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Transfer pricing alert

Canada announces proposed country-by-country reporting requirements

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As anticipated by many, Canada's 2016-2017 federal budget, released March 22, 2016, proposes new country-by-country (CbC) reporting for large multinational entities (MNEs). While draft legislation is not yet available and will be released for comment "in the coming months", indications in the 2016 budget are that Canada's CbC rules will be consistent with the Organisation for Economic Co-operation and Development (OECD) recommendations in the October 5, 2015 final report *Transfer Pricing Documentation and Country-by-Country Reporting – Action 13* (OECD Guidance).

Canada has generally indicated support for the OECD's action plan on base erosion and profit shifting ("BEPS"). Countries including the United States, United Kingdom, Ireland, Australia, France and the Netherlands all have introduced domestic legislation to adopt CbC reporting for large MNEs. With the release of the 2016 budget, Canada has now also communicated proposed CbC reporting implementation, and has also formally endorsed other BEPS-related changes to international guidance on transfer pricing for MNEs.

While full details will only be available when legislative changes are enacted, at this time the following key transfer pricing themes are known from the 2016-2017 budget:

1. CbC reporting threshold

The first question taxpayers will consider in respect of CbC reporting is whether they actually have a requirement to prepare the CbC report (or are likely to be required to do so in the near future) or whether they are exempt from this obligation. The budget has made clear that taxpayers with total annual consolidated group revenues below EUR750 million do not have a CbC filing obligation. It appears that the reporting threshold is in euros rather than Canadian dollars for consistency with OECD Guidance.

While many countries have used the OECD recommended CbC threshold of EUR750 million, a number of countries have proposed a local currency denominated threshold, such as the CbC reporting threshold of USD850 million contained in the proposed U.S. regulations or the CbC reporting threshold of AUD1 billion contained in Australia's legislation. The use of different currencies for CbC reporting thresholds could give rise to inconsistent global CbC filing requirements.

For example, assume that at the current exchange rates, there is harmony between the U.S. and Canadian thresholds for CbC reporting. Therefore, today, if an MNE with a U.S. ultimate parent and a subsidiary in Canada has group annual revenue of EUR750 million, both the Canadian tax authorities and the U.S. tax authorities would require a CbC report, since the assumption is that EUR750 million = USD850 million, and therefore both thresholds are met. However, if the same MNE has group annual revenues in a subsequent year equal to EUR750 million, but the USD has appreciated considerably as compared to the euro and EUR750 million is now less than USD850 million, this could give rise to the situation in which the CbC report may not be required in the United States, but would be required in Canada.

It remains to be seen how countries will deal with the issue of changes in foreign exchange rates over time, which could give rise to inconsistent CbC reporting requirements. At this point in time, it appears that MNEs will be required to monitor the rules in subsidiary jurisdictions in addition to the rules in the ultimate parent entity's jurisdiction, or risk running afoul of local CbC requirements.

2. CbC report data requirements

Consistent with the OECD Guidance, although with a relatively low level of detail at this point, the budget notes that the CbC report will include the global allocation by country of key variables for the MNE including: revenue, profit, tax paid, stated capital, accumulated earnings, number of employees and tangible assets, as well as the main activities of each of its subsidiaries. It is expected that the draft legislative proposals will add clarity to exactly what is expected to be included in the CbC report, and in what format.

3. First year of CbC report

The budget has noted that the first CbC report will be required in Canada for taxation years after 2015. In other words, taxpayers with a calendar year end will first have CbC filing requirements pertaining to the year ending December 31, 2016. This is consistent with the OECD Guidance and many countries globally.

The Canadian CbC filing requirement is likely to be one year earlier than in the United States, as the U.S. proposed regulations are expected to apply to taxable years that begin on or after the date of publication of the U.S. Treasury decision adopting the rules as final regulations. Since the final U.S. regulations will likely be published sometime in 2016, taxpayers in the U.S. with a calendar year end would first have a CbC reporting requirement for U.S. purposes with respect to the year ending on December 31, 2017, rather than December 31, 2016.

MNEs are again cautioned to consider the filing requirements of subsidiaries as well as ultimate parent entities, since local rules may vary, and some jurisdictions - including Canada - will likely require CbC reporting for subsidiaries even if the ultimate parent entity is in a jurisdiction that does not require a CbC report.

4. Deadlines to file CbC reports

As noted in the budget, MNEs required to file a CbC report with the CRA will be required to do so within one year of the end of the fiscal year to which the report relates. Therefore, for taxpayers with a calendar year end, the CRA would expect the

CbC report from Canadian CbC filers by December 31, 2017 in respect of the first CbC year-end December 31, 2016. This is consistent with the OECD Guidance.

