This article was created with assistance from Nathan Jin Bao, a summer student at Gowling WLG.

In Part I and Part II of this article,[1] we provided an overview of transfer pricing developments and jurisprudence, respectively, in Canada since the start of the Organization for Economic Cooperation and Development’s (“OECD”) project on Base Erosion and Profit Shifting (“BEPS”). Part III of this article, the final segment, deals with self-initiated transfer pricing adjustments and, more particularly, what has changed in this area since 2012.

**Self-Initiated Upward Transfer Pricing Adjustments**

Where a Canadian corporation has determined that it has understated taxable income on its filed tax returns, due to an error in its transfer pricing analysis, either a voluntary disclosure (“VD”) or an application for an Advance Pricing Arrangement (“APA”) with a rollback[2] to prior taxation years are generally the taxpayer’s only options to correct the matter. The Canada Revenue Agency (“CRA”) VD and APA programs both provide the taxpayer with the opportunity to revise its transfer prices in filed tax returns without triggering a transfer pricing penalty.

Where taxpayers do not want to utilize the CRA's VD or APA programs, for example, either because they are not eligible or they are prepared to risk remaining non-compliant with the arm’s length principle for those filed taxation years, they put themselves in a waiting game where they are hoping these taxation years become statute barred before any CRA audit activity.
Taxpayers should discuss with their tax advisors all possible ramifications when considering whether to pursue, or not pursue, a VD or an APA (with a rollback), including whether relief for double taxation will be given in the foreign jurisdiction. These two processes are the subject of detailed CRA guidelines and are generally well understood within the transfer pricing community. Where the uncertainty and confusion often arises with respect to self-initiated transfer pricing adjustments, however, is when the Canadian corporation has overstated its taxable income in prior years and is in need of a downward transfer pricing adjustment.

**Self-Initiated Downward Transfer Pricing Adjustments**

There are two mutually exclusive processes for attempting to get the CRA to allow a downward transfer pricing adjustment on a tax return that has been assessed and the notice of objection period has expired. The first process, and most widely recognized, is to make a taxpayer request ("TPR") to the CRA for a reassessment (e.g. to create a refund) notwithstanding it did not file a notice of objection within the prescribed time period. The second process would be to have the related company amend its tax returns in the foreign jurisdiction and then, after the foreign tax administration reassesses the return (i.e. which is an upward transfer pricing adjustment in the foreign jurisdiction), request the CRA, through the Mutual Agreement Procedure ("MAP"), to provide correlative relief to the Canadian related party (i.e. a downward transfer pricing adjustment) to resolve double taxation. TPRs are handled by the taxpayer’s local tax services office, while MAP requests are handled by the Canadian competent authority.

There has historically been a lot of confusion in the transfer pricing community regarding these processes and under what circumstances the CRA will grant relief, largely attributed to the following:

**TPR Process**

- Under the TPR process, in addition to the regular conditions that have to be met pursuant to IC75-7R3, downward transfer pricing adjustments in Canada require Ministerial approval under subsection 247(10) of the Income Tax Act ("Act"), notwithstanding that the adjustment to be made is fully in accordance with the arm’s length principle and otherwise authorized under subsection 247(2).
- The CRA does not take the position, however, that Ministerial approval is needed under subsection 247(10) where correlative relief (a downward adjustment) is being provided by the Canadian competent authority under a MAP settlement. The downward reassessments are
made automatically by the CRA once a MAP settlement is reached between the two governments and the taxpayer has agreed to the settlement.

- There has generally been a lack of published guidance from the CRA regarding TPRs and the conditions upon which Ministerial approval under subsection 247(10) will be granted. Although the CRA have published some guidelines on the matter,[7] these guidelines are relatively silent on the CRA's true concerns with TPRs, which are retroactive tax planning and double non-taxation.

- Consequently, when taxpayers choose to go through the TPR process, they are virtually at the mercy of the CRA which can deny the TPR on policy reasons (e.g. issues of perceived abuse) that have nothing to do with the technical issues (i.e. the merits of the revised arm's length transfer price being sought).

