TAX EXECUTIVES INSTITUTE (TEI) - CANADA REVENUE AGENCY (CRA)

LIAISON MEETING - DECEMBER 6, 2011

Question 1 - Follow-up Questions from Prior Years

a) International Tax Forms Simplification

In response to Question 6 of the 2009 liaison meeting agenda, CRA said that it was reviewing the scope and content of various forms, including Forms T1134A and B. In a follow-up question during the 2010 liaison meeting, CRA said that consultations with stakeholders about potential changes to the forms were continuing. We invite an update on the status of CRA's review and a discussion of potential revisions to various forms, especially Forms T1134A and B.

CRA Response

Forms T1134A and B have been reviewed by external and internal stakeholders. The forms are in the final stages and will be released soon.

Revisions to the Form T1134A include:

- The filing thresholds remain unchanged however the meaning of the term "gross receipts" has been clarified to include all receipts (such as loans), not just income amounts.

- Links to the official list of NAICS codes on the Statistics Canada website and the NR4 guide T4061 for the list of country codes. This eliminates the additional pages on the form.

- Functional currency: Similar to the T106, the T1134 forms include a single area on the front of the form with instructions in regards to the functional currency election.

- Actual amounts for the foreign affiliate's gross revenue are required instead of selecting a set revenue range.

Revisions to the Form T1134B include:

- Similar changes to Form T1134A;
- Part III, Section 3 (x), *FAPI under the description of C in the definition of FAPI in subsection 95(1) of the Act*, was deleted per the change in legislation; and
- Added lines under Part III, Section 5 related to subparagraphs 95(2)(a)(v) and 95(2)(a)(vi) per the change in legislation. (New subparagraph 95(2)(a)(v) relates to “excluded property” and 95(2)(a)(vi) relates to transactions involving currency and foreign exchange risks.)

b) Advisory Panel on Canada’s System of International Taxation: Large Corporations and Double Taxation Cases

Paragraph 7.24 of the *Report by the Advisory Panel on Canada’s System of International Taxation* states:

> Rules regarding tax prepayment or security and deficiency interest in transfer pricing cases should differ from the general rules applying to other tax cases because, in double taxation cases, tax has already been paid to another government in respect of that amount.

In Question 11 of the 2009 liaison meeting, TEI observed that CRA’s Legislative Policy and Regulatory Affairs branch was understood to be reviewing the Advisory Panel’s recommendations, including the requirement to prepay 50 percent of the disputed tax prior to seeking competent authority relief. In response, CRA said its working group’s deliberations were “ongoing.” In response to a follow-up question last year, CRA reported that its deliberations had not yet concluded.

Would CRA (i) update TEI on the working group’s status and its current thinking (especially about the requirement that large corporations prepay 50 percent of the disputed tax prior to seeking competent authority relief) and (ii) comment on CRA’s next steps in the evaluation of the administration of the current system of international taxation?

CRA Response

i) The OECD tax collection position as stated in its "Transfer Pricing Guidelines for Multinational Enterprises ("MNE") and Tax Administration" recommended that countries that do not have procedures to suspend collection during Mutual Agreement Procedure (MAP) negotiations are encouraged to adopt them where permitted by domestic law, although subject to the right to seek security as protection against possible default by the taxpayer.

The CRA in support of these OECD recommendations, and to the extent permitted by domestic law, adopted a policy to allow large corporations to provide acceptable security, in lieu of payment, when the Canadian based MNE sought the assistance of the Competent Authority for potential double taxation or taxation not in accordance to the Convention. The CRA's acceptance of security policy in this matter thereby removes the immediate payment obligation, potential refunding issues, and any significant economic and financial burden placed on MNE groups where part of the domestic adjustment resulted in a tax assessment that may have been paid previously in another jurisdiction. Additionally, by accepting security in lieu of the 50% payment requirement towards the Part I tax assessment associated with MAP cases, the CRA mitigates a portion (50%) of the revenue risk and protects the tax base from possible default by the MNE until the matter is finally determined.

ii) The CRA working group has done as much as it can do with each recommendation of the Transfer Pricing Subcommittee. The working group's next steps are to roll up and release its responses.

c) Partnership Returns

In Question 5(c) of the 2010 liaison meeting, TEI inquired whether CRA kept a log of return filings so that a partnership can obtain an acknowledgement of the fact of filing its return. CRA advised that it would "consider a paper notification process as part of the on-going development of Information Returns" in order to advise when a partnership return had been received and processed. We invite an update on the status of CRA's efforts to provide a notification process for partnership returns.

CRA Response

We are not currently pursuing a paper notification process to inform partnerships of the receipt of T5013 returns. Instead, we are working on an online solution through the MyBA portal that would allow partnerships to view the status of returns that have been filed. We won't have this process in place for the 2011 filing year, but we expect to have it in place for the 2012 filing year.

d) My Business Account

In response to Question 14 about "My Business Account" in the 2008 liaison meeting, CRA acknowledged that the system was designed with small business users in mind and that it was working on system enhancements for large businesses. In a follow-up meeting between representatives of CRA and TEI, a number of issues were discussed, including the need to balance proper authentication controls for users (including who within a corporate tax department should be able to access or view what information) with safeguards for the taxpayer and CRA (especially around transfers of funds among accounts); CRA said that making the system changes envisioned might require several years. TEI invites a discussion on the progress CRA has made in making "My Business Account" more usable by large file taxpayers.

CRA Response

Complementing the suite of information and services available within My Business Account, the CRA has expanded the flexibility and controls available to large businesses using our secure online services. Represent a Client, the portal for all third parties including employees of large businesses, has added tools to more easily manage the access of employees to information and services. These tools include the ability to manage the access of groups of employees without the need for new authorizations. Represent a Client has also extended the accountability and transparency of third party interactions with the CRA by enabling businesses to view the activities performed by third parties (including employees) on their behalf. We are confident these enhancements will meet the needs of large businesses and welcome your feedback.

This issue was previously identified by TEI in the 2008 Questionnaire and the CRA responded that it was premature to assess the scope of this request without TEI sharing stakeholder reports with the CRA. Further, consultations with representatives of TEI on February 28, 2011 allowed the CRA to identify gaps in service for several account concerns and begin evaluating potential solutions. Over the next year, the CRA is conducting a feasibility study from an account perspective of what type of complex account-level activities might suggest a need for additional service offerings. In this regard, it would be helpful to have a few key individuals from your organization meet with representatives of the Business Accounting Division to explore the account specific issues your stakeholders may have.

Background Information regarding CMS

The CRA is committed to enhancing the suite of secure electronic services available to Business, Individuals and Representatives (which includes employees of businesses). However, the security and protection of confidential tax information is one of the CRA's highest priorities when we offer electronic services. Currently, our electronic services allow business owners, individuals and authorized representatives to view detailed information on tax assessments, changing an income tax return or address, as well as viewing, modifying or deleting direct deposit information.

As these services are very sensitive in nature, we must adopt security technology and procedures that are appropriate for the services offered. Accordingly, CRA procedures for accessing our more secure services include establishing a user’s identity, including that of representatives, using existing CRA information.

Business owners, for instance, must identify themselves by providing their social insurance number, date of birth, postal code and the dollar amount of a specific tax line on their income tax return. In addition, they are mailed to their personal mailing address a CRA security code, which they must then enter when logging in for the first time. In the case of representatives, including employees of businesses, the CRA establishes their identity by asking them to provide the Access Code from their personal Notice of Assessment as well as their postal code.

It is important for the CRA to know the identity of all individuals accessing confidential information, even if it is on behalf of another taxpayer or business. By providing this information, the user is identifying them self as the one who will be accessing another individual's or businesses tax information online. Once this process is completed, the CRA provides representatives with a Rep ID which individuals or businesses use to authorize them to act on their behalf. It should be noted that the personal information provided by representatives to identify themselves with the CRA is not disclosed/linked to any individual or business that authorizes them to act on their behalf.