It appears that the expectation is that there will be a six month time lag between receiving the reports and exchanging them with other jurisdictions, as it is noted that the first exchanges between jurisdictions of CbC reports are expected to occur by June 2018. This is also consistent with the OECD Guidance, which mentions that CbC reports should be exchanged as soon as possible, and not later than 18 months after the last day of the fiscal year of the MNE Group.

5. Subsidiary filing requirement

The budget notes that in some circumstances, it is possible that the Canadian CbC requirements may necessitate a CbC report to be filed by a Canadian subsidiary, if the foreign ultimate parent entity does not face the same obligation in its tax jurisdiction, or if there is no mechanism that would allow Canada to obtain the CbC report filed in that jurisdiction. In such instances, the budget suggests that an MNE may avoid the imposition of this filing requirement on multiple subsidiaries in multiple jurisdictions by designating one of its subsidiaries to be a “surrogate” for filing purposes.

6. Increased compliance burden

The new CbC reports will require significantly increased compliance effort in respect of gathering and preparing CbC information. Certain data may not be readily available on a global level within MNEs, and many will have to upgrade their existing information systems or introduce new measures to be able to retrieve and gather the required data.

One strategy to better prepare for CbC reporting is to proactively perform a mock CbC report prior to implementation based on historical data. This approach would provide MNEs the opportunity to determine whether existing systems are up to the task of gathering the necessary data before filing deadlines loom.

7. Increased amount of information provided to tax authorities

The new CbC reports are meant to provide tax authorities around the world with high-level overviews of the global operations of large MNEs to enhance transparency. While the information is intended solely to “assist tax administrations in performing effective risk assessments” and not as a sole means of calculating transfer pricing adjustments, the questions that tax administrations may ask subsequent to their review of the CbC reports may ultimately lead to adjustments.

By preparing a mock CbC report proactively as suggested above, in addition to identifying whether the required data can be reliably captured, MNEs can also assess the information produced and consider how it may be interpreted by a tax authority. These insights will provide MNEs the opportunity to understand potential or perceived risk areas and determine whether additional information is needed to clarify the CbC data, as well as whether transfer pricing policies themselves may require further clarification and monitoring for adherence to changes to the OECD transfer pricing guidelines.

8. Additional CbC questions yet to be answered

Given the limited details provided in the budget, a number of questions remain that will likely be answered when draft legislation is released for comment in the coming months. Such questions include, for example, the potential penalty regime in Canada for failure to provide CbC reports to the Canada Revenue Agency (CRA) on time, whether additional exemptions from CbC reporting will be included in Canada similar to the U.S. exemption related to national security, the specific details in respect of international exchange of information (for example by way of signing the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports or negotiating separate agreements with each of the countries with which Canada expects to exchange CbC data), subsidiary requirements to inform the CRA of the jurisdiction of their ultimate parent entity or “surrogate” entity, specifics in respect of global inconsistencies in CbC reporting requirements, and detailed definitions for key concepts and reporting items.

9. Other revised transfer pricing guidance

While the arm’s length principle is mandated by section 247 of the Income Tax Act, the Act itself is silent as to how this principle is to be interpreted and applied. As a result, the CRA, taxpayers and Canadian courts have used the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* for interpreting and applying section 247. The budget has clarified that the OECD’s recent BEPS-related revisions to these Guidelines are being applied by the CRA.

The budget asserts that the CRA’s current audit and assessing practices already apply the OECD’s revisions. The revisions are noted as providing an “improved interpretation of the arm’s length principle”, rather than as a “change in the guidance”. It is possible that the intent of this wording is to allow for retroactive application of “improved interpretation” instead of applying the revised guidance only to subsequent taxation years. It is easy to see potential complications as a result of this view.

The budget announcement that the revised Guidelines are being applied by CRA could have far-reaching consequences, though additional specific interpretation will be required for clarity. For example, the revised Guidelines introduce a three-tiered documentation structure that, in addition to the CbC report, includes master file and local file requirements. The budget does not contain any specific references to a potential adoption of the master file or any significant revisions to the existing documentation requirements currently described in subsection 247(4) of the Act.

Looking ahead

While many questions will only be answered when the draft legislative proposals are released in the coming months, it is clear from the 2016-2017 budget that Canada is committed to the OECD’s BEPS project and will continue to work with the international community in the interest of global transfer pricing consistency. Despite this direction of global coordination, it will be important for MNEs to be vigilant in identifying local variations in respect of BEPS implementation in order to ensure proper compliance with CbC requirements.

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