December 19, 2008

Advisory Panel on Canada’s System of International Taxation Submission
Attn.: David Messier
333 Laurier Avenue West, 15th Floor
Ottawa ON K1A 0G5

By e-mail: advisorypanel@apcsit-gcrcfi.ca

Re: Transfer Pricing as Related to Enhancing Canada’s International Tax Advantage

Dear Mr. Messier:

On behalf of the American Bar Association Section of Taxation, we provide the following comments with respect to transfer pricing, addressed in Chapter 5 of the April 2008 consultation paper Advisory Panel on Canada’s System of International Taxation. These comments have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

William J. Wilkins
Chair, Section of Taxation

Enclosure

cc: Ms. Patricia Spice, Director, Competent Authority Services Division, Canada Revenue Agency
Mr. Barry Shott, LMSB Deputy Commissioner (International), Internal Revenue Service
The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”). These Comments have not been approved by the House of Delegates or Board of Governors of the American Bar Association, and should not be construed as representing the position of the American Bar Association.

The Comments were prepared by members of the Section’s Transfer Pricing Committee (the “Committee”). Principal responsibility for preparing these Comments was exercised by Brian Trauman, and substantive contributions were made by Timothy Dehan and Miller Williams. These Comments were reviewed by Sean Foley and David Canale on behalf of the Section’s Committee on Government Submissions and Stephen Shay, the Section’s Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise influence the development or the outcome of, the specific subject matter of these Comments.

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Date: December 19, 2008
EXECUTIVE SUMMARY

In November 2007, the Government of Canada created the Advisory Panel on Canada’s System of International Taxation to study and recommend measures to further improve the competitiveness, efficiency, and fairness of the Canadian system of international taxation. In April 2008, this Advisory Panel issued a consultation paper, Enhancing Canada’s International Tax Advantage (“Consultation Paper”), which posed a series of questions regarding Canada’s international taxation system, presented the Advisory Panel’s initial views, and requested comments. On behalf of the American Bar Association Section of Taxation, we provide the following comments with respect to transfer pricing, addressed in Chapter 5 of the Consultation Paper, which addresses “Administrative Issues,” including transfer pricing.

The Advisory Panel raised three sets of questions regarding substantive and procedural issues arising from Canadian transfer pricing rules, and these comments will respond to each, with a goal of furthering open discussion on these points, and developing a better economic environment for those Canadian taxpayers affected by transfer pricing issues. As described in more detail below, we recommend that:

- The Canadian Revenue Agency (“CRA”) and the Internal Revenue Service (“IRS”) endeavor to agree on how to mutually and practically interpret certain substantive principles, including how to treat the provision of management and other services, transfers of marketing and imbedded intangibles, and other comparable transfer pricing issues. These agreements should be published to (i) provide taxpayers with clear guidance as to what is reasonable and appropriate, (ii) avoid double or zero taxation, and (iii) allow both governments to more quickly resolve existing and future cases. It is inappropriate to expect that the treaty arbitration provision will adequately or most efficiently address these issues.

- Collections rules under the Canadian Income Tax Act, which require that large corporations make substantial (50%) payments of tax, interest, and penalties upon the issuance of a reassessment, particularly in transfer pricing matters where there is double taxation and where the initially assessed amounts are substantial, be revised. This law should be amended to be consistent with international standards, general fairness, and the objective of reducing barriers to doing business in Canada. Taxpayers should be allowed to exhaust reasonable appeals before being required to pay a normal transfer pricing assessment.

- CRA take steps to allow taxpayers to become more involved in discussions with CRA economists, who currently function at a head or national office (and not a field) level and are thus removed from fact-finding, discussions, and negotiations. Taxpayers should also be permitted to become more involved at all stages of penalty assessments. These steps will foster greater understanding and respect from taxpayers, and allow CRA to more quickly and efficiently reach resolutions.
CRA work independently and together with the IRS to measure and improve taxpayer satisfaction with its APA Program. Current satisfaction is not high, and could lead to the eventual demise of the Program.
SPECIFIC RESPONSES TO CONSULTATION PAPER

Question 1: What issues commonly arise regarding the application of Canada’s transfer pricing rules? What measures could be implemented to improve the application of these rules?

