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TPM-03

Downward transfer pricing adjustments under subsection 247(2)

October 20, 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.

Introduction

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This document provides guidance on dealing with situations that involve downward transfer pricing adjustments. These situations may occur during an audit or when a taxpayer requests an adjustment from the local tax services office. This document does not deal with whether a TPR is valid-that issue is set out in paragraph 4 of [IC75-7R3, Reassessment of a Return of Income](#). In addition, this document does not deal with Competent Authority settlements or Advance Pricing Arrangements.

Subsections 247(2) and (10) of the *Income Tax Act* (Act) work together to provide the CRA

with the discretion and ability to assess downward pricing adjustments. This legislation applies to tax years and fiscal periods that start after 1997. Before subsections 247(2) and (10) existed, downward transfer pricing adjustments required the involvement of Canada's Competent Authority or the presence of contractual price adjustment clauses. (For more information, see [IT169, Price Adjustment Clauses](#).)

Subsection 247(2) allows the CRA, for tax purposes, to adjust the value of transactions with non-arm's length non-residents to reflect amounts that would have been entered into in arm's length transactions. This adjustment can increase or decrease the transfer price for tax purposes.

Subsection 247(10) places a limit on any downward transfer pricing adjustment: The adjustment must be considered appropriate in the opinion of the Minister. Paragraph 26 of [IC87-2R, International Transfer Pricing](#), provides guidance on applying subsection 247(10):

However, the Minister may decide not to exercise his discretion under 247(10) where:

- the taxpayer's request has been prompted by the actions of a foreign tax authority and the taxpayer has the right to request relief under the Mutual Agreement Procedure article of the applicable treaty; or
- the taxpayer's request can be considered abusive.

What may be considered abusive

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Examples

- When a Canadian taxpayer requests an increase in the transfer price of purchases or acquisitions without repatriation being carried out within a reasonable time - This may be considered abusive, as there is an increased expense or cost without an outlay.
- When a Canadian company requests a decrease in the transfer price of sales to a non-arm's length non-resident without repatriation and subsections 15(1), 56(2) or 246(2) do not apply to the amount - This situation may be considered abusive because the Canadian taxpayer has turned an otherwise taxable receipt of monies into a non-taxable amount.
- When a Canadian parent company requests a decrease in the transfer price of sales to a non-resident subsidiary without repatriation - This is **not** considered abusive. The downward adjustment indicates an appropriation of an identical amount from the subsidiary. Subsection 15(1) would apply and offset the downward adjustment. Only through repatriation would the Canadian parent company avoid the application of subsection 15(1).

The decision to apply a subsection 247(3) penalty will not affect the decision on the downward transfer pricing adjustment. To do otherwise would penalize the taxpayer twice.

Authorization of a downward transfer pricing adjustment

Under subsection 220(2.01), the Minister may authorize an officer or class of officers to exercise powers or perform duties of the Minister under the Act. Only the Director General of the International Tax Directorate (ITD) and the Director of a tax services office (TSO) have been delegated the authority to determine the appropriateness of the adjustment for purposes of subsection 247(10). **All** files that have a downward transfer pricing adjustment must be referred in writing as follows:

A file with a downward transfer pricing adjustment must be referred to the Director of a TSO if:

- the total of upward transfer pricing adjustments for a tax year exceed the downward transfer pricing adjustments for that tax year for each of the years in question (see [Example 2](#)); or
- the downward transfer pricing adjustments for a tax year exceed the upward transfer pricing adjustments for that tax year by no more than \$5,000,000 (see [Example 1](#)).

A file with a downward transfer pricing adjustment must be referred to the Director General of ITD if: [Top of page](#)

- the downward transfer pricing adjustments for a tax year exceed the upward transfer pricing adjustments for that tax year by more than \$5,000,000; or
- the downward transfer pricing adjustment results from an adjustment made to the related non-resident by a tax authority with which Canada has a tax treaty (see [Example 4](#)).

For referral purposes only, the following rules apply:

- transfer pricing adjustments are calculated separately for each non-arm's length non-resident with whom Canadian taxpayers deal (see [Example 3](#));
- where Canadian taxpayers have transactions involving more than one product, bundle the transfer pricing adjustments for the transactions for all the products;
- where Canadian taxpayers have transactions involving products, services, and royalties with the same non-arm's length non-resident, bundle those transactions;
- where more than one referral is required for a single Canadian taxpayer, all referrals should be made together.

Situations may arise where one downward pricing adjustment should be referred to the Director of a TSO and another to the Director General of ITD on the same file. In this type of situation, all referrals will be made to the Director General of ITD to ensure consistency (see [Example 3](#)).

Referrals should be made after adjustments are proposed but before the letter finalizing the file is sent to the taxpayer. They should include the amounts and tax years involved, the parties involved and their relationship, a general description of the facts, taxpayer representation, steps to be taken by the taxpayer with respect to repatriation, and a recommendation on whether or not the adjustment should be considered appropriate and why.

Only the Director of a TSO or the Director General of ITD has the authority to determine if it is appropriate to make the downward pricing adjustment. **All** files involving a downward pricing adjustment must be referred.

