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Transfer Pricing: Using the Comparable Uncontrolled Price method

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Summary

The transfer price is the price set by two related parties when transferring products, services, etc between the parties. This thesis examines the Comparable Uncontrolled Price (CUP) method, one of the existing methods to price the transactions. The thesis is written from a Canadian perspective but because of the wide acceptance of the arm's length principle as the corner stone of transfer pricing, large parts of the content of the thesis should be applicable in other countries as well.

The CUP method is the most accurate method to find a correct transfer price. OECD's transfer pricing guidelines, which are the number one transfer pricing source for the taxpayer, state that the transfer price should be set as if the parties were dealing at arm's length with the market forces deciding the price. The CUP method solves the pricing issue by finding a comparable transaction between unrelated parties and then using the price in that transaction as guidance on how to price the controlled transaction. There are two ways of finding comparables; 1) by examining another transaction of the same product made by one of the controlled corporations to an unrelated party (internal comparable) and 2) by examining a transaction between other independent parties (external comparable). Because of the complexity of international business the compared transactions rarely are exactly the same. For every existing economical relevant difference between the controlled and the comparable transaction adjustments are needed. The guidelines provide five categories of differences when adjustments are needed; functional, characteristics of the property, contractual terms, economical circumstances and business strategy. As the examined case law demonstrates it can be extremely complicated to make adjustments for differences between the transactions. If the differences are significant the accuracy of the comparison is jeopardized. Obviously the more and the bigger differences that exist the more difficult it becomes to apply the method. No particular guidance is provided in the guidelines on how to handle the differences and how far a taxpayer is supposed to go to be able to use the CUP method. The examined case law provides some patterns on when the method could be used. The best chance to use the CUP method is when it is a simple product transferred. It is fairly easy to find potential comparables, both internal and external. The taxpayer has therefore a better opportunity to use exactly the same product as in the comparable transaction which is crucial. If it is a complex product there is a large risk that no other transactions made by other parties exist and that the taxpayer is thus principally only left with the possibility to use internal comparables. In many cases no such comparables exist.

Preface

This thesis was written during the summer of 2003 in Montreal. I was at McGill University for two semesters as an exchange student and decided to stay during the summer to finish my Swedish degree. This was a decision I will never regret.

I would like to express my gratefulness to my supervisor Sture Bergström, Professor of law, for his help and support. I would also like to thank Julia Carbone deeply for her help with correcting the language and for all her other help. Kate Taylor, Stuart van Leenen and Paula Price also deserve some words of gratitude.

1 Introduction

1.1 Choice of subject

Practically every corporation has the goal to pay as little tax as possible. For a multinational enterprise, the fact that the group will be affected by tax regulations in more than one country opens up the possibility to save tax costs. This could be done by pricing intercorporate transaction in such a way that a large part of the profit ends up in a tax jurisdiction with a low income tax rate. The price set by such a corporation is the transfer price. Every nation will try to protect its tax base and consequently rules exist governing how an intercorporate transaction should be priced. Since the world of business is so complex, it is not possible to create rules that provide an exact answer for all pricing decisions. Instead it is in the end the facts and the circumstances in each case that will decide how the price should be set. This makes the transfer pricing issue so complicated and at the same time so interesting.

This thesis deals with the CUP method, one of the methods that could be used to find the transfer price. When using the CUP method, the taxpayer examines other uncontrolled transactions of the same product. The price charged in the uncontrolled transaction will work as guidance to how the controlled transaction should be priced.

1.2 Questions at issue

The thesis answers the following two questions:
1) How does a taxpayer find the comparable uncontrolled price?
2) Under what circumstances can and should a taxpayer use the comparable uncontrolled price method?

1.3 Purpose and limitations

There is obviously no possibility to provide a complete answer to the questions posed above. The purpose of this paper is to guide taxpayers on how to use the CUP method.

The thesis is written from a Canadian perspective but since the arm's-length principle is so widely accepted among the developed countries in the world, the content of the paper should be applicable in other countries as well.

Since there is almost no Canadian transfer pricing jurisprudence I found it necessary to examine foreign cases as well. I chose to use US case law since it is very extensive and because of the great influence US has had in the area of transfer pricing. The arm's-length principle is the cornerstone in both countries' legislations and so the principles held in the US cases should be applicable in Canada as well.

Several of the article and books used in this thesis are dealing with transfer pricing from a US perspective. Obviously one has to be careful when another country is at issue but generally it is not a problem since the principles of transfer pricing are the same everywhere. The arm's-length principle is as stated above the mutual element in the regulation governing transfer pricing in most countries in the developed world.

The paper will only deal with transfer pricing of tangible property. Thus, the more complicated areas of services and intangible property will not be included.

1.4 Method

Since the OECD's transfer pricing guidelines are such an important source for taxpayers a large part of the content in this thesis was found in the guidelines. Most articles used in the thesis are from either the Canadian Tax Foundation or the Canadian Tax Journal. The database Taxfind was used when searching for these articles. The material to the part about US transfer pricing was found at the US database, Bnatax.

1.5 Disposition

Chapter one starts with an introduction to transfer pricing where the multinational enterprises and the international transfer pricing regulations are presented. Chapter two presents the relevant transfer pricing regulations for Canada. Chapter three deals with the different existing transfer pricing methods. Chapter four demonstrates how the CUP method is used. Chapter five goes through what should be accomplished with transfer pricing documentation. In the last two chapters the case law is presented: chapter six deals with Canadian jurisprudence while chapter seven goes through some of the relevant US case law.

