The Joint Committee on Taxation of
The Canadian Bar Association

and

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November 5, 2019

Ted Cook
Director General
Tax Legislation Division
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Department of Finance
90 Elgin Street
Ottawa, ON K1A 0G5

Dear Mr. Cook:

Subject: Transfer Pricing Amendments

In the draft legislative proposals released by the Department of Finance on July 30, 2019 (the "**Draft Legislation**"), the Government proposes to amend the transfer pricing rules in the *Income Tax Act* (Canada) (the "**Act**")[1] in accordance with proposals first announced in Budget 2019. Our initial comments on the Budget 2019 proposals were set out in our submission dated May 24, 2019. The purpose of this submission is to comment on the revised proposal in the Draft Legislation.

In Budget 2019, the Government stated that instances have arisen wherein both the transfer pricing provisions in Part XVI.1 and other provisions of the Act may apply to determine the quantum or nature of the same amount for purposes of computing tax under the Act. To address this potential concern, the Government announced its intention to amend the Act to provide that the transfer pricing rules in Part XVI.1 take priority over any other provision of the Act.

In our comments on the Budget 2019 proposals, we expressed concern that the proposed "ordering" rule in what was then draft subsection 247(1.1) was inconsistent with the policy of

[1] Unless otherwise stated, all statutory references in this submission are to the Act.

the existing rules and could lead to additional interpretive uncertainty, confusion, and administrative burden for the Canada Revenue Agency and taxpayers. Based on the clear words of existing subsection 247(2), the original policy of the provision was that transfer pricing adjustments be made after the application of all other provisions of the Act, with the exception of the GAAR. This general policy was supported by the administrative guidance of the Canada Revenue Agency with respect to situations where the transfer pricing rules have potential application alongside rules of more specific application.[2] We expressed concern that undesired implications may arise from attempting to make transfer pricing adjustments in a legislative vacuum, and suggested limiting the scope of any amendment either to resolving conflicts between subsection 247(2) and particular provisions of concern (i.e., an expansion of current subsection 247(8)), or limiting a more general "ordering" rule to the application of transfer pricing penalties.

The Draft Legislation is apparently intended to resolve the identified circularity problem in draft subsection 247(1.1) as included in Budget 2019, but retains the general premise that subsection 247(2) applies in priority to all other provisions of the Act. We remain concerned about the potential for unintended consequences of this approach, as outlined by way of specific examples below. These examples illustrate that the priority of application of the provisions of the Act expressed in draft subsection 247(2.1) creates ambiguity as to the scope of the transfer pricing rules and uncertainty as to whether transfer pricing penalties apply to a much broader range of transactions than would be consistent with legislative policy as expressed to date.

First, based on the existing legislation, in our view it was clear that subsection 247(2) should not apply to a contribution of capital made by a Canadian-resident parent to a non-resident subsidiary, or to a gift by a Canadian-resident individual to a non-resident relation. Other provisions of the Act operate to specify appropriate consequences of such transactions, and there is no room for any further adjustment under subsection 247(2). In providing that subsection 247(2) applies before any other provision of the Act, draft subsection 247(2.1) calls into question whether the transfer pricing rules could apply to such transactions. There seem to be two potential interpretations flowing from this legislative change, neither of which is, we submit, desirable. The first potential interpretation is that the transfer pricing rules do apply to such transactions based on a literal interpretation of the Act, resulting in the need to comply with transfer pricing documentation requirements (which, by definition, will not be possible in some cases, such as gifts) and the potential application of transfer pricing penalties. The second potential interpretation is that the transfer pricing rules should be "read down" so as not to apply to transactions to which those rules do not "appear" to be directed, resulting in an unexpected and undefined narrowing of the scope of the transfer pricing rules.