Question 2 - EFILE and Form T106

Taxpayers generally use certified software packages listed on the CRA website to prepare their corporate income tax returns. Such software generally permits data entry for Form T2 (*Corporation Income Tax Return*) as well as other schedules, annexes, and forms, including information and data in respect of Forms T106 (*Information Return of Non-Arm's Length Transactions with Non-Residents*). The EFILE section of the CRA website, however, does not alert taxpayers to the separate paper filing requirement for Forms T106. Indeed, the only website reference to separate paper filing requirements is the following statement:

> Inform your client that elections, designations, agreements, waivers, and special elective returns must be submitted on paper by the appropriate due date, as established in the *Income Tax Act.*

Form T106, however, is not an "election, designation, agreement, waiver or other special elective return."

Some companies that employed the EFILE option for their T2 returns have been assessed late filing penalties and interest on the grounds that Form T106, which was included with the electronically filed return, must be filed in paper format even where the taxpayer uses the EFILE option. The affected taxpayers have filed requests for relief arguing the penalties and interest were unfairly assessed since (1) electronic returns prepared with certified software were accepted as filed and (2) there are no EFILE website instructions alerting taxpayers to file Form T106 separately on paper. Without regard to how CRA will resolve pending requests for relief, we invite a discussion of the following issues:

a) Will CRA consider expanding the EFILE process to include Form T106 in order to eliminate the separate paper filing requirement? If so, when might the system be updated to permit this?

CRA Response

The ITD participates in the International Tax Data Working Group, which reports to the Assistant Commissioner of the Strategies and Integration Branch of CRA and the Assistant Deputy Minister of the Tax Policy Branch of the Department of Finance. The mandate of this working group is to examine and recommend ways to improve the reliability and utility of data obtained from international tax forms, taking into account the recommendations of the Subcommittee on International Tax Forms (established under the Advisory Panel on Canada's System of International Taxation). E-filing of foreign reporting forms is an avenue currently being studied by the working group however the Electronic and Print Media Directorate of the Public Affairs Branch of the CRA recently informed the working group that the e-filing initiative is not currently a top priority for the CRA because its main concern is making all forms available in alternate formats to comply with certain court decisions and recommendations from the Canadian Human Rights Commission. The working group will continue to explore e-filing possibilities for foreign reporting forms and make recommendations to executive management.

b) Will the EFILE process be expanded to facilitate electronic filing of other forms, such as Forms T1134A, T1134B, and T5013? Is there a timetable for facilitating electronic filing of such forms and eliminating paper filing?

CRA Response

The International Tax Data Working Group is studying e-filing possibilities for all foreign reporting forms. However, since additional e-filing initiatives have currently been halted by the CRA due to other priorities, no timetable has been established.

c) To minimize confusion about Form T106 filing requirements, will CRA update the electronic filing instructions on its website to clarify and confirm that Form T106 must be filed on paper even where EFILE is employed?

CRA Response

The Assessment and Benefit Services Branch is looking at adding some clarifications on the Corporate Internet Filing pages of our website as well as in the messaging included in T2 software packages.

Question 3 - Details of Part XIII Reassessments

Many taxpayers receive Part XIII tax reassessments as a consequence of Part 1 tax adjustments made by CRA's international tax directorate. The documentation CRA issues to the taxpayer, however, lacks detail making the account analysis and reconciliation of Part XIII tax difficult and time consuming. Unlike account statements issued by TSOs where account balances are segregated by taxation year, accounts coded "NR" lump all "non-current" year balances into a single "bucket." Does CRA plan to upgrade its accounting for "NR" accounts in order to mirror the detail provided for accounts coded "RC"? If not, how should taxpayers obtain the details underlying Part XIII reassessments?

CRA Response

As identified in the question, the assessment and reassessment of Non-Resident Part XIII Tax and of corporate Part I Tax are different as they contain different information.

For Part I Tax the assessment of tax on corporate accounts is carried out on a line by line basis (i.e. income, expenses, tax credits, etc.). When a reassessment is carried out on the account, the amounts originally assessed and the adjusted amounts are provided to the client for the specific tax years. For multiple tax year adjustments, multiple statements will be provided. The assessment or reassessment will also include the total amount owing to the Canada Revenue Agency (CRA).

For Non-Resident Part XIII Tax, assessment/ reassessment notices provide a notice containing the tax year for the assessment, the amount of tax previously owing, the amount of the current assessment (tax, penalty, and interest), the income type, and the tax rate. For reassessments, the original notice number of the assessment being reassessed is also included. There may be several tax assessments for the same taxation year as different types of income may be assessed at various rates, depending on the taxpayer's country of residence, however, only one tax year will be included on each assessment/reassessment. The notice will also have the taxpayer's balance owing. This includes the total of any previous balance and the amount of the current assessment.

Although there are no plans to upgrade the accounting for Non-Resident accounts to mirror the detail provided in the corporate accounts, this information is available if requested by the taxpayer.

Should a taxpayer require additional information regarding an assessment or reassessment, they may contact the International Tax Services Office, Non-Resident Withholding Division, by writing to PO Box 9769, Station T, Ottawa, Ontario, K1G 3Y4 or by telephone, toll-free, at 1-800-267-3395 (within Canada and the United States) or at 613-952-2344 from anywhere else. The fax number is 613-941-6905.

Question 4 – Functional Currency Reporting Rules

The technical notes to subsections 261(20) and (21) state that they are intended to prevent abuses of the functional currency tax reporting regime. At the May 2011 International Fiscal Association (IFA) Roundtable, CRA was asked to provide scenarios where it would apply the anti-avoidance rule in subsection 261(21). The facts of the example CRA provided were as follows:

1. Canadian dollar functional currency parent lends to US dollar functional currency subsidiary.
2. The loan is denominated in Canadian dollars.
3. On the repayment of the loan, the subsidiary incurs a foreign exchange loss.
4. The foreign exchange loss in the subsidiary is denied.

Why does CRA consider this scenario to be abusive and subject to the anti-avoidance rule? The impetus for a taxpayer to make a functional currency election for tax purposes is that Canadian generally accepted accounting principles may require a taxpayer to maintain one or more (but not all) of its corporate accounts in the foreign currency. By making the election, the taxpayer is endeavouring to save the time and expense of maintaining two sets of books of original entry for the affected accounts. We invite CRA to elaborate on its response at the IFA Roundtable.

CRA Response

Subsection 261(21) of the *Income Tax Act* (Canada) (the "Act") provides that fluctuations in the relative values of tax reporting currencies of related taxpayers are deemed not to have occurred when determining the income, gain or loss in respect of a transaction if the following conditions described in subsection 261(20) are satisfied:

1. The transaction was entered into, directly or indirectly, at any time by a taxpayer and a related corporation.

2. The taxpayer and the related corporation had different tax reporting currencies at any time during the period in which the income, gain or loss in respect of the transaction accrued (the "accrual period").

3. In the absence of subsections 261(20) and (21), it would be reasonable to consider that a fluctuation in the relative values of the respective tax reporting currencies of the taxpayer and the related corporation, which occurred during the accrual period, either increased the taxpayer's loss, reduced the taxpayer's income or gain, or caused the taxpayer to have a loss instead of income or gain in respect of the transaction.

Subsections 261(20) and (21) were enacted by section 80 of the *Budget Implementation Act, 2009*,[1] and apply in respect of taxation years commencing after June 27, 2008. The Department of Finance published Explanatory Notes relating to these provisions on November 10, 2008.[2] In addition to indicating that subsections 261(20) and (21) were intended to protect against potential abuses of the functional currency tax reporting regime, the Explanatory Notes include an example in which a foreign exchange loss arising on the repayment of an amount owing by a subsidiary to its parent corporation would, in effect, be disallowed by subsection 261(21) in computing the subsidiary's income.[3]

At the IFA Roundtable, we were asked to provide examples of situations in which the CRA would consider applying subsection 261(21). In response, we referred to the example contained in the Explanatory Notes. Further to this, we would add that

[1] S.C. 2009, c.2.

