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GUIDANCE ON 247(10): WHY TPM-03R FALLS SHORT

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A. OVERVIEW OF THE ARTICLE

Canada's transfer pricing rules[23] generally comport with the OECD's guidelines[24] with a few notable exceptions. One such exception comprises the limitations imposed by subsection 247(10) on a taxpayer's right to report favourable self-initiated adjustments (i.e., downward transfer pricing adjustments) under the basic arm's length requirements of subsection 247(2).

This paper focuses on the essence of subsection 247(10) and the guidance (or lack thereof) provided by the Canada Revenue Agency (the "**CRA**") in its recently revised Transfer Pricing Memorandum 03R[25] respecting this limitation.

B. BRIEF OVERVIEW

Subsection 247(2) requires that a transaction or a series of transactions between a Canadian resident and a non-arm's length non-resident bear an arm's length price (among other terms and conditions), absent which the price shall be adjusted to an arm's length price. Subsection 247(2) is directionally indifferent in that it applies whether the adjustment increases or decreases tax payable by the Canadian resident.

For example, if a Canadian corporation (Canco) pays a foreign parent $100 for a product (and claims a corresponding deduction in computing its taxable income) but the arm's length price is $50, subsection 247(2) would increase Canco's taxable income by $50. However, if the arm's length price is $150, subsection 247(2) would decrease Canco's taxable income by $50, provided that the rule in subsection 247(10) applies.

Subsection 247(10) provides that the $50 decrease under subsection 247(2) is available only if "in the opinion of the Minister, the circumstances are such that it would be appropriate that the [decrease] be made". What does this mean? What circumstances should be considered? How is appropriateness determined? There is no guidance in the Act or its regulations.[26] There are no substantive court decisions.[27] So one would hope there would be meaningful guidance in the non-binding TPM-03R released by the CRA in June 2022, which is discussed further below.

C. CORE ISSUE AND BASIC DISCUSSION

The core issue in examining the basic question raised by subsection 247(10)—in what circumstances is it appropriate to permit a self-initiated downward adjustment—is that the basic rule is a contradiction in terms, and a perplexing one at that.

This stems simply and directly from two interrelated factors. First, the underlying situation is not in dispute: the taxpayer has initially overstated its income by using an incorrect transfer price (one that did not meet the arm's length standard of subsection 247(2)) and is simply seeking to establish the correct amount of its Canadian tax liability.

Second, given the first factor, why could it possibly be appropriate or reasonable—or make sense—for the subsection 247(2) adjustment to be denied? Can that question be put as follows: can there be a difference of overall Canadian tax results (or any specific Canadian tax results) as between, for example, a Canadian subsidiary of a foreign group initially paying (with no subsequent change) an arm's length price (say of $100) to a foreign member of the group for a purchase of widgets or instead initially paying a below arm's length price of $90 and then making a $10 adjustment (addition to the price) under subsection 247(2)? —or doing so with respect to any other type of transaction?

Does the latter drive one to posit the notion that there indeed can be, and there is, a difference between the two above-noted scenarios, the difference is some net reduction of Canadian tax by having the two-piece determination (but what is it?), and the taxpayer foresaw that advantage and deliberately adopted that two-piece approach?

Then do one or perhaps two different sequential questions arise?

The first and immediate question is whether there can be identified any incidence of the net Canadian tax reduction referred to above. If the answer is affirmative, then there is indeed a role for subsection 247(10).

That does not seem to be the case in the illustration above. But it appears to be affirmative where the transaction involves Part XIII because there appears to be no automatic application of Part XIII to the $10 adjustment under subsection 247(2) if the example above involved a Part XIII payment as opposed to a widget payment.[28] As discussed below, this is noted in TPM-03R.

The second question is purely speculative (although raised in TPM-03R)—should Canadian tax law and determinations be affected by tax law in other countries where there is no specific authorization in the Act, such as the specific authorization seen in both the Act and the regulations respecting foreign affiliates? The answer should be negative, but if it is affirmative, the basic query raised above would ask whether there is some overall tax benefit to the group of initially using an incorrect transfer price and then correcting it under subsection 247(2).

There is a third possibility, also raised in TPM-03R. Were the drafters of section 247 opposed to the use of subsection 247(2) that gave rise to a difference between tax books and financial statements even if its use did not give rise to a net tax difference?

In particular, was the primary purpose of subsection 247(10) to prevent a taxpayer from having inconsistency between financial facts and tax reporting? Where there is an inconsistency, would that constitute circumstances where it would be inappropriate to permit the use of subsection 247(2) to reduce taxable income? If so, why?