A. Double Taxation

When there are differences in substantive application of transfer pricing rules, or other tax rules for that matter, there is significant potential for double taxation. Potential for double taxation is by far the biggest impediment to cross-border trade, and this potential exists whenever a revenue authority proposes an adjustment with respect to a related-party cross-border transaction. Of course this is not unique to Canadian proposed adjustments; however, there are certain issues that commonly arise regarding the application of Canada’s transfer pricing rules that make this potential for double taxation more significant. We respectfully submit that Canada would reap advantages from further developing its already sophisticated transfer pricing rules to make them more consistent with those of the international community and Canada’s largest trading partners. We also suggest that Canada work with its trading partners to reach agreements on how to address certain common areas of dispute, as described in more detail below.

B. Services and Management Fees

Introduction: One of the more prevalent issues, and one of the easiest for Canada to address, is the consistent determination of an appropriate price for the intercompany transfer of services. The United States and other countries that follow the widely accepted Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published by the Organisation for Economic Co-operation and Development (“OECD Guidelines”) determine an appropriate price for the transfer of services by reference to the benefit received by the service-recipient, and the allocation to such recipient of the service-provider’s costs in providing those services. Thus, at arm’s length, service-providers charge their foreign affiliates for any services that provide any benefit to those affiliates; only services that solely benefit the provider as shareholder are not charged. These charges are typically based on the costs expended in performing such services and include a markup on those costs. In some cases, the IRS permits domestic service-providers to render those services at cost (without a mark-up), resulting in reduced charges to the service-receiving affiliates.

The CRA commonly disallows, in whole or in large part, the payment of reasonable services fees from Canadian service-recipients to U.S. service-providers. CRA’s initial position has been to disallow either the entire charge or the profit element of such charge, and both positions unreasonably raise the prospect of potential double taxation.

Disallow entire charge: When the entire charge (costs and profit elements) is disallowed, the service-recipient has the practical burden of proving with significant detail what service was received, what the benefit was, and what the appropriate amount of compensation was. Certainly, these are important elements, but the international community has recognized that these types of services generate relatively low levels of profit and generally should not be the
focus of significant administrative record-keeping or review. The materiality of any correction is minimal relative to the documentary evidence that could be required. Thus, both the U.S. and the OECD have adopted the use of reasonable “allocation keys” as a means of determining the benefit, and cost, to each service-recipient, and these keys are generally respected as long as they are reasonable. To the contrary, CRA’s practice unduly burdens a taxpayer, and causes significant time, effort, and outside consulting fees to be expended in sustaining the payment of intercompany service fees. We suggest that CRA adopt the more practical approach of applying allocation keys to these services. Such an approach would be more consistent with international practice.

**Disallow profit element:** When CRA consistently disallows the payment of a profit element from a Canadian service-recipient to a U.S. service-provider, it is not operating consistently with the arm’s length principle. At arm’s length, and absent special circumstances, service-providers will not provide services at cost; rather, they will instead charge an amount to cover those costs and provide an element of profit. This is consistent with Canadian rules and should be consistent with CRA practice. The U.S. permits U.S. service-providers to elect to charge service-recipients for costs incurred in providing certain services without a mark-up, but this is a taxpayer election and only applies where the service meets certain standards evidencing the ministerial nature of the service. Canadian rules do not provide for this election. CRA’s practical imposition of this election on U.S. taxpayers, and not on Canadian taxpayers, is inconsistent with U.S. and OECD rules, and is inconsistent with the arm’s length principle. This practice increases tension in audits and in subsequent competent authority discussions.

