Canadian Transfer Pricing – Applied Case Studies

Markus Navikenas
Shiraj Keshvani
Deloitte LLP

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Agenda

Canadian Transfer Pricing – applied case studies

- Business restructuring
- Intangibles and intellectual property
- Relevant court cases
- Transfer Pricing predictions

Business restructuring

The Canadian Experience

Purpose and scope of Chapter IX

Context

Business restructuring

- New TPG Chapter IX (incorporated into commentary to Article 9 of OECD Model Convention)
- Part I: Special considerations for risks
- Part II: Arm's length compensation for the restructuring itself
- Part III: Remuneration of post restructuring controlled transactions
- Part IV: Recognition of the actual transactions undertaken

Growing international dialogue and cooperation

Intangibles

- OECD currently scoping project on transfer pricing aspects of intangibles
- transfer pricing issues of intangibles identified as key area of concern for governments and taxpayers
- Objective of project is guidance on the definition, identification and valuation of intangibles for transfer pricing purposes

Expect tax administrations to immediately apply new Chapter IX both retrospectively, i.e. audits and prospectively

Practical implications of Chapter IX
Canadian perspective

- There are no provisions in the ITA which deal specifically with this aspect of transfer pricing
- The transfer pricing rules contained in Section 247 of the Income Tax Act ("ITA") apply to a transaction or series of transactions
- Definition of "transaction" in Subsection 247(1) ITA is broad enough to cover business restructurings/same with "series of transactions"
- CRA has challenged such restructurings or aspects of restructurings, particularly under paragraph 247(2)(b) of the ITA
- The general anti-avoidance rules (GAAR) in section 245 ITA may be invoked, but high threshold to apply
- CRA has challenged structures on the grounds that the entity in the lower-tax jurisdiction does not have the managerial and/or financial capacity to bear risks such as intellectual property ownership and R&D programs

Practical implications of Chapter IX (cont'd)
Canadian perspective

- CRA has challenged conversions of full-fledged entities into low-risk entities and transfers of intellectual property rights to lower-tax jurisdictions (crown jewels argument), even when fully documented
- IP migration cases are subject to mandatory referrals to CRA HQ
- Reallocation of profit potential – CRA tends to compare the pre- and post-restructuring profitability of the restructured entity
- Entity in lower-tax jurisdiction and managerial and/or financial capacity to bear risks
- "Exit tax" provision in ss. 128.1(4) ITA that deems a taxpayer to have disposed of its tangible and intangible property upon emigrating from Canada

Business restructuring in Canada

Development of tax authority approach

The Canadian story so far...

- Early Tax authority approach
  - Lack of understanding of BR in a transfer pricing context
  - No central unit responsible for co-ordination sporadic referrals to HQ
  - Variable extent of scrutiny and little effective challenge
  - Key challenges on not clear systematic approach to resolving issues– case-by case basis
  - Some coordination but challenges primarily centred around
    - Local closing/restructuring costs
    - “No change” leading to restoration of full-fledged TPM

Now

- Strong coordination and central influence in North America
- Large volumes of data requested regarding change (or lack of it)
- Increasing tendency to more focused questions (extent of data can still be voluminous)
- “Nothing has changed” challenge/ foregone profit compensation
- Current analytical emphasis
  - Focus on residual profit
  - Focus on local intangibles, lost business opportunity, abusive termination of contracts
  - Focus on before and after profitability
  - Pseudo recharacterizations

Hot tax audit topics
Key tax issues challenged

Compensation	• Starting point for tax authorities – Reduction in profits regularly leads to scrutiny by tax authorities • Compensation claimed by local tax authorities for transferred intangibles (patents, know-how, brand names, trademarks, contracts, customer lists, business opportunities, goodwill, etc.) upon conversion of local entities into (e.g., low risk distribution entities and toll manufacturers)
Substance	• Lack of commercial purpose/substance in business change challenged by tax authorities • Particularly in the case of changes in risk profile or changes in ownership of intangibles • Wherewithal to bear the risks – financial capacity • Control over the risk/ability to manage the IP – conduct of parties challenged re consistency with agreements/documentation • With insufficient substance in principal company, profit shift entirely refuted as "nothing has changed"
Post-restructuring pricing	• Arm's length nature of transfer prices after restructuring (e.g., commission fee, contract manufacturing fee, contract R&D fee, license fee, etc.) • Compliance with transfer pricing documentation requirements
Disregard of a restructuring	• Tax administration may not recognize actual arrangement in "exceptional circumstances" • Tax authorities can agree with the nature of the transactions, but still adjust the price or other terms and conditions • These adjustments while presented as a re-pricing, can at times, only be brought into effect if the transaction were disregarded