The issues raised by these questions can be illustrated as follows.

Assume in December 2022, a Canadian company (**"Canco"**)—with a calendar year-end—purchases product for resale from a U.S. parent for $150, pays $150, and resells the product before 2023. Assume the arm's length price is $150 such that Canco reports cost of goods sold of $150 in its tax return filed by June 30, 2023. Consequently, there is no subsection 247(2) adjustment—no need to consider subsection 247(10)—and the books and tax reports and section 247 are aligned.

That would seem to also be the result if the parties erroneously invoice the December sale at $100—rather than the arm's length price of $150—and Canco only pays $100, but before Canco files its 2022 tax return (say in May 2023) it discovers the error (say in March 2023) and then pays to the U.S. parent the additional $50 and self-assesses under 247(2) the additional cost of goods sold of $50. The result of the overall events is that the books, tax reports, and section 247 are aligned. The Minister should approve, under subsection 247(10), the use of 247(2).

But would the Minister reject Canco's self-assessment under 247(2) if, upon discovering the error in March 2023, Canco does not make a $50 payment to its U.S. parent, on the unwritten notion that the tax and accounting books are not aligned? But where is the harm?

D. WHAT DOES TPM-03R ADVOCATE? WHAT GUIDANCE DOES IT PROVIDE?

TPM-03R essentially consists of four parts—there is the CRA expressing a dim view of the prospects or likelihood of taxpayers meeting the requirements of subsection 247(10) and three prongs that seem designed to (try to) make that a self-fulfilling prophecy.

1. Basic View

As to the dim view, paragraph 30 states "Downward transfer pricing adjustments are only available in limited circumstances." Why this pessimistic prognosis?

2. Prong One

One of the three supporting prongs is a number of potential mechanical obstacles—which do not seem to be relevant to determining appropriateness—foreshadowed by paragraph two of TPM-03R which reads as follows:

> The purpose of this memorandum is to provide guidance on how downward transfer pricing adjustments should be directed. For the downward transfer pricing adjustments that should be directed to a TSO, this memorandum also provides guidance on how they will be managed.

Those potential mechanical obstacles are as follows:

> (a) Paragraph 12 sets out four conditions in order that the CRA "accept a request under the Mutual Agreement Procedure that involves a request for a downward transfer pricing adjustment."
> (b) Paragraph 17 sets out three conditions in order that the CRA "consider a downward transfer pricing adjustment that involves a transaction in a treaty country."
> (c) Paragraph 19 really belongs to Prong Two discussed below in that it raises an obstacle (double non-taxation) where an upward transfer pricing adjustment is reduced after an audit by way of objection or appeal and that results in a downward transfer pricing adjustment that exceeds the ultimate upward adjustment.
> (d) Paragraph 30 restricts downward transfer pricing adjustments involving a treaty country at the audit stage to situations where "they are closely linked to, and do not exceed, the upward transfer pricing adjustments."

Beyond the scope of this discussion is whether the above guidelines fetter the CRA's discretion and could be challenged by taxpayers on such basis if followed too rigidly.

3. Prong Two

The second prong consists of anti-avoidance factors, introduced in paragraph 8 of TPM-03R as follows:

> Downward transfer pricing adjustments are not intended to serve as a vehicle for taxpayers to implement retroactive tax planning or base erosion and profit shifting strategies, nor are they intended to achieve double non-taxation.

Paragraph 29, under the heading "Conclusion", restates this refrain.

This prong, elaborated on below, is curious because why would anyone think that taking steps to conform with the dictates of the Act (here, getting the transfer pricing correct) would house nefarious plans to implement retroactive tax planning or base erosion planning or profit shifting strategies or to achieve double non-taxation? Indeed, the Minister's discretion aside, a downward transfer pricing adjustment, like an upward transfer pricing adjustment, is merely a consequence of a factual determination.

Moreover, in the context of a transfer pricing audit, paragraph 15 stipulates, without apparent authority, that a request for a downward adjustment will be denied unless the taxpayer can "demonstrate to the CRA's satisfaction the absence of retroactive tax planning, base erosion and profit shifting strategies, or double non-taxation."

Footnote 6 of TPM-03R strangely illustrates retroactive tax planning as follows: "For example, the taxpayer prepares a revised transfer pricing study or utilizes a new methodology and determines different results."