**Effect of CRA practices:** CRA’s audit practices create a difficult audit environment, which has resulted, and will continue to result, in non-Canadian companies seeking to minimize otherwise reasonable service charges to Canadian affiliates to avoid audit conflict. By minimizing these charges, more costs remain in the U.S., and more income remains in Canada. This reaction is not in response to appropriate transfer pricing practices or the arm’s length principle, but solely because of the audit environment in Canada. Necessarily, companies take these costs of doing business – the costs of the audit environment and the after-tax effects of an allocation of costs and income – into account when deciding where to do business. These issues may adversely affect the calculation whether a non-Canadian company will make an investment in or add to an investment in Canada.

**Cost Components:** Additionally, the U.S. and Canada have different rules with respect to what constitutes a cost of providing a service. The U.S. rules require that stock-based compensation is a cost to be included in any charge, and the Canadian rules do not. Because the IRS and CRA have differing views on this topic, and there is no agreement as to how to address this difference, U.S.-Canada trade flows involving stock-based compensation will be subject to double taxation.

**Recommendation:** CRA and the IRS should endeavor to agree on how to mutually interpret transfer pricing principles consistently in a practical way. This interpretation should be memorialized in a competent authority agreement to (i) provide taxpayers with clear guidance as to what is reasonable and appropriate, and (ii) avoid the prospect of double taxation. Such an agreement would allow both governments to more quickly resolve existing and future cases.
C. Other Services

Similar issues arise with respect to other types of services, such as contract research and development and contract manufacturing, although the primary issue in these cases is the appropriate markup on the relevant costs associated with such services. The appropriate markup is typically measured with respect to a benchmark set by a group of comparable companies, but because third-party comparables can be difficult to find in these areas, protracted and intransigent discussions typically ensue. The U.S.-Canada relationship is known for difficult discussions, despite efforts to reach more reasoned agreements.

Indeed, CRA and the IRS executed a number of Memoranda of Understanding (“MOUs”) in 2005 to address these and other issues, and agreed thereunder to develop guidelines to avoid these types of disputes.¹ These MOUs are indicative of the issues commonly faced by the CRA and the IRS in attempting to resolve double tax cases, and of the continued strain these issues have had on the CRA-IRS relationship. Nevertheless, it does not appear that these MOUs have been further developed or followed, and the same issues remain. CRA would do well to conclude common agreements with the IRS addressing the mechanics of resolving common and recurring issues.

D. Marketing Intangibles

CRA has frequently asserted that Canadian taxpayers engaged in distribution activities are entitled to returns in excess of what could be commonly recognized as a routine distributor return consistent with the arm’s length principle. These actions often are due to CRA’s attribution of profits to these distributors from their purported “ownership” of “marketing intangibles.” Many of the positions taken have yet to be considered by a court but in some iterations appear to be unsupported in Canadian intellectual property law; moreover, CRA’s actions are inconsistent with international practice.

Canadian tax law does not appear to define intangible property; thus, in tax disputes, one must refer to commercial intellectual property law and related case law. We understand that these authorities identify certain intangible property that legally can be owned and thus protected, such as trademarks, and others that cannot and thus are not recognized, such as goodwill or “marketing intangibles.”² Because CRA has attributed to Canadian distributors


² See François Vincent, Transfer Pricing in Canada (2nd edn.), p. 161 (“The Circular states: ‘one member of the multinational group is seldom entitled to the total return attributable to the valuable or unique assets, such as intangible’. The example provided relates to the development of a marketing intangible ... While this statement seems reasonable in theory, it may be difficult to apply in practice where the contractual instruments between the parties stipulate that all rights in and value of the intangible shall accrue to the owner of such intangible. This type of stipulation is not unusual and is commonly found in agreements between parties dealing at arm’s length. This may force a showdown of the economic theory on the development of marking intangibles versus the legal ownership of such intangibles. This clash may give
returns based on ownership of marketing intangibles, there has been a great deal of discussion and disagreement regarding how much value can be attributed to something that is, first and foremost, arising out of routine activity and, secondly, not legally protected. For instance, CRA often has refused to acknowledge that the Canadian distributor should pay a royalty to a U.S. entity for the use of the U.S. entity’s legally owned and protected trademark, in return for the Canadian entity’s purported marketing intangible and its purported related income. CRA has not made similar arguments when a U.S. distributor uses a trademark legally owned and protected in Canada; rather, it has taken the position that the profits are related to the Canadian trademark and are earned by the Canadian entity.