Case #1 – manufacturing plant shut down

- Manufacturing shut down
- Local distribution only

CanCo

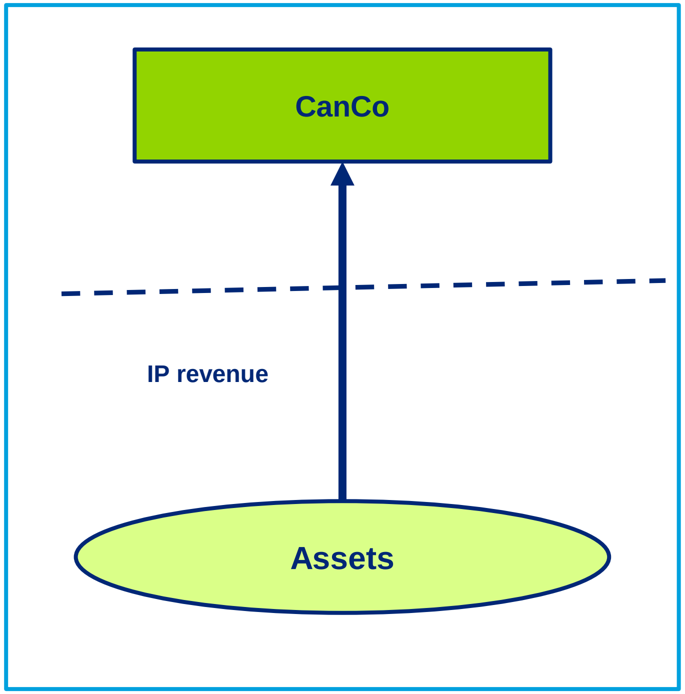
USCo

- Manufacturing continued and consolidated with Canadian plant assets

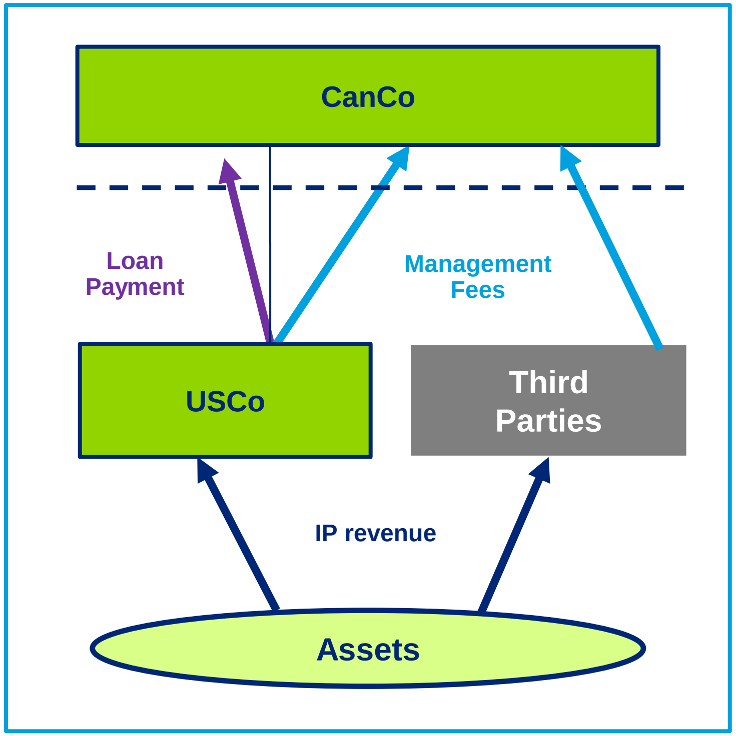
- Local distribution continued

Case #2 – IP asset company

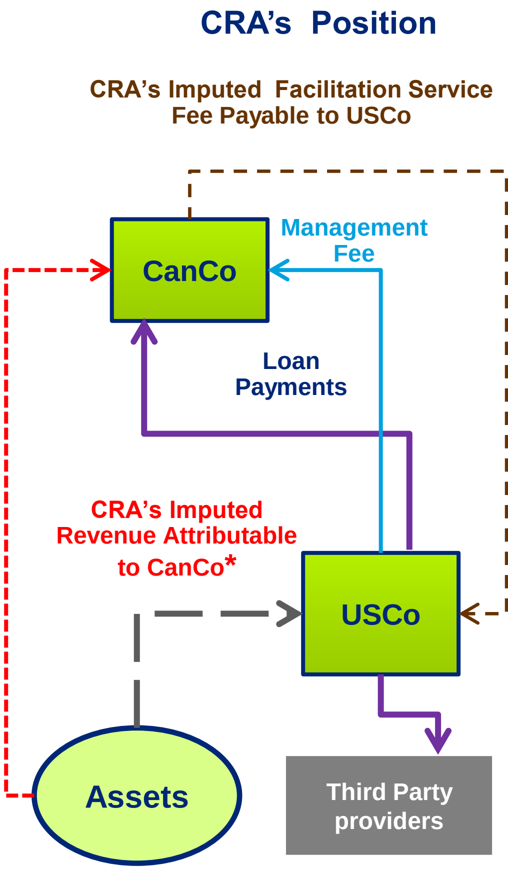
Original Position



Restructured Position



Case study #2 – CRA‘s restructuring of asset manager



*Total Revenue – (Management Fees + Loan Payments + Other U.S. Expenses)
i.e. Equal to Net Income of U.S. Entities

Implications of the OECD draft chapter VI transfer pricing aspects of intangibles

Canadian Perspective

What is an intangible? (A definition)

- Something of value
- Does not appear to be limited to traditional concept of property
- Intangible vs. intangible property
- Ownership and control
- Specifically excluded
- Know-how and trade secrets