MAP Process

- Some of Canada's treaty partners, including the U.S. at a point in time, take the position that cases where the taxpayer has been assessed an upward transfer pricing adjustment as a consequence of a VD or the filing of an amended tax return are not eligible for the MAP. That is, some countries differentiate, for purpose of their obligations under the transfer pricing (i.e. Associated Enterprises) and MAP Articles of their respective tax treaties, between upward transfer pricing adjustments caused from a government action (e.g. a tax audit) and those upward adjustments caused from self-initiated adjustments.

- Competent authorities around the world are also concerned about the potential for self-initiated transfer pricing adjustments being used as a means of retroactive or after-the-fact tax planning. So this also brings uncertainty to taxpayers as to whether their amended tax returns will be viewed in this negative light by the competent authority and accepted into the MAP.

- It is difficult to obtain reliable information regarding a foreign competent authority's policies regarding self-initiated transfer pricing adjustments and MAP eligibility. Often the competent authorities do not have adequate relevant guidelines available to the public.

- Consequently, Canadian corporations often must decide to initiate this process (i.e. file an amended return in the foreign state) without 100% assurance that the amended return will be i) assessed, in whole or in part, by the foreign tax authority and, if assessed, ii) whether it will be accepted by both countries into the MAP program.

General Comments
Regardless of the process chosen, the CRA often has little sympathy, or a desire to assist the taxpayer, where there is any perceived notion of possible retroactive tax planning.

TPM-03 states that the CRA may decide not to exercise its discretion under subsection 247(10) where "the taxpayer’s request has been prompted by the actions of a foreign tax authority and the taxpayer has the right to request relief under the MAP of the applicable treaty". In other words, if taxpayers have a right to make a MAP request, the CRA will not accept a TPR. However, what happens if a taxpayer has a right to make a MAP request, but its request is denied (not accepted into the MAP) for policy reasons? Although the taxpayer can then file a TPR, it could likely be denied by the local tax services office for the same policy reasons.

Where the taxpayer is denied access into the MAP program by the Canadian competent authority or its TPR is rejected by the CRA pursuant to subsection 247(10), it is the CRA’s position that the taxpayer would not have any objection or appeal rights, since no assessment to the Canadian taxpayer is issued as a consequence of those decisions. The only recourse for taxpayers to contest these decisions would be for the taxpayer to file an application to the Federal Court for judicial review.

In summary, Canadian corporations have historically found themselves in a predicament when they discover that they are in need of downward adjustments due to mistakes in their transfer pricing analysis on filed returns. More often than not these mistakes are simply due to the complexity of the relevant transfer pricing guidelines or a lack of due diligence (i.e. often because of cost factors) at the time the transfer pricing documentation was initially prepared. These cases certainly do not always involve abuse or retroactive tax planning.

Recent developments in Canada - Self-initiated transfer pricing adjustments

2013 Canadian Competent Authority Announcements on Downward Adjustments

In a CRA Newswire dated December 20, 2013, the Canadian competent authority published some Q&As on the CRA website addressing, among other topics, downward transfer pricing adjustments. It confirmed it would accept requests under the MAP with respect to self-initiated downward adjustments in Canada if certain conditions were met. That notice was recently pulled off the CRA website. However, it is the author’s understanding that this remains the Canadian competent authority’s policy and it will be incorporated, with similar language, in the next update to Information Circular 71-17 – Guidance on Competent Authority Assistance Under
Canada’s Tax Conventions. Question #2 of the 2013 Q&A reads as follows:

"Question 2(a): Will the Canadian competent authority accept a case under the mutual agreement procedure (MAP) that involves a request by a Canadian entity to reduce its Canadian taxable income (downward transfer pricing adjustment) if the request relates to a self-initiated (that is, not initiated by a tax authority) adjustment to increase the income of a related entity in another country (upward adjustment)?