2 Introduction to transfer pricing

2.1 The multinational enterprise

The importance of multinational enterprises (MNEs) in world trade has increased dramatically during the last few decades. The integration of national economies and technical progress, particularly in the area of communication, are two of the main factors that have led to a rapidly growing global economy and a boom for the MNEs. The world is now the marketplace for the MNEs.[1]

The MNE is a highly integrated group of organizations with a mutual goal; to maximize the after tax profit for the whole group of corporations. The mother corporation and its affiliates are engaged in substantial amounts of intrafirm transactions of goods, intangible property and services. The price charged for these transactions is called the *transfer price*. Transfer pricing is defined by the OECD as "the price at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises".[2] The importance of the choice of price is crucial since the pricing will determine the allocation of profits for tax purposes. For example, if a Canadian Computer group buys micro-chips from its subsidiary in Singapore, the size of the profit that ends up in each respective country is partly determined by how much the subsidiary charges for the micro-chips. A high price will imply that funds will be transferred to Singapore and consequently be taxed there. A low price on the other hand will move a larger part of the profit to Canada where it will be taxed. Since income tax rates differ from one country to another the total amount of tax paid by the MNE will depend on where the profit is taxed. Consequently the total after tax profit of the MNE will also depend on where the profit is taxed.

The importance of transfer pricing can not be exaggerated. Some tax experts assert that it is the single most important international tax issue facing MNEs.[3] Considering the fact that more than 60 % of world trade takes place within MNEs it is easy to understand the significance of how these

[1] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (herein referred to as "the guidelines"), Preface, paragraphs 1-2 and Lipman, Karyn R (1999) Ontario Tax Conference, Canadian Tax Foundation, 5: 1-2

[2] The guidelines, Preface, paragraph 11

[3] See for example Hadari, Yitzhak, Canadian Tax Journal, p.29 and Purdy, Emma J., and Zanchelli, Jeffrey, (1996), Canadian Tax Journal p. 157

enterprises act.[4] Traditionally transfer pricing has only been associated with large public MNEs but it is important to keep in mind that transfer pricing is also an issue for small- and medium-sized businesses expanding globally.[5] The same rules apply for these groups of corporations involved in cross-boarder transactions.

Moving profits to jurisdictions with lower income tax rates is the main incentive for a MNE to manipulate the price of a transaction within the group. However, there are several other reasons why an MNE could be tempted to manipulate its internal prices such as;

- To off set loses in one jurisdiction with profits in another jurisdiction
- To minimize tariffs by keeping down the price
- To move profits to the mother corporation thereby minimizing the total tax burden for the MNE. Since many jurisdictions charge a withholding tax on dividends paid to a shareholder abroad, the total tax burden could be lower if the profit ends up at the mother corporation directly even though the income tax rate in the jurisdiction of the subsidiary might be slightly lower. The less dividend that has to be paid the less withholding tax will the MNE face.[6]

Every MNE strives toward lowering the total costs for the group and thereby maximizing the profit. Paying tax in a jurisdiction with low income tax rate is part of that goal since tax expenses are a cost like any other cost. The fact that more than one jurisdiction is involved causes problems. Every nation's tax authority has an interest of protecting its tax revenue and that interest obviously conflicts with the interest of the MNE. Consequently rules are required how to price intrafirm transactions.[7]

2.2 The transfer pricing regulations

2.3 Goals of international taxation

What makes international taxation and thus transfer pricing so complex is that the ultimate tax burden is decided by tax systems of home and host governments, each with its own fiscal objectives. The fact that more than one tax system comes into play, with the possibility that the two legislations solve a taxation issue in different ways, is a problem for the MNEs. [8]

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[4] Neighbour, John, (2002) OECD
[5] See for example Humphreys, Brenda J., (1998) Canadian Tax Foundation, p. 40:1-2 and Swanewald, Hendrik, (2000), , p. 1-2
[6] Riahi-Belkaoui, Ahmed, (1998) p. 97 and Eden, Lorraine, (1998), p.22-23 and 83-88
[7] Eden, Lorraine, (1998). 3-8 and the guidelines, Preface, paragraph 12
[8] Shapiro Alan, (1996), p. 535, se also Arnold Brian J. and McIntyre Michael J., (2002) p. 44

Two of the main tax principles include *neutrality* and *equitability*. A neutral tax is one that does not influence, for example, how a business decision is made. Thus, the goal for the legislator is that businesses should be planned by factors other than taxation. Another aim for the legislator when creating a good tax system is to make it equitable. Equitability is reached when two taxpayers in similar economic circumstances pay the same tax.

Nationally, neutrality and equitability are not that difficult to accomplish. When more than one country is involved, the problems start. On one hand all countries benefit from free trade, but at the same time every country is interested in protecting their own interest, their tax revenue. The latter fact is the major reason why neutrality and equitability are so hard to reach in international taxation. In a perfectly neutral tax world the corporate tax would be the same everywhere and more importantly no costs would arise when moving money from one country to another. In the imperfect world, MNEs have to adjust to tax systems that often affect where and in what forms they invest. If an MNE makes investment decisions based on a tax system as opposed to profitability then the gross world product will be reduced.[9]

The goal for the transfer pricing legislator when creating an equitable and neutral tax system is to avoid double taxation of income and to prevent tax avoidance and evasion. OECD has done an important job to assist in creating such provisions.[10]

2.3.1 OECD and the transfer pricing regulations

OECD has played an important role in the international development of rules for transfer pricing. The *Transfer Pricing Guidelines for Multinational Enterprises and Tax administrations* (the guidelines) and the OECD *Model Tax Treaty*[11] together with the U.S. regulations are the most important sources of inspiration for the regulations of transfer pricing for the developed world.