Transfer pricing for intangibles

Pricing the use of an intangible

- Arm’s length royalty rate
- Paid as consideration for the use of intangible(s)
- Generally pursuant to a license of the intangible
  - No transfer of ownership contemplated

Pricing the sale of an intangible

- Interaction of arm’s length principal and fair market value

Transfer Pricing – basic rules

Acceptable Transfer Pricing methods

Transactional methods

- Comparable uncontrolled price (CUP)
  - Comparison of royalty rates in arm's length licences
  - Gross margin based

Profit based methods

- Transactional net margin method/comparable profits method (TNMM/CPM)
- Profit split methods

Cost sharing arrangements

Transfer Pricing – basic rules (cont'd)

U.S. CUT method

From a practical perspective, the application is identical to the CUP method

However, two additional criteria

- Commensurate with income standard
- Similar profit potential demonstrated by NPV or other analysis
  - Taxpayer burden of proof
  - Practically, a very difficult analysis to prepare and support
    - Lack of information on comparable arrangements
  - May nonetheless use comparables in other analyses

Controversial issues

1. **Are comparables ever comparable?**

2. **Definition, value and ownership**
   - Economic ownership
     - Developer – assister concepts, application of OECD 6.36 – 6.39
     - Bright line test of normal expenditures
   - Vague historic documentation/agreements

3. **Expectation of profit**
   - Can royalty create/increase losses?
   - Expectation of profit

Controversial issues (cont'd)

4. **Residual royalty analysis**
   - TNMM/CPM analysis to determine income of routine licensee
     - Transactional focus
   - Would anyone enter into arm's length agreement if 100% of benefit paid to licensor

5. **Rule of thumb**
   - Old principal, not consistently applied
   - Use quashed in U.S. court
   - Appears to have legs in Canada, for now

6. **Quasi- recharacterization**
   - License of technology akin to provision of a service

7. **Sale and migration transactions**

The big issue – sale and migration transactions

Tier 1 issue in U.S., with $billions of tax at stake

Numerous cases being reviewed in Canada and elsewhere

U.S. response

- 2005 proposed regulations
- 2007 coordinated issue paper
- 2008 temporary cost sharing regulations and 2011 final regulations
  - Premised on “investor model” and “realistic alternative”

OECD response

- Chapter IX of OECD Guidelines on business restructuring
- Current “Intangibles Project” to revise Chapter VI