Consistent with U.S. and OECD guidance, attribution of value to an asset that is not legally protected should follow economic ownership of that asset, but even if Canada and the U.S. continue to have inconsistent tax and intellectual property laws and application, it is important to the development of cross-border investment that the governments develop a framework under which they can reach a mutual resolution, consistent with OECD principles, that avoids the prospect of double taxation.

E. Imbedded Intangibles

Both CRA and the IRS have recognized in their published guidance that some transactions are so linked that they cannot be evaluated adequately on a separate basis, and that the transactions should instead be evaluated in the aggregate, or bundled. This guidance is consistent with the OECD Guidelines. However, in practice, there is a recurring audit issue in Canada regarding whether a transaction is more appropriately characterized as a transfer of services or of intangibles, each with different transfer pricing consequences. In the June 2005 MOU, CRA and the IRS recognized that “whether a transaction is properly characterized as a service versus a license of intangibles” constituted a substantive issue that has resulted, and could result, in a failure to relieve double taxation.

The U.S. has provided helpful guidance to its taxpayers in the form of revised regulations for services and intangibles, more in line with the OECD Guidelines, but these revisions do not fully comport with CRA guidance. Indeed, CRA appears to be moving further from OECD

rise to the following question: can a party claim rights in an intangible from an economic perspective if such party cannot enforce those rights?”); see also “Mogle Chronicles Transfer Pricing’s Evolution in 20-Year Career,” BNA Transfer Pricing Report (24 May 2006) (“In the real world, no distributor spends money to make somebody else’s trademark valuable. That was the point of the original cheese examples [in Regs. §1.482-4(f)], which I think got muddled in their language, causing people to focus on the word ‘ownership.’ The point was not that ownership can’t be in this jurisdiction because I have the legal title in the other place. / The point should [ ] be to look at the KERT functions to see whether that subsidiary is performing the key entrepreneurial risk-taking functions that justify spending that money. If the answer to that is yes, then you impute a license arrangement and the subsidiary is treated as a licensee with market risk and not a distributor providing routine services to the offshore manufacturer. If the answer is no, then you’re going to treat the subsidiary as a distributor and allocate those expenses back to where they belong – the party performing those KERT functions. Again, the whole idea was to look at KERT in deciding in a related-party situation, which doesn’t exist at arm’s length, how to interpret what the parties actually did.”).

3 IC87-2R (paras. 37-43); 26 CFR 1.482-1(f)(2)(i).

4 OECD Guidelines, paras. 1.42-1.44.
practice, as CRA has recently issued guidance indicating that even if bundled transactions are derived by commercial considerations, each property and service should withstand individual testing. This divergence from generally and widely accepted principles is unsettling, and CRA would do well to revisit this issue in consideration of these principles. Again, however, the U.S. and Canada need not agree on substantive guidance in their respective countries, although it does not bode well to grow farther apart on this topic. Nevertheless, in order to alleviate the very real prospect of double taxation in cases where there exists bundled transfers, the governments should work to “reach an agreement establishing guidelines to be applied with respect to resolving cases involving [this] issue,” as they committed to under their MOU.

F. Arm’s Length Results

Once CRA and IRS competent authorities reach an agreement on issues including treatment of intangibles, aggregation, methods, and comparables, they should agree on the appropriate arm’s length price. In many cases, the IRS prefers to use a statistical measure to improve the comparable results, and its measure of choice is the interquartile range around the median observation. The IRS also may incorporate the use of multiple years of data to take into account results over various industry and business cycles. The interquartile range and multiple-year averaging are cornerstones of the IRS approach, are reflected in its published guidance to taxpayers, and are generally accepted in OECD countries. The CRA, on the other hand, prefers to target a point in the full range, and prefers to use a single year of observations. Although CRA has not published these preferences as official policy, CRA has made public reference to them, and these approaches are commonly experienced at audit and in competent authority discussions.