The international standard that OECD-members have agreed upon for determining transfer prices for tax purposes is the *arm's-length principle*. According to the arm's-length principle, related parties should determine the price for intercompany transactions as if they were unrelated parties. The two corporation involved in the transaction should chose the price as if they were dealing at arm's-length distance, with market competition deciding the price. If the price decided is different from what two independent corporations would have charged, according to the arm's-length principle,

[9] Shapiro Alan, (1996), p. 536-537 and Eden, Lorraine, (1998) p. 3 and 9
[10] Eden, Lorraine, (1998), p. 33-35
[11] OECD, Model Double Taxation Convention on Income and on Capital, (1977)

the tax authority in that country has the right to include in the taxable income the profit that would have accrued if the parties would have been dealing on arm's-length.[12]

The guidelines provide five different methods to find the arm's-length price. The methods principally use other transactions between unrelated parties to guide how two related parties should price there transactions. The guidelines stipulate that the Comparable Uncontrolled Price (CUP) method is the method of choice. According to the method, the price of a comparable transaction between unrelated parties should decide the transfer price. Exact comparable transactions are normally difficult to find and that is why adjustments are often needed. Applying the CUP method could be an extremely complicated task.[13]

The arm's-length principle is the only accepted way by OECD to decide the transfer price and it is the method used by the member-countries. There exist only one major alternative to the arm's-length principle namely a formulary approach commonly referred to as *unitary taxation*. This approach allocates the global profits of a MNE group on the basis of a predetermined formula. The formula would most likely be based on a combination of costs, assets, payroll and sales. Thus, the unitary taxation does not allocate profits on a transaction-by-transaction basis which is the case with the arm's-length principle. Instead a formula is used to find the percentage of the total worldwide income that should be allocated to a firm and thus, taxed in that firm's jurisdiction.[14] Unitary taxation is used in Canada and US to allocate domestic corporate tax revenues among provinces and states. In the US though, a few states, in particular California, have used the unitary system to allocate profits among corporations in MNEs.[15] In the European Union (EU) a similar system has been proposed. This system, called *Home State Taxation*, would allocate the profits based on how large part of the surplus value that was created in each state.[16]

The legislator's response to the transfer pricing issue can cause a major problem for the MNE. Since two jurisdictions are involved in every international transfer, the MNE also has to deal with two tax authorities. If the tax authorities have different opinions on how to price the transaction the MNE runs the risk of being taxed twice for the same profit. If, for example, the two authorities use different transfer pricing methods for the same transaction or if they use the same method but in different ways it can result in double taxation. This is a problem observed by OECD and is one of

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[12] The guidelines, chapter 1, see particularly paragraphs 1:2 and 6, see also Eden, Lorraine, (1998), p. 34-35

[13] See chapter four where the methods are presented. See chapter 5 where the CUP method is closely examined

[14] The guidelines, Chapter 3c, Paragraphs 3.58-74, see also Eden, Lorraine, (1998), p. 35-36

[15] Eden, Lorraine, (1998), p. 35-36

[16] See for example, Westberg, Bjorn, Skattenytt, (2001), p. 554-567

the most important aspects of the guidelines.[17] If one jurisdiction uses the arm's-length principle and another the formula approach the risk for double taxation is impending since the two systems are totally different.[18] Double taxation can create an obstacle to cross-boarder transactions which means that the tax system is not neutral, since the higher tax costs when investing abroad could effect how an investment is made. Double taxation is negative for all parties, governments included, since it reduces the amount of international transactions, which is negative for economical development, resulting in less total tax revenue.[19]

2.3.2 Categorization of transfer pricing rules

The guidelines clearly states that transfer pricing should not be confused with rules governing tax fraud and tax avoidance even thought MNE can use transfer pricing for such purposes.[20] When comparing the income tax rate of the developed countries the difference is normally not that significant. Typically it ranges from 30 to 35 %. Here are a few examples; US around 35 %, Canada around 29 %, UK 30 % and France 35%.[21] An American MNE will thus pay a few percentages less tax if a profit ends up at an UK subsidiary. Thus, the incentive to try to manipulate prices to move profits to the country with the lowest income tax might not be so strong. Especially if one considers the consequences a MNE could face if a transaction is not accepted by the tax authorities.

Canada and most other member's of OECD have adopted transfer pricing rules with two different remedies if a corporation has priced an intercorporate transaction incorrectly. The first step that a tax authority can take is to adjust the income tax to the level it would have been if the correct price was charged. This is a transfer pricing adjustment. In addition, a penalty may be imposed on the taxpayer. The size of the penalty differs from one country to another. In the US a penalty will be somewhere between 20 to 40 percent of the underpayment of income tax while the Canadian Income Tax Act (ITA) impose a penalty of 10 percent. [22] The severe penalties that a taxpayer can face have affected the way one should regard the regulations governing transfer pricing. While it used to be a guide for the tax authorities to examine transfer pricing it is now as much a guide for taxpayers trying to avoid penalties.[23] If a transfer pricing adjustment is

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[17] The guidelines, Preface, Paragraphs 3,4 and 12
[18] The guidelines, Chapter 3, Paragraph 3:66
[19] The guidelines, Preface, Paragraphs 3-5 and 7
[20] The guidelines, Chapter 1, Paragraph 1:2
[21] Ernst & Young, Worldwide Corporate Tax Guide, , See each separate country
[22] ITA Subsection 247(3), Macdonald, Barry and Robertson, Murray, Canadian Tax Foundation, (2002) 15:5-8 and Birnkrant, Henry J., Canadian Tax Foundation (1998), 40b:1-2
[23] Birnkrant, Henry J., Canadian Tax Foundation (1998), 40b:2, The article deals with US transfer pricing rules but the role of the transfer pricing regulations should be the same everywhere penalties are imposed.

made and a taxpayer will pay more tax in one country, he is normally compensated by another country's tax authority. Bilateral income tax treaties step in to prevent double taxation.[24] A transfer pricing adjustment should therefore normally not be the major concern for the taxpayer. It is the severe penalties that could be costly for the taxpayer.

