of these cases.

APA Program Report

The 2010 APA program report heralds the twentieth anniversary of the APA program. In total, 142 APAs have been concluded since 1990 when the program commenced. In the 2010 fiscal year, 16 APAs were concluded. Like the MAP program, the APA program has accepted a greater number of cases than it has completed, resulting in a growing backlog of 95 unresolved cases. This represents a 50% increase from the 2008 program report, where there were a total of 63 unresolved cases at year end. This increased interest in the APA is likely the result of a growing awareness and concern among taxpayers about transfer pricing issues. An APA remains the only avenue under which a taxpayer can obtain certainty as to whether its transfer pricing policies will withstand future scrutiny by the tax authority. However, the number of completed APAs is miniscule compared to the number of related party cross-border transactions.

One of the principal reasons that taxpayers shy away from the APA program is the time it takes to complete an APA. Bilateral or multilateral APAs completed in the 2010 fiscal period were in process, on average, 48.8 months from the date of acceptance in the program to the date that the APA was signed by the parties. This is a significant increase from the average completion time in the previous fiscal period (42.2 months). As a result of this four-year completion time, only those cross-border transactions that remain static for several years would make good candidates for an APA. The CRA also noted this as a possible reason that two cases were withdrawn from the APA program during the year:

Since APAs are predicated on the basis that the facts and circumstances underlying the covered transaction will not change over the course of the APA term, any event which brings into question the continuity of the transaction could potentially result in a taxpayer's withdrawal from the APA program on a premature basis.

The CRA defends this high average completion time by suggesting that a "disproportionate number of outlier cases are taking considerably longer periods to conclude". The CRA supports this argument by comparing over the last five years the lower total APA completion times based on the annual median, to the higher APA completion times based on the annual average. Notwithstanding the effects that "outliers" may have on the average, the annual

median completion time for the last fiscal year was still 45.8 months — a substantial increase from median completion time reported in the two previous APA program reports (35.6 months in 2009 and 25.9 months in 2008) and much higher than the five-year weighted averages shown in the report.

The APA program report also states that taxpayers withdrew from the process prior to initial acceptance in the APA program 11 times during the 2010 fiscal period. The CRA attributes this high number of withdrawals to the “evolution of the APA pre-file meeting”. According to the program report, “the CRA has been increasingly proactive in ensuring that taxpayers are well-equipped with the necessary feedback on their proposed transfer pricing methodologies and covered transactions”. The CRA noted that in some cases the taxpayer chooses to withdraw after receiving CRA feedback, due to the taxpayer's financial constraints, business restructurings, or personnel changes. The pre-acceptance withdrawals were also precipitated by the CRA in circumstances where it felt that the key issues in processing a taxpayer's APA were currently under consideration by the Canadian courts (for example, the value of implicit support in respect of a guarantee fee paid by a Canadian subsidiary to a foreign parent — one of the central issues in the *GE Capital Canada* case).

The 2010 APA program report also provides a breakdown of its completed APAs and current work-in-progress inventory by industry. Interestingly, the industries that dominate the MAP program also figure prominently on the list of completed APAs and APAs in-progress. The automotive and other transportation equipment industry is the most active industry in the APA program and makes up 30% of all completed APAs and 24% of the APAs in-progress. The metals & minerals industry and the computer & electronics industry are the next largest (each have 12% of the aggregate of completed and in progress APAs). These three industries together make up almost half of the APAs in-progress. Other industries have significantly less completed APAs or APAs in progress. Given the high number of cases from these same industries in the MAP program, one wonders whether the consistent pursuit of transfer pricing audit adjustments in these industries over the years has been a factor in causing these businesses to seek the certainty offered by the APA program.

As international tax audits continue to focus on transfer pricing issues in Canada, increased demands are likely to be made on the MAP and APA programs in the future. One hopes that the CRA will continue to allocate the necessary resources to these important programs and to improve on its efficiency in bringing transfer pricing issues to a conclusion and delivering results that are fair and free of double taxation.