The IRS’s practices are more in line with international techniques than are CRA’s practices, and we suggest that CRA be more consistent with respect to relieving double taxation on principled and widely accepted economic grounds. In any case, certainly some compromise can be found with respect to this and similar points where the taxpayer is the only party to suffer from these protracted discussions unrelated to principle, and could cause a taxpayer to rethink investing in trade flows between the two countries.

Question 2: Are the transfer pricing rules being applied and administered in a balanced manner?

A. Balance of Negotiations

Under the Canada-U.S. competent authority relationship, most of the cases involve U.S. parent companies and their Canadian subsidiaries and, over the past six years, more than 80% of the adjustments have been Canadian initiated. This balance, or imbalance, results in CRA having an advantage in negotiations, because U.S. parent companies are proportionally more

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5. Canada Revenue Agency TPM-6, Bundled Transactions, 16 May 2005.
affected by a failure to resolve double taxation. Consequently, the U.S. competent authority has been more likely to act unilaterally to reach a resolution of the case; i.e., to grant U.S. taxpayers economic relief from double taxation. However, in an effort to prevent this deleterious effect on U.S. revenues, to the benefit of Canadian revenues, the U.S. competent authority has announced, consistent with existing procedures, that it will apply more scrutiny to those situations where principled relief should come from Canada and will pursue bilateral negotiations in more cases. A reduction in unilateral U.S. action appropriately should shift the balance of negotiations to achieve fairer outcomes, and encourage all parties (including taxpayers) to seek to avoid double taxation.

As further background, under U.S. foreign tax credit rules, if a transfer pricing adjustment results in double taxation that is not resolved by the competent authorities under the mutual agreement procedures, then the U.S. taxpayer is allowed to treat as creditable foreign taxes the foreign taxes that give rise to the legal double taxation. This effectively mitigates the U.S. taxpayer’s economic double taxation through the “foreign tax credit” mechanism, however, the U.S. Treasury loses revenue equal to this credit.

According to the U.S. competent authority, the U.S. practice of granting automatic economic relief from double taxation may be coming to an end, and the IRS will be focusing more on applying already existing guidance regarding the requirement that a taxpayer pursue its effective and practical remedies to reduce its foreign tax. Under U.S. law, foreign taxes are only creditable if they are compulsory, meaning that the taxpayer has pursued all effective and practical remedies to minimize the foreign taxes paid. Although the invocation of competent authority under the treaty is one such remedy, the U.S. competent authority will be issuing clarifying guidance detailing what other remedies may have to be pursued, including administrative appeals and litigation. This is not a new standard for the IRS; rather it would represent a stricter application of existing law and policy.

Unfortunately, taxpayers can be expected to expend substantially greater resources in pursuing all effective and practical remedies to minimize the foreign taxes paid, in order to obtain the foreign tax credit with respect to the remainder of such taxes and this may result in additional expense for the Canadian government as a result of increased taxpayer use of administrative and judicial procedures. The U.S. Treasury also may be adversely affected by this stricter application of policy, through additional disputes where the U.S. taxpayer argues that Canadian litigation is neither effective nor practical, or where the assessment in Canada is finally resolved to be greater than would have been achieved at the competent authority level. For these reasons, CRA and the IRS should strongly consider how to reach agreements as suggested above in response to Question 1.

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8 Comments by IRS Deputy Commissioner, International, Barry Shott at American Bar Association Section of Taxation, meeting of the Transfer Pricing committee (9 May 2008).

9 26 CFR 1.901-2(e)(5).
B. Onerous Collections Rules in Canada

To the extent a Canadian “large corporation” (i.e., most taxpayers facing significant transfer pricing adjustments) receives a transfer pricing reassessment, that taxpayer must within a few days remit 50% of the tax, interest, and penalty reassessed, without regard to how the taxpayer opts to dispute that reassessment. This can be a significant burden on businesses choosing to operate, or continue operations, in Canada.