It is important to keep in mind that the guidelines provide guidance on how to solve transfer pricing issues, and nothing more. There exists no exact answer on how to price transactions within a MNE. The facts in each case decide the transfer price.[25] However, this does not mean that the taxpayer has the liberty to choose which method to use and how to price a transaction. He must be able to show proper documentation how the transfer price is reached. Documentation is consequently the key for a MNE to avoid transfer pricing disputes that could lead to state imposed transfer pricing adjustments but more importantly, severe penalties.[26]

[24] IC 87-2R Paragraphs 214-221
[25] Wilkie, J. Scott, Canadian tax Foundation (1995), p. 42:2-3
[26] The guidelines, chapter 5, paragraph 5:1, see also Macdonald, Barry and Robertson, Murray, Canadian Tax Foundation, (2002) 15:1-4

3 Rules, regulations and guidelines for Canadian transfer pricing

3.1 The Canadian Income Act

The rules governing transfer pricing is principally found in section 247 of the Canadian Income Tax Act (ITA). These rules were introduced in 1997 replacing the old provision in subsections 69(2) and (3). The new set of rules was an effort to harmonize Canada's transfer pricing practice with the arm's-length principle outlined by the OECD.[27]

The driving provision is subsection 247(2) which stipulates that the arm's-length principle should govern how to price transaction between parties not dealing at arm's length. If a transaction is priced otherwise the taxpayer's income should be adjusted to an amount equal to what would have arose if the parties were dealing at arm's length.

Subsection 247(3) adds a 10% penalty to any state imposed transfer pricing adjustment unless the taxpayer has demonstrated that "reasonable efforts" were made to determine the arm's-length price. The maximum penalty is $5.000.000.

Subsection 247(4) deems the taxpayer to not have made such reasonable efforts unless the taxpayer provides documentation of the transaction. Such documentation should, for example, provide the basis on which transaction is priced.

3.2 IC 87-2R

The rules in the ITA provide only a general and basic framework for the transfer pricing regime in Canada. In the information circular IC 87-2R the legislator gives his interpretation of the regulations. What role does the interpretation circular play? Jurisprudence has clearly stated that although these kinds of publications by Revenue Canada are not binding as law they can have a persuasive value in interpreting ambiguous provisions of the

[27] See Canada, Department of Finance, 1997 Budget, Budget Plan, 1997, see also Vincent, Francois and Freedman, Ian M., Canadian Tax Journal, (1997), p. 1215

act.[28] It must be difficult to find more an ambiguous provision than the rules in ITA regulating transfer pricing so it is clear that the IC 87-2R is an important source for the taxpayer.

Revenue Canada's view of how to interpret the legislation seems fairly explicit. Interpretation of the IC 87-2R relies heavily on the OECD's guidelines and the way OECD has stipulated how to use the arm's-length principle. The second and third part of the circular deals with the arm's-length principle and how to apply it and both parts constantly refer to the guidelines.

3.3 OECD's guidelines' signification for a Canadian taxpayer

Concern from the OECD about transfer pricing was first communicated in the 1979 publication of a report on transfer pricing.[29] The report was followed up by additional reports on related issues, the first in 1984[30] and another in 1987.[31] The 1979 OECD report was revised in 1995 by the release of the OECD's guidelines. These reports have been the basis for several legislation of OECD-member countries, Canada included.[32]

As seen above it is explicit that the guidelines are a vital part of the Canadian transfer pricing landscape. Considering that the regulations were changed a few years ago to harmonize the Canadian legislation with the guidelines and that the IC 87-2R refers to the guidelines, it is obvious that the legislator views the guidelines as the basis for the regulations. One must assume that the Canadian tax authorities will follow the guidelines; however the guidelines treatment in the jurisprudence is another question. In any case the guidelines are the most useful source for a Canadian corporation when looking for guidance how to price its international transactions. For the rest of this paper the guidelines will be the main source when dealing with transfer pricing issues.

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[28] See for example Nowegijick v. R., (1983) 1 S.C.R 29 (1983) C.T.C 20, 83 D.T.C. 5041 (S.C.C.) p. 37 and Mattabi Mines Ltd. v. Ontario (Minister of Revenue) (1988) 2 S.C.R. 175, (1988) 2 C.T.C. 294, 53 D.L.R. (4th) 656 (S.C.C.)

[29] OECD, Transfer Pricing and Multinational Enterprises, (1979)

[30] OECD Transfer Pricing and Multinational Enterprises - Three Taxations Issues (1984)

[31] OECD Thin capitalization; Taxation of Entertainers, Artists and Sportsmen, Issues in International Taxation no. 2 (1997)

[32] Humphreys, Brenda J., Canadian Tax Foundation, (1998), p. 40:5-7

4 The arm's-length principle and the transfer pricing methods

As established in the introduction the need for rules governing transfer pricing originates in the special character of MNEs. The groups within the MNE are closely connected which to begin with results in a problem to find the correct price of a transaction. A second issue is that forces other than market forces could decide the price. The OECD's answer to this problem is to use a separate entity approach. When deciding the price of the transaction, it should be done as if the corporations were two separate unassociated entities, even though they are tightly connected.[33] The arm's-length principle should be used.

OECD presents five different methods to find the arm's-length price. There is no simple answer as to which method should be used and no method is suitable for every possible situation. The method to use must be decided on a case-by case basis, depending on the facts and the reliability of the data available. OECD leaves an opening for other methods to be used but only if they satisfy the arm's-length principle.[34] The five methods can be divided into two categories; traditional transactions methods and transactional profit methods.

4.1 Traditional transaction methods

The three traditional transfer pricing methods - comparable uncontrolled price, resale price and cost plus - are all based on comparable arm's-length transactions. This means that a transaction between two related corporations is compared with a similar transaction made between two unrelated corporations. Thus, all three methods are using uncontrolled transaction, but the methods compare different areas.[35]

4.1.1 Comparable Uncontrolled Price (CUP) method

The aim for the arm's-length principle is, as stated above, to choose a price that two unrelated parties would have chosen. The most direct way, the CUP method, to establish if the transfer price is correct is to compare the price

[33] The guidelines, Chapter 1, paragraph 1:2 and 6
[34] The guidelines, Chapter 1, paragraph 1:68 and 69
[35] The guidelines, chapter 2, paragraph 2:5

with the price charged in comparable transactions between independent parties. A comparable transaction could either be the same product traded between the MNE and an unrelated party or the same or similar product traded between two other unrelated parties under the same or similar circumstances.[36]

If there is a difference between the two compared prices it could indicate that the transfer price does not respect the arm's-length principle.[37] Another reason could be that the transactions simply are not comparable and that the comparison is irrelevant. CUP can not be used if that is the case. The transactions are comparable either if 1. "none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or 2. reasonably accurate adjustments can be made to eliminate the material effect of such differences".[38] Thus, if there exists any differences between the two transactions and they are relevant, adjustments need to be made. This could be a third reason why the price differs between two transactions.

