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TPM-01

Referrals to the Transfer Pricing Review Committee

March 26, 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.

Referrals to the Transfer Pricing Review Committee

Introduction

This document provides guidelines for referrals to the International Tax Directorate (ITD) and the Transfer Pricing Review Committee (TPRC) regarding possible penalties under subsection 247(3) or reassessments under paragraph 247(2)(b) of the *Income Tax Act*. The referral procedures identified in this document become effective the date of this publication.

The document does not deal with the fact situations required to raise a penalty or reassess using recharacterization. These are dealt with in Information Circular 87-2R, *International Transfer Pricing*.

Background

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The CRA's policy on transfer pricing legislation is found in IC 87-2R, *International Transfer Pricing*. In the paragraphs reproduced below, the CRA states that before any assessment under paragraph 247(2)(b) or subsection 247(3) is issued, the file will be referred to the TPRC for review to ensure that the law is applied fairly and consistently.

46. **All** proposed assessments to recharacterize a transaction under paragraph 247(2)(b) will be referred to the Transfer Pricing Review Committee before the assessment is issued, to ensure fair and consistent application. (Emphasis added)

178. Tax services offices are responsible for identifying taxpayers who may have failed to make reasonable efforts to determine and use arm's length prices as part of the normal audit review. However, the Department [now the CRA] recognizes the importance of applying the transfer pricing penalty provisions in a fair and consistent manner. Thus, before a penalty is assessed, tax services offices will refer **all** cases to the Transfer Pricing Review Committee for review. (Emphasis added)

The TPRC is co-coordinated within ITD by the International Tax Operations Division (ITOD).

Committee membership

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The committee comprises the following members:

- Director of ITOD - Chairperson
- Director of Competent Authority Services Division (CASD)
- Senior economist in ITOD and/or CASD
- Manager of Field Advisory Services (FAS) in ITOD
- Representative from the Department of Justice

The TPRC chairperson may also invite other CRA or non-CRA individuals to sit on the committee as appropriate. For example, a manager from the Tax Avoidance and Special Audits Division will be asked to sit on the TPRC to hear recharacterization cases involving the application of paragraph 247(2)(b) of the ITA. Similarly, representatives of the Audit Directorate may be asked to participate.

Referral procedures

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Penalties referrals

The application of penalties under subsection 247(3) must be considered in all cases where the total of transfer pricing capital and income adjustments for a taxation year,

- exceeds $5,000,000 **or**
- exceeds 10% of gross revenue for the year as calculated under subparagraph 247(3)(b)

(i).

All these files must be referred to the FAS unit within ITOD responsible for the auditor's region before sending a proposal letter to the taxpayer. Note that set-off adjustments are not taken into consideration in determining the above amounts.

Taxpayers must be made aware of the transactions under review and the potential for a penalty under subsection 247(3). Before the files are referred to FAS, taxpayers should be asked to submit any information they wish to have considered.

A FAS case officer will be assigned to help the auditor determine if there is sufficient support to apply the set-off provisions of subparagraphs 247(3)(a)(i) and (ii). In cases where there is not sufficient support, the proposal letter to the taxpayer will include penalties. FAS will respond within 30 days to referrals containing all information necessary to support a recommendation.

All files where penalties have been proposed require a formal referral to the TPRC before the file is completed. The FAS case officer will work with the auditor to ensure the referral contains the supporting material needed to enable the TPRC to come to a decision.

Recharacterization referrals

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As soon as it becomes apparent that paragraph 247(2)(b) may be recommended as an assessing position, the auditor must seek assistance from the FAS group. The FAS case officer assigned to work with the auditor will provide direction on preparing an initial referral report to the TPRC. The early referral will result in a more timely evaluation of whether the auditor should continue with an in-depth audit of the potential recharacterization.

The TPRC will provide an opinion about whether the potential recharacterization issue should be pursued. Where the TPRC gives its recommendation to proceed, the auditor will carry out an in-depth examination to establish the recharacterization.

The auditor should advise the taxpayer what transactions are being reviewed for possible recharacterization under paragraph 247(2)(b). The taxpayer should be encouraged to bring forward facts for consideration during the review. In this way, the taxpayer will be aware of what transactions and facts the auditor will consider during the review.

Once the audit is complete, but before the auditor sends a proposal letter, the auditor will formally refer the case to the FAS. The auditor must give the taxpayer or a representative a copy of the fact portion of the referral to ensure that the taxpayer agrees on the facts. The auditor should also ensure that the taxpayer has an opportunity to submit any additional information. Where possible, referrals should be made at least three months before the returns become statute-barred. If there is a potential statute-barred problem, this should be highlighted in the referral.

The FAS case officer will review the formal referral to ensure it contains all necessary information. This includes a copy of the auditor's recharacterization report, the draft proposal letter, and any representation the taxpayer sent to the auditor. The FAS case officer may request additional information from the auditor or taxpayer before scheduling the review of the file by the TPRC.

The TPRC members will review the referral and discuss whether the facts and circumstances support the auditor's position to apply or not to apply the recharacterization provisions. The TPRC may refer the case back to the auditor if further audit work is needed before a decision can be made. Once the TPRC has reached a decision, the Director of ITOD will communicate the recommendation to the auditor.

If the TPRC recommends the auditor proceed with recharacterization, the auditor will issue the proposal letter and invite the taxpayer to make any additional representations. The auditor will forward the taxpayer's representations, along with the auditor's comments, to the FAS case officer for the TPRC's final consideration. If no changes result, the auditor will be informed that the recommendation remains valid and that assessment may proceed.

In dealing with Large File cases, all audit issues presented to the taxpayer, including the potential application of the transfer pricing penalty and/or recharacterization, are to be routed through the Large File Case Manager. The international auditor will attend all meetings with the taxpayer to discuss any aspect relating to the international audit.

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