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TPM-04

## Third-Party Information

October 27, 2003

Please note that the following Transfer Pricing Memorandum, although correct at the time of issue, has not been updated to reflect subsequent legislative changes since the date of issue. As a result, some information may no longer be valid.

This memorandum does not replace the law found in the *Income Tax Act* and its Regulations. It is provided for your reference. As it may not completely address your particular situation, it would be advisable to refer to the *Income Tax Act*, any applicable Regulation, and relevant case law. You may also want to contact a tax services office of the Canada Revenue Agency for more information.

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### Introduction

This document provides guidelines on the use of confidential third-party information in the context of transfer pricing audits.

As described throughout Information Circular [IC87-2R, \*International Transfer Pricing\*](#), the audit of transfer pricing involves verifying the prices at which services, tangible property, and intangible property are traded across international borders between related parties. When the transfer prices between these related parties do not reflect market forces and the arm's length principle, an appropriate adjustment is achieved by establishing the conditions of the commercial and financial relations that one would expect to find between independent

enterprises in similar transactions under similar circumstances. To accomplish this, information is obtained from comparable companies. In the event that comparable information is not available publicly, the Canada Revenue Agency (CRA) uses confidential information obtained from third parties.

## Competing interests

There are four competing interests in the use of confidential third-party information for transfer pricing audits:

1. Interests of the CRA - Third-party information is often the most reliable data to be used in determining an arm's length price in transfer pricing audits. However, to promote voluntary filing of tax information, the CRA is required by law to maintain a high degree of confidentiality.
2. Interests of taxpayers - Taxpayers have the right to know the facts and assumptions on which the CRA relies when it proposes or raises an assessment. Without the comparable information, taxpayers may be hindered in making representations to proposed audit adjustments and/or Notices of Objection.
3. Interests of third parties - Generally, third parties are at an economic disadvantage when competitors pay less tax. It is, therefore, beneficial for them to disclose information on comparable transactions. However, with this disclosure there is a risk of compromised business strategies for the third parties, which may also affect their competitive positions. Relevant information is not limited to price, applicable margins, and detailed product or service descriptions. It may include the identities of the parties, their market strategies, and the terms of their contracts with other parties. This additional information is not usually shared with competitors due to its sensitive nature.
4. Interests of treaty partners - The two main purposes of a tax treaty are to prevent fiscal evasion and to eliminate double taxation. While the use of third-party information helps prevent fiscal evasion, some treaty partners may not be prepared to give consideration to this information due to its confidential nature, making the elimination of double taxation problematic. In such situations, Competent Authority may advise taxpayers to seek recourse by going through Appeals first.

## Policy

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### (a) Gathering the information

The *Income Tax Act* gives the CRA the right to collect confidential third-party information (e.g., section 231.1), and auditors should continue to exercise this right. However, auditors should always inform the third party of the true purpose for gathering information.

Third parties need to be informed because certain provisions of the Act apply if they do not provide documents or information voluntarily. For example, when a third party refuses to provide information requested by the CRA, and this information is sought to reassess an unnamed taxpayer, the CRA must obtain judicial authorization to serve a domestic requirement on the third party under section 231.2 of the Act.

In addition, auditors should never enter into agreements with third parties that promise not to disclose any of their information. Disclosure is determined solely by section 241 of the Act. Under subsection 241(5), for example, the CRA is allowed to provide third-party information to any person, with the consent of the third party. Auditors may and should request this consent, in writing, regardless of when the information is obtained. If consent is provided, auditors will not be subject to the guidelines in this document.

### (b) Using the information as the basis of an assessment

The CRA will continue to use confidential third-party information as an audit tool for screening purposes and for secondary support (i.e., so-called "sanity checks"). However, auditors should

only use the information as a last resort to form the basis of any assessment. Every effort should be made to develop an assessing position based on publicly available information. This will facilitate negotiations with the taxpayer as well as reduce the likelihood of double taxation.

Auditors who want to use third-party information, as the basis of an assessment for transfer pricing, must refer the file to the International Tax Operations Divisions (ITOD) before they send a proposal letter to the taxpayer.

The Field Advisory Services (FAS) of ITOD will review the third-party information and evaluate the auditor's effort to locate and use publicly available information. ITOD will either approve the use of third-party information or help develop an assessing position based on publicly available information.

### **(c) Disclosing third-party information to the taxpayer under audit**

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The CRA is committed to protecting the confidentiality of third-party information and will continue to take a strict interpretation of section 241 of the Act.

Paragraph 241(4)(b) of the Act does not require the CRA to release third-party information during the audit stage of the file. While it does enable an officer to communicate information that may reasonably be regarded as necessary for determining the tax or other amount payable by the taxpayer, auditors should not disclose third-party information other than basic amounts used to calculate tax (such as price, profit margin, or mark-up). Other information may be provided if it is necessary to understand the basis of the assessment and it does not directly or indirectly reveal the identity of the third party.

Generally, third-party information will remain confidential unless and until the taxpayer under audit files a Notice of Appeal with the Tax Court of Canada. Before releasing this information, the CRA will contact the third parties to allow them to pursue their legal rights by protecting their information through a confidentiality order from the courts.

### **Conclusion**

While the CRA will continue to use confidential third-party information, every effort will be made to balance the interests of all relevant parties.

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