[2] Canada, Department of Finance, "Legislative Proposals and Explanatory Notes Relating to Functional Currency Tax Reporting" November 2008 [hereinafter the "Explanatory Notes"].

[3] *Ibid.* at 39.

subsection 261(21) applies whenever the conditions in paragraphs 261(20)(a), (b) and (c) are met.

Question 5 – Distributions from Foreign Corporations

At the May 2011 IFA roundtable CRA was also asked whether Technical Interpretation 2004-0060131I7 (October 21, 2004) continues to apply to distributions of share premium of a foreign affiliate. CRA confirmed its position in the interpretation and added that subsection 15(1) also applies to distributions. Under what circumstances will CRA apply subsection 15(1) to distributions of share premium? Assuming the August 19, 2011, foreign affiliate legislative provisions are enacted, would CRA still apply subsection 15(1) to distributions covered by the return of capital provisions?

CRA Response

In our view, the proper approach for determining the character of a distribution from a foreign corporation to a shareholder for Canadian tax purposes is the same two-step approach that is used for the classification of foreign entities for Canadian tax purposes as set out in ITTN #38. That is, the first step is to determine the characteristics of the distribution under foreign corporate law (not tax law), and then compare these characteristics with those of recognized categories of distributions under Canadian common law and corporate law in order to classify the distribution under one of those categories. This view is a slight change from the view that was expressed in document 2004-0060131I7 where we said that where the foreign corporate law specifies the character of a distribution, that characterization will generally be determinative for purposes of the Act.

However, the nature of a distribution under the foreign corporate law may contain nuances that do not exist in Canadian law. Therefore, as a practical matter, the CRA will adopt the following general guidelines:

- Where the distribution is a dividend or a return of legal capital under the foreign corporate law, that characterization will generally not be challenged by the CRA.

- Where the distribution is not a dividend or a return of legal capital under foreign corporate law, the distribution will be considered to be a dividend for purposes of the Act if it meets the basic common law requirements to be a dividend, such as being a pro rata distribution among shareholders of a particular class or series of shares.

- If the August 19, 2011 amendments are enacted as proposed, a pro-rata distribution after August 19, 2011 made by a foreign affiliate as described in new subsection 90(2) will be deemed to be a dividend. Taxpayers may also choose to apply a slightly modified version of new subsection 90(2) to a pro-rata distribution made by a foreign affiliate after February 27, 2004 and before August 20, 2011.

- Subsection 15(1) may apply if the distribution is not otherwise described above and is not one of the exceptions described in subsection 15(1).

Question 6 - Advance Pricing Agreement Program

The APA program is highly valued by taxpayers because it provides certainty about the taxation of intercompany transactions. We understand that there has been a marked decline in the rate of acceptance of applicants into the APA program by the Competent Authority Services Division. We invite CRA's comments on whether there has been a change in its policy on the availability of the APA Program or changes in the criteria for acceptance into the program.

CRA Response

In the past year (2010-11), only six applications were withdrawn at the pre-file stage. We do not capture and report on reasons for withdrawals but note that this could be the result of either a taxpayer's decision or in response to the CRA's request. Withdrawals at the pre-file stage are to be expected – the primary objective of the pre-file meeting is to provide an opportunity to both the taxpayer and the CRA to explore the suitability of the APA program based on taxpayer needs, its cooperation and the proposed covered transactions. However, some of the taxpayers who have withdrawn can re-submit their applications should they decide to proceed and agree to provide the information requested by the CRA.

The APA program is a discretionary administrative service available to taxpayers who desire future certainty for the tax treatment of transfer pricing of inter-company transactions with related enterprises. Unlike the Mutual Agreement Procedure (MAP) program, which is a right granted by the tax treaty and must be provided by the CRA, the APA program is a voluntary service provided by the CRA. Given the discretionary nature of the service, the CRA may not be able to accommodate all APA requests, as its ability to provide service is based on the availability of resources.

Drawing from our experience, it is prudent on our part to make an informed assessment of the potential for a successful resolution of an issue and to provide the necessary feedback before the taxpayer devotes substantial resources to the preparation of an APA submission and before the CRA commits its limited resources. Therefore, we have increased our due diligence prior to deciding to accept taxpayers into the APA program.

For the program to be successful, it requires unfettered cooperation of taxpayers and free flow of information. To use the existing resources more efficiently, the CRA is encouraging taxpayers at the pre-file stage to provide a more thorough explanation of their proposed transactions and corresponding transfer pricing methodologies in order for the CRA to evaluate their appropriateness.

For example, a taxpayer's submission must contain the rationale and support for the proposed transfer pricing methodology and the taxpayer must be open to the consideration of alternative methodologies and/or transactions. It is the CRA's practice to question any methodology or transaction where the rationale is lacking in the APA application.

Further, our increased due diligence at the pre-file stage includes asking for more information on certain types of transactions, including transactions involving intangibles, to make an informed decision about whether to accept or reject an APA request. We are providing more feedback during and after the pre-file meeting with the intention of helping taxpayers come up with a balanced and complete submission.

Lastly, we have recently confirmed, in response to queries from accounting and legal representatives, that the CRA will not accept business restructuring transactions or the valuation/ownership issues that result from a restructuring during or before the APA period. We have determined that business restructuring cases are not suitable for an APA as they do not cover recurring and unchanging transactions where the underlying assumptions that form the basis of an APA transfer pricing methodology do not change over the duration of both the immediate pre-APA period and the APA period itself. The CRA requires a certain stable cycle or period of time without a significant event in order to work an APA file. Without this stability we are unable to conduct a proper analysis.

In our view, the more rigorous screening of APA applications, including increased information requirements and the elimination of business restructuring and valuation/ownership issues, is a reasonable CRA response to increased taxpayer demand in the current environment of fiscal restraint and limited resources. It is also our view that such an approach is in line with the intent of the APA program as described in the CRA's Information Circular 94-4R *International Transfer Pricing: Advance Pricing Arrangements (APAs).*

Question 7 - Risk-Based Audit Approach

HM Revenue & Customs in the United Kingdom has published substantial guidance about its risk-based audit approach for large businesses.[4] The guidance affirms HMRC's publicly stated goal of having a large business framework produce a robust, externally auditable measure of the number of low-risk large business customers. To satisfy its goal HMRC has taken a number of steps, including:

- Publishing the criteria for risk evaluation;
- Asking for an independent review of the application of the criteria to ensure that they are being applied on a uniform basis across the large business taxpayer community;

[4] *See, e.g.*, http://www.hmrc.gov.uk/manuals/tcrmanual/index.htm.

- Sharing the results of the review with the large business taxpayer community, including the finding that criteria in the program were not applied consistently; and
- Remedying inconsistent application of the criteria.

Since CRA has also implemented a risk-based audit approach for large business taxpayers, we invite CRA's comments on the following questions:

i) Will CRA disclose the criteria used in evaluating the risk of a particular taxpayer, and, if so, supply that information to the taxpayer?

CRA Response

The CRA's Approach to Large Business Compliance (ALBC) discloses the criteria used in risk evaluating all taxpayers, namely:

The large business population is being risk assessed using several techniques, such as:

- Undertaking a historical analysis of audit results and a corresponding analysis of behavioural patterns;
- Regions examining every large business taxpayer in their TSOs and assessing their risk based on analysis and local knowledge;
- Effective Tax Rate analysis being developed and utilized to compare large business taxpayers with average rates within their industries;
- Issue based risk assessment is being conducted to determine whether taxpayers are participating in tax planning schemes; and
- Determining whether there are linkages between tax planning schemes and tax intermediary involvement.

Additionally, consideration is being given to a number of risk factors, such as:

- Audit History;
- Industry Sector Issues;
- Unusual and/or complex transactions;
- Corporate Structure;
- Major acquisitions and disposals;
- International transactions;
- Corporate Governance;
- Participation in aggressive tax planning; and
- Openness and transparency.

