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TPM-09

Reasonable efforts under section 247 of the Income Tax Act

Date: September 18, 2006

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 primary purpose of this transfer pricing memorandum is to provide guidance as to what constitutes reasonable efforts to determine and use arm's length transfer prices or arm's length allocations. The concept of reasonable efforts is also contained in the definition of a Qualifying Cost Contribution Arrangement, and that will be addressed later in the transfer pricing memorandum.

Subsection 247(3) of the *Income Tax Act* (Act) provides for a transfer pricing penalty when the net amount of transfer pricing adjustments exceeds a specific threshold. The penalty is intended to be a compliance penalty focusing on the efforts that a taxpayer makes to determine an arm's length price and not solely on the ultimate accuracy of the transfer prices. Therefore, provided a taxpayer makes reasonable efforts to determine and use arm's length prices or allocations, the transfer pricing penalty does not apply. The provisions of subsection 247(4) may deem that taxpayers have not made reasonable efforts to determine and use arm's length prices or allocations.

The Transfer Pricing Review Committee (TPRC) is responsible for reviewing all cases where a transfer pricing penalty may be assessed (i.e. the adjustments are above the threshold for the application of penalties set out in subsection 247(3) of the Act) to evaluate whether reasonable efforts have been made and to ensure fair and consistent application of the law.

What is reasonable in any situation can only be determined on a case-by-case basis, depending on the facts and circumstances of each case; however, general guidance will be given to provide a framework on what constitutes reasonable efforts.

Background

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Subsection 247(3) of the Act imposes a penalty equal to 10% of the net result of certain adjustments made under subsection 247(2) of the Act calculated as follows:

- The total of the transfer pricing income and capital adjustments (upward adjustments, whether there maybe reasonable efforts or not);

minus:

- the total of transfer pricing income and capital adjustments for which a taxpayer has made reasonable efforts to determine and use arm's length transfer prices or arm's length allocations (upward adjustments for which there are reasonable efforts); and
- the total of transfer pricing income and capital setoff adjustments for which a taxpayer has made reasonable efforts to determine and use arm's length transfer prices or arm's length allocations (downward adjustments for which there are reasonable efforts).

If the taxpayer has not made reasonable efforts to determine and use arm's length prices or allocations, subsection 247(3) does not permit a reduction of the amount subject to the penalty.

Subsection 247(4) of the Act (Contemporaneous Documentation) deems a taxpayer not to have made reasonable efforts to determine and use arm's length transfer prices or allocations unless the taxpayer has prepared or obtained records or documents which provide a description that is complete and accurate in all material respects of the items listed in subparagraphs 247(4)(a)(i) through (vi) of the Act. The documentation must be prepared or obtained on or before the taxpayer's documentation-due date for the tax year or fiscal period in which the transaction is entered into. The taxpayer must provide the records or documents specified in subsection 247 (4) to the CRA within three months of service of a written request to do so. TPM-05, Contemporaneous Documentation provides a directive concerning requests for contemporaneous documentation. Taxpayers will generally produce or obtain the required documentation at the time the transaction is entered into. If the taxpayer does not meet all the requirements of subsection 247(4), which includes providing the documents within the 3 months, the taxpayer is deemed not to have made reasonable efforts to determine and use arm's length transfer prices or allocations for purposes of the penalty in subsection 247(3) of the Act.

Contemporaneous Documentation Under Subsection 247(4)

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The term “contemporaneous documentation” is not defined in the Act.

The policy of the Canada Revenue Agency (CRA) regarding transfer pricing legislation is found in Information Circular IC87-2R International Transfer Pricing. IC87-2R states that

"In light of the obligations set out in subsection 247(4), taxpayers will generally produce

> or obtain the required documentation at the time the transaction is entered into."
>
> and
>
> "Taxpayers may, after a transaction has occurred but before the filing due date, recognize that the transfer price recorded for that particular transaction does not represent an arm's length price."

However, subsection 247(4) of the Act states that the taxpayer must make or obtain, on or before the taxpayer's documentation-due date for the taxation year or fiscal period, certain records or documents.