Second, draft subsection 247(2.1) creates uncertainty as to the application of "rollover" rules such as subsections 85(1), 86(1) and 51(1). Take for example the circumstance where a taxpayer takes back less than fair market value consideration for eligible property in a transaction to which subsection 85(1) applies. Under the existing rules in the Act, if the transferor intended for the deficiency in consideration to be a benefit conferred on a related person (other than a wholly-

[2] See Information Circular IC 87-2R – *International Transfer Pricing* (September 27, 1999) at para 21.

owned subsidiary), the elected amount would be adjusted upward to the extent of the deficiency, resulting in additional deemed proceeds for the transferor. Applying the proposed transfer pricing rule, because the consideration received by the taxpayer in such a situation apparently is to be adjusted under subsection 247(2) before subsection 85(1) is applied, paragraph 85(1)(e.2) arguably has no application, and the consideration received by the taxpayer is to be adjusted without regard to the exceptions to paragraph 85(1)(e.2), and whether the information contained in an election filed under subsection 85(6) is incorrect. It is, moreover, unclear what the specific adjustment under subsection 247(2) would be – i.e., whether the taxpayer would be deemed to receive additional shares or additional "boot". If the transfer pricing adjustment is additional "boot", then the transferor would appear to have additional consideration even in circumstances where the exceptions to paragraph 85(1)(e.2) would have applied – including, perhaps in the case of a transfer to a wholly-owned corporation. If the transfer pricing adjustment is additional shares, then it would appear that the additional consideration that could have arisen under section 85 but for the transfer pricing proposed amendments would be reversed when section 85 is applied after the transfer pricing adjustment. Neither result seems intended.

Third, the Draft Legislation reverses the long-standing administrative policy and assessing practice of the Canada Revenue Agency, alluded to above, which was to apply rules of the Act of more specific application relating to section 17 and the thin capitalization rules in priority to the transfer pricing rules. Example 1 set out in the Explanatory Notes accompanying the Draft Legislation illustrates how applying the transfer pricing rules and the thin capitalization rules in "reverse" order may result in a larger transfer pricing penalty than would have been the case under the existing rules. Moreover, it is unclear whether the adjustment to income is itself larger. There is no clear policy reason for this result. Moreover, as is suggested by Example 2 in the Explanatory Notes, subsection 17(1) would be rendered redundant as between non-arm's length parties if draft subsection 247(2.1) is enacted as proposed, even though such non-arm's length circumstances were "front and centre" in the design of the subsection 17(1) rules. More specifically, it now appears that any "safe harbour" contained in section 17 or other specific rules of the Act may be rendered moot by the prior application of subsection 247(2).

Finally, we would note that the drafting of the proposed amendment to subsection 247(2) remains problematic with respect to the question of circularity. The proposed amendment refers to amounts determined without reference to sections 247 and 245. This raises the question, for example, as to what amounts are determined for the purposes of the Act where section 17 may be applicable. Arguably, based on the proposed Explanatory Notes, what is meant – and what should be reflected in the statutory language – is a reference to amounts determined for the purposes of *applying* other provisions of the Act or determined for the purposes of the Act *before any adjustment* by virtue of any provision of the Act. That would seem to better capture the intended effect of the proposals.

In conclusion, we believe that the proposed amendments introduce considerable scope for unintended and undesirable consequences. To the extent the Government wishes to expand the circumstances in which the transfer pricing rules apply or the scope of transfer pricing penalties, we continue to believe that a more nuanced approach would achieve the intended result without the afore-mentioned unintended and undesirable consequences. We refer you to our prior

submission of May 24, 2019 for a specific drafting recommendation on this point. If the current drafting is maintained, it would be helpful if the Explanatory Notes could, at a minimum, set out examples clarifying that section 247 is not intended to override the application of rollover provisions, or apply to arrangements that would not give rise to any income adjustment under the existing rules.

Members of the Joint Committee and others in the tax community participated in the discussion concerning this submission and contributed to its preparation, including:

- Bruce Ball – CPA Canada
- Ken Griffin – PwC Canada
- Amanda Heale – Osler, Hoskin & Harcourt LLP
- Ian Crosbie – Davies Ward Phillips & Vineberg LLP
- Angelo Nikolakakis – EY Law LLP
- Anthony Strawson – Felesky Flynn LLP
- Jeffrey Trossman – Blakes, Cassels & Graydon LLP

We trust that you will find our submission helpful. We would be pleased to discuss it further at your convenience.

Yours very truly,

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