These factors will vary by taxpayer and the taxpayers will be advised as to the factors considered in their risk assessment when the ALBC approach is discussed, in the face to face meeting that the CRA will hold with them.

ii) Will CRA identify which of its personnel are involved in a particular taxpayer's risk evaluation? For example, in addition to personnel from the local TSO are others from regional offices or headquarters involved in the risk-evaluation process for specific cases? When will taxpayers be informed of the identity of all the CRA individuals making the risk-assessment?

CRA Response

The ALBC is based on a comprehensive risk assessment involving all the areas within the International and Large Business Directorate (Domestic, International and Aggressive Tax Planning, Industry Specialist services, etc.). The CRA plans to hold face to face meetings with all the large business taxpayers over the 5-year phase-in period of ALBC. The Large File Case Managers (LFCM) are responsible for managing all aspects of the Large Business, including the taxpayers risk assessment. The composition of CRA representatives in the meeting will be dependent upon the nature and extent of risks identified and may include all or some of the individuals involved in the overall risk assessment process.

iii) Will CRA share the outcome of the risk-based evaluation with specific taxpayers? Does CRA have any reports or statistics compiling and reporting how many taxpayers have been advised of the outcome of their evaluation?

CRA Response

The CRA plans to hold face to face meetings with all the large business taxpayers. The objectives of these meetings are:

- To provide the taxpayer with an overview of the ALBC;
- To discuss the ILBD's migration to a risk based approach;
- To fully discuss the taxpayer's tax risk management and corporate governance principles related to tax strategies and decisions;
- To discuss the taxpayer's risk issues;
- To inform the taxpayer of the correlation between the risk issues identified and the planned compliance approach;
- To discuss the potential for the development of an enhanced relationship with the large business taxpayer;
- To provide an opportunity for the taxpayer to share their views on the ALBC; and
- To heighten the ILBD's awareness of any issues that could impede compliance.

At the conclusion of the meeting the LFCM will document the details of the meetings using a specifically designed template. This information will be submitted to CRA Headquarters.

iv) Is CRA implementing a process to ensure consistent application of its criteria across all large business audit teams, TSOs, and, to the extent they are involved, Headquarters personnel?

CRA Response

The comprehensive risk assessment of the large business population is completed using the National Risk Assessment Model (NRAM). The NRAM criteria were developed through a consultative process involving the Regions/TSOs and Headquarters. Risk assessments are completed on an annual basis. The summary of all large business risk assessments are submitted to Headquarters in August and are reviewed by Headquarter personnel. Headquarters personnel also meet annually with the Regions/TSOs to discuss the risk assessment process, and to ensure the consistency of the application of its criteria and for all files nationally. Feedback from the face to face meetings held with large business taxpayers during that phase and any changes required to NRAM or the ALBC are also discussed.

v) Will CRA conduct a post-evaluation review of the consistency of the application of the criteria for its program?

CRA Response

The CRA is undertaking a detailed analysis to determine if there is a correlation between the risk rating assigned to a file and the actual results of that audit. This analysis will continue throughout the ALBC phases to ensure the consistency of the application of the criteria for the program.

vi) Is CRA considering any steps to improve the transparency of the program to taxpayers?

CRA Response

The CRA conducted several meetings with accounting firms, industry associations and other large business representatives prior to the implementation of ALBC. The CRA will be meeting with all large business taxpayers over the next 4-5 years, which will substantially enhance the transparency of the approach. We are also giving consideration to creating an ALBC Website to provide taxpayers with information about the approach.

8. Tax Earned by Auditor (TEBA)

Organizational behaviour theory posits that the behaviour of individuals and groups is strongly influenced by the metrics used to measure performance. In other words, “you get what you measure.” TEBA is a metric used by CRA to evaluate and allocate audit resources to individual Tax Services Offices (TSOs). TEI questions whether TEBA is an appropriate metric to motivate auditors and TSOs to perform in the best interests of the Agency.

We invite CRA's views on its use of TEBA.

CRA Response:

Tax Earned By Audit – TEBA, is only one component of the overall measurement framework used to evaluate taxpayers' compliance rate, as well as the performance of the Audit program in the Agency. No individual quotas are assigned to any auditor.

Auditors are instructed to use a risk-based approach to identify current and emerging compliance risks and issues; based on which tax returns and cases are selected for audit. Our approach in the Large Business compliance area involves establishing collaborative/cooperative relationships with taxpayers so that compliance issues can be identified and resolved as early as possible in the audit process, thereby efficiencies for all parties involved may be realized.

Question 9 – Advance Deposit Accounts

a) Transfers to Payroll Accounts

In large corporations with multiple payroll processing and disbursement centres and multiple tax accounts across the country, unintentional mistakes in payroll tax remittances can occur for a variety of reasons. In such cases, the application of advance deposit amounts to payroll tax obligations to mitigate penalties would be beneficial.

In its Fact Sheet on *Making and Managing Advance Deposits,*[5] CRA states that an advance deposit on reassessments may be transferred and used as a remittance on a payroll account. In addition, the response to question 6 of the Question and Answers of the publication reiterates that taxpayers may transfer an advance deposit as a remittance on a payroll account.

While some TSOs routinely permit transfers from the advance deposit account and do not assess a penalty for the late remittance where such an amount is used to satisfy a payroll tax obligation, TEI members report that at least one TSO requires a written request for the transfer of the advance deposit *before* the due date of the payroll remittance. By imposing such a requirement, the TSO is effectively vitiating the relief the advance deposit mechanism is intended to afford to taxpayers. Since CRA has the funds in the advance deposit account, a written request before the payroll deposit due date should not be required. Would CRA please clarify the procedure for transfers of advance deposits to payroll accounts?

CRA Response

Thank you for bringing this situation to our attention. This type of feedback is helpful to the CRA as we are continuously looking for ways to improve our services.

[5] Available at http://www.cra-arc.gc.ca/whtsnw/tms/dvncdpsts-fs-eng.html.

If a taxpayer wishes to transfer an advance deposit to their payroll account, the request should be sent to the attention of Business Accounting at the responsible Tax Centre (TC). The TC staff would be glad to help you out in this regard. These procedures will be clarified with the TCs and TSOs to ensure they are being followed correctly.

Alternatively, a taxpayer or authorized representative may make a request through the MyBA portal, via the "Make Online Requests" tab in order to transfer credits to their payroll account. It should be noted that this functionality is also available for transfers from the GST/HST to Corporate Tax and vice versa.

b) Advance Deposits Must Be Assigned to a Specific Tax Year

As discussed in connection with Question 13 during last year's liaison meeting, TEI believes CRA's current approach to the administration of advance deposits and prepayments for tax reassessments is cumbersome. With the recently enacted reduction in the interest rates paid on refunds, would CRA reconsider its administrative requirement that taxpayers allocate prepayments to specific tax years, revert to its prior process of holding taxpayer funds in an undesignated account as of the effective interest date, and apply the funds when and as reassessments are made? Properly administered, the advance deposit mechanism protects corporate taxpayers from onerous, non-deductible interest charges on deficiencies. By reducing the after-tax cost of settling disputes, the mechanism also reduces the scope and degree of controversies between CRA and taxpayers.

CRA Response

The CRA met with representatives of TEI on February 28, 2011 to discuss the requirements to maintain the advance deposit allocation process.

The CRA administers advance deposits in accordance with the *Income Tax Act* (ITA), the *Income Tax Regulations*, and in the spirit of promoting voluntary tax compliance and self-assessment.

