Canada

TPM-17

The Impact of Government Assistance on Transfer Pricing

March 2, 2016

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

1. The purpose of this transfer pricing memorandum is to provide guidance on the impact and treatment of government assistance in the context of a transfer pricing analysis. This policy on government assistance applies for the purpose of determining transfer prices. It does not affect or change the tax treatment of government assistance under other provisions of the *Income Tax Act*.

Background

2. Canadian subsidiaries of multinational enterprises (MNEs) sometimes receive government assistance,[1] such as scientific research and experimental development (SR&ED) credits or wage subsidies. Auditors may encounter a situation where government assistance receipts are used to offset costs in a transfer pricing analysis. This policy addresses the impact on transfer prices when a Canadian taxpayer receives such assistance and engages in controlled transactions [2] with non-arm's length non-resident persons.

3. The following is a common scenario:

- A Canadian resident corporation (CanCo) provides products or services to a non-arm's length non-resident corporation (ForCo);
- CanCo is considered the tested party [3] and the transfer price for this transaction is tested using a cost-based method;[4]
- CanCo receives financial assistance from one or more government agencies or programs;
- In calculating the cost base for transfer pricing purposes, CanCo reduces the cost base by an amount equal to the government assistance received.

Policy

4. When a cost-based transfer pricing methodology is used to determine the transfer price of goods, services, or intangibles sold by a Canadian taxpayer to a non-arm's length non-resident person and the Canadian taxpayer receives government assistance, the cost base should not be reduced by the amount of the government assistance received, unless there is reliable evidence that arm's length parties would have done so given the specific facts and circumstances. Refer to the Appendix for an example that illustrates this policy.

Guidance

5. Under the arm's length principle, detailed in section 247 of the *Income Tax Act*, the transfer price for the transaction or series of transactions that a Canadian taxpayer and a non-arm's length non-resident person enter into should reflect the outcome that would have resulted had the parties been dealing at arm's length, regardless of the methodology used.
6. When a Canadian taxpayer receives government assistance, it is an uncontrolled transaction between arm's length parties at one level of the market (that is, an input market, which is a market the resources to produce a good or service are acquired in). When a Canadian taxpayer provides goods or services to a non-arm's length non-resident person, it is a controlled transaction at a different level of the market (that is, an output market, which is a market the goods or services are sold in).
7. It would be inappropriate to assume that the Canadian taxpayer would pass on the government assistance received, dollar for dollar, only to a non-arm's length non-resident person.
8. The transfer prices for controlled transactions established by a taxpayer are tested by the parties to the transactions. They are tested either directly, by looking at arm's length prices in comparable uncontrolled transactions (for example, using a CUP methodology), or indirectly, by valuing and/or comparing the functions performed, the assets used, and the risks assumed (for example, using a cost plus, resale price or transactional net margin method). These prices are then compared to various margins of comparable arm's length companies. Refer to the *Guidelines* for further guidance on using these methods.
9. To the extent that government assistance has an impact on arm's length prices or margins, such an impact should be incorporated into the transfer price by applying these prices or

margins in the controlled transactions. The taxpayer should document this impact in their contemporaneous documentation. The following are some of the items that may be considered:

- identification of all characteristics that are relevant to the market or industry;
- the accounting treatment of the government assistance in both the tested party and any comparable identified, for example, whether the government assistance is deducted from the costs or it is presented separately,[5] since not considering differences such as the accounting treatment can affect profit level indicators;
- whether and to what extent the government assistance is passed on to arm's length customers or suppliers in that particular market or industry;
- when the government assistance is not fully passed on to arm's length customers or suppliers, the manner in which arm's length enterprises operating under similar circumstances would allocate such benefits between them through further enquiry;
- any other relevant information.

10. To establish whether a transfer price is consistent with the arm's length principle, the most appropriate transfer pricing methodology must be used. The cost plus method may not always be the most appropriate method in cases where government assistance exists. It may be appropriate to supplement the cost plus method by considering the results achieved from applying other methods. For example, when the government assistance can be considered as highly integrated to the operations and significantly affects the economically relevant market conditions, a transactional profit split method may be the most appropriate transfer pricing method.

Conclusion

11. When a Canadian taxpayer receives government assistance and participates in a cross-border controlled transaction, it is presumed that the Canadian taxpayer will keep the government assistance, unless it can be proven that arm's length enterprises would effectively share all or part of that assistance.
12. This transfer pricing memorandum also expands on the guidance provided, in the context of cost contribution arrangements, in paragraph 134 of IC87-2R.

Appendix – Example

A.1 The following is an example to illustrate this policy:

A.2 A Canadian company (CanCo) carries on a business in Canada. It performs research and development (R&D) in Canada for a foreign affiliated company (ForCo). Since CanCo carries on R&D in Canada, it may be eligible to apply for SR&ED tax credits or subsidies for eligible expenses. ForCo does not carry on a business in Canada and cannot apply for these particular forms of government assistance.

As filed by the taxpayer – markup applied on net costs

A.3 The MNE establishes the transfer price between CanCo and ForCo by applying a mark-up to CanCo's costs (net of the government assistance received) incurred to perform the R&D services.

A.4 For example, CanCo incurs R&D costs of $60 and other costs of $40, receives government assistance of $10, and applies a 10% mark-up to the net cost base. The MNE determines the transfer price as follows:

Example of a transfer price and net income calculation as determined by a taxpayer

Transfer price calculation		CanCo income statement		
R&D costs	$60	Revenue (transfer price to ForCo)		$99
Less: government assistance	$(10)	R&D costs	$60	
Other costs	$40	Government assistance	$(10)	
Total costs	$90	Other costs	$40	
Add 10% mark-up	$9	Total costs		$90
Transfer price to ForCo	**$99**	Net income		**$9**

A.5 The issue is whether the tax credits received or receivable should reduce the transfer price by reducing the cost base by the amount of tax credits. When there is no evidence to support independent enterprises allocating government assistance, it is presumed that CanCo, the company that received the assistance, will keep the assistance.

A.6 The following shows the CRA's approach when it has determined that the government assistance should not be netted against the R&D costs incurred. It also shows the impact on the transfer price CanCo receives from ForCo when government assistance is included in the cost base.

CRA approach – markup applied on gross costs

A.7 In the context of a transactional net margin method, using return on total costs as a profit level indicator, this presumption translates into the use of gross costs as shown below:

Example of a transfer price and net income calculation as determined by the CRA

Transfer price calculation		CanCo income statement		
R&D costs	$60	Revenue (transfer price to ForCo)		$110
Other costs	$40	R&D costs	$60	
Total costs	$100	Government assistance	$(10)	

Total costs	$100	Government assistance	$(10)	
Add 10% mark-up	$10	Other costs	$40	
Transfer price to ForCo	**$110**	Total costs		$90
		Net income		**$20**

A.8 In this situation, the transfer pricing adjustment would be $11, which is the difference between the transfer price used of $99 (as filed by the taxpayer) and the revised transfer price of $110 (as calculated by the CRA).

A.9 This example illustrates that simply applying a net approach may give unexpected results. For example, when the total amount of government assistance is passed on to ForCo, the profit CanCo sees as a result may be less than it would be had it received no government assistance. In addition, the amount of government assistance received may exceed the mark-up on the reduced cost base. In this case, the key profit-driving function of CanCo would be the business of obtaining government assistance rather than providing services to ForCo. Such a result would probably not meet the arm's length principle, since it is unlikely that arm's length parties are in the business of obtaining government assistance.

[1] Government assistance is defined as direct or indirect financial assistance received from a government, municipality, or other public authority whether as a grant, subsidy, forgivable loan, tax deduction, investment allowance, or any other form of assistance.

[2] Controlled transactions refer to transactions between parties not dealing at arm's length. Uncontrolled transactions are transactions that take place either between two arm's length parties outside the group or between a member of a related group and an arm's length party outside the group (Information Circular 87-2R, International Transfer Pricing).

[3] The tested party is most often the entity that is the least complex of the parties to the controlled transaction. The Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Guidelines) discuss the selection of the tested party in more detail.

[4] The Canada Revenue Agency (CRA) considers a cost-based method to be one of the OECD's endorsed methods or any other method that relies on costs directly or indirectly to test or calculate a transfer price. The Guidelines provide additional information about using the most common methods.

[5] For private enterprises, refer to sections 3800 and 3805 in Part II of the Chartered Professional Accountants (CPA) of Canada Handbook – Accounting (CPA Handbook). For publicly accountable enterprises, refer to IAS 20 in Part I of the CPA Handbook.

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