The "documentation-due date" is defined in subsection 247(1) of the Act. In the case of a person, it is the person's filing-due date for the year. For example, in the case of a corporation, the filing-due date is within six months after the end of the taxation year pursuant to paragraph 150(1)(a) of the Act. Accordingly, the corporate taxpayer must make or obtain, within six months after the end of the relevant taxation year, the transfer pricing records or documents required under subsection 247(4) of the Act. Records or documents prepared in this time period are considered to satisfy the documentation-due date requirement.

Pursuant to subsection 247(4), a taxpayer is deemed not to have made reasonable efforts unless the taxpayer makes or obtains, on or before the documentation-due date, records or documents that provide a description that is complete and accurate in all material respects of:

> (i) the property or services to which the transaction relates,
>
> (ii) 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 participants in the transaction,
>
> (iii) the identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into,
>
> (iv) the functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction,
>
> (v) the data and methods considered and the analysis performed to determine the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction, and
>
> (vi) the assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction.

Where a transaction spans more than one taxation year or fiscal period, the documentation must be updated to reflect any material changes on or before the documentation-due date for the year or period in which the material change occurs.

In summary, although our policy as set out in IC 87-2R recommends that taxpayers determine their transfer pricing on an on-going basis during the year in order to ensure the pricing is appropriate and in accordance with the arm's length principle, the Act allows taxpayers to make or obtain the required documentation on or before the documentation-due date. If the documentation described in subsection 247(4) is not made or obtained by the documentation-due date, (or is not provided to the CRA within three months of service of a written request to do so) the taxpayer is deemed not to have made reasonable efforts for the purposes of the penalty in accordance with subsection 247(3) of the Act.

Reasonable Efforts - Transfer Pricing Penalty

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Transfer pricing is not an exact science and requires the exercise of judgment on the part of both the tax administration and the taxpayer. That judgment must be exercised in a reasonable manner.

The reasonable efforts test is contained in both subsections 247(3) and 247(4) and contains two elements:

(1) the general determination of reasonable efforts, and

(2) the deeming provision of not having made reasonable efforts.

The general determination of whether a taxpayer has made reasonable efforts to determine and use arm's length transfer prices or allocations is a question of fact. The CRA will consider taxpayers to have made reasonable efforts if they have taken all reasonable steps to ensure that their transfer prices or allocations conform with the arm's length principle.

The reasonable efforts test in both subsections 247(3) and 247(4) also refers to a dual obligation in that taxpayers must make reasonable efforts:

(1) to determine arm's length transfer prices or arm's length allocations, and

(2) to use those prices or allocations.

Therefore, in determining whether the transfer pricing penalty is applicable, it will be necessary to show that reasonable efforts were made both in establishing and using arm's length pricing.

A reasonable effort means the degree of effort that an independent and competent person engaged in the same line of business or endeavour would exercise under similar circumstances. What is reasonable is based on what a reasonable business person in the taxpayer's circumstances would do, having regard to the complexity and importance of the transfer pricing issues that arise in the taxpayer's case.

When the TPRC is evaluating whether a taxpayer has made reasonable efforts to determine and use arm's length transfer prices or allocations, the TPRC will first review if the deeming provision contained in subsection 247(4) applies. The TPRC will evaluate:

(1) whether the documents obtained or prepared contain a description that is complete and accurate in all material respects of the items listed in subsection 247(4);

> (2) whether the documents were prepared or obtained by the documentation-due date; and

> (3) whether the documents were provided within three months of a written request to do so.