Footnote 7 of TPM-03R does two things. First, it explains the CRA's use of the term "double non-taxation" and second, it affirms the concern expressed in Section C above that the CRA may, without statutory authority, import foreign tax law into determinations respecting section 247. The footnote reads as follows:

> Double non-taxation includes a deduction from income in one jurisdiction without a corresponding increase to income in the other jurisdiction. Taxpayers must provide supporting documentation such that auditors are satisfied and able to confirm that the increase has been reported, reassessed and taxes have been paid (or losses carried forward decreased) in the other jurisdiction with respect to the corresponding transfer pricing adjustment.

The double non-taxation refrain is revisited in Example 3 of Appendix A, in a somewhat convoluted multi-year hypothetical involving both downward and upward adjustments.

Finally, Example 4 of Appendix A raises CRA concerns about how an innocent quest for a subsection 247(2) adjustment can, at once, actually harbour "base erosion and profit shifting and retroactive tax planning." The example reads as follows:

> The taxpayer submits a request for a downward transfer pricing adjustment based on a new transfer pricing study. The non-arm's length non-resident entity reports the corresponding increase in the other jurisdiction after undergoing a corporate reorganization in that other jurisdiction. The reorganization resulted in the non-arm's length non-resident having significant losses which would absorb the corresponding increase to

income. This may be considered base erosion and profit shifting and retroactive tax planning and may not be considered appropriate in the opinion of the Minister.

4. Prong Three

The third prong is the portion of TPM-03R that raises, in one discussion, the two possible weaknesses discussed in Section C in seeking to show appropriateness.

It is noted in Section C that it is arguably not appropriate to be granted a downward adjustment if a difference between the books and tax records arises because the Canadian party does not pay the amount of the adjustment. Section C separately discusses inappropriateness where an adjustment involves Part XIII that is not triggered.

Both of these issues are discussed in TPM-03R under the heading “Repatriation” in paragraphs 26 to 28 which, not surprisingly, adopt the restrictive approach discussed in Section C.

E. CONCLUDING COMMENTS

The foregoing discussion indicates that with subsection 247(10), Finance has handed the CRA a tiger by the tail—a rule that on its face is at once curious, if not mysterious, and having regard to TPM-03R difficult for the CRA, let alone taxpayers, to come to grips with.

Should Canada take a leaf from the United States which doesn’t have such a rule[29] and consider repealing it?

Footnotes

[1] The CRA previously outlined this position at the 2010 CTF roundtable: CRA Document 2012-0465221E5.
[2] CRA Document 2018-0776661I7.
[3] Income Tax Folio S5-F2-C1, “Foreign Tax Credit”.
[4] Question #6 of the CRA roundtable.
[5] Question #5 of the CRA roundtable. The following background was provided: Commercial crypto-asset mining operations often involve the use of several GPU mining rigs or ASIC miners to generate computing power (hash power). In the context of commercial crypto-asset mining operations, the cost of both GPUs and ASIC miners generally represents a significant portion of the total cost of capital assets relating to the operation.
[6] As noted in a prior position: CRA Document 2019-0791541I7.
[7] https://www.canada.ca/en/revenue-agency/services/tax/international-non-residents/information-been-moved/foreign-reporting/questions-answers-about-form-t1134.html.
[8] “Know-how and similar payments to non-residents” (January 1, 1995) [archived].
[9] Subsection 212(5) provides for the application of Part XIII withholding tax in respect of payments for the right in or the use of film, video tape, or other means of reproduction for use in connection with television, that has or will be used or reproduced in Canada.
[10] *Copyright Act*, R.S.C., 1985, c. C-42 (“**Copyright Act**”).
[11] [2012] 2 S.C.R. 231 (“**SCC Decision**”).
[12] All statutory references are to the Act unless indicated otherwise.
[13] Subsections 212(1) and (2).
[14] The Canada Revenue Agency is of the view that, for purposes of determining whether a reduced withholding rate under a tax treaty applies in respect of amounts paid or credited to a partnership, one must look through the partnership to the residency of the partners (see, e.g., CRA Views 2004-0074241E5, “212(13.1)(b) and ITAR 10(6)” (19 July 2005), and 2009-0340031E5, “Application of 212(1)(b) to partnership—212(13.1)” (21 July 2010)). Article IV:6 of the Canada-US tax treaty explicitly provides for this look-through approach.
[15] See e.g., *Iberville Developments Limited v. The Queen*, 2018 TCC 102, at para. 41.
[16] Deductibility is tested without regard to any election that may have been made under section 21 to capitalize, instead of deducting as an expense, the cost of borrowed money used to acquire

depreciable property or used for exploration, development, or the acquisition of a resource property. The proposed amendment to paragraph 212(13.1)(a) discussed below also disregards section 21 elections.