In part because of the extraordinary size of many transfer pricing reassessments, CRA amended its administrative policy in 2005 to allow for a taxpayer to obtain a bank guarantee in lieu of this remittance when the taxpayer has invoked competent authority procedures. Nevertheless, this relief does not toll the running of the compound interest, and does not make that interest deductible. Further, bank guarantees can be expensive on these large reassessments. Lastly, because these are transfer pricing reassessments, the tax often will have been paid in another country.

Canada’s rules in this regard are unique and are inconsistent with OECD recommendations. The OECD Guidelines correctly recognize that taxpayers in a MAP process have already paid double tax and that it is within this context that collections policies should be suspended under the Treaty. The Guidelines state:

The process of obtaining relief from double taxation through a corresponding adjustment can be complicated by issues relating to the collection of tax deficiencies and the assessment of interest on those deficiencies or overpayment. A first problem is that the assessed deficiency may be collected before the corresponding adjustment proceeding is completed, because of a lack of domestic procedures allowing the collection to be suspended. This may cause the MNE group to pay the same tax twice until the issues can be resolved…. Countries that do not have procedures to suspend collection during a mutual agreement procedure are encouraged to adopt them….

We respectfully submit that Canada should adopt a policy, consistent with international standards and recommendations, and a general sense of fairness, that permits resolution of mutual agreement procedures without prepayment of an assessment. This would reduce a disincentive to doing business in Canada.

C. Taxpayer Involvement

CRA’s involvement of taxpayers at appropriate stages of administrative audits and appeals can result in reduced costs of compliance (both for taxpayers and CRA) and greater trust and perceptions of fairness. The IRS has had some success with dealing directly with taxpayers

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12 OECD Guidelines, para. 4.64 (emphasis added).
early in issue identification and resolution processes, including through adoption of various prefilining agreement and industry issue resolution programs, as well as in standard corporate audits. U.S. taxpayers have a great deal more of contact and communication with the IRS during the audit process than do Canadian taxpayers with CRA. We believe that, as a result, issues can be resolved earlier and faster under such an approach.

As one practical example, most transfer pricing cases are mounted on “expert” economic theory, but CRA’s economists generally are not intimately involved at the Field level or with taxpayers nor do they have the audit or legal training that as do international auditors in the U.S. Ultimately, this results in Canadian taxpayers and economists being unable to communicate with one another, adversely affects the potential for decisions to be taken by other than the primary finder of fact (the Field or economist), and causes issues to become developed without full information, and CRA resources to be inefficiently deployed.

CRA staff economists work either in the Head Office audit group “Field & Advisory Services” or in Competent Authority (MAP and APAs). In our experience, Head Office economists and managers involve themselves in the vast majority of cases and “direct,” if not “control” fact-finding by the Field auditor, as well as the ultimate decision to reassess. Taxpayers, on the other hand, rarely have the opportunity to have substantive discussions with Head Office before receiving their 30-day or other form of proposal letter to which a lengthy Head Office economic analysis (“Head Office Memorandum”) is attached.

Thus, Head Office affects the development of the case and the ultimate decision, without necessarily helping to aid the debate or advance meaningful discussions that might in fact identify fruitful paths toward resolution; rather, this can result (and, some would say, has resulted) in more difficult negotiations with a Field auditor who doesn’t possess the information or “expert” theoretical background to reach an expeditious or different resolution with the taxpayer. CRA could realize faster case resolutions and reduced expenditures, and foster greater understanding and respect from taxpayers, by including taxpayers in discussions with those controlling the outcome of the audit.