Despite the legislated refund interest rate change for corporate taxpayers, there is still a need to manage advance deposits in a consistent and prudent manner. The administrative process allows all businesses (including unincorporated ones) to deposit funds to protect themselves from interest costs resulting from a reassessment. The Auditor General, in her spring 2009 report, recommended the Agency should:

> …*develop and consistently apply a robust administrative policy framework for managing advance deposits,* and *analyze the likelihood of future reassessment and calculate future interest expense for accounts with advance deposits.*

In light of the Auditor General recommendations, the Agency revisited its administrative policy framework for managing advance deposits with a view to strengthening it, particularly as it relates to potential refunds and interest expenses. The existing administrative process encourages one on one discussions between each taxpayer and our Audit and Business Accounting staff. This dialogue ensures that taxpayers do not pay interest unnecessarily, that the CRA fully consults with taxpayers so that they understand their potential for reassessment and that taxpayers do not leave funds on deposit needlessly.

c) Lack of Documentation regarding Related Party Transfer Guidelines

While CRA has provided guidelines for transferring advance deposits between different years and different types of accounts (*e.g.*, between an income tax account and a GST/HST account) there is no guidance on transferring amounts between related entities in large corporations. Previously, related party transfers were permitted. Would CRA confirm whether transfers are permitted among related parties in a corporate group? In addition, would CRA confirm that the transfers are permitted between corporate entities and partnership entities?

CRA Response

Transfers within the same account or between related accounts of a corporation will be completed based on the following guidelines:

- Only an authorized officer/representative of the corporation can ask for a transfer of installment payments;
- Payments are to be applied to specific tax years;
- A taxpayer can transfer funds between tax years in the same account or to another account to pay an existing balance or required installments. A taxpayer can also remit on an employer account;
- A taxpayer can transfer either part of a payment or an amount made up of several payments;
- A taxpayer can ask for more than one transfer during the year; and
- A taxpayer cannot transfer a payment after we have assessed the income tax return for the tax year in question.

These guidelines relate to a single corporate entity.

In reference to the second part of the question of whether transfers are permitted, the CRA would like to meet with a TEI representative to clarify under what circumstance transfers would be requested between corporate entities and partnerships.

d) Automatic Settlement of Offsetting Tax Liabilities by CRA

CRA will occasionally, without consulting with the affected entities or taxpayer, transfer tax deposits intended to cover a particular tax year or tax type to offset other unpaid tax liabilities from other years or tax types. Thus, the unilateral transfers are between different tax years of the same tax types as well as different types of tax accounts (*e.g.*, between an income tax account and a GST/HST account). Often, the application of the deposit by CRA is not the course of action the entity would prefer. As important, once the action is discovered, it is difficult for the entity to track and reconcile its accounts to make corrections. Where there is no credit or collection risk (*e.g.*, in respect of large corporate groups), would CRA consider instituting a process check to cease automatic transfers to settle offsetting tax liabilities of large corporations?

CRA Response

The CRA is obligated to comply with the legislative provisions in the Income Tax Act (ITA) and the Excise Tax Act (ETA). Advance deposits that have been applied to a specific tax year are not subject to the allocation offset process. However, available credits will be allocated/offset in the following order: to an existing debt on the account, to an existing debt in the division (e.g. RT) and then to existing debts on other revenue lines for the Business Number.

A system change was made in 2009 to remove the account details for transfers from the outputs (Statement of Interim Payments and Statement of Arrears) if the Business Number that the credit was transferred to differed from the originating Business Number account. These transfers are simply reflected as a “Transfer” on the outputs.

The CRA continues to provide details about transfers that are within the same Business Number.

Question 10 - Transfer Pricing (1)

Michael Danilack, Deputy Commissioner (International), Large Business & International, of the Internal Revenue Service made remarks during TEI’s *61st Midyear Conference* in Washington, D.C. (April 5, 2011) in respect of transfer pricing and competent authority negotiations that we believe are apropos to Canada.[6] Specifically, CRA auditors

[6] Mr. Danilack said:

> I suggest that [Article 9 of the OECD Model Tax Convention can] also be read to mean that, if the taxpayer has, in good faith, completed a sound analysis to establish an arm’s length result under accepted transfer pricing principles and fully documented that effort in both countries, and if it’s apparent from the situation, and from all the evidence, that the taxpayer has not misused transfer pricing to reduce its overall tax burden, then the treaty should limit the ability of either contracting state to make an adjustment.
>
> I put forward this proposition because, as we all know, it’s relatively easy to challenge any transfer price or expense allocation simply by invoking a different comparable set, applying a different methodology, or pointing to extraneous factual considerations. If reallocation were permissible in any case in which two enterprises are related or controlled, then virtually every cross-border reporting position would be subject to proposed reallocation and presentation to [competent authority] for resolution. In other words, just because a decent examiner or economist can dive into a case and come up with a different set of numbers in a country’s favor shouldn’t mean that the adjustment is permitted under the treaty and should be presented to the other country for correlative adjustment. To prevent this from happening, I think it’s important for the adjusting country to show that, in fact, there are conditions made or imposed between the enterprises differing from those which would be made between independent enterprises and that those conditions involved mispricing to gain a tax advantage.

commonly assert transfer pricing positions that differ from those of the taxpayer because, as Mr. Danilack notes, it is easy to do so by simply "invoking a different comparable set, applying a different methodology, or pointing to extraneous factual considerations." The ability of auditors to make adjustments "because they can," however, frustrates taxpayers and is contrary to the underlying premise of a self-assessment system.

Since many Canadian transfer pricing disputes involving a U.S. counterpart will be referred to Competent Authority and if unresolved within a two-year timeframe be subject to the arbitration provisions of the Canada-U.S. Tax Treaty, it would be more efficient for the government and taxpayers to minimize transfer pricing reassessments, especially where the taxpayer has a well-documented transfer pricing analysis. Would CRA consider working with the IRS to develop a coordinated approach to transfer pricing audits that minimizes transfer pricing reassessments based on differing assumptions, especially where the taxpayer has not attempted to use transfer pricing to reduce its overall tax liabilities and has fully documented its analysis in establishing arm's length pricing with its related U.S. entities? We invite CRA's comments.

CRA Response

The CRA has the responsibility of protecting Canada's federal and provincial tax base by ensuring compliance with its domestic and treaty legislation. Thus compliance initiatives are an essential part of a functional self-assessment system, and the CRA intends on maintaining its compliance activities.

As a member of the OECD, Canada endorses the OECD Transfer Pricing Guidelines and the arm's length principle in the application of its transfer pricing legislation. The CRA is of the opinion that the proposed approach would be at odds with the arm's length principle and should not be considered. Further, in the context of Canada's high level of inbound transactions, such an approach would risk eroding Canada's federal and provincial tax bases.

The determination of arm's length prices and allocations is a fact-based process. The fact that a multi-national enterprise (MNE) has documented its analysis of arm's length prices and has not attempted to reduce its overall tax liability is not proper assurance that all

Further, I'll point out that, in the competent authority process, the adjusting country has the burden of proof in this regard. First, paragraph 2 of Article 9 makes clear that the specific conditions supporting the reallocation must distinguish the case from a situation in which those conditions don't exist. In addition, the OECD commentary on paragraph 2 of Article 9 makes clear that the country from which relief is requested is required to provide correlative relief only if it determines the adjustment is justified, both in terms of principle and in terms of the amount . . . .

If the taxpayer has conducted a strong analysis to establish arm's length results under accepted principles and fully documented that effort in both countries, and if it's apparent from the situation that the taxpayer hasn't misused transfer pricing to reduce its overall tax burden, then the treaty should operate to limit the ability of either contracting state to make an adjustment. Personally, I believe this concept is critical to ensuring that both taxpayers and competent authorities are not overwhelmed with proposed adjustments triggered by nothing more than common ownership and some of the subtleties that can lead to pointy-headed debates when applying the arm's length standard.

facts and circumstances have been considered and that income has been adequately allocated between jurisdictions. Nevertheless, the fact that a reassessment is raised as a result of transfer pricing adjustments does not indicate that the CRA believes that a taxpayer has deliberately manipulated its taxes.

The CRA understands concerns where amounts subject to reassessments are not material however acceptance of materiality is understandably different from the perspective of a Canadian taxpayer compared to a much larger US company.

