

Department of Finance releases consultation paper proposing amendments to Canada's transfer pricing regime

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Authors: [Peter Macdonald](#), [Amanda Heale](#), [Kaitlin Gray](#)

On June 6, 2023, the Department of Finance released a [consultation paper](#) on Canada's transfer pricing rules. This consultation was first announced in [Budget 2021](#) in response to the Federal Court of Appeal's decision in the *Cameco* case, from which the Supreme Court declined to give the Government leave to appeal. More than two years after announcing its intention to initiate a public consultation on Canada's transfer pricing rules "with a view to protecting the integrity of the tax system while preserving Canada's attractiveness as a destination for new investment and business activity", the Government has now released a consultation paper with draft legislative amendments, requesting that any submissions on the proposals be made by July 28, 2023.

Consultation paper

The accepted international standard for transfer pricing is the arm's length principle. The consultation paper suggests that the Government's proposed amendments to section 247 of the *Income Tax Act* would "provide greater clarity on the application of the arm's length principle in Canada in line with international consensus." The consultation paper begins by describing section 247 as lacking explicit guidance compared to "more modern" transfer pricing provisions in other jurisdictions. An Appendix to the consultation paper includes extracts from legislation in Australia, New Zealand, the United Kingdom and the United States.

The consultation paper also notes the Government's concerns with the outcome in *Cameco* and suggests that a "lack of detail in the current version of section 247...has led to an overemphasis on intra-group contracts, rather than on the factual substance of transactions", further stating that this has resulted in "outcomes in which the profit allocations between the Canadian and non-resident taxpayer were at odds with the economic contributions of the parties." The Government's interpretation of the *Cameco* case and the strength of its articulated need for the proposed new rules warrant close scrutiny and are likely to face criticism in the consultation process.

The consultation paper describes two main steps in a transfer pricing comparability analysis: identification of the conditions and economically relevant characteristics of the controlled transaction (Step 1) and comparison to the conditions of comparable transactions between independent enterprises (Step 2). The consultation paper states that "[t]he purpose of Step 1 is to establish a starting point for the comparison in Step 2. It requires the accurate delineation of the controlled transaction." It also states that the transaction or series as structured by the taxpayer is not a sufficient starting point and that "economically relevant characteristics" should be taken into account, making specific reference to the concepts of control over risk and financial capacity to assume the risk as those concepts are discussed in

the 2022 OECD Transfer Pricing Guidelines. Although the consultation paper does not address this, Canadian courts — including the Tax Court and the Federal Court of Appeal in *Cameco* — have made express reference to prior versions of the Guidelines, including their guidance on “economically relevant characteristics” of transactions, in deciding transfer pricing cases under the existing legislation.

In general terms, the draft legislative proposals in Appendix A would

1. introduce a new provision stating that the “conditions” (to be interpreted broadly) of a transaction or series of transactions are to be “analyzed and determined with reference to [their] economically relevant characteristics” (based on a new definition to be added to subsection 247(1))
2. introduce a new provision stating that the hypothetical comparison is to include all conditions that would have been included in comparable circumstances had the parties been acting at arm’s length
3. in certain circumstances, replace the controlled transaction entirely, reflecting a new approach to the recharacterization rule in current paragraphs 247(2)(b) and (d) that eliminates the “tax benefit” requirement in the existing test
4. introduce a “consistency rule” requiring section 247 to be applied so as to achieve consistency with the OECD Transfer Pricing Guidelines (defined as the 2022 version, or any other text prescribed by regulation), unless the context otherwise requires

Certain language in the proposed amendments stems from the Base Erosion and Profit Shifting (BEPS) project, including reference to the “actual conduct” of the participants to the transaction or series, as well as the concept of a “delineated” transaction or series. It is far from clear how the interpretation and application of these concepts (if adopted) would work in practice and how the courts would approach the proposed rules. It is worth noting that the proposed amendments do not include a proposed coming into force date; however, the consultation paper states that they are expected to apply on a prospective basis.

The consultation paper also discusses certain proposed administrative measures, although no draft legislation relating to these measures is present. These measures include

- aligning Canada’s contemporaneous documentation requirements with current OECD standards
- increasing the absolute penalty threshold to \$10 million
- introducing streamlined pricing approaches for
 - low-value-adding intra-group services
 - routine distribution activities
 - intra-group loans

The consultation paper also describes administrative measures that the Government considered but decided not to pursue at this time.

Submissions

The consultation paper solicits submissions in response to 23 questions. Interested parties are invited to make submissions in response to these and other aspects of the consultation paper by July 28, 2023. Osler intends to prepare a submission as part of the consultation.

For further information on the implications of the consultation paper, the proposed amendments to section 247, or if you have any interest in making or contributing to a submission on the consultation paper, please contact any member of our National Tax Group.