OECD intangible project

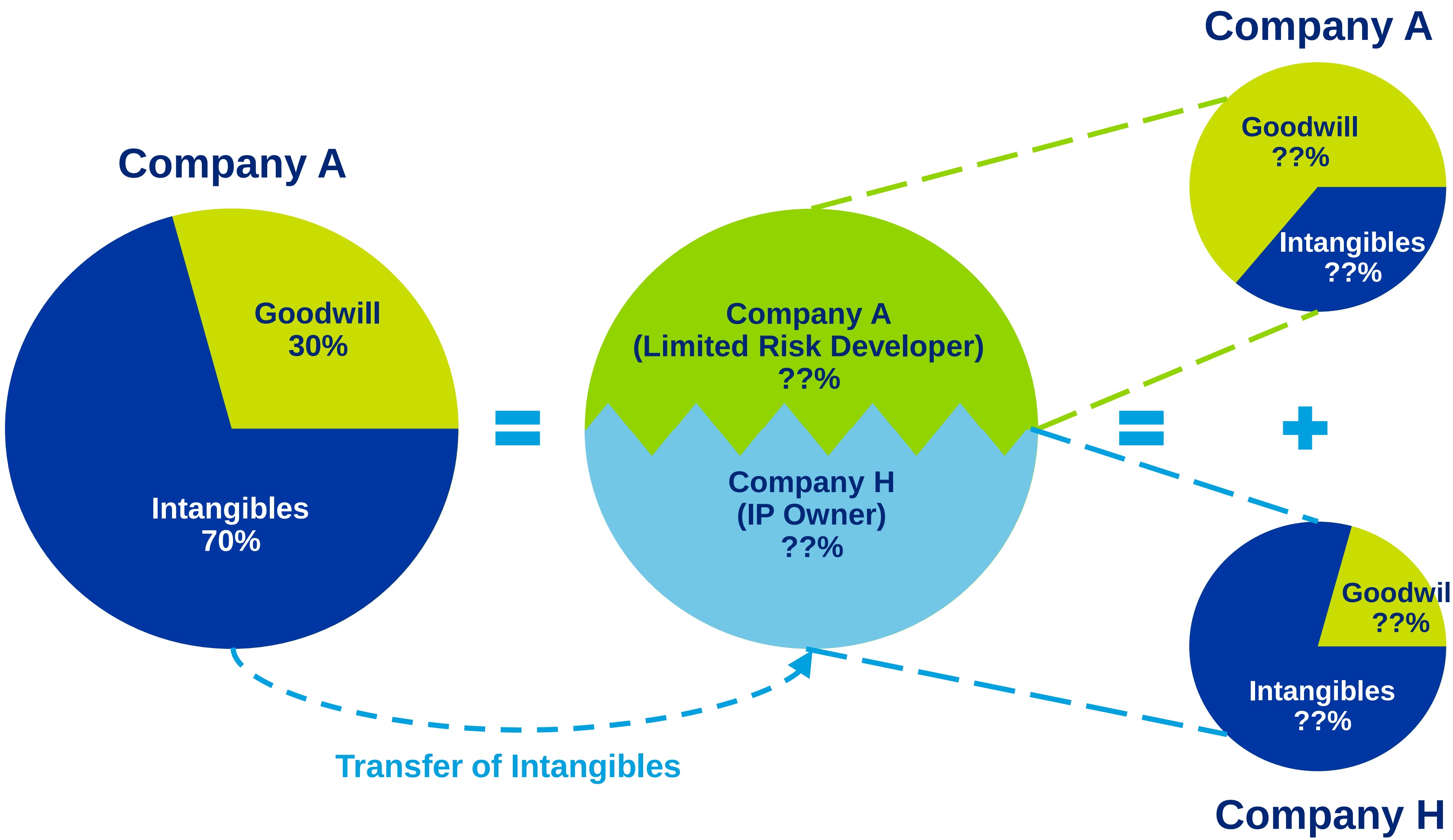
Areas for further work

- Framework for analysis of intangible-related transfer pricing issues
- Definitional aspects
- Specific categories of intangibles
- Right of an enterprise to share in the returns from intangibles it does not own
- Pricing
- Recharacterization

Focal points from latest consultation session

- Definition of intangibles
- Definition and treatment of goodwill
- Definition of the term “brand” and its importance for transfer pricing
- Approach for determining entitlement to intangible returns
- Importance of synergies

Underlying valuation premise



Company A: Valuation process

A determination of the goodwill allocation between Company A and Company H as a six step process of elimination

Company A

- Pre-Reorganization → 1. Determine the value of Company A prior to any reorganization
- − Post-Reorganization → 2. Determine the value of Company A on a proforma basis, post-reorganization

