

Transfer Pricing: The Treatment of the OECD Guidelines
by the Tax Court of Canada, the Federal Court of Appeal
and the Supreme Court of Canada

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I was asked to prepare a short "highlight" presentation on how OECD Guidelines have been treated by Canadian courts in transfer pricing cases.

Income tax provisions in Canadian tax statutes applicable to transfer pricing were introduced over 70 years ago. Predecessors to subsection 69(2), repealed as of the 1997 taxation year, were in the

Income Tax War Act (**Read 69(2)**). The current provision, section 247, came into force in the 1997 taxation year (**Read 247(2)**). Despite having been introduced such a long time ago, these provisions have only been raised in court proceedings in recent years and, the reported Canadian federal tax decisions comprise only five cases actually dealing in substance with the *ITA's* transfer pricing provisions, namely *Indalex Ltd. V. R.*, *Safety Boss Ltd. V. R.*, *GlaxoSmithKline v. R.*, *General Electric Capital Canada Inc. v. R.*, and *Alberta Printed Circuits v. The Queen*. Note that *General Electric* and *Alberta Printed Circuits* appeals related to post 1996 taxation years and new subsection 247.

From time to time the Canada Revenue Agency, the taxing authority in Canada, publishes information circulars on assessing policy. In Information Circular 87-2 "International Transfer Pricing and other International Transactions" dated February 2, 1987, the Agency acknowledged its reliance on OECD Commentaries in assessing. Circular 87-2 was replaced on September 27, 1999 (Info Circ. 87-2R).

Analysis

Before entering into a description of the case law substantively addressing transfer pricing, I would like to bring to your attention to the FCA's decision in *SmithKline Beecham Animal Health Inc. v. Canada* in 2002. In confirming an order from the TCC regarding discovery of evidence, the FCA addressed the relevancy of the OECD Guidelines:

8 It appears to be common ground that the OECD Guidelines inform or should inform the interpretation and application of subsection 69(2) of the *Income Tax Act*. The OECD Guidelines state the principles for determining international transfer prices and, where possible, the agreement among OECD members with respect to the practices to be followed. According to the OECD Guidelines, there are a number of methods for determining an arm's length price in the context of international transactions. The method that is said to be in principle the most appropriate and in theory the easiest is the comparable uncontrolled price method, or "CUP" method. In general, the CUP method requires a direct reference to prices in comparable transactions between enterprises that are independent of each other.

[Emphasis Added]

Now, here are Canadian cases dealing with "transfer pricing":

1. *Indalex Ltd. v. Canada*

Indalex has limited relevance to the interpretation and the application of transfer pricing principles because the assessment and the judgements were essentially based on provisions dealing with tax avoidance rather than on transfer pricing in subsection 69(2). The trial Judge did not address or refer to the OECD Guidelines at all in her analysis.

The FCA confirmed the trial Judge's decision but did not specifically address the transfer pricing issue because it also was concerned with tax avoidance provisions.

[1986] F.C.J. No. 16 (QL), Federal Court of Canada – Trial Division

[1987] F.C.J. No. 1150 (QL), Federal Court of Appeal.

2. *Safety Boss Ltd. v. Canada*

In *Safety Boss Ltd.*, the TCC ruled that the bonus and the management fees paid to the non-resident shareholder/employee of

a Canadian corporation did not exceed a reasonable amount pursuant to subsection 69(2) of the ITA. In coming to that conclusion, former Chief Justice Bowman undertook an objective analysis of the facts but did not consider or mention the OECD Guidelines.

[2000] A.C.I. no 18 (QL), Tax Court of Canada

3. *GlaxoSmithKline Inc. c. Canada*

In *GlaxoSmithKline*, at paragraphs 59 to 65, I reviewed the principles emerging from the OECD Guidelines to determine a reasonable transfer price. I noted that both Ss. 69(2) and Article 9(1) were analogous since they both rely on the arm's length principle to determine prices set by multi-nationals. Thus I stated that:

83 The 1995 Commentary can assist me in considering transfer pricing issues before me. Neither party pointed to any inconsistencies between the 1995 and earlier Commentary [1979]. The 1995 Commentary is more detailed and provides more examples than the earlier version. The preface to the 1995 Commentary sets out that they are "intended to be a revision and compilation of previous reports by the [OECD] addressing transfer pricing ... The principal report is [the 1979 OECD

Commentary]".²⁶ Both the 1979 and the 1995 Commentaries have a role in the CUP analysis.

(Emphasis Added)

2008 TCC 324, Tax Court of Canada

I took comfort in analyzing the various methods recommended by OECD Guidelines in 1979 and 1995. Both counsel at trial referred to the OECD Guidelines as well.

At the end, I applied the CUP method to determine whether the price was reasonable in the circumstances.

I was appealed and my decision was overthrown in both the Court of Appeal and the Supreme Court.

The FCA did not address the OECD Guidelines in its decision because the only issue related to my application of the 69(2) test. The FCA stated that I should have taken into consideration the extraneous circumstances surrounding the contract, that the test under 69(2) does not operate regardless of the business reality. The

FCA preferred to leave the determination of the reasonable amount to me as trial Judge, and consequently did not proceed to make any determination.

2010 FCA 201. Federal Court of Appeal

The Supreme Court of Canada took the opportunity to establish the proper analytical approach to transfer pricing determinations under old subsection 69(2) of the *ITA*.