When the TPRC is reviewing the general determination of reasonable efforts a number of different factors will be taken into consideration, including but not limited to:

- Compliance vs. accuracy
- Demonstrated efforts
- Administrative burden

Compliance vs. Accuracy

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- The penalty focuses on the efforts that a taxpayer makes to determine and use an arm's length price and not solely on the ultimate accuracy of the transfer prices.
- A penalty will not be applied if reasonable efforts to determine and use an arm's length results were made, but it was subsequently established that the appropriate arm's length result was different from that reflected in the taxpayer's return. However, this will result in an adjustment to the transfer price.
- A taxpayer should endeavour to determine transfer pricing for tax purposes in

accordance with the arm's length principle, based on the information reasonably available at the time of determination.
- In general, the CRA considers that the making of reasonable efforts requires the taxpayer to consider applying a recommended transfer pricing methodology in accordance with the natural hierarchy of recommended methodologies referred to in IC 87-2R. The taxpayer should explain the choice of the particular method applied.
- One of the factors taken into account in determining whether a taxpayer reasonably selected and applied a specified method is whether the taxpayer made a reasonable search for data. It may be reasonable for a taxpayer to devote relatively less effort to find detailed comparable information supporting relatively small controlled transactions than for large transactions. The term "small controlled transactions" may be measured relative to the size of the business. However, the degree of compliance effort must also be assessed against the absolute size of the controlled transactions, so that it would be reasonable for taxpayers to devote proportionally more effort to find comparables for larger controlled transactions, regardless of their relative importance in the taxpayer's business.
- Where differences exist between the taxpayer's situation and that of the entities engaged in comparable transactions, it may be difficult to determine the adjustments necessary to eliminate the effect of these differences on transfer prices. Taxpayers should make efforts to identify and make any adjustments required to account for those differences. In situations where large databases of public corporations are used to find comparable entities, when making adjustments for material differences is very difficult, taxpayers should make efforts to choose and apply screens to the entire database in order to find entities whose key economic characteristics are similar to the taxpayer and then consider if further adjustments are required.

Demonstrated efforts

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- The use of proper documentation is the most effective way that taxpayers can demonstrate to the CRA that they have made reasonable efforts to comply with the arm's length principle. However, inconsistencies in methods, data and factual representations can undermine the reliability of the documentation.
- IC 87-2R explains that the expected documentation should include:
  - the general organization and description of the business;
  - the selection of a particular transfer pricing methodology, including an explanation of why the selected method is more appropriate than any higher-ranking methods;
  - the projection of the expected benefits as they relate to the valuation of an intangible;
  - the scope of the search and criteria used to select comparables;
  - an analysis of the factors determining comparability, including a review of the differences and attempts made to make adjustments; and
  - the assumptions, strategies, and policies as they relate to the tangible property, intangible property, and services being transferred.
- The list of documents in subsection 247(4) of the Act is not intended to be an exhaustive list of the documents necessary to substantiate that a taxpayer has made reasonable efforts to determine and use arm's length transfer prices or allocations. Subsection 247 (4) provides a basic framework for documentation, however additional documentation may be required to satisfy the general determination of reasonable efforts.
- The taxpayer should maintain sufficient documentation to establish that the taxpayer reasonably concluded that, given the available data and the applicable pricing methods, the method, and the application of the method, provides an arm's length result.
- Penalties will generally not be imposed on taxpayers who have made reasonable efforts in good faith to set the price and terms of their transactions with related parties in a manner consistent with the arm's length principle. In particular, a transfer pricing penalty would likely not be imposed on a taxpayer for failing to consider data to which the taxpayer did not have access, or for failure to apply a transfer pricing method that would have required data that was not available to the taxpayer when the access to or availability of the data was beyond the taxpayer's control.
- The taxpayer needs to explain all steps taken to ensure compliance with the arm's length principle.

Administrative burden

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- When preparing documentation the taxpayer should attempt to weigh the significance of the transactions in relation to their business with the additional administrative costs required to prepare or obtain such documentation. The obligation of finding comparable transactions for applying the arm's length principle is not an absolute one. The cost and likelihood of finding such comparables relative to the significance of the transactions to the taxpayer should be taken into account.
- Taxpayers are not required to go beyond what is reasonable in terms of documentation. What is reasonable is determined on the basis of what a reasonable business person in the taxpayer's circumstances would do, having regard to the complexity and importance of the transfer pricing issues that arise in the taxpayer's case.