An example will clarify further how adjustments work. If a Canadian corporation is selling tables to an unrelated Brazilian corporation for $ 100 each, this could indicate that this should be the transfer price between the Canadian corporation and its American subsidiary. The arm's-length principle states that the price between two related should be determined the same way as if the two corporations were dealing on arm's length, which is the case in the first transaction. The differences of the circumstances of the two transactions could be significant even though it is the same product transferred and adjustments of the price are therefore needed. The Canadian corporation could for example still be responsible for any problems that occur after the tables have been sold by the American subsidiary to their customers. If the same arrangement is not used for the transfer of tables to the Brazilian part this should affect the price. The Brazilian corporation is taking a larger risk than the American corporation and should therefore pay less for the tables. Thus, if using the price paid by the Brazilian corporation as a comparison when finding the transfer price the American subsidiary should pay, one must make an adjustment of that price upwards with the value of the risk taken by the Brazilian corporation. The issues of comparability and adjustments will be dealt with under chapter 5.

It is important to establish that most transfer pricing issues arise in situations when CUP does not exist. In these cases other methods need to be examined.[39]

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[36] The guidelines, chapter 2, paragraph 2:5, See also for example Eden, Lorraine, (1998), p. 37-38

[37] The guidelines, chapter 2, paragraph 2:6

[38] The guidelines, chapter 2, paragraphs 2:6 and 7

[39] Black, David R., Canadian Tax Journal, (1993), p.145,

4.1.2 Resale Price method

Where CUP cannot be used, an alternative method is to focus on one side of the transaction, either the seller or the buyer. This is the way the resale price method works. When deciding the transfer price, resale price concentrate on the price the buyer (reseller) charges when reselling the product to its customer. From this price a gross margin is subtracted out of which the buyer should cover its costs and create an appropriate profit. The amount the remains after the subtraction should be the transfer price.[40] The profit margin that should decide the price in a controlled transaction should be found by looking at other transactions between parties dealing on arm's length. This could be done by comparing the margin the same reseller, or another reseller in similar circumstances, earns on the same product or on other similar products purchased from unrelated parties and later sold. A distributor is likely to charge approximately the same sales margin when selling a TV and a VCR. If for example the TV is bought from an unrelated party the margin when reselling the TV can be used when calculating the transfer price for the VCR.[41]

An example will explain how the resale price method works. A manufacturer sells tables to its foreign subsidiary, which is then distributing the product to the public. The first step is to find the margin the distributor should earn. If other table distributors who bought the tables in similar circumstances, at arm's length, normally earn a 10 % margin when selling tables to the public this is the margin our distributor should earn. The public pays $100 for a table and consequently $10 should be subtracted from that price since this is the amount the distributor should earn. The transfer price is therefore $90.

When comparing the gross margin used in other transactions the same principles are applied as under CUP. Thus, comparability of the two transactions and adjustments made are also relevant when applying the resale price method.[42]

4.1.3 Cost Plus method

Using the cost plus method the focus is turned to the other side of the transaction; the seller or the manufacturer. The first step in this method is to find the costs incurred by the manufacturer of the product. An appropriate mark up is then added to the costs to create a profit for the seller. What is

[40] The guidelines, chapter 2, paragraph 2:14
[41] The guidelines, chapter 2, paragraph 2:15, see also Eden, Lorraine, (1998), p. 40-41
[42] The guidelines, chapter 2, paragraph 2:16

arrived at may be regarded as the arm's length price for a controlled transaction.[43]

The main issue of the cost plus method is to find the proper gross mark up. This is the point when other transactions between unrelated parties are investigated. The best way of finding the proper mark up is to compare the mark up the same supplier is earning in comparable transactions with unrelated parties. If that is not possible, the mark up other independent enterprises is using on comparable transaction may lead to an appropriate transfer price.[44]

Once again the same principles are used as under CUP when dealing with comparables and adjustments.[45] One important aspect of the comparability between two transactions is accounting consistency. If two different accounting systems are use an adjustment must be done. For example the way of finding the gross margin could be different from one country's accounting system to another.[46]

4.1.4 Resale Price or Cost Plus

It is fairly clear that CUP is the number one method and that it should be used if possible (more about this in chapter 4.4). If CUP cannot be used, as stated above, the traditional transaction methods should be used if possible. Consequently, either RP or cost plus should decide the transfer price. However, over and above a few indications, the guidelines do not clearly state which of the two methods should be used. Again, because of the complexity of transfer pricing, the guidelines can do nothing but indicate.

The fact that the transfer price is decided from only the buyer's point of view means that special considerations must be made when to use the method. The guidelines establish that the resale price method is best used when "the reseller does not add substantially to the value of the product". The method is difficult to apply when the goods are further processed or if they are transformed to another product.[47]

The field of application for the cost plus method is different from the one of resale price. It is most useful where semifinished goods are sold between related parties and when the manufacturer performs simple functions.[48]

Since this paper is dealing with the CUP method the choice between RP and cost plus is not a topic that needs further investigation.

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[43] The guidelines, chapter 2, paragraph 2:32
[44] The guidelines, chapter 2, paragraph 2:33
[45] The guidelines, chapter 2, paragraphs 2:34-35
[46] The guidelines, chapter 2, paragraph 2:39-41
[47] The guidelines, chapter 2, paragraph 2:22
[48] The guidelines, chapter 2, paragraph 2:32, see also Eden, Lorraine, (1998), p. 234

4.2 Transactional profit methods

As stated above the three traditional transaction methods are the most reliable and direct way of establishing a correct transfer price. However, since the modern business is so complex it may be difficult to apply these methods, mainly because the information available is not detailed enough. This could imply that for example adjustments cannot be made to achieve comparability. In these cases the taxpayer has to consider applying transactional profit methods.[49]

These methods examine the profits that arise from transactions within a MNE. Independent parties rarely if ever use these kind methods to establish the price. Nevertheless, examining profits arising from controlled transactions can be a relevant indicator if the arm's-length principle is followed. The guidelines only approve of two methods, the profit split method and the transactional net margin method.