Answer 2(a): The Canadian competent authority will accept a case under the MAP that involves a request for a downward adjustment in these circumstances:

• The upward adjustment has been accepted for consideration by the foreign tax authority;
• The foreign competent authority tries to resolve the case under the MAP. That is, the foreign country reviews the case, provides the Canadian competent authority with a detailed analysis as to why the foreign authority agrees with the adjustment and agrees to negotiate the case;
• The request for competent authority assistance is made within the time limits of the applicable treaty; and
• The issue is not one that the Canadian competent authority has decided, as a matter of policy, not to consider.

Question 2(b): What will happen if one of the requirements above is not met (for example, the foreign competent authority does not accept the case)?

Answer 2(b): If the above requirements are not met, the Canadian competent authority will close its MAP case. The taxpayer will then have the option to apply to the Audit Division of the local tax services office to ask for a downward adjustment, in accordance with the information in Transfer Pricing Memorandum TPM-03, Downward transfer pricing adjustments under subsection 247(2)."

The 2013 Q&A provided some needed guidance to the Canadian transfer pricing community, but still leaves Canadian corporations with a high level of uncertainty for the following reasons:

• Since the question relates to the MAP, the answer did not address the situation where a Canadian corporation attempts to resolve the matter unilaterally by filing a TPR with the local tax services office without requesting upward adjustments, or filing amended returns, in the foreign jurisdiction. One could read the Q&A, however, as suggesting that, due to the CRA’s concerns about double non-taxation, the Canadian corporation should first attempt to resolve the matter by having its related corporation request upward adjustments, or filing amended returns, in the foreign jurisdiction and then resolve the matter under the MAP. Only then, if the taxpayers are denied access to the MAP, the Canadian corporation could file a TPR with the

local tax services office.

- The Canadian competent authority still maintains the right to reject cases on policy matters. For example, if the Canadian competent authority believes the taxpayer is engaged in retroactive tax planning,[8] it could, presumably, still reject the MAP request. As alluded to above, this begs the question would a local tax services office decision to accept a TPR be any different and, if not, why submit the TPR?

- The requirement that the foreign competent authority must provide a detailed analysis as to why it agrees with the adjustment is problematic, in that it forces the foreign competent authority to provide the Canadian competent authority its independent analysis of the arm’s length principle and not just rubber stamp their resident taxpayer’s analysis. In other words, it forces the foreign competent authority to do the work that would have normally been done by its tax auditors and documented in an auditor’s report. Taxpayers cannot possibly predict whether foreign competent authorities would fulfill these procedural requirements.

Recent Changes in IRS Policies on Self-Initiated Adjustments

The U.S. competent authority has not been consistent over the years on this subject. However, the U.S. competent authority’s current policy suggests that it may be prepared to accept certain self-initiated adjustments into its MAP program. This is important in light of the Canadian competent authority’s position as stated in their 2013 Q&A. It is beyond the scope of this article to analyze the conditions set out in Rev. Proc. 2015-40, but taxpayers should be aware that any such competent authority requests in the U.S. would require a pre-file meeting.

Upcoming Changes to TPM-03 – Downward Transfer Pricing Adjustment under subsection 247(2)

At a Canadian Tax Foundation conference in March 2019, the CRA announced that TPM-03 is currently being updated to better clarify the CRA’s positions on TPRs, including when such files should be dealt with by the local tax services office (as TPRs) versus the Canadian competent authority (under the MAP). As of the release date of this article, the CRA had not published an updated version of TPM-03.

Upcoming Changes to Information Circular 71-17 –
Guidance on Competent Authority Assistance Under Canada's Tax Conventions

The Canadian competent authority has been working on a revised version of Information Circular 71-17 for quite some time. This is a comprehensive information circular, last updated in 1995, and, as mentioned above, will include some updated guidelines on self-initiated transfer pricing adjustments. As of the release date of this article, the CRA had not published an updated version of this circular.