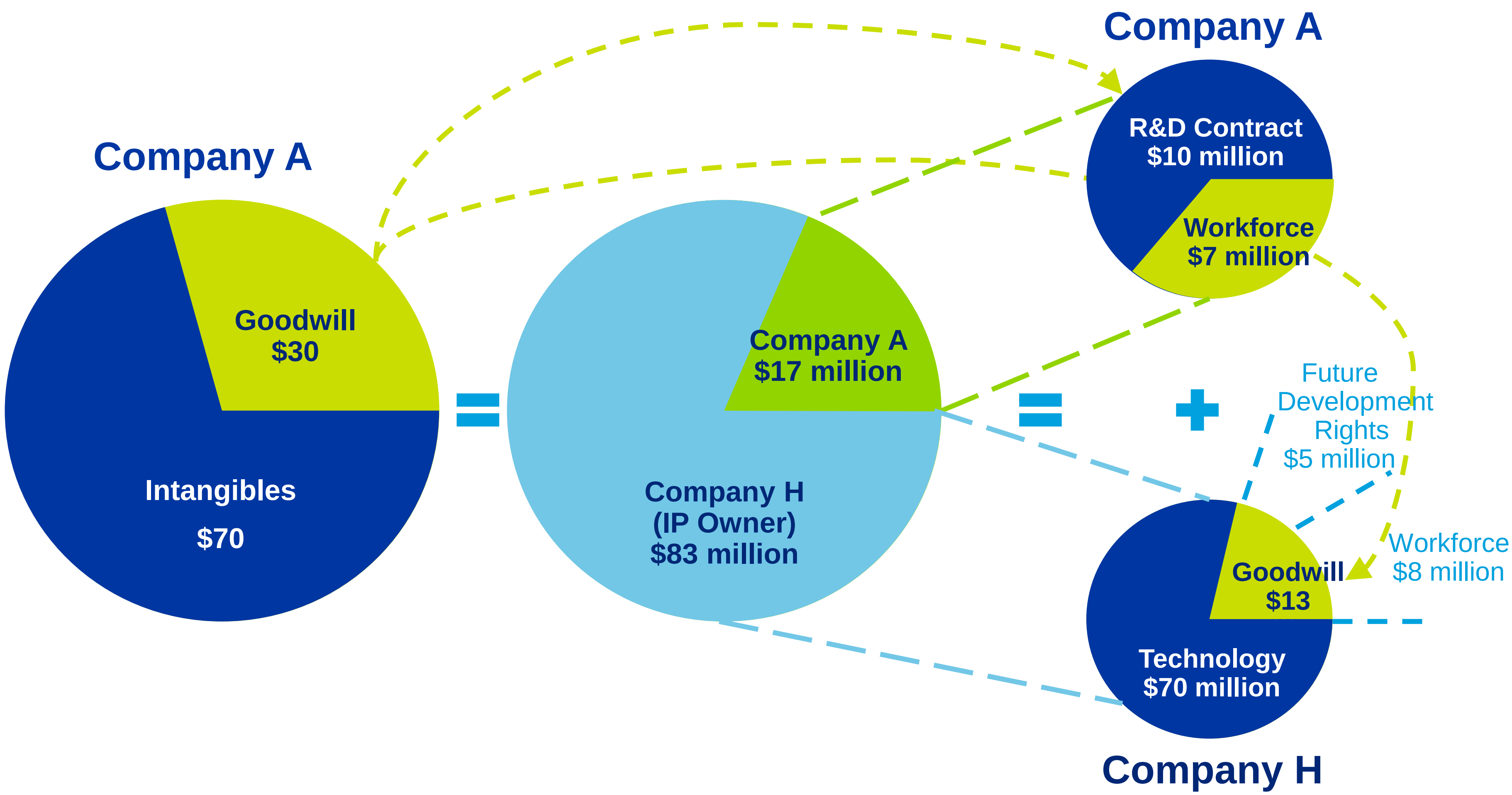
Company H

- = Value Transferred → 3. Deduct the post-reorganization value of Company A from the pre-reorganization value
- − Value of Intangibles → 4. Determine the value of any intangibles owned by Company H on a pro-forma basis
- = Value of Goodwill Transferred → 5. Deduct the value of Company H intangibles from the value transferred

Company A

- − Value of Goodwill Pre-Reorganization → 6. Deducted the value of Company H goodwill from the pre-reorganization goodwill value of Company A
- = Value of Goodwill Retained

Value Summary



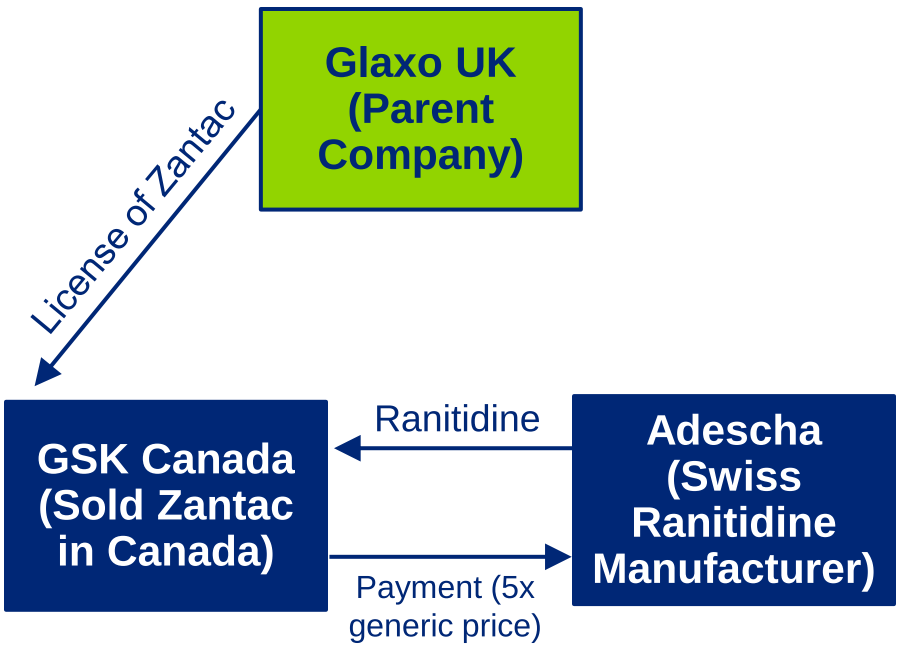
Key considerations

- ✓ Assumption of arm's length market rate for contract services into perpetuity
- ✓ Contract R&D services imply a lower risk profile than IP ownership
- ✓ Existing IP is less risky than goodwill, including future development rights and assembled workforce
- ✓ Assembled workforce is less risky than future development rights
- ✓ Entering into a contract R&D arrangement gives rise to the creation of a, previously unidentified, intangible asset for the LRD

Relevant court cases

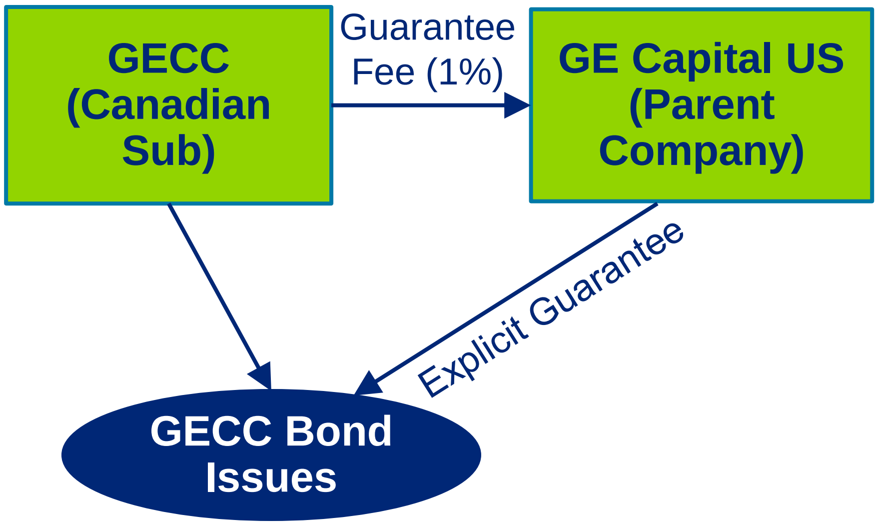
Canadian implications

GlaxoSmithKline Canada



- First transfer pricing case heard at the Supreme Court of Canada on January 13, 2012
  - Identification of transaction limited to *bona fide* legal arrangements?
  - Bundling vs. unbundling of transactions for analysis
  - Arm’s length standard vs. “reasonable business person” test
- CRA - only generic cost of ranitidine be considered as market cost (CUP method)
- GSK – question is whether arm’s length parties would accept transaction as entered into, ignoring ingredient to be used by branded product Zantac – reasonable under the circumstances?