[17] For example, income from carrying on business in Canada.

[18] CRA Views, 2003-0039231E5, "Paragraph 212(13.1)(a)" (25 May 2004); see also CRA Views, Conference, 2004-0072131C6, "IFA Round Table 2004 Q.1—212(13.1)(a)" (7 May 2004) where the CRA made similar comments.

[19] It is beyond the scope of this article to go into the issue of whether each partner can be considered to be a party to transactions entered into by the partnership, but we note that where limited partnerships formed under the Ontario *Limited Partnerships Act* or similar legislation are involved, older non-tax cases taking a "look-through" approach should be read in light of a more recent case of the Ontario Court of Appeal that denies the existence of any legal relationship between the limited partners and a third party that has entered into a contract with the limited partnership (*Hudson's Bay Company v. OMERS Realty Corporation*, 2016 ONCA 113).

[20] See, e.g., CRA Views, 9121825, "Partnership as member of a partnership" (3 February 1992) (Canadian partnership can have as a member another Canadian partnership, all of whose members are Canadian residents, on the basis of the CRA's understanding that "as a matter of law the members of a partnership that is itself a 'member' of another partnership are also members of the latter partnership").

[21] CRA, Form NR302, "Declaration of eligibility for benefits (reduced tax) under a tax treaty for a partnership with non-resident partners", online: canada.ca. The instructions state that partnerships must collect a signed and dated "statement of Canadian residency" from their Canadian partners that sets out the partner's name, Canadian address, Canadian tax identification number, and confirmation that the partner is a Canadian resident. One of the examples included in the Form further provides that the statement should confirm the partner will report the income on their Canadian income tax return.

[22] Admittedly, existing paragraph 212(13.1)(a) could still result in withholding tax applying to the portion of a deductible amount where that portion of expense is allocable to a Canadian tax-exempt member; however, this is only the case if the deduction is relevant in computing income from Canadian sources.

[23] See section 247 of the *Income Tax Act* (Canada) (the "**Act**"). Unless otherwise specified, all statutory references herein are to the Act.

[24] Organisation for Economic Co-Operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022* (Paris: OECD, January 20, 2022).

[25] Canada, TPM-03R—Downward Transfer Pricing Adjustments (Ottawa: Department of Finance, June 21, 2022) ("**TPM-03R**").

[26] The Department of Finance explanatory notes, published in December 1997, effectively paraphrase subsection 247(10): "Proposed new subsection 247(10) provides that adjustments (other than adjustments that result in or increase a transfer pricing capital or income adjustment of a taxpayer for a taxation year) shall not be made under proposed new subsection 247(2) unless the Minister considers that such adjustments would be appropriate in the circumstances".

[27] The sole judgments rendered to date address a procedural question as to whether disagreements regarding ministerial discretion exercised under subsection 247(10) should be adjudicated at the Federal Court or the Tax Court of Canada ("**TCC**"). In *Dow Chemical Canada ULC v. The Queen*, 2020 TCC 139, the judge, on a Rule 58 motion, held that jurisdiction for such challenges is vested in the TCC. However, the Federal Court of Appeal overturned that decision in *Canada v. Dow Chemical Canada ULC*, 2022 FCA 70, finding that such challenges should instead be brought before the Federal Court. An application for leave to appeal has been filed with the Supreme Court of Canada. At the time of writing, no decision on this leave application has been made. Substantive proceedings before the Federal Court and the TCC are being held in abeyance pending a final resolution of the procedural debate. For a useful background discussion, see Scott Wilkie, "Downward Transfer Pricing Adjustments: *Dow Chemical Canada ULC v. The Queen*" (2021) 28:3 *International Transfer Pricing Journal*, and Scott Wilkie, "A Short Update on The *Dow Chemical Canada Case*: Downward Transfer Pricing Adjustments" (2022) 29:5 *International Transfer Pricing Journal* 351-355.

[28] Subsection 247(12)—which would deem a Part XIII dividend if Canco overpaid for the widgets—has no application where Canco has underpaid.

[29] "Treas. Reg. Section 1.482-1(a)(3): Taxpayer's use of section 482. If necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed U.S. income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged. Except as provided in this paragraph, section 482 grants no other right to a controlled taxpayer to apply the provisions of section 482 at will or to compel the district director to apply such provisions. Therefore, no untimely or amended returns will be permitted to decrease taxable income based on allocations or other adjustments with respect to controlled transactions. See §1.6662-6T(a)(2) or successor regulations."

Note that not all countries (including the UK) permit taxpayer-initiated downward adjustments outside of treaty MAP.