OECD and BEPS Initiatives – Action 14

In the BEPS 2015 final report on Action 14 Making Dispute Resolution Mechanisms More Effective, the OECD identified a number of best practices that are related to, but not part of, the minimum standards for that action. Best Practice #9 reads as follows:

"Countries' published MAP guidance should provide that taxpayers will be allowed access to the MAP so that the competent authorities may resolve through consultation the double taxation that can arise in the case of bona fide taxpayer-initiated foreign adjustments – i.e. taxpayer-initiated adjustments permitted under the domestic laws of a treaty partner which allow a taxpayer under appropriate circumstances to amend a previously-filed tax return to adjust (i) the price for a transaction between associated enterprises or (ii) the profits attributable to a permanent establishment, with a view to reporting a result that is, in the view of the taxpayer, in accordance with the arm's length principle. For such purposes, a taxpayer-initiated foreign adjustment should be considered bona fide where it reflects the good faith effort of the taxpayer to report correctly the taxable income from a controlled transaction or the profits attributable to a permanent establishment and where the taxpayer has otherwise timely and properly fulfilled all of its obligations related to such taxable income or profits under the tax laws of the two Contracting States." (underlining for emphasis)

The commentary to Articles 9 and 25 in the OECD Model Tax Convention on Income and on Capital was updated in 2017 to reflect the final recommendations made by the OECD under Action 14. This revised commentary includes updated information to reflect Best Practice #9 above. Canada appears to be fully in agreement with the new commentary, since it did not enter an observation on it. Furthermore, Canada has now posted its "Dispute Resolution Profile" on the OECD website. Under item B(9), Canada confirmed that it will accept within the scope of the MAP article double taxation cases resulting from "bona fide" taxpayer initiated foreign adjustments.
The OECD has defined self-initiated transfer pricing adjustment cases as "bona fide" where taxpayers are acting in good faith to report correctly the arm's length principle in both jurisdictions. This would be consistent with the CRA's concerns in these cases regarding double non-taxation. However, other than the reference to "good faith efforts", there is nothing in the new commentary or Best Practice #9 providing guidance on cases that could be considered offensive to tax administrations (e.g. retroactive tax planning cases, where the self-initiated adjustments result in significant "net" tax refunds between the two related entities). Although it seems clear that the OECD would like to see competent authorities throughout the world adopt policies that would not be restrictive in allowing its taxpayers access to the MAP, competent authorities will likely still reserve the right to deny access into their respective MAP programs where they perceive some kind of abuse. The authors are hopeful that any new guidelines in IC 71-17 will be consistent with Canada's commitments to the OECD under BEPS Action 14 and will shed some light on when cases may be rejected based on retroactive tax planning concerns.

**Recent Changes to Canada's Voluntary Disclosure Program**

On December 15, 2017, the CRA released the current version of Information Circular IC00-1R6 – Voluntary Disclosure Program, which significantly tightened up its program for applications received after February, 2018. Because of complexity, VD applications relating to transfer pricing matters are now to be referred to the Transfer Pricing Review Committee ("TPRC") for consideration. Although the CRA's new VD guidelines are silent with respect to the waiver of possible transfer pricing penalties, it is our understanding that the intention of the CRA is to waive such penalties on a VD application where the taxpayer is providing the CRA with the proper transfer pricing documentation. In the Sifto Canada Corporation case (see comments in Part II of this series), the CRA's VD division, arguably, acted carelessly in accepting the taxpayer's transfer pricing analysis without conducting its own transfer pricing analysis or, alternatively, referring the file to an area within the CRA with the expertise to conduct such an analysis. The CRA's new policy to forward all applications to the TPRC is presumably as a consequence of the Sifto Canada Corporation scenario.