4.2.1 Profit split method

The profit split method finds the transfer price by using a formula to allocate the profit from a controlled transaction. The formula is based on the relative value of the contribution by each group and take into account the costs and risks undertaken by each party. There are many different ways of measuring the value of the contributions within the MNE. The most common way is to use the operating assets of the corporations to decide where the portions of the profit from a transaction should end up.[50] An example will clarify the matter. Corporation A produces lamps and transfers them to its foreign subsidiary. The cost of producing 100 lamps is $120. The subsidiary sells the lamps for $200 creating a total gross profit for the group of $80. Let us set corporation A's operating expenses at $10 and the subsidiary's expenses at $20. Consequently the total operating expense is $30 and the operating profit for the group is $50. According to the profit split method this profit should be apportioned to the corporations based on the operating assets of each party. Let us assume that corporation A's operating assets are $3000 and the subsidiary's are $2000. 3/5 of the operating profit should be earned by corporation A. This decides the transfer price. The transfer price should create an operating profit for corporation A of $30 (3/5 of the operating profit). The cost (production and operating) for the corporation were $120 and $10, with the profit added the transfer price will be $160. The subsidiary costs for the lamps will consequently be $160+$20 and since the lamps are sold for $200 the operating profit for the

[49] The guidelines, chapter 2, paragraph 2:49
[50] The guidelines, chapter 3, paragraphs, 3:25-27, See also Eden, Lorraine, (1998), p. 45 and Black, David R., Canadian Tax Journal, (1993), p. 148-149

subsidiary will be $20, equal to 2/5 of the total operating profit for the group.[51]

It is important to keep in mind that when the transfer price is decided the MNE does not know how big the actual profit will be. Instead when applying the profit split method predictions are used what the operating profit will be.[52] Occasionally it may be more appropriate to split the gross profit. For example it can sometimes be difficult to accurately determine the operation costs and therefore the method is better used by allocating the gross profits and thereby finding the transfer price.[53]

The method has resemblances to the formula approach used in unitary taxation, which is rejected by the OECD. The important difference is that the profit split method allocates the profit from each transaction while unitary taxation allocates the total annual profit for the MNE between its corporations.

It is also worth noticing that this method does not use other transaction between unrelated parties to guide how an intercorporate transaction should be priced.

4.2.2 Transactional Net Margin Method (TNMM)

The TNMM operates in a manner similar to the cost plus and resale price methods. The method compares the net profit (gross profit minus operating- and net income expenses) margin from a controlled transaction with the net profit margins realized by arm’s length parties from similar transactions. The margins are examined relative to an appropriate base such as costs, sales or assets. The base to be used depends on the facts and circumstances of each case. Since the method is used in the same way as the cost plus and resale price methods the same principles concerning comparability and adjustments must be applied. This means that as a first option the net margin of a controlled transaction should be compared to other transactions made by the same taxpayer with uncontrolled parties. If that is not possible other independent enterprises’ net profit margins should be used as a comparison.[54]

The TNMM only examine one side of the transaction. The method should be applied to the party for which the most reliable data exists. This often implies selecting the least complex party that does not contribute to valuable or unique intangible assets.[55]

[51] See Eden, Lorraine, (1998), p.45-47 where a similar example is presented
[52] The guidelines, chapter 3, paragraph 3:12
[53] The guidelines, chapter 3, paragraph 3:17
[54] The guidelines, chapter 3, paragraph 3:26
[55] The guidelines, chapter 3, paragraph 3:43, see also IC 87-2R, part 3, paragraph 108

4.3 Other methods

The guidelines leave an opening for MNE to use other methods then the five methods described above. The prices established by other methods must still satisfy the arm's-length principle.[56] Thus, it is required that the method used find a price for a transaction that unrelated parties could have reached.

The unitary taxation system, described in the introduction, does not meet the arm's-length principle since no price is found for any particular transaction. Parties dealing on arm's length are pricing there transactions. This system is therefore rejected by the guidelines.[57]

[56] The guidelines, chapter 1, paragraph 1:68

[57] See the guidelines, chapter 3C, paragraphs 3:58-74 for a further discussion about unitary taxation

5 Using the Comparable Uncontrolled Price method

When first approaching the CUP method it might not seem too complicated to use. An intercorporate transaction is priced by comparing the transaction to another uncontrolled transaction. For a MNE it is far more complex than it looks on the surface.

5.1 Comparables

The first step, when applying the CUP method, is to find a comparable transaction. This could be done in two different ways. The easiest and most preferable way is to compare the controlled transaction with another transaction made by the same MNE but with an unrelated party. This is an "*internal comparable*". The reason why it is preferable is that the quality of the data is more accurate since the MNE is part of the transaction and thus has access to all the facts of the transaction. The quality of the data will determine the ability to identify differences between the uncontrolled and the controlled transaction and thus also determine the possibility to use the CUP method. However, in practice, the existence of internal comparables is the exception rather than the rule. For example the manufactures in a multinational group frequently do not sell to unrelated distributors and if such sales exist the unrelated distributor is usually not in the same market as the related distributor. Typically the price of a transaction must be tested with transactions made by other independent parties, called "*external comparables*". Since the MNE is not part of the comparable transaction it is increasingly difficult to find accurate data. It is often necessary to make use of publicly available databases. These databases are an important part for the MNEs concerning the search for potential comparables. They contain statistics about public companies. For a corporation involved in a unique business it could be difficult to find comparables.[58]

When applying the CUP method, irrespective of whether an internal or an external comparable is used, the circumstances of the two transactions must be comparable. For such comparisons to be useful, the relevant economic