Examples

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Examples of situations where taxpayers are at risk for a transfer pricing penalty are as follows:

- There is no process in place or documentation to check the selection or application of transfer pricing methods.
- There is some contemporaneous documentation but no analysis of functions, assets, risks, market conditions or business strategies.
- There is evidence of limited efforts to develop and implement a transfer price setting process but the process is not sufficiently developed or properly implemented having regard to the complexity and importance of the particular transfer pricing issues. The taxpayer has relied on data that is broadly comparable but has not sought to refine it to their circumstances or has not used it in conjunction with an adequate comparability analysis.
- The taxpayer has used non-arm's length transactions as comparables.
- The taxpayer opts immediately to apply for a transfer pricing methodology such as the Comparable Profits Method (CPM) without first examining whether higher ranking methods are applicable (i.e. a failure to follow the natural hierarchy of transfer pricing methodologies).
- The documentation prepared by the taxpayer relies on inappropriate statistical tools (i.e. inappropriate use of multiple year data).
- The taxpayer's transaction(s) have been recharacterized under paragraph 247(2)(b).

An example of a situation where taxpayers are less likely to be at risk for the transfer pricing penalty:

- The taxpayer carefully undertook arm's length pricing analyses (and appropriate future monitoring) using available data from uncontrolled comparables, having regard to comparability - including an analysis of functions, assets, risks, market conditions and business strategies and this analysis is supported by contemporaneous documentation.

Appendix A contains some examples of cases that have been reviewed by the TPRC, indicating where a penalty was applied.

Reasonable Efforts - Qualifying Cost Contribution Arrangement (QCCA)

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The concept of reasonable efforts is also contained in the definition of a QCCA found in subsection 247(1) of the Act. In general, a QCCA is an arrangement whereby two or more parties have made reasonable efforts to share the costs and risks of producing, developing, or acquiring any property, or acquiring or performing any services, in proportion to the benefits which each participant is reasonably expected to derive from the property or services as a result of the arrangement.

A cost-sharing arrangement will not be defined to be a QCCA if the taxpayer does not make reasonable efforts to match the contributions of the participants to their respective expected benefits. Taxpayers will be deemed not to have participated in a transaction that is a qualifying cost contribution arrangement unless the taxpayer has prepared or obtained records or documents which provide a description that is complete and accurate in all material respects of the items listed in subparagraphs 247(4)(a)(i) through (vi) of the Act.

The documentation pertaining to a QCCA will generally address:

- the identity of participants in the QCCA;
- the scope of the activities covered by the arrangement;
- the nature and extent of each participant's effective ownership interest in the results of the QCCA activities;
- the manner or basis on which proportionate shares of expected benefits are to be measured;
- the rationale and any assumptions underlying the projections of expected benefits;
- the form and valuation of each participant's contributions;
- the rationale and any assumptions underlying the valuation of each participant's contributions;
- the duration of the arrangement;
- the allocation of tasks and responsibilities;
- the procedures for entering or withdrawing from the arrangement and the consequences thereof; and
- the policies and procedures governing balancing payments.

Similar to the discussions above in the section Reasonable Efforts - Transfer Pricing Penalty, the reasonable efforts test is contained in both subsections 247(3) and 247(4) and contains two elements:

(1) the general determination of reasonable efforts, and

(2) the deeming provision of not having made reasonable efforts.

The reasonable efforts test in both subsections 247(3) and 247(4) for QCCAs requires the taxpayer to match the contributions of the participants to their respective expected benefits.

When the TPRC is evaluating whether a taxpayer has made reasonable efforts to match the contributions of the participants with their respective benefits, the TPRC will first review if the deeming provision contained in subsection 247(4) applies. The TPRC will evaluate:

(1) whether the documents obtained or prepared contain a description that is complete and accurate in all material respects of the items listed in subsection 247(4);

(2) whether the documents were prepared or obtained by the documentation-due date; and

(3) whether the documents were provided within three months of a written request to do so.

When the TPRC is reviewing the general determination of reasonable efforts they will look at the types of factors discussed above.

Note that transfer pricing adjustments made to cost contribution arrangements are aggregated with other transfer pricing adjustments for purposes of the penalty calculation.