Proposal letters

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Regarding the option to repatriate funds to the non-resident, the Canadian taxpayer should be reminded that if this option is not taken at the time of the audit or request from the taxpayer, there can be Part XIII implications if monies are returned or paid to the non-resident at a later date. The International auditor will note in the Audit Report the need for subsequent audits to review inter-company transactions to ensure repayment has not been made after the audit. No specific follow-up will be coded unless there are indications the taxpayer intends to make repayments at a later date.

The taxpayer should be informed that the downward adjustment must be referred to the Director of the TSO or the Director General of ITD for consideration of its appropriateness. The taxpayer should be made aware of whether or not the auditor is recommending that the adjustment be considered appropriate.

Repatriation payment

Repatriation can be accomplished by:

- offsetting inter-company accounts receivable from the non-resident - It should be remembered that this method of repatriation might have an effect on other items. For example, interest charges may have to be adjusted on a going-forward basis to reflect the revised inter-company balances;
- the transfer of money or its equivalent to the non-resident corporation;

- where a Canadian parent company cannot otherwise effect repatriation within a reasonable time, the creation of a shareholders loan account - This would be effective at the date of the transfer pricing transaction and may result in the application of subsection 15(2) of the Act; or
- netting upward and downward transfer pricing adjustments from different non-residents if both the taxpayer and all the non-residents involved agree in writing to have the amounts offset - See [Repatriation of funds by Non-Residents - Part XIII Assessments](#).

In **all** circumstances where the downward transfer pricing adjustment exceeds the upward transfer pricing adjustment and involves a treaty country, the Canadian taxpayer will be informed that the CRA may be sending the information to the foreign jurisdiction. This is not a point of negotiation. The auditor will forward details of the transfer pricing adjustment to the International Tax Directorate, Competent Authority Services Division, Exchange of Information, once the audit is complete.

Examples

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Example 1

The following example illustrates what procedure must be followed where the downward transfer pricing adjustments exceed the upward transfer pricing adjustments by no more than \$5,000,000.

A Canadian corporation deals with one non-arm's length non-resident corporation. There are upward transfer pricing adjustments of \$3,000,000 on goods and \$6,000,000 in downward transfer pricing adjustments on services. Therefore, the downward transfer pricing adjustments exceed the upward transfer pricing adjustment by less than \$5,000,000. A referral to the Director of the TSO for determination of appropriateness is required. As there is only one non-resident taxpayer involved, the Canadian corporation may repatriate the net amount of \$3,000,000.

Example 2

The following example illustrates what procedure must be followed where the total of upward transfer pricing adjustments exceed the downward transfer pricing adjustments for the year in question.

A Canadian corporation deals with one non-arm's length non-resident corporation. There are upward transfer pricing adjustments of \$8,000,000 on goods and downward transfer pricing adjustments of \$6,000,000 on services. Therefore, the total of upward transfer pricing adjustments exceed the downward transfer pricing adjustments for the year. This file would require a referral to the Director of the TSO. The non-resident may repatriate the net amount of \$2,000,000.

Example 3

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The following examples illustrate what procedure must be followed when there are transfer pricing adjustments to two or more non-arm's length non-residents. Transfer pricing adjustments are calculated separately for each non-arm's length non-resident with whom the Canadian taxpayer deals. These separate adjustments are the ones to be considered under subsection 247(10) of the Act.

(a) A Canadian corporation deals with two non-arm's length non-resident corporations: A and B. The transactions with Corporation A result in upward transfer pricing adjustments of \$1,000,000 and the transactions with Corporation B result in downward transfer pricing adjustments of \$1,000,000. The downward transfer pricing adjustments of \$1,000,000 with Corporation B requires a referral to the Director of the TSO. The amounts may not be netted for repatriation purposes unless all parties agree in writing.

(b) A Canadian corporation deals with two non-arm's length non-resident corporations: A and

B. The transactions with Corporation A result in downward transfer pricing adjustments of \$1,000,000. The transactions with Corporation B result in downward transfer pricing adjustments of \$5,500,000. Since one of the two downward transfer pricing adjustments is over \$5,000,000, both must be referred to the Director General of the International Tax Directorate. There will be one referral for Corporation A and one for Corporation B.

(c) A Canadian corporation deals with two non-arm's length non-resident corporations: A and B. The transactions with Corporation A result in a downward transfer pricing adjustment of \$2,000,000. The transactions with Corporation B result in a \$4,000,000 downward transfer pricing adjustment. Since the two adjustments are each less than \$5,000,000, they must both be referred to the Director of the TSO. There will be one referral for Corporation A and one for Corporation B.

Example 4

The following example illustrates what procedure must be followed when the downward transfer pricing adjustment results from an adjustment made to the related non-resident by a tax authority with which Canada has a tax treaty. The taxpayer should be referred to Information Circular [IC71-17R5, *Guidance on Competent Authority Assistance Under Canada's Tax Conventions*](#) which explains the role of competent authority under the mutual agreement procedures in Canada's income tax conventions.

A Canadian corporation requests a \$1,000,000 downward transfer pricing adjustment. The request is based on the result of a recent audit of its non-resident parent by that country's tax authority. The parent company resides in a treaty country. This adjustment must be referred to the Director General of the International Tax Directorate.

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