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## TPM-13

# Referrals to the Transfer Pricing Review Committee

October 30, 2012

### Legislative and policy changes

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.

### References and other information

This memorandum does not replace the law found in the *Income Tax Act* and its Regulations. Since this memorandum may not address your particular situation, you should refer to the *Income Tax Act*, any applicable Regulation, and relevant case law. For more information, you can contact a Canada Revenue Agency tax services office.

## Introduction

This memorandum cancels and replaces Transfer Pricing Memorandum TPM-07, *Referrals to the Transfer Pricing Review Committee*, dated August 2, 2005. The purpose of this memorandum is to provide information about the guidelines for referrals to the Transfer Pricing Review Committee (TPRC) of the Canada Revenue Agency (CRA) regarding possible transfer pricing assessments under paragraphs 247(2)(b) and (d) and penalties under subsection 247(3) of the *Income Tax Act*.

## Background

Paragraphs 46 and 178 of Information Circular IC87-2R, *International Transfer Pricing*, state that before an assessment under paragraphs 247(2)(b) and (d) is issued or a penalty under subsection 247(3) is levied, the file will be referred to the TPRC for review to ensure 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 (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 concept of reasonable efforts is contained in the definition of a qualifying cost contribution arrangement (QCCA) found in subsection 247(1) of the *Income Tax Act*. A cost contribution arrangement (CCA) will not be determined to be a QCCA if the taxpayer does not make reasonable efforts to match the contributions of the participants to their respective expected benefits. Transfer pricing adjustments made to CCAs are aggregated with other transfer pricing adjustments for purposes of the penalty calculation. Therefore, only CCA audit issues that exceed the penalty threshold under subsection 247(3), by themselves or in combination with other transfer pricing

adjustments, will be included in the penalty referral to the TPRC for review.

The TPRC is coordinated by the International Tax Division (ITD) within the International and Large Business Directorate of the Compliance Programs Branch.

### Committee membership

The Committee members vary, depending on the type of referral under review.

Generally, the Committee will include the following:

- the director of the ITD – the Chairperson of the TPRC
- a senior economist from the ITD
- managers of the International Advisory Services Sections (IASS) in the ITD
- the manager from the Transfer Pricing Specialty Section in the ITD
- a representative from the International Tax Service Team within Legal Services

For final consideration of cases involving the application of paragraphs 247(2)(b) and (d) of the *Income Tax Act*, a manager from the Aggressive Tax Planning Division and a senior official from the Tax Policy Branch of the Department of Finance Canada will be asked to participate.

## Referral procedures

### I. Penalty 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:

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

The following steps are involved in making a penalty referral:

Taxpayers must be made aware of any transactions that may be subject to a subsection 247(3) penalty. This should be done through a draft penalty referral report provided to the taxpayer with the proposal letter.

The draft penalty referral report provides taxpayers with an opportunity to submit any additional information they want the TPRC to consider. After the report is issued, the taxpayer will be given a reasonable time (generally 30 days) to make representations with respect to the potential application of subsection 247(3). This will be the taxpayer's only opportunity to submit additional information for the TPRC's consideration.

Once representations with respect to the penalty proposal are received from the taxpayer, the auditor will include these representations along with his or her comments in the penalty referral report.

The completed penalty referral report will then be forwarded to the Secretariat of the TPRC to be prepared for presentation to the TPRC. Referrals to the TPRC will first be assigned to an IASS case officer within the ITD. The case officer will review the referral to ensure that sufficient information has been provided by the auditor to proceed with a formal presentation to the TPRC. After the review by the IASS case officer, the auditor will forward a copy of the formal penalty referral report to the taxpayer immediately before it is presented to the TPRC.

The chairperson of the TPRC will decide whether reasonable efforts were made by the taxpayer. The decision and reasons for the decision will be communicated by memorandum to the Assistant Director of Audit (ADA) of the tax services office (TSO) that is responsible for the file. The memorandum will be issued within 45 days of receipt of a referral that contains all the information necessary to allow the TPRC to make a recommendation to the chairperson. 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. The TSO will be responsible for informing the taxpayer of the decision and the reasons for the decision.

When considering the application of transfer pricing penalties, auditors should be aware that taxpayers may choose to use the Pacific Association of Tax Administrators (PATA—this organization is currently known as the Leeds Castle Group, with a larger membership) Transfer Pricing Documentation Package to avoid the imposition of transfer pricing penalties with respect to a transaction.

Taxpayers that use the PATA documentation package need to satisfy three operative principles:

- They need to make reasonable efforts (as determined by each member tax administration) to establish transfer prices in compliance with the arm's length principle;
- They need to maintain contemporaneous documentation of their efforts to comply with the arm's length principle; and
- They need to produce the contemporaneous documentation in a timely manner, at the request of a member tax administration.

The PATA documentation package provides an exhaustive list of documents that the tax administrations of the Leeds Castle Group view as necessary to provide transfer pricing penalty relief. This listing of documents includes the documentation referred to in subsection 247(4). However, referrals are still required to be made to the TPRC when the threshold for the application of penalties has been exceeded in order to make a decision as to whether the first operative principle was satisfied. The [PATA Transfer Pricing Documentation Package](#) is available on the CRA Web site.

## II. Recharacterization referrals

In situations involving the application of paragraphs 247(2)(b) and (d), the TPRC uses a three-stage approach:

- Initial consideration
- Consideration of a formal referral
- Final consideration

### 1. Initial consideration

As soon as it becomes apparent that paragraphs 247(2)(b) and (d) may be recommended as an assessing position, the auditor **must** seek assistance from the appropriate IASS. The IASS case officer assigned to work with the auditor will provide direction on how to prepare the initial referral report to the TPRC.

The TPRC will meet to determine whether or not the first stage referral should be approved. The auditor will be advised, by memorandum, whether the recharacterization issue should be pursued. If the TPRC considers that recharacterization may apply, the auditor will carry out an in-depth examination to determine whether the facts support an application of the recharacterization provision. At that time, the auditor will advise the taxpayer that the application of paragraphs 247(2)(b) and (d) are being considered with respect to the transactions under review. The taxpayer should be encouraged to bring forward facts for consideration during the review.

### 2. Consideration of a formal referral

Once the audit is complete, but before a proposal letter is issued, the auditor **must** formally refer the case to the TPRC. The auditor must provide the taxpayer a copy of the fact section of the referral report before the formal referral is presented to the TPRC and during the audit phase. This will allow the taxpayer to submit additional information in order to seek agreement on the facts of the case. The taxpayer's representations and the additional information will be considered when

completing the formal referral report.

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

The TPRC members will review the formal referral report and discuss whether the facts and circumstances support the application of the recharacterization provision. The TPRC may refer the case back to the auditor if further audit work is needed. The decision and reasons for the decision will be communicated by memorandum to the ADA of the TSO that is responsible for the file. The memorandum will be issued within 45 days of receipt of a referral that contains all the information necessary to allow the TPRC to make a recommendation to the chairperson. The TSO will be responsible for informing the taxpayer of the decision and the reasons for the decision.

### **3. Final consideration**

If the TPRC decides that an auditor should proceed with recharacterization, the auditor will issue the proposal letter. If additional representations are made by the taxpayer in response to the proposal letter, the auditor will forward the representations, along with the auditor's comments, to the IASS case officer for the TPRC's final consideration. The ADA of the TSO will be informed in a memorandum of the final decision and reasons for the decision. The TSO will be responsible for informing the taxpayer of the final decision and reasons for the decision.

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