TPM-06

Bundled Transactions

May 16, 2005

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

The purpose of this document is to provide information concerning the bundling of transactions in relation to transfer pricing and non-resident tax.

Generally, transfer pricing is the process of setting prices at which services, tangible property and intangible property are traded across international borders between related parties. For the purposes of this document, a bundled transaction is one in which a single price is established for a number of different properties and/or services that have been packaged together to form a single transaction.

One of the issues for Canadian tax purposes is whether this bundling results in a price that differs from that which would otherwise have been established if the property or services were

sold on an individual basis. Often, to evaluate overall price, it is necessary that transactions be unbundled in order to determine separate values for which comparable information exists.

Another concern is that bundling may disguise transactions so that tax on a non-resident's income under Part I or Part XIII of the Income Tax Act (the Act) is lowered or avoided altogether. When tax is only applicable to an element of a transaction, unbundling is necessary in order to determine the value of the element subject to tax. An example would be the unbundling of a transaction involving the sale of goods to recognize royalties that were included in the sale - thus giving rise to Part XIII tax on the value of the royalties.

Legislation

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As stated in section 247 of the Act, Canada's transfer pricing legislation:

- requires taxpayers who participate in cross-border transactions with non-arm's length parties to conduct such transactions on terms and conditions that would have prevailed had the parties been dealing at arm's length;
- requires taxpayers to contemporaneously document their transfer pricing transactions, including the steps taken to ensure that the terms and conditions of such transactions satisfy the arm's length principle; and
- imposes a penalty, in certain circumstances, where a taxpayer fails to make reasonable efforts to determine and use arm's length transfer prices or allocations in respect of transfer pricing transactions.

Even though there is no explicit reference to a bundled transaction or a requirement to separately price property or services in the Act (other than section 68, which provides for the specific allocation of consideration between the disposition of property and the provision of services), bundling can result in a transfer pricing adjustment if the terms and conditions of the bundled transaction fail to meet the arm's length standard. An example would be the provision of installation services in combination with the sale of tangible property. If the taxpayer's transfer price amounted to what would have been paid for the tangible property alone, an adjustment would be appropriate to include the arm's length price of the installation services.

Withholding taxes may also be applicable to an element of the bundled transaction. Section 105 of the Income Tax Regulations (Regulation 105) provides for the withholding on payments to non-residents in respect of services rendered in Canada, while Part XIII of the Act imposes a withholding tax on certain amounts paid or credited to non-resident persons. In determining the amount that is subject to withholding tax, "where a payment can reasonably be considered to be in part for something taxable and in part for something non-taxable,"[1] there is authoritative tax jurisprudence in Canada stipulating that the onus is on the Canada Revenue Agency (CRA) to prove the nature and amount of the allocation[2].

Policy

The CRA's administrative policy in regards to transfer pricing is contained in the current version of Information Circular IC87-2R, *International Transfer Pricing*. In particular, paragraphs 36 to 42 are relevant to bundling and unbundling.

The Arm's Length Principle

The CRA endorses the arm's length principle and its application on a transaction-by-transaction basis. Paragraph 36 of IC87-2R states:

"...to arrive at the most precise approximation of an arm's length price or allocation, the arm's length principle should ideally be applied on a transaction-by-transaction basis. Therefore, in establishing transfer prices, taxpayers should set prices separately for each transaction they enter into with a non-arm's length party. This separate determination usually provides the most reliable estimation of an arm's length price."

As defined in subsection 247(1), a transaction "includes an arrangement or event." Historically, the courts have taken a broad interpretation of what constitutes a transaction - giving it a far wider meaning than "sales" or "contracts."[3]

As a matter of principle, while the CRA generally accepts business transactions as structured by the parties, our view is that properties and services should be priced and evaluated individually.