General Electric Canada Company



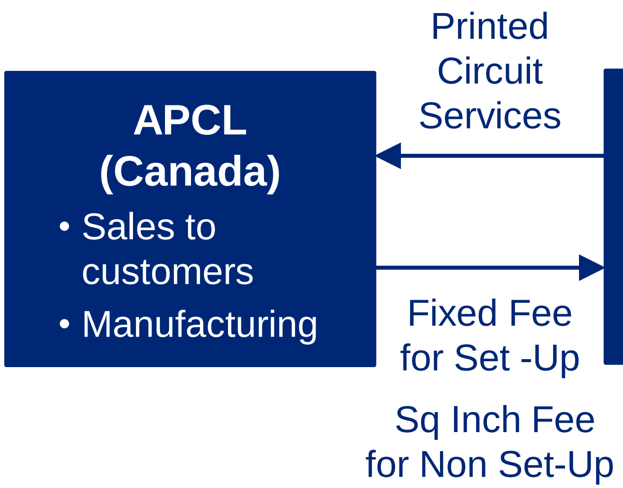
On December 19, 2011, the Tax Court dismissed a motion by General Electric Canada Company ("GECC") and GE Capital Canada Funding Company ("the Appelants")

The Appellants sought to strike several paragraphs from the Replies filed by the Crown on the basis that the Crown was re-litigating a previously-decided matter

Motion dismissed on basis of different taxpayers and years in question

Leave given to the Crown to make a small amendment to one of the Replies to clarify the distinction between legally binding guarantees and implied guarantees or support

Alberta Printed Circuit Ltd.



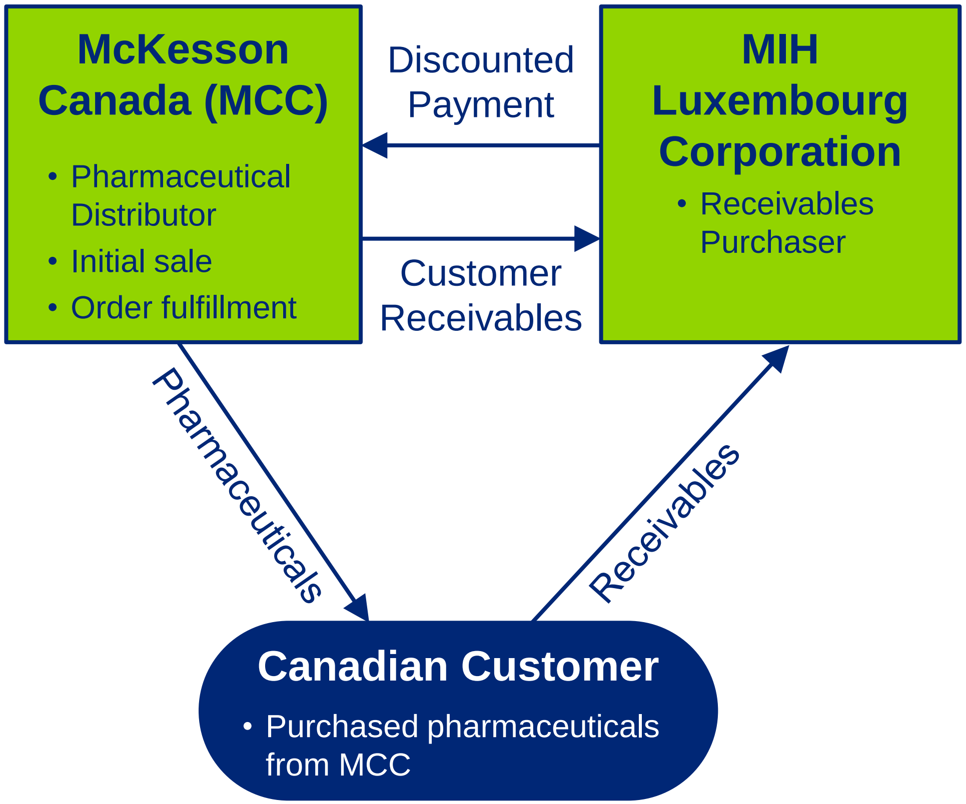
Taxpayer presented support for the use of CUP method

Court agreed with taxpayer's position and strongly criticized CRA for not considering CUP as appropriate method

- Comparatively much smaller transactions
- Involved low tax jurisdiction (Barbados)

Further evidence of endorsement of the CUP method

McKesson Canada



Concluded on February 3, 2012 and judgment should be released in coming months

Sale of receivables to related Luxembourg company

CRA: The agreed-upon discount rate for factoring accounts receivable differed from the discount rate to which the parties would have agreed had they been dealing with one another at arm's length