**New arguments being raised within tax community that notices of objection can be filed where the CRA denies a TPR under Subsection 247(10)**
In a recent article entitled "Disputing Denied Downward Transfer Pricing Adjustments" by Daniel Sandler and Lisa Watzinger, it was suggested that in light of subsection 247(11), taxpayers should have the right to file a notice of objection where the CRA has denied a TPR pursuant to subsection 247(10). Subsection 247(11) is the provision in Canada's transfer pricing rules which lists certain provisions in Part I of the Act, including the notice of objection rules in section 165, that should apply in transfer pricing cases "with such modifications as the circumstances require". At the time this article was released the authors are not aware of any CRA documents, guidelines or statements that would indicate that they agree that subsection 247(11) would apply to give taxpayers objection rights in these circumstances. However, the arguments raised in the Sandler/Watzinger article are not without merit and it is possible the Canadian tax community may see the interaction of subsections 247(2), 247(10), 247(11) and 165(1) addressed in a Canadian court.

Conclusion

In recent years, the Canadian transfer pricing community has received a significant amount of additional information on this subject and even more is to be released shortly by the CRA. However, taxpayers and their related companies must proceed with extreme caution before initiating any action with the CRA or a foreign tax administration to amend tax returns that have not yet been subject to audit activity. Taxpayers must fully understand the interplay amongst the TPR, MAP and VD processes, in both countries, to ensure they do not expose themselves to unresolved double taxation or transfer pricing penalties as a consequence of self-initiated actions.

[1] Part I of this article can be read here: Transfer pricing: What's new in Canada (Part I) and Part II here: Transfer pricing: What's new in Canada (Part II)

[2] The purpose of the APA program is to allow taxpayers to have certainty on their transfer pricing methodology for prospective years. However, in the case of a bilateral APA ("BAPA"), the CRA allows the taxpayer, under certain conditions, to request that the agreed upon transfer pricing methodology under the APA be rolled back to non-statute barred years. The CRA's policy is not to apply transfer pricing penalties to the rollback years.

[3] In the case of a BAPA where both competent authorities have agreed to a rollback, the foreign tax administration would already be undertaking to provide correlative relief (i.e. to resolve double taxation) in those prior years. That would not necessarily be the case with an upward adjustment arising from a VD. In the latter case, once the CRA accepted the VD and reassessed the taxpayer, the taxpayer and its related foreign company would then have to initiate competent authority requests under the Mutual Agreement Procedure in the hopes of
resolving the double tax.


[5] The CRA’s policies as to when it will accept TPRs, in transfer pricing and non-transfer pricing cases, are described in Information Circular 75-7R3 - Reassessments for a Return of Income.

[6] Subsection 247(10) basically states that a downward transfer pricing adjustment shall not be made "unless, in the opinion of the Minister, the circumstances are such that it would be appropriate that the adjustment be made." All statutory references in this article are to the Act.

[7] See TPM-03 - Downward transfer pricing adjustment under subsection 247(2) and paragraph 26 of Information Circular 87-2R - International Transfer Pricing.

[8] Consider low or preferential tax regimes in the foreign treaty country or scenarios where the foreign related company is in a significant loss position and any upward adjustments in those countries are going to result in nominal additional foreign tax when compared to the Canadian tax refunds being sought.

NOT LEGAL ADVICE. Information made available on this website in any form is for information purposes only. It is not, and should not be taken as, legal advice. You should not rely on, or take or fail to take any action based upon this information. Never disregard professional legal advice or delay in seeking legal advice because of something you have read on this website. Gowling WLG professionals will be pleased to discuss resolutions to specific legal concerns you may have.

Related Tax, Tax Dispute Resolution

Authors

Jim Wilson
Partner - Transfer Pricing & National Tax Group, Ottawa

Email jim.wilson@gowlingwlg.com
Gowling WLG is an international law firm comprising the members of Gowling WLG International Limited, an English Company Limited by Guarantee, and their respective affiliates. Each member and affiliate is an autonomous and independent entity. Gowling WLG International Limited promotes, facilitates and co-ordinates the activities of its members but does not itself provide services to clients. Our structure is explained in more detail on our Legal Information page.

© 2020 Gowling WLG International Limited. All rights reserved.