Further, it is the CRA's position that unbundling is not a matter of recharacterization, which generally involves a change to the fundamental nature of the transaction. Instead, unbundling is simply the pricing and/or allocation of price to the separate properties or services of the transaction that have been packaged together. This does not change the underlying nature of the transaction but rather facilitates the determination of an arm's length price and/or the allocation of value using the best available data when different tax treatments apply. We believe that if bundled transactions are driven by commercial considerations, each property or service should withstand individual testing. In fact, arm's length transactions are even unbundled when it is evident that the total consideration relates to separate economic transfers and those transfers are subject to different tax treatments.

Closely Linked or Continuous Transactions

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We acknowledge that it may be necessary to combine transfers when the properties or services are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. Three examples of closely linked or continuous transactions are provided in paragraph 38 of IC87-2R:

- long term contracts for the supply of commodities or services - Where the price of a commodity would otherwise be low and easily discerned in the marketplace but for the fact that it is provided (presumably with a guarantee of supply) over a specified period of time; this term or condition of the transaction may contribute to and increase the price the commodity would otherwise command;
- rights to use intangible property - Where the synergy or integration between intangible and/or tangible properties is so significant that neither element can be valued separate and apart from the other. A possible indicator of integration is significant differences in the end-market selling price of the final product - where customers perceive value in the way the various products or services are combined; and
- the pricing of a range of closely linked products when it is impractical to determine pricing for each individual product or transaction (e.g. in a product line).

In the examples above, there may be more comparable information available to judge the arm's length nature of the transaction as a bundle. However, even if bundled for valuation purposes, the transaction may still need to be unbundled for non-resident tax and withholding purposes.

Criteria for Pricing Separately or on an Aggregate Basis

Paragraph 39 of IC87-2R provides a specific list of factors that taxpayers should consider when determining whether inter-company transactions should be priced separately or on some aggregate basis, as follows:

- intangibles associated with various transactions;
- availability of quality information on comparable transactions;
- functional comparability of transactions; and
- additional costs associated with valuing transactions separately.

These factors should be addressed in a taxpayer's contemporaneous documentation for transfer pricing. The cornerstones of this documentation are the functional analysis and the selection of the transfer pricing method (identification and use of reliable internal or external comparable data).

If the taxpayer has considered, in advance, the functions performed by the related entities and

the availability of comparable information, the decision to bundle or not should be easier to justify and document in writing. For example, if there is a strong commercial rationale for bundling, as indicated by consistent patterns within a particular industry, it is less likely that a taxpayer will find quality data available to set the price for separate transactions within that industry.

For practical questions taxpayers/auditors might consider when deciding whether transactions should be bundled or not, see Appendix A.

Withholding Tax

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As previously mentioned, an important factor to consider when analyzing transactions is the withholding tax that may be applicable under either Regulation 105 or Part XIII of the Act. The relevant tax convention must then be examined to determine whether there is any tax relief provided therein, such as an exemption or a reduction in the Part XIII withholding rate.

The current version of IC75-6R2, *Required withholding from amounts paid to non-residents providing services in Canada* discusses the CRA's administrative position on the identification and allocation of payments for which withholdings are required, in connection with services performed in Canada by non-residents. Only the portion of the payment attributable to services performed in Canada will be subjected to withholding under Regulation 105.

The CRA's position with regard to Part XIII tax is discussed in the current version of IC77-16R4, *Non-resident income tax*. It is important to note that Article XII of the *Canada-United States Tax Convention (1980)* was amended in the Third Protocol (1995) to expand the class of royalties exempt from withholding tax at source. Other than payments in connection with rental or franchise agreements, the exemption includes royalties paid for the use of, or the right to use, designs or models, plans, secret formulas, or processes to the extent that they represent payments for the use of, or the right to use, information concerning industrial, commercial, or scientific experience (i.e., know-how).

The distinction between know-how and other royalties/services is not always clear so it is important to give special consideration to these types of transactions between non-arm's length parties in Canada and the United States. Generally, know-how is the confidential technical information that is necessary to reproduce a product or process[4] and may provide a competitive and/or comparative advantage. An example includes the narrative description and diagrams of a secret manufacturing process such as those used in pharmaceutical drug development.