D. Perception of Fairness

Right or wrong, taxpayers and practitioners widely have the perception that CRA has targeted transfer pricing as a revenue raiser, and that CRA operates to increase revenue at the expense of principle. It is believed that CRA uses increased funding to initiate various transfer pricing compliance programs (with related staff increases), and then measures the “success” of those initiatives in terms of revenue collected, in order to justify further funding and staff increases. These budgetary concerns are believed to have impacted the nature of resolution under administrative appeals and competent authority discussions, and resulted in a perceived departure from principled negotiations, as discussed above. We respectfully suggest that CRA address such perceptions through transparently principled assessments, administrative appeals, and competent authority negotiations. Failure to address these issues would perpetuate adverse perceptions of CRA’s commitment to principled application of transfer pricing rules, resulting in increased taxpayer wariness to do business in Canada.
E. **Advance Pricing Agreements**

The underlying rationale for any APA program is best expressed by the OECD in its Guidelines For Conducting Advance Pricing Agreements Under the Mutual Agreement Procedure as such: “The term APA refers to a procedural arrangement between a taxpayer…and a tax administration intended to resolve potential transfer pricing disputes in advance…. To be successful, the process should be administered in a non-adversarial, efficient and practical fashion and requires the co-operation of all the participating parties.” Taxpayers that have experienced difficult audits commonly turn to APAs in advance of other disputes in order to provide some measure of certainty, but the same problems that have affected MAPs now permeate the bilateral APA process and many APAs have led to a lack of certainty, increased audit risk, and wasted time and money.

The APA program (in both countries) is dependent upon its ability to “attract” taxpayers. Some would argue that today, in the Canada-U.S. context, the continued viability of the APA program may well be in question. Some of the fundamental differences in approach between the U.S. and Canada that result in the problems experienced can be traced to the fact that the U.S. charges a relatively reasonable flat user fee while CRA seeks to recover all out-of-pocket expenses including all travel and accommodation. It is not surprising that CRA therefore seeks far more “site” visits than the IRS and this often leads to disparate fact-finding. In recent years, the Canadian program also appears to have been complicated by a series of newly announced administrative rules, at least one of which was subsequently abandoned.

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13 OECD Guidelines, para 4.144. (emphasis added).

14 CRA APA Program Report, 2004-2005, p. 11, CRA announced the following new policy related to APAs:

“Starting in 2005-2006, the CASD will implement a rating system for APAs. APAs that have a ‘green light’ will proceed as usual. APAs with a ‘yellow light’ will proceed with a strong warning. APAs that have a ‘red light’ will not proceed.

Green Light: Although CASD may express some concerns, there is a general view that the methodology proposed in the taxpayer’s APA request continues to have a high probability of leading to a resolution.

Yellow Light: The CASD has serious concerns and is highly unlikely to conclude an APA using the methodology proposed in the taxpayer’s APA request. The methodology would not, in the opinion of CASD, form the basis for productive Competent Authority negotiations and there is higher risk that the APA process will become stalled or will not achieve resolution.

Red Light: The methodology proposed in the taxpayer’s APA request is, in the opinion of the CASD, highly unreliable and/or may not be demonstrative of ‘reasonable efforts’ to determine an arm’s length price. In these situations, it would be inappropriate to proceed with the taxpayer’s APA request.”

On October 6, 2006, the CRA Director General, International, announced that policy was being set aside. (“Canada Abandoning Color-Based System of Rating APA Submissions, Official Says,” 5 Transfer Pricing Report, 10/11/06).

Other recent policies include those announced in TPM-10, “Advance Pricing Arrangement (APA) Rollback” which limits rollbacks if the Field has requested a taxpayer’s contemporaneous transfer pricing documentation. Such requests often precede the actual audit of the year. This policy means that the timing of a request for contemporaneous documentation by the Field could effectively foreclose the possibility of a taxpayer obtaining one of the key benefits of an APA – its rollback to earlier years.
Taxpayer satisfaction is an important element to any voluntary program such as the APA program, and consideration might be given to applying some objective assessment standards. For instance, it may be instructive to conduct an assessment of the program through interviews with Canadian and U.S. taxpayers and representatives, similar to the assessment undertaken by then-Director General, International, Mr. Gary Zed, in 2000.\footnote{This survey is referenced annually in CRA’s public reports on the program. In the annual APA report covering 1993-2000, CRA stated at p. 9: “In 2000, the International Tax Directorate commissioned an independent study of the APA Program. The results of this study were extremely valuable and prompted many changes to the way the APA program is administered, including:

- further increasing the number of staff dedicated to processing APA requests;
- implementing new pre-filing procedures – an “up-front” approach that explains the role and commitment of the CCRA, its expectations of the taxpayer, and immediate feedback on the proposed APA;
- introducing case management techniques – case plans to ensure that APAs proceed on schedule;
- imposing internal deadlines – one year to complete the position paper; and
- launching a new marketing plan to increase awareness – the APA Program Development Strategy.}

Alternatively, or additionally, one might track the level of renewal requests and completions; a low proportion of requests could indicate a low level of satisfaction, and a low proportion of renewal completions could signal a deeper issue.\footnote{For example, CRA recently has attempted to change the transfer pricing methodology and approach in a renewal APA, despite the facts and circumstances of the renewal request being materially similar to that covered by the original APA.}

F. Resolving Cases Before Arbitration

As referenced above, the Canadian and U.S. competent authorities released an MOU in June 2005 recognizing and responding to concerns that their MAP process had broken down. The MOU identified shared agreement on the essentials of MAP, and procedural and substantive issues responsible for the breakdown. Under these terms, the competent authorities committed to (i) create a further MOU (subsequently released in December 2005) to establish a procedure for determining the facts and circumstances relevant to a particular matter; and (ii) create guidelines to use in resolving the identified substantive issues and procedural issues.

In May 2007, these competent authorities described the new arbitration provision under the Canada-U.S. Income Tax Convention as supplanting, or obviating, these MOUs.\footnote{BNA Transfer Pricing Report (1 November 2007) ("U.S. and Canadian officials have said the MOUs have been set aside, in part because the arbitration provision would obviate the need for them."); see also BNA Transfer Pricing Report (11 July 2007) (Director General of CRA’s International Tax Directorate, Fred O’Riordan, stated that with arbitration in the treaty, it “really does undercut the necessity to have the MOU for resolution of factual disputes…. I can see us moving away from the MOU and having the treaty there as an alternative.”); BNA Transfer Pricing Report (18 October 2007) (Commissioner of the IRS’s Large and Mid-Size Business Division, Frank Ng, stated that “We had a little bit of concern that if we were to pursue an MOU kind of environment and try to define what the application should be, we are really potentially restricting some of our discretion in resolving double tax.”).} We respectfully disagree and urge that this issue be revisited. The potential impact of significant
parts of the June 2005 MOU is quite different from any impact arbitration might have; the results of arbitration will be confidential and impact single cases, whereas the intent of the MOU was to provide specific and publicly available guidance on specific issues. Further, we believe the MOU process introduced in the December 2005 MOU would be an important parallel and immediately available process to resolve an element of difficulty in a MAP case that would not be similarly resolved through arbitration (which takes two years to access).

Indeed, the main problem set to be resolved by these MOUs was how to apply essentially the same rules, under different processes. Even with the advent of arbitration, a proper agreement between competent authorities on certain issues could help break the logjam of cases and leave only those peculiar or exceptional cases for arbitration. Arbitration is not the answer for many of the substantive issues discussed earlier, including whether to use the full or interquartile range, whether or not to markup costs associated with management services, and whether to use multiple-year or single year comparisons. We recommend that the MOUs be revisited and that both governments make representations that they are not “set aside” by the arbitration provision.

**Question 3: Are penalties in the transfer pricing area being assessed fairly? Are the penalties appropriate?**

We offer two comments with respect to this Question 3. First, we encourage CRA to involve taxpayers in the penalty determination process as early as possible, and to allow them to remain involved as the Penalty Review Committee reviews the case, for the same reasons addressed in section C of the response to Question 2 above; namely, CRA will reach a faster and more efficient resolution by including taxpayers in the process. Second, both CRA and the IRS should generally recognize that the countries have approximately the same effective tax rate, and taxpayers thus do not have an incentive to put income in one country over the other. Of course, unusual circumstances do occur where strategic tax planning could yield different results depending on the location of the investment, but suspicion of sheltering income and the attendant reassessment and penalties generally should not be first on the list.