In order to increase efficiency of transfer pricing audits, the CRA stresses the importance of a risk-based approach to file selection, proper assessment of facts and circumstances relevant to OECD comparability factors, well supported and documented audit files, and assessments that respect the arm's length principle. Efficiency may also be gained if information required to perform a proper review of a taxpayer's facts and circumstances were available on a timely basis, thus allowing international tax auditors to make timely conclusions. Documentation exchanges through exchange of information services and simultaneous or joint audit efforts would also lead to increased efficiency.

The issues raised in this question may also be raised with the OECD Working Party No. 6 at the Annual Meeting on Transfer Pricing of the Global Forum on Treaties and Transfer Pricing or through its project on the administrative aspects of transfer pricing.

Question 11 - Transfer Pricing (2)

a) Application of Arm's Length Transfer Prices Established through Competent Authority or an APA to Similar Transactions with Non-Treaty Countries

Taxpayers often have transactions with multiple, related, non-resident companies where the nature of the transactions and the applicable transfer-pricing methodology are identical. Would CRA be willing to apply the approach (or results) achieved in a negotiated Competent Authority agreement between treaty countries to all identical transactions, even for transactions with non-treaty countries? Using the same approach for identical transactions would be more efficient for taxpayers and government and ensure consistent treatment of transactions.

CRA Response

Competent Authority settlements under the Mutual Agreement Procedure (MAP), including bilateral or multilateral advance pricing arrangements, are not precedent setting. That is, they are settlements entered into for the purpose of relieving double taxation or taxation that is not in accordance with a treaty in respect of (a) particular taxpayer(s), particular taxation year(s) and particular transaction(s). Furthermore, terms of individual treaties vary and may not all apply equally; therefore, similar transactions between residents of different treaty-partner countries may end up with a different resolution under the MAP process.

b) International Tax Directorate Economists

In international audits of large corporations in Canada, a team from CRA's International Tax Directorate (ITD) is often assigned to the file in support of the local auditor's review. Two trends have developed, however, that are disconcerting to taxpayers.

First, when taxpayers inquire why they have received inapt or overbroad requests for information, the local auditor's response often is that the ITD is directing the audit from Ottawa.

Second, when a transfer pricing adjustment is raised and the taxpayer applies to Competent Authority for relief, the economist from ITD who wrote the report in support of the adjustment is often brought into the Competent Authority proceeding to assist in resolving the MAP case. Similarly, the economist that assisted in a field audit may also be an advisor to Competent Authority in respect of an APA case.

i) In respect of the first trend, would CRA develop audit guidelines to ensure the efficient use of limited taxpayer resources and curb the issuance of overbroad Information Requests that, for example, require production of "all documents ever produced"? In many cases, a taxpayer could never reasonably comply with such a request whether voluntarily or under a court order.

CRA Response

When auditors come up against complex issues and require assistance, they can avail themselves of the ITD's International Advisory Services. These Headquarters-based teams are available to provide advice and assistance on the proper conduct of an audit of international tax issues. However the ITD has different methods to ensure that the right questions are being asked of the right parties and that verification of taxpayers' positions can be done as quickly and efficiently as possible, while ensuring a thorough review is done. An example of this is the policy on mandatory referrals to the ITD of files with certain characteristics, which has been in place for about one year now. This policy requires that files involving intangibles, involving proposed reassessments on years that are or will be time barred by treaty, or involving cost contribution arrangements are to be referred to Headquarters.

The ITD has also established a program with the Department of Justice to ensure timely access to lawyers during the conduct of the audit so that taxpayers are not faced with requirements or other legal processes that may be improperly drafted and therefore wasteful for all parties. The ITD's advice to auditors in transfer pricing files typically is that the proper documentation must be collected in order to properly verify the tax position taken. When auditors examine the books and records and want to verify an entry, they do not just look at the entry. They look at the manner in which the entry was derived and all of the data that resulted in it. It is the same for a transfer pricing audit. Information on the transactions, the parties thereto, the functions performed, taking account the assets used and the risks assumed by each of the parties, the business context of the transaction, and how it is expected to generate value are among the information that is required to verify a transfer price. The ITD's advice is to gather and analyze this information as efficiently as possible.

ii) With respect to the second trend, taxpayers believe that having the same ITD economist participate in both the field audit and the MAP (or APA) case is a conflict of interest comparable to assigning the field auditor who reassessed a taxpayer to the appeal of issues identified in a taxpayer's Notice of Objections. Will CRA consider staffing the Competent Authority proceeding with an economist who is independent from the audit team?

CRA Response

The Competent Authority Services Division (CASD) has always staffed its APA program with its own economists. However, recently, in order to meet the demand of growing APA inventory, the CASD has borrowed some economists from the International Tax Division (ITD). In addition, it has started using the services of ITD senior economists on APA cases based on their availability. Given limited economist staff available to the CRA, it is efficient for CASD to use ITD economists on APA cases and we would point out that the coincidence of an economist working on both an audit and APA for the same taxpayer is extremely rare. When it does occur, the ITD economist has had an opportunity to learn a great deal about taxpayer's transactions and is available to assist CASD to arrive at a reasonable position for negotiation.

It is important to note that the economist's job is to provide an unbiased transfer pricing analysis of a transaction solely based on the facts and circumstances applying the arm's length principle, whether the analysis is related to audit or APA. It is also important to note that APA positions are developed under the guidance of CASD's Chief Economist and hence the positions are developed to accord with CASD's mandate to resolve double taxation. Given CASD's mandate under the treaty and the rarity of the same economist working on the file at both the audit and APA stages, the potential for conflict of interest in using the ITD economists' services on APA cases should be either a non-existent or acceptable risk when balanced against the effective use of CRA's economic resources.

CASD does not use ITD economists' services on MAP cases. If an ITD economist has completed an analysis for an international transfer pricing audit that presents as a MAP case, CASD may ask for details of the economic analysis from the ITD economist. The purpose of the discussion is to understand the basis and rationale of the analysis which assists CASD to arrive at a position for the case. The CASD analyst is solely responsible for preparing the MAP position paper. Any additional economic analysis, if required, is done by a CASD economist.

c) Non-resident Withholding Tax related to Transfer Pricing Adjustments

After CRA issues a transfer pricing reassessment under section 247 a secondary adjustment is typically made pursuant to paragraph 214(3)(a) for an amount considered to be a benefit — a deemed dividend — paid by a corporation resident in Canada to its "ultimate shareholder." Subsection 212(2) of Part XIII is then applied to tax the deemed dividend at a rate of 25 percent, subject to reduction under an applicable treaty with the non-resident's country. Once CRA reassesses the Part XIII tax amount, there is seemingly no provision under the Act permitting a taxpayer to defer payment or to pay any amount less than the full amount of tax plus interest.

Where a taxpayer is successful in obtaining a reduction in the transfer pricing adjustment (whether at Appeals or Competent Authority), a corresponding reduction in the proposed Part XIII tax will result.

i) Would CRA consider deferring its reassessment of the Part XIII amounts until the underlying transfer pricing issue is resolved? Such a delay would permit the final amount of Part XIII tax liability to be determined before the taxpayer is required to pay that tax.

ii) Alternatively, would CRA consider applying collection rules similar to subsection 225.1(7) to Part XIII tax so that the amount of Part XIII payable by a taxpayer during the pendency of an Appeal or Competent Authority proceedings is limited to 50 percent of the tax amount?

CRA Response

i) The CRA has considered deferring the assessment of Part XIII tax resulting from a transfer pricing adjustment and concluded that such an approach is not advisable.

The performing of a review, raising of an assessment or directing that one be done falls within Audit's mandate while the mandate of Appeals and Competent Authority is to provide relief, if warranted, from actions taken by Audit. Thus, it is Audit's duty to raise all applicable assessments based on the facts before it, in accordance with the *Income Tax Act.* These assessments crystallize the taxpayer's obligation to make payment (or provide appropriate security), raise the issues, and define the issues for consideration by Appeals or Competent Authority.