Know-how differs from the provision of services in that the technical information, which already exists, is disclosed to another party for use of their own account. Other than providing the information, the payee's contractual obligation will not be substantial, and they retain an interest to the information provided (i.e., the payer will be subject to a confidentiality agreement). On the other hand, a service provider undertakes and performs a task for the other party without necessarily transferring to them pre-existing knowledge, skills, or expertise.

The OECD[5] provides several examples of payments that should be treated as consideration for the provision of services and not know-how, they include:

- payments obtained as consideration for after-sales service,
- payments for services rendered by a seller to the purchaser under a guarantee,
- payments for pure technical assistance,
- payments for an opinion given by an engineer, a lawyer or an accountant, and
- payments for advice provided electronically, electronic communications with technicians or for access to a database that provides non-confidential information.

Penalties/Reasonable Effort

Part 7 of IC 87-2R discusses in detail subsection 247(3) penalties and reasonable efforts.

Subject to a minimum threshold, the penalty is equal to 10% of the net adjustment when taxpayers are found not to have made reasonable efforts in determining and using arm's length transfer prices. Subsection 247(4) deems taxpayers not to have made reasonable efforts in terms of when and how they completed their contemporaneous documentation. Two paragraphs in IC 87-2R are especially relevant to bundling and making reasonable efforts.

Paragraph 182 is applicable to a bundled transaction in that a "taxpayer must have records or documents that provide a complete and accurate description...of the terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the persons or partnerships involved in the transaction."

Paragraph 198 impacts bundling decisions indirectly by requiring the taxpayer to consider a hierarchy of methods in determining an arm's length transfer price. To be seen as making a reasonable effort, taxpayers must not only explain their choice of methodology but they must document why higher-ranking methods were rejected.

Therefore, bundling may result in transfer pricing penalties if transactions are not properly described or the taxpayer has not properly documented their justification for pricing the transaction as a bundle.

Besides the reasonable efforts penalty in subsection 247(3), taxpayers may be subject to penalties for not withholding or remitting in accordance with subsection 227(8), if Part I or Part XIII tax is applicable on payments to the non-resident for property or service packaged as part of a bundle.

Conclusion

Bundling is a practical issue that comes up often in transfer pricing and the preparation of contemporaneous documentation. In order to make reasonable efforts, the onus is on the taxpayer to have accurately described and to have considered, in advance, whether the arm's length principle is being followed for all related party transactions, bundled or not. Bundling is also an issue that should be considered for all payments to non-residents (even if the parties are not related) as it may have reduced or eliminated, otherwise applicable, withholding taxes.

APPENDIX A

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PRACTICAL QUESTIONS

Practical questions taxpayers/auditors might consider include the following (this list is not exhaustive):

1) Practical factors/commercial reality

a) What is the make-up of the transaction?

b) Can separate elements be easily identified?

c) How integrated are the various elements? Can they be transferred individually?

d) Does the commercial value depend upon the use in combination of the various elements?

2. What is the underlying business rationale for the transaction?

3. Normal industry practice

a) How does the structure of the transaction compare with normal industry practice?

b) Are the components sold separately by competitors?

c) Are the prices at arm's length?

4. Which structure provides the best information for determining an arm's length price?

5. If components were individually priced would there be a large discrepancy from the overall price?

6. Is there a written contractual agreement between the parties?

7. How is the transaction and reason for bundling addressed in the contemporaneous documentation?

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[1] Hasbro Canada Inc. v. The Queen, 98 DTC 2129 (FCC).

[2] See *The Queen v. Farmparts Distributing Ltd.,* 80 DTC 6157 (FCA); *Quality Chekd Dairy Products Association (Co-operative) v. MNR,* 67 DTC 5303 *(Ex. Ct.);* and *Brad-Lea Meadows Ltd. v. MNR,* 90 DTC 1269 (TCC).

[3] See MNR v. Granite Bay Timber Co., 59 DTC 1262 and Boardman v. the Queen, 85 DTC 5628.

[4] Model Tax Convention on Income and on Capital, Organization for Economic Co-Operation and Development (2003) Commentary on Article 12, paragraph 11.4.

[5] Ibid

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