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Transfer pricing alert CRA guidance on the impact of government assistance on transfer prices

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The Canada Revenue Agency (CRA) issued its 17th Transfer Pricing Memorandum (TPM), *The Impact of Government Assistance on Transfer Pricing*, on March 2, 2016. TPM-17 provides guidance on the impact of government assistance in the determination of transfer prices.

TPMs issued by the CRA do not have the force of law in Canada. However, along with Information Circular 87-2R, *International Transfer Pricing (IC87-2R)*, TPMs are key sources of documented guidance to taxpayers regarding the CRA's views and administrative positions on a number of transfer pricing-related topics.

The key takeaways from TPM-17 are summarized below.

1. Government assistance should stay in Canada

The CRA has explicitly stated that government assistance is presumed to remain in Canada in the context of non-arm's length party transactions using a cost-based transfer pricing methodology. Canadian taxpayers should not use government assistance receipts to reduce the cost base when determining the transfer price of goods, services or intangibles sold to a non-arm's length non-resident person, unless there is reliable evidence of arm's length arrangements to the contrary.

2. The CRA has a presumed view of arm's length behaviour

As noted above, the CRA presumes that Canadian taxpayers, in the context of a related party transaction, should keep any government assistance they receive unless there is evidence to the contrary from comparable arm's length arrangements. We are aware of certain commercial situations where arm's length parties, through negotiation, decide to share this assistance.

For example, many large businesses add specific terms to their contracts with suppliers that require cooperation on maximizing and sharing the benefit of scientific research and experimental development (SR&ED) credits. The underlying rationale for the SR&ED program is to encourage the performance of research and development activities in Canada. Canadian firms with this capability are normally in a more competitive pricing position, because of the SR&ED program, when bidding on third party research contracts. Essentially, they share the government assistance through this more competitive pricing.

Taxpayers that choose to use government assistance to partially offset costs in a non-arm's length scenario will have the burden of providing reliable evidence to the CRA that arm's length parties would share all or part of that assistance.

3. The all-encompassing definition of “government assistance” could have unforeseen implications

TPM-17 defines government assistance 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”.

This definition is open to a broad interpretation and application by the CRA, both in terms of the source and scope of assistance. It is particularly unclear what types of indirect subsidies and assistance might be captured by this policy. For example, would municipal assistance towards the development of a research park facility be imputed by a CRA transfer pricing auditor? Further clarification is necessary to provide taxpayers with greater certainty going forward.

4. TPM-17 may contradict the CRA's current QCCA guidance

TPM-17 expands on the guidance provided by IC87-2R in the context of qualifying cost contribution agreements (QCCAs). Paragraph 134 of IC87-2R requires costs subject to allocation under a QCCA to be calculated before deducting any tax incentives (i.e., SR&ED tax credits). We believe that TPM-17 broadens this requirement to include all government assistance.

However, paragraph 134 also allows for the deduction of subsidies granted by a government before calculating the cost base. It is unclear whether this will continue to be allowed in light of the issuance of TPM-17.

5. Taxpayers must be mindful of the contemporaneous documentation requirement

Taxpayers are required by subsection 247(4) of the Income Tax Act to prepare and maintain contemporaneous documentation in support of their transfer prices. TPM-17 states that a taxpayer should document the impact of government assistance in this contemporaneous documentation. This can include the accounting treatment of the government assistance or the extent to which government assistance is passed on to arm's length customers or suppliers.

6. Potential for tax audit issues

Due to the broad definition of “government assistance”, taxpayers should be aware that CRA auditors may apply the guidance in TPM-17 to a variety of situations. In particular, in situations where arm's length parties would share a subsidy, it will be important for taxpayers going forward to be able to provide reliable evidence of this comparable behaviour when under audit by the CRA.

7. The CRA continues to give deference to the chosen method

While TPM-17 provides examples using the cost plus or transactional net margin methods, the CRA has reiterated its adoption of the global standard that the selection

of a transfer pricing method always aims at finding the most appropriate method for a particular set of circumstances. In some cases, it may be necessary to supplement a cost-based method. The example provided in TPM-17 describes a situation where the government assistance is so highly integrated into the operations of a taxpayer that it significantly affects the economically relevant market conditions and, thus, the choice of transfer pricing method. In this instance, a transactional profit split method may be the most appropriate method.

Conclusion

To the extent that government assistance has an impact on arm's length prices, the CRA's policy is that such impact should be incorporated into the determination of a transfer price. This requires taxpayers employing a cost-based transfer pricing methodology to carefully assess whether government assistance should be used to offset some of the costs included in the cost base used to calculate transfer prices. Taxpayers choosing to use government assistance to offset costs in a transfer pricing analysis should have reliable evidence that arm's length parties would have done so. They should document the impact of government assistance including evidence of arm's length behavior in their contemporaneous transfer pricing documentation.

TPM-17 is a broad policy statement and we would welcome further clarification by the CRA on the types of arrangements that would be subject to this policy.

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