Interesting aspects of the McKesson case

- CRA's perspective – securitization instead of outright sale of receivable, denied most of discount on receivables
- Crown did not argue 247(2)(b) – re-characterization of transaction
  - As a result, Crown arguments were limited to 247(2)(a)
- Lengthy discussions on the scope and thresholds of application of 247(2)(a) vs. (b)
- Wording of 247(a) critical
  - 247(2)(a) does not contain "reasonable in circumstances" standard – does it allow for structural adjustments to the price?
- Implications of Supreme Court decision in Shell Canada (and similar decisions)
  - Legal agreements driving much of discussion and therefore critically important
  - Demonstrating risk transfer took place is critical
- OECD guidelines and perspective only considered as reference

Please Remember to Complete Your Evaluation

Speaker bios

Shiraj Keshvani is a Partner in Deloitte LLP's Global Transfer Pricing and Tax Controversy Practice and the National APA/Competent Authority Leader.

Since joining Deloitte, Shiraj has assisted multinational clients to manage and resolve difficult and contentious tax controversy issues. He has also conducted a number transfer pricing projects, in a variety of industries, involving audit defense, competent authority assistance, APAs as well as planning and documentation studies. Currently Shiraj is personally involved in over 20 APAs at various stages and a wide range of planning and controversy engagements dealing with issues such as business restructurings, the treatment of intangibles, and characterizations. Shiraj continues to remain active on the policy front and is currently a member BIAC Tax Committee (The Business and Industry Advisory Committee to the OECD) and the ICC (International Chamber of Commerce) Commission on Taxation. Shiraj was recently voted into Legal Media Group's World's Leading Transfer Pricing Advisors.

Shiraj holds Bachelors (honours) and Masters of Arts degrees in Economics and, prior to joining Deloitte, was the Chief Economist for Canada Revenue Agency's (CRA) Competent Authority Services Division and the national APA Coordinator. He has an deep understanding of CRA's policies and procedures and the CRA perspective and focus on many contentious issues.

Phone: +1 613 751 5293
Email: skeshvani@deloitte.ca

Markus Navikenas is a Partner and leads the Transfer Pricing Services practice for Deloitte LLP in Calgary, Alberta. Markus has significant experience in transfer pricing. His client work often involves dealing with the tax authorities on a wide range of transfer pricing matters, and assisting clients in compiling and presenting information in support of transfer pricing audits.

Markus consults of Deloitte's clients in the petrochemical and energy industries. His practice specializes on designing business models and transfer pricing analysis and cuts across all sectors of the energy industry. He also assists multinationals with responding to tax authorities, voluntary disclosures advance pricing arrangements and double taxation cases.

Markus has written articles and frequently speaks on the topic of transfer pricing for the Tax Executive Institute, Council for International Tax Education, Canadian Association of Petroleum Producers, Calgary Petroleum Tax Society, Deloitte's Global Tax Roundtable, Acumen, as well as the Economics Society of Calgary.

Markus holds an MBA from Western Ontario's Richard Ivey School of Business and an MA from the University of Victoria.

Phone: +1 403 267 1859
Email: mnavikenas@deloitte.ca

Appendix

Case #1 – manufacturing plant shut down

- Manufacturing shut down
- Local distribution only

CanCo

USCo

- Manufacturing continued and consolidated with Canadian plant assets
- Local distribution continued

Facts

- CanCo and USCo in the same business
- Business restructuring involved shutting down two manufacturing plants of Canco
- CanCo manufacturing plants were operating based on obsolete equipment and were previously reporting continuous operating losses
- CanCo did not have the resources to invest in new manufacturing technology
- Significant quality concerns for both plants
- Both plants were unable to fulfill customer orders on their own as they could not produce minimum quantities,
- Equipment assets (that were functioning and could be salvaged) were transferred at NBV to the U.S. manufacturing operations
- Land and building real estate assets were disposed of at FMV to local third parties

Transfer Pricing analysis

Potential adjustment

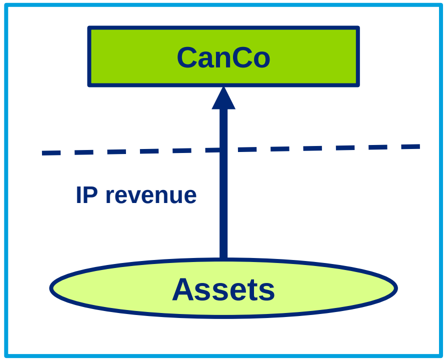
- Compensation due to Canada as USCo benefits and would pay

Analysis

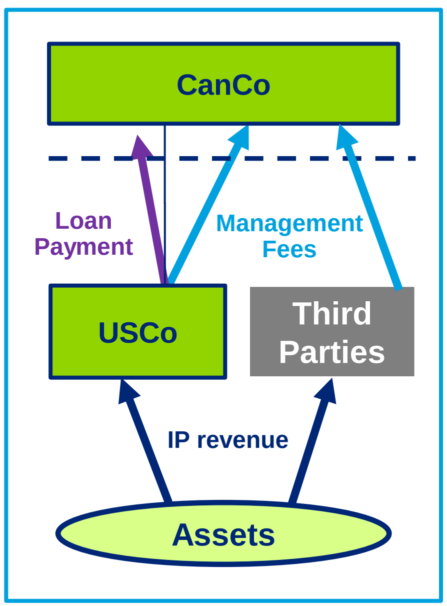
- Performed a macroeconomic industry analysis
  - ✓ Reviewed Porter's five forces model for buyers, suppliers, new entrants, substitutes, and rivalry
- Considered realistically available alternatives per OECD guidelines para 9.59
  - ✓ Documented restructuring measures to cut costs and rationalize manufacturing
  - ✓ Considered management reviews of plant operations in CanCo and USCo for viability going forward
- Reviewed interco legal agreements for contractual termination clauses and compared with expected AL terms and conditions
- Explored potential alternative uses of the plant assets