In its analysis, the SCC addressed the role of the OECD Guidelines in the determination of the transfer price. At paragraph 20, Rothstein J. stated:

20 In the courts below and in this Court, there has been reference to the 1979 Guidelines and the 1995 Guidelines (the "Guidelines"). The Guidelines contain commentary and methodology pertaining to the issue of transfer pricing. However, the Guidelines are not controlling as if they were a Canadian statute and the test of any set of transactions or prices ultimately must be determined according to s. 69(2) rather than any particular methodology or commentary set out in the Guidelines.

He continued:

21 Section 69(2) does not, itself, offer guidance as to how to determine the "reasonable amount" that would have been payable had the parties been dealing at arm's length. However, the Guidelines [page17] suggest a number of methods for determining whether transfer prices are consistent with prices determined between parties dealing at arm's length.

Regarding the four methods that ought to be used to determine the transfer price, the SCC established that while a transaction-by-transaction approach might be ideal in some cases, the OECD Guidelines themselves recognize that it is not appropriate in all cases and that other methods should be used. The Court provided further guidance on the determination of the reasonable amount and the use of the Guidelines.

Rothstein J. analyzed the provisions of paragraph 1.42 of the 1995 Guidelines to find "the more precise approximation of fair market value, the arm's length principle should be applied on a transaction-by-transaction basis." He held, therefore, that:

42 Thus, according to the 1995 Guidelines, a proper application of the arm's length principle requires that regard be had for the 'economically relevant characteristics' of the arm's length and non-arm's length circumstances to ensure they are 'sufficiently comparable'. Where there are no related transactions or where related transactions are not relevant to the determination of the reasonableness of the price in issue, a transaction-by-transaction approach may be appropriate. However, 'economically relevant characteristics of the situations being compared' may make it necessary to consider other transactions that impact the transfer price under consideration. In each case it is necessary to address this question by considering the relevant circumstances.

Thus the Guidelines were influential in the Supreme Court consideration of the appeal.

The SCC did not proceed to determine the reasonable amount leaving it to the parties to agree, failing which I will have to reopen the appeal.

2012 CSC 52, Supreme Court of Canada

4. *General Electric Capital Canada Inc. v. Canada,*

In *General Electric*, the TCC Judge based his analysis on my reasoning in *GlaxoSmithKline* and "*recognized that the arm's length*

principal enunciated in the OECD Guidelines outlines the proper interpretation and application of former subsection 69(2)". However, because both parties acknowledged that there were no comparable uncontrolled transactions and therefore the resale price and cost plus methods were inapplicable, the TCC benefited from expert witnesses who provided alternative methodologies that were not rooted in the OECD Guidelines. However, the trial judge did state that these opinions were in conformity with OECD Guidelines on which Canadian transfer pricing rules are based. Ultimately, the Tax Court endorsed the yield approach for financial guarantees fees over the proposed insurance methodology approach and allowed the appeal. This also went to appeal.

2009 TCC 563, Tax Court of Canada

The FCA rejected the taxpayer's appeal and confirmed the TCC Judge's decision on the basis that the judge did not err regarding any of the legal or factual questions in a way that would change the ultimate outcome of the decision. Accordingly, the FCA did not undertake an analysis under the OECD Guidelines.

2010 FCA 344, Federal Court of Appeal

5. *Alberta Printed Circuits Ltd. v. Canada,*

In *Alberta Printed Circuits Ltd.*, the TCC had to deal with multiple issues including a determination of transfer price. The trial Judge undertook an analysis of the OECD Convention and Guidelines, and restated the role of the Guidelines as established by the FCA in *SmithKline Beecham*, as I mentioned earlier.

The Judge explained the principles arising from subsection 247(2) of the *ITA* and the OECD Guidelines, and then described the hierarchy of methods that can be used to determine the transfer price.

The Judge analyzed the transfer price in light of the experts' evidence before him. His analysis was guided by and was in accordance with the OECD Guidelines. For example, the Judge commented both on the Internal CUP and also the External CUP. He undertook the analysis under the transactional net margin method but

rejected it, preferring the CUP method as the appropriate one in the circumstances.

2011 TCC 232, Tax Court of Canada

CONCLUSION

The first transfer pricing, *Indalex*, case was heard more than 27 years ago, and even though the first OECD Guidelines were already published at the time, they were not considered by the TCC nor the FCA. Fifteen years later, in *Safety Boss Ltd.*, former Chief Justice Bowman had to determine if an amount paid was reasonable in light of old paragraph 69(2). Again, no reference was made to the OECD Guidelines.

It is only in 2008, in *GlaxoSmithKline*, that use was made of OECD Guidelines in a transfer pricing case. The two decisions which came after *GlaxoSmithKline*, namely *General Electric* and *Alberta Printed Circuits Ltd.*, both relied on and addressed the importance of the OECD Guidelines. It should be noted that in *General Electric*, the Court struggled to apply the methods proposed in the Guidelines due

to the particular fact pattern. Finally, the utility and the almost necessity of these Guidelines in the determination of the transfer price was confirmed when the *GlaxoSmithKline* case reached the Supreme Court of Canada in 2012.

So, in Canada, the courts will first rely on the particular provision of the law on which the assessment is based. If the law does not offer guidance on how to determine a price or reasonable price arm's length parties would pay, which it does not do, then the court will look to the OECD Guidelines. But the OECD Guidelines are not law. One has to look first to one's domestic law for the answer as to value and if you cannot find it in the domestic law, then you have to refer to the OECD Guidelines.