[58] Birnkrant, Henry J., Canadian Tax Foundation (1998), 40b:10-1, Brodie, John R and Denusik, Gord, Canadian Tax Foundation, 2000, P. 13:5-6 and Cassidy, Daniel J, Canadian Tax Foundation (2000), P. 15:5-7. The first and the latter papers are dealing with transfer pricing from an US perspective but the contents used in this paper is valid for all transfer pricing. See also Macdonald, Barry and Robertson, Murray, Canadian Tax Foundation (2002), p. 15:11

characteristics must be sufficiently alike. If differences exist which are relevant for the price of a product adjustments are needed.[59]

5.2 Adjustments

The guidelines provide a large number of different occasions where adjustments should be made. This is not a complete list of all possible situations when adjustments are needed. As will later be illustrated in the case law, the complexity of the business world is far too great for such a list. Any relevant economic differences between two transactions should be taken into account when deciding the transfer price.

5.2.1 Functional analysis

A very important and fundamental part of the comparison is to examine the functions of the parties involved in the transactions. An accurate functional analysis will help a person who is not familiar with the business activities of the corporations to understand the roles that each party plays within the MNE.[60]

There are three important aspects that must be considered when comparing transactions. To begin with the *activities* performed by the parties must be examined. The guidelines give several examples: design, manufacturing, assembling, research and development, marketing, financing, etc. These kinds of activities partly decide the price of a transaction between two entities and thus, adjustments of the price must be made if differences exist between transactions.[61] For example, take a Canadian corporation that is selling golf balls to both its US subsidiary and an unrelated Canadian party. When deciding the transfer price, one must examine what activities the two buying corporations are performing. If the unrelated party is responsible for the marketing of the golf balls while the Parent is performing the marketing for its subsidiary adjustments are needed. The unrelated party's marketing activities cost money and thus it should pay less for the golf balls than the subsidiary.

Another functional aspect that must considered is the *risk* assumed by the parties. The more risk a buyer takes the higher return he expects to get. Consequently, he is prepared to pay less for the product. For example, if a distributor is also responsible for marketing and advertising a product, the price the distributor is willing to pay will be affected. In marketing and advertising, the distributor invests more of his own capital and so, expects a higher return than a distributor acting merely as an agent. Another good

[59] The guidelines, chapter 1, paragraph 1:15
[60] Brodie, John R and Denusik, Gord, Canadian Tax Foundation, (2000), p. 13:2-3
[61] The guidelines, chapter 1, paragraph 1:21

example of when the risk level could be different is when there exist functional differences between two manufacturers. If one of them is a contract manufacturer while the other manufacturer is a normal full-fledge manufacturer, this must be considered. A contract manufacturer normally takes less risk since in most cases it does not undertake many entrepreneurial activities. Instead, the manufacturer is often using technology developed by its customer. A full-fledge manufacturer, on the other hand, normally has its own intangible properties, production technology, etc. A larger risk is consequently borne by such a manufacturer and the price must be adjusted for such differences. Other risks that must be considered include financial risks caused by changes in interest rates and exchange rates and risks involved in investing in research and development because of failure or low return on the investment.[62]

A third aspect of the functional analysis is to identify the *assets* used by the parties, including assets such as equipment, plants and intangible assets. The nature of the assets used, such as age and value, also play a part in the functional analysis.[63]

It is obvious that the three different aspects of the functional analysis are connected. If a distributor is involved in part of the production of a product, this activity will include investing money in assets needed for the production. This investment will imply a risk for the distributor.

When two unrelated corporations deal the functions performed by each party affect the price of the transaction. Two related parties must also consider the functions. The transfer price for a transaction with the distributor discussed above must be lower than the price charged when selling the same product to another unrelated distributor not involved in production of the product. If the transaction with the unrelated party is used as a comparable an adjustment of the price paid must be made when deciding the transfer price of the controlled transaction. [64]

5.2.2 Characteristics of the property

Since the CUP method determines the transfer price by comparing the price of a product, it is important that the same kind of product is compared. It is obviously not very helpful to compare a transaction for VCR when deciding the transfer price for a TV. The marginal might be similar and thus one of the other two traditional transactions methods could be used. When using the CUP method, the product has to be the same or at least similar.[65]

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[62] The guidelines, chapter 1, paragraphs 1:23-25 and Swanewald, Hendrik, Canadian Tax Foundation, (2000), p. 7

[63] The guidelines, chapter 1, paragraphs 1:22

[64] The guidelines, chapter 1, paragraph 1:20

[65] The guidelines, chapter 1, paragraph 1:19 and chapter 2, paragraph 2:5

Even though two transactions might seem similar adjustments could be necessary. The guidelines give a good example. An enterprise sells unbranded Colombian coffee beans to related parties. If the only available uncontrolled transaction involves unbranded Brazilian coffee beans the question arises: will the products' differences affect the price. The quality of the beans should be the most important factor when pricing the product but it is not the only one. The source of the beans could affect the price as well. Perhaps Brazilian beans have a better reputation because of their reliability on the market and therefore are priced higher. Also, the amount of the beans transferred can affect the price. It is not exceptional that quantity discounts are offered.[66] These kinds of assessments must be made when comparing products from different transactions.

5.2.3 Contractual terms

When independent parties are doing business the contractual terms generally define how the responsibilities, risks and benefits are allocated. In this way the issue of contractual terms is closely connected to the functional analysis discussed above. When parties dealing at arm's length enter into a contract, the mutual interest of making money guarantees that the parties will hold each other to the terms of the contract. The same incentive does not exist when transactions are made within a MNE. Therefore, it is important to examine whether the terms of the contract really reflect how the parties acts. If a product is sold to a distributor and it is claimed that the distributor assumes the exchange rate risk, this will make the price lower. If, in reality, the transfer price will be adjusted in case of exchange rates movements the risk allocation is not true. It is thus the true underlying economic meaning of the contract that is interesting. If the contract states that payment is required in ten days but in reality the purchaser always pays for the acquired product in 45 days and the seller never objects, this conduct by the parties must be considered when the contractual terms are examined.[67] Another aspect of the contractual terms' credibility is the fact that it is highly unlikely that a corporation takes a connected party to court and consequently adjustments might be needed because of that. On the other hand one could argue that both parties benefit from the facts the risk of being sued is nonexistent and that it therefore should not affect the price. That argument gets weaker if one considers that in an uncontrolled transaction normally one party takes a bigger risk of getting sued.