Case #2 – IP asset company

Original Position



Restructured Position



Facts – originally

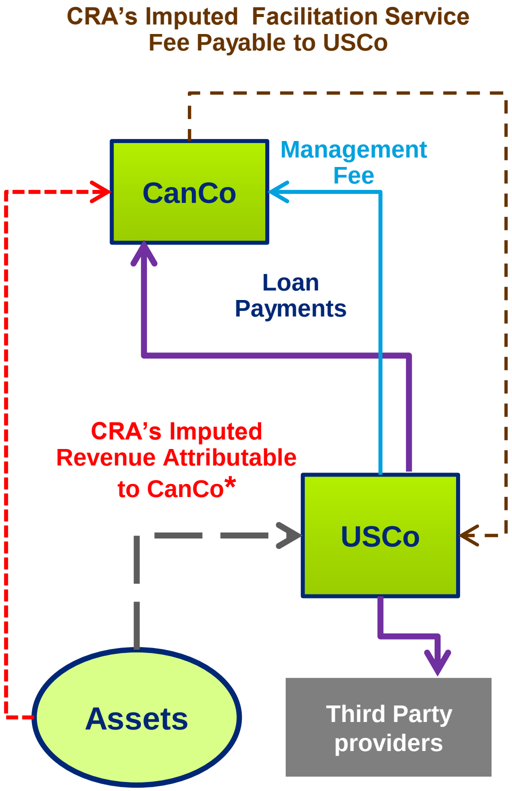
- CanCo established in the 90's as for purposes of investing in IP assets
- After several years only successfully acquired one IUP asset
- CanCo acquired in the late 90's, with a view to expanding the business and taking advantage of rapid growth in the IP market
- After some time and several unsuccessful efforts new owner failed to grow the business
- Lack of interest on the part of lenders to provide capital across borders to fund investments
- Lack of interest on the part of asset owners to sell IP across borders
- Inability to compete due to higher borrowing premiums and additional transactions costs
- Taxpayer highly risk averse paid two different advisors for in depth analyses
- Both advisors arrived at very similar conclusions

Facts – post restructuring

- USCo acquires new IP investments and bears associated risks.
- USCo capitalized with original IP and equity
- Interco loan with rates of 6% to 10%
- USCo raised additional funds externally
- This debt was secured against USCo's assets and USCo was legally obligated to service these debts
- USCo entered into agreements with third parties to acquire the IP assets
- Third Parties contractually obliged to pay IP revenue to USCo
- CanCo performs management and portfolio management services for USCo
- CanCo provided similar services to arm's length investor
- USCo does not have any employees, but board meetings are held regularly
- USCo also pays significant fees to third party advisors
- During the audit period, USCo raised or 90% of its total debt financing from third parties

Case study #2 – CRA's restructuring of asset manager

CRA's Position



*Total Revenue – (Management Fees + Loan Payments + Other U.S. Expenses) *i.e. Equal to Net Income of U.S. Entities*

CRA audit position

- Interest paid on loans was not unreasonable
- Payments to CanCo for services consistent with the ALP
- USCo's only resources came from CanCo
- USCo was a holding company with no assets. Its sole purpose was just to be a U.S. Corporation; which certainly is not a driver of profit in this business
- The CRA argued that USCo was simply a conduit that was not in a position to assume or mitigate the risks and all profit should be earned by CanCo
- The CRA used the range of fees established by CanCo for its investment management services in support of the imputed transaction
- The range of fees was between 0% and 4%, i.e. a full range. The CRA then arbitrarily chose 0.5% of invested capital because USCO does not actually perform the investment management services
- The CRA argued that all the remaining profit should flow back to CanCo
- The CRA relied on 247(2)(a)and (c) to make this adjustment and not 247(2)(b)and (d)

Transfer Pricing analysis

- CRA disregards the U.S. entities, legal arrangements and contractual obligations to third parties
- The ultimate decision to invest in a royalty asset was made by USCo's board of directors
- USCo took measures to manage and mitigate the risks
- USCo spent approximately US$5 million in fees to raise the necessary funds
- The same transaction was entered by a third party
- Legitimate business reasons as evidenced by subsequent IP Acquisitions and third party financing
- CRA position implies that all dividend income can be repatriated via transfer pricing adjustments
- Reassessments were not raised in respect of the transfer prices for the provision of services and debt
- Consequently there is no further basis for an adjustment under paragraphs 247(2)(a) and (c) as no other transactions exist
- The current reassessment would result in a change to the legal and economic substance of the transactions. The threshold and procedures for recharacterization were not met

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