Transfer Pricing Review Committee (TPRC)

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TPM-07, Referrals to the Transfer Pricing Review Committee outlines the process for referrals to the TPRC regarding possible transfer pricing penalties under subsection 247(3). The TPRC will review these referrals to evaluate whether reasonable efforts were made by the taxpayer to determine and use arm's length transfer prices or allocations. The TPRC review will be limited to a determination of whether transfer pricing penalties are applicable to the transfer pricing adjustments raised. The TPRC's role is not to question or review the adjustments that gave rise to the penalty referral.

When evaluating a referral, the TPRC will examine the Penalty Referral Report prepared by the auditor, which should provide the following:

(1) an overview of the case and the penalty issue;

(2) the facts of the case;

(3) an analysis of the taxpayer documentation taking into consideration the six items listed in subparagraphs 247(4)(a)(i) to (vi) and the issues identified by the auditor;

(4) other related information such as a copy of the formal contemporaneous documentation request letter and requested opinions from other areas within the CRA;

(5) representations made by the taxpayer or the representative of the taxpayer with respect to the penalty; and

(6) any comments the auditor may have on each of the points raised in the taxpayer representations.

Examples of some of the items the TPRC will possibly take into consideration during the evaluation are:

- whether the documents obtained or prepared by the taxpayer contain a description that is complete and accurate in all material respects of the items listed in 247(4); whether the documents were prepared or obtained by the documentation-due date; and whether the documents were provided within three months of a written request to do so;
- where a foreign-based requirement under section 231.6 of the Act, and/or any domestic-based requirement under section 231.2 was issued, whether the taxpayer provided all of the items requested;
- the significance of the controlled transactions subject to penalty consideration in terms of the taxpayer's overall business and whether the documentation prepared or obtained by the taxpayer was sufficient given the significance of the transaction;
- what efforts have been made to determine and use arm's length transfer prices or allocations, i.e. evidence of “reasonable efforts”;
- the magnitude of the transfer pricing adjustments required;
- any downward transfer pricing adjustments considered for setoff against upward transfer pricing adjustments in calculating the amount subject to penalty;
- the auditor's comments on each of the points raised in the taxpayer's representations; and
- any comments made by the Large File Case Manager.

Refer to TPM-07, Referrals to the Transfer Pricing Review Committee for additional information regarding transfer pricing penalty referrals and QCCA referrals.

Conclusion

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It is difficult to set out precisely what would amount to reasonable efforts to demonstrate an arm's length result. A good starting point would be to consider what a reasonable business person in the taxpayer's circumstances would do, having regard to the complexity and importance of the particular transfer pricing issue.

Appendix A Examples of cases reviewed by the TPRC

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The following are some examples of cases where the penalty was applied:

- The taxpayer did not make or obtain the contemporaneous documentation on or before the documentation-due date for the taxation year or fiscal period and was deemed not to have made reasonable efforts under subsection 247(4).
- The taxpayer provided some, but not all of the documentation required under subsection

247(4) and was deemed not to have made reasonable efforts. The terms and conditions between the related parties to the transactions and related allocation of risks were not provided. The data, methods, analysis, and assumptions claimed to have been used to arrive at an arm's length transfer price are sketchy, not consistent with the actual transfer price reported, and are not tied to the transfer price in any clear manner.

- With a transaction involving management fees it was deemed that the taxpayer, in providing the documentation under subsection 247(4), did not make reasonable efforts. No files existed supporting the descriptions of the costs, no names of principals, or a functional analysis of what the recipient does to earn the fee, or copies of any questionnaires or surveys that practitioners often complete as part of their engagement.
- The taxpayer came up with a transfer price using a flawed and low-ranked transfer pricing methodology while completely ignoring a perfectly good internal comparable uncontrolled price or price charged to an arm's length third party.
- The taxpayer had a transfer pricing policy in place. However, audit adjustments were required for a number of consecutive years bringing into question whether the taxpayer had made reasonable efforts to follow/adjust the policy outlined in its contemporaneous documentation.
- The taxpayer did not prepare a detailed transfer pricing study, as the revenues of the Canadian taxpayer were relatively insignificant when compared to the overall worldwide operations. It was decided to penalize as it was concluded that the taxpayer was deemed not to have made reasonable efforts.