5.2.4 Economical circumstances

[66] The guidelines, chapter 1, paragraph 1:19 and chapter 2, paragraphs 2:10-11, see also Cassidy, Daniel J, Canadian Tax Foundation (2000), P. 15:6
[67] The guidelines, chapter 1, paragraphs 1:26, 28-29, see also Cassidy, Daniel J, Canadian Tax Foundation (2000), p. 15:8-9

In the business world the price of exactly the same product could vary from one place to another. Therefore it is important that the independent and the related corporations' markets are comparable. When comparing markets, several factors must be examined. For example, the size of the market, the availability of substitute goods, the extent of competition in that market and the competitive position of the parties within that market are areas that must be considered. Other factors that could be relevant are consumer purchasing power, costs of production, government regulation etc.[68] The following example will clarify how the economic circumstances can imply that adjustments are necessary. A US company is making t-shirts containing the logo of different sport franchises. It sells the shirts to Canadian distributors. The price charged for a Canadians T-shirt sold to an unrelated distributor in Montreal may not be compared to Maple Leaf T-shirts sold to a related distributor in Toronto, if during the year, the Maple Leafs did not make the playoffs while the Canadians won the Stanley Cup![69]

5.2.5 Business strategy

Different business strategies can affect how prices are set and must therefore be considered when examining comparables. An example of such a business strategy is a market penetration scheme. A corporation that is trying to enter a new market or increase its market share could be willing to charge a lower price than other comparable products in a market. For the same reason, a taxpayer could also accept higher costs than other corporations. Both these scenarios could lead to temporary losses for a corporation.[70] If a MNE is trying to get into a new market and therefore sells the product in the new market for a lower price lower than other comparables this must affect the transfer price. The price of the comparable product must be adjusted when deciding the transfer price for the controlled transaction. If no such adjustment would be made and the market price would be used a too large part of the profit would end up at the party transferring the product.

An important question that arises as a result of a market penetration attempt is what party should bear the costs for the penetration attempt. An example will explain the issue. A product costs $50 to produce and is normally sold to the public for $100. The transfer price is normally $75 splitting the profit equally between the manufacturer and the distributor. The MNE wants to increase its market share and decides to sell the product to the public for $75. How should this fact affect the transfer price? If the same transfer price is used as before the whole profit will end up at the manufacturer. If instead the transfer price is lowered to $50 the distributor will be making the same kind of profit as before the action. The guidelines suggest that the issue is

[68] The guidelines, chapter 1, paragraph 1:30
[69] Cassidy, Daniel J, Canadian Tax Foundation (2000), p. 15:10-11
[70] The guidelines, chapter 1, paragraphs 1:31-32, see also Humphreys, Brenda J Canadian Tax Foundation, (1998) p. 40:16

handled the same way independent parties would solve the question. A distributor acting merely like a sales agent with little or no responsible for long-term marketing development is not likely to bear the costs for such a strategy. On the other hand a distributor more involved in for example the production process should be more interested in a marketing penetration action and therefore willing to bear some of the costs.[71] Thus, the facts will decide how much the distributor is paying for the product.

5.3 Other aspects that should be considered when using the CUP method

5.3.1 Separate or combined transactions

The guidelines state that the arm's-length principle should be applied to a transaction by transaction basis. However, there are some exceptions where separate transactions are so closely linked that such an approach will not lead to an accurate result. Thus the arm's-length principle works better when the transactions are examined together. The guidelines provide a few examples.

- Some long-term contracts for the supply of commodities or services
- Rights to use intangible property
- Pricing a range of closely-linked products when it is impractical find a price for each individual product[72]

Since this paper is examining how the CUP method is applied to tangible property the issue of separate and combined transaction is not that important. It seems fairly clear that each transaction should be examined separately.

5.3.2 Arm's length range

The complexity of transfer pricing often makes it hard to find an exact price for an intercorporate transaction. When applying a method, the figures can vary. Since the arm's-length principle only produces an estimate of how independent parties would price a transaction, none of these figures are necessarily incorrect. These kinds of varying results are therefore just natural. After all, transfer pricing is not an exact science. The guidelines provide the possibility to create a range within which the transfer price must fall. As always, the taxpayer must exercise good judgment when using a

[71] The guidelines, chapter 1, paragraph 1:34-35
[72] The guidelines, chapter 1, paragraph 1:42-43

transfer price range.[73] More about how price range is used, see chapter 5.1.1.3

5.3.3 Use of data from prior years

An important possibility when examining comparable transactions could be to use data from years prior to the taxation year when a transaction took place. In some cases the information available from the year of the transfer might not be enough. Conditions from earlier years can affect the price of a product and, in some case, so much so, that the comparable product cannot be used. Another example of when data from earlier years can be necessary is when a product's life cycle is examined. The data can show that a product is not an appropriate comparable or at least that adjustments need to be made. As described above it could be necessary to make adjustments because of the economical circumstances concerning a product. When for example examining how the competition is on a market figures from earlier years might be necessary.[74] The guidelines provide these examples of when earlier data could be used. It is clear that it is a non-exhaustive list.

5.3.4 Losses

When a corporation constantly shows losses while at the same time the MNE is profitable, the guidelines stipulate that some kind of adjustments could be necessary. Obviously a corporation within an MNE, just like an independent corporation, can sustain losses for several reasons. However an independent party would not tolerate multiple years of losses. Instead, it would cease its business activities. On the other hand, a dependent party will stay in the business in spite of the losses as long as