Upon receiving a (re)assessment on a transfer pricing issue, a taxpayer has a number of options: do nothing, make a competent authority request, and/or file an objection and possibly an appeal to the courts. Audit has no way of knowing at the conclusion of an audit which course of action will be pursued, or where or how the case will eventually be resolved. Moreover, if a taxpayer decides to proceed with an objection or an appeal, by the time the associated transfer pricing issue is resolved, the CRA could be barred from raising a Part XIII assessment not by the *Income Tax Act* but by the time limitations in the applicable tax treaty. Canada has over 80 tax treaties with varying rules regarding time limits. For example, the MAP Article in the Canada-Switzerland tax treaty states that "[a] Contracting State shall not,… after six years from the end of the taxable period in which the income concerned has accrued, increase the tax base of a resident of either of the Contracting States by including therein items of income which have also been charged to tax in the other Contracting State." It would be difficult to develop and administer transfer pricing agreements for the assessment of Part XIII tax that takes into consideration the varying rules in Canada’s treaties. In this respect, we are concerned that the administration of transfer pricing could become cumbersome and inefficient and could lead to the loss of Part XIII tax revenues.

ii) With regard to Part XIII (Non-Resident Withholding Tax) amounts, which typically represents a secondary adjustment and assessment related to a transfer pricing reassessment, the withholding provisions do not contain any collection restrictions and are payable forthwith.

However, Part XIII collection policy has also been adopted and applied by CRA in recognition of the OECD guidelines on Transfer Pricing by allowing MNE’s to post acceptable security in lieu of the 100% payment as required by the *Income Tax Act*.

The Part XIII security policy position has been adopted to mitigate the risk of default but also to provide financial flexibility to MNE’s when repatriation terms under a MAP settlement are being considered. In practice, once the repatriation of MNE’s income has been satisfied under a MAP agreement, the Part XIII assessment is typically reversed, and the security provided is released.

Recognizing that CRA's large corporation Part I and Part XIII collection policy is consistent with related OECD guidelines and prudent fiscal policy, the recommendation to introduce any legislative rules that would alter this policy position is not supported by CRA.

However, to address recommendation (6) by the Transfer Pricing Subcommittee and to clarify Part I and Part XIII collection policy and practices concerning transfer pricing MAP proceedings, *Information Circular* 71-17R5 will be amended when revisions are being considered to reflect the collection policy that security in lieu of 100% payment is acceptable.

With respect to the suggestion that the Part XIII payment obligation be reduced to 50% instead of 100% during MAP proceedings, we would simply note that the CRA has no legislative basis for reducing the payment obligation and, for the reasons discussed above, we are not supportive of this approach.

Question 12 - 2010 OECD Transfer Pricing Guidelines

In July 2010 the OECD Council approved revisions to Parts I-III of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.* TEI invites CRA comments on the following aspects of the revised OECD transfer pricing guidelines (TPG):

a) “Most Appropriate” Method

The 2010 TPG move away from the strict hierarchy of methods set forth in the 1995 Guidelines in favour of selecting the “most appropriate method.” Paragraph 2.2 of the 2010 Guidelines explains that —

> the selection process should take account of the respective strengths and weaknesses of the OECD recognised methods; the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis; the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods; and the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them.

Paragraph 2.3 of the 2010 TPG states that, in circumstances where a traditional method and a transactional profit method can be applied in an equally reliable manner, the traditional method is preferred. What is CRA’s view of the 2010 TPG with its de-emphasis of the hierarchy of methods vis-à-vis the stricter approach of the 1995 Guidelines? Does CRA accept the 2010 TPG’s de-emphasis of the hierarchy of methods?

CRA Response

The 2010 Transfer Pricing Guidelines essentially suggest that there is no strict hierarchy to be applied to the selection of a transfer pricing method. Rather the focus should be on the quality of the data that is available and, consequently, what will be the most appropriate method. At the same time the Guidelines continue to suggest that there exists a natural hierarchy to the methods, as referred to in paragraph 2.3. The CRA agrees that the focus of determining the method to use should be the method that will provide the most direct view of arm’s length behaviour and pricing. Information Circular 87-2R states that a natural hierarchy exists in the methods. Both Information Circular 87-2R and paragraph 2.3 of the 2010 Transfer Pricing Guidelines state that the traditional transaction methods (e.g. CUP) are preferred over a transactional profit method. For the CRA, it is not so much a de-emphasis on the hierarchy as a re-focusing on what is truly relevant: the degree of comparability available under each of the methods and the availability as well as reliability of the data.

b) Tested Party — Data Segmentation

Paragraph 2.78 of the 2010 TPG provides commentary about using an “appropriate level of segmentation of a taxpayer’s financial data” when determining or testing the net profit from controlled transactions of the tested party. The 2010 TPG are more direct about the need to use data segmentation rather than company-wide data for testing net profit from a controlled transaction. What is CRA’s view about using data segmentation approach for the tested party? Does CRA accept that data segmentation is more appropriate when available?

CRA Response

This is not a change in the guidance. The Guidelines have long stated that transfer pricing should be conducted on a transactional basis. This clearly requires transaction level data wherever possible. Where reliably available data is available at a transactional level it will provide a more direct view of arm's length behaviour and pricing than using a more aggregated level of data.

c) Statistical Tools

Paragraph 3.57 of the 2010 TPG states:

> It may also be the case that, while every effort has been made to exclude points that have a lesser degree of comparability, what is arrived at is a range of figures for which it is considered, given the process used for selecting comparables and limitations in information available on comparables, that some comparability defects remain that cannot be identified and/or quantified, and are therefore not adjusted. In such cases, if the range includes a sizeable number of observations, statistical tools that take account of central tendency to narrow the range (e.g. the interquartile range or other percentiles) might help to enhance the reliability of the analysis.

What is CRA's view about the use of statistical tools to enhance the reliability of a comparability analysis?

CRA Response

The CRA view is that the use of statistical measures, such as an inter-quartile range, does not necessarily enhance the reliability of the comparable data considered in producing a range because they do not relate to comparability. The CRA does not endorse the use of statistical measures which are commonly used in the application of the transactional net margin method (TNMM). Instead, the CRA relies on the facts and circumstances of the case to determine a range, or the particular point in a range, that is the most reliable estimate of an arm's length price or allocation.

d) General View of the 2010 OECD TPG

Does CRA subscribe fully to the 2010 version of the TPG or does CRA object to or have reservations about any of the guidelines or commentary in the 2010 TPG? What is CRA's position in respect of the guidelines or commentary to which it objects or has reservations about applying?

CRA Response

The TPG is a consensus document that is developed by participating countries in Working Party 6 at the OECD. No objections or reservations can be placed on the TPG.

The 2010 changes to the TPG represent the Committee on Fiscal Affairs' continuing work in transfer pricing to reflect the experience gained. The OECD encourages countries to follow the 2010 version of the TPG when reviewing transfer pricing and encourages taxpayers to follow the 2010 version of the TPG in evaluating whether their transfer pricing complies with the arm's length principle.

The CRA endorses the application of the arm's length principle and the 2010 version of the TPG for the administration of the *Income Tax Act* in transfer pricing matters.

Question 13 - Publications

During the 2009 liaison meeting CRA discussed its plan to update its guidance, including Interpretations Bulletins (ITs) and Information Circulars (ICs). CRA's goal was to update 12 bulletins in 2010. More recently, CRA requested that stakeholders submit recommendations of critical and high priority ITs and ICs that should be revised. TEI was pleased to provide its recommendations in a letter submitted August 29, 2011. We invite CRA to provide a status report on its ongoing efforts to update its ITs and ICs. Has CRA developed a priority list of critical and high priority updates and can it share the list? If additional resources are necessary for this endeavor, has CRA secured them?

CRA Response

Being able to consult an authoritative source of technical tax information and the CRA's interpretation of the legislation it administers is of unquestionable benefit to taxpayers, their advisors and CRA staff. In recognition of this, the Income Tax Rulings Directorate has undertaken to review and improve the income tax technical publications product.

There are two main aspects to this initiative: format and content

Format

From a format perspective, several improvements will be made. Related information will be consolidated into more comprehensive publications. Furthermore, as an exclusively electronic publication, the resulting product will capitalize on the advantages offered by the internet, such as by including links to statutory references, jurisprudence and related publications. In light of this significant make-over, the product will be re-branded. Each updated technical income tax publication will be known as an "*Income Tax Folio*". Each *Folio* will be published on an "as completed basis." At the same time, the Bulletin or Bulletins that a *Folio* replaces will be cancelled.

Content

Accuracy of published tax information is obviously a priority. Although much of the information contained in the 272 active Interpretation Bulletins is out of date, it is impossible to update 272 Bulletins all at once. The process is expected to take a number of years. Necessity and practicality suggest that the initial focus be on the topics that are the most important to our various stakeholders. To make this determination, a number of indicators were considered. We checked the number of hits each Bulletin received over the past several years on the CRA website. We also gathered similar data from the various commercial tax publishers. Officials at numerous areas within the CRA as well as members of tax professionals' organizations in the private sector were consulted. All of this feedback and data permitted the identification of Bulletins to be reviewed and updated in the first several phases.

Among the publications that emerged as the most in demand were those related to:

- the medical expense tax credit,
- education and tuition tax credits, along with scholarships and bursaries,
- interest deductibility,
- foreign exchange gains and losses,
- legal and accounting fees,
- health and welfare trusts,
- determining residency,
- residence of a trust,
- employee stock options, and
- damages & settlements.

Among the publications that were identified as being in the next level of priority were those related to:

- principal residence,
- eligible capital expenditures,
- foreign tax credit,
- CCA,
- losses of a corporation,
- meaning of the term "corporation",
- support payments,
- retiring allowances, and
- amalgamation of Canadian corporations.

This initiative is a challenging one on many levels. But with the planned enhancements and a revised process for updating technical content, we are confident that the effort is well worth it. *Income Tax Folios* will be a valuable resource for years to come.

Question 14 - Section 79.1 Seizure of Property — Effect on Creditor

Section 79.1 applies when a property is seized at any time by a person in respect of a debt. Under subsection 79.1(2) "a property is seized at any time by a person in respect of a debt where (a) the beneficial ownership of the property is acquired or reacquired at that time by the person; and (b) the acquisition or reacquisition of the property is in consequence of another person's failure to pay to the person all or part of the specified amount of the debt." We invite CRA's reactions to the following issues about seizures.

Question 14.1

In TEI's view, where a creditor seizes *any* property, which may include, but is not limited to the property used to secure the debt, from a debtor in respect of a debt, section 79.1 should apply because the statute refers broadly to seizure of "*a* property" acquired by a creditor as a result of the debtor's failure to pay the debt. (The statute is not limited to a seizure of *the* property that secures the debt.) For example, property seized may be shares of the debtor or a partnership interest in the debtor. We invite CRA's comments on the issue.

CRA Response

We concur with your view that the property referred to in paragraph 79.1(2)(a) of the Income Tax Act (the "Act") may include, but is not limited to, a property used to secure the debt referred to in paragraph 79.1(2)(b) of the Act. However, as described in the Department of Finance's 1995 Technical Notes, section 79.1 of Act contemplates a creditor seizing property surrendered by the debtor or previously transferred from the original debtor to a third party and there is no creditor/debtor relationship between the third party and the creditor. Therefore, in our view, the property referred to in paragraph 79.1(2)(a) of the Act must have been held by the debtor and would not include an ownership interest in the debtor (i.e., would not include shares of, or a partnership interest in, the debtor).

Question 14.2

For purposes of section 79.1, a property is considered seized by a person when "(a) the beneficial ownership of the property is acquired or reacquired at that time by the person." The term "beneficial ownership" is not defined for purposes of this section. We invite CRA's comments its interpretation of the term in the context of section 79.1.

With respect to each of the following scenarios, please comment on whether the creditor acquires a beneficial ownership in the Asset.

CRA Response

Whether a person acquires beneficial ownership of a property is a question of fact that can only be made after consideration of all the facts and circumstances of a particular case. The concept of legal and beneficial ownership for tax purposes is discussed in Interpretation Bulletin IT-437R, Ownership of Property (Principal Residence). Paragraph 4 of IT-437R states:

> **¶ 4.** Beneficial ownership must be distinguished, however, from the other types of physical possession of property which a person may enjoy. For example, a tenant of a property, or a person who is allowed to occupy it only because the true owner has no objection, is not the beneficial owner of the property. In determining whether a person has beneficial ownership, one should consider such factors as the right to possession, the right to collect rents, the right to call for the mortgaging of the property, the right to transfer title by sale or by will, the obligation to repair, the obligation to pay property taxes and other relevant rights and obligations. Not all of these incidents of ownership need occur concurrently before it is concluded that the person has beneficial ownership of the property, which is a question of fact in each particular case (subject to any determination under the law regarding beneficial ownership such as, for example, in the manner described in ¶s 6, 8 or 9 below).

Scenario A

Company A owes an outstanding debt to a creditor and also owns an Asset that secures the debt. Company A defaults on the debt and, following negotiations between the creditor and Company A shareholders, the creditor acquires the shares of Company A. The debt is extinguished.

Would CRA's view change if the debt is not extinguished?

CRA Response

In the above scenario, the creditor has not acquired beneficial ownership of the Asset but rather has acquired beneficial ownership of the shares of Company A which owns the Asset.

Our view would not change if the debt was not extinguished. The question of whether a property is seized for the purposes of section 79.1 of the Act is not dependent on extinguishment of debt but rather on a person's failure to pay the creditor all or part of the debt. In fact, where any portion of the particular debt is outstanding immediately after that time, paragraph 79.1(7)(c) of the Act provides for the determination of the creditor's cost amount of that portion of the debt.

Scenario B

A Partnership owes an outstanding debt to a creditor and owns an Asset that secures the debt. The Partnership defaults on the debt and following negotiations between the creditor and partners of the Partnership, the creditor acquires an interest in the Partnership. The debt is extinguished.

Would CRA's view change if the debt is not extinguished?

CRA Response

In the above scenario, the creditor has not acquired beneficial ownership of the Asset but rather has acquired beneficial ownership of an interest in the Partnership which owns the Asset.

Our view would not change if the debt was not extinguished.

Scenario C

A Limited Partnership owes an outstanding debt to a creditor and owns an Asset that secures the debt. The Partnership defaults on the debt and following negotiations between the creditor and partners of the Partnership, the creditor acquires shares of a corporation that is a General Partner of the Partnership. The debt is extinguished.

Would CRA's view change if the debt is not extinguished?

CRA Response

In the above scenario, the creditor has not acquired beneficial ownership of the Asset but rather has acquired beneficial ownership of the shares of a corporation that is a General Partner of the Partnership which owns the Asset.

Our view would not change if the debt was not extinguished.

Scenario D

Company A owes an outstanding debt to a creditor and owns an Asset that secures the debt. Company A defaults on the debt. The creditor incorporates a subsidiary. Following negotiations between the creditor and Company A, the subsidiary of the creditor acquires the Asset from Company A in exchange for the assumption of the debt.

CRA Response

In the above scenario, the creditor has not acquired beneficial ownership of the Asset but rather the subsidiary of the creditor has acquired beneficial ownership of the Asset.

Scenario E

Company A owes an outstanding debt to a creditor and owns an Asset that is used to secure the debt. Company A defaults on the debt. The creditor incorporates a subsidiary.

Following negotiations between the creditor, the subsidiary, and Company A, the Asset is transferred to the subsidiary and the debt is extinguished.

CRA Response

In the above scenario, the creditor has not acquired beneficial ownership of the Asset but rather the subsidiary of the creditor has acquired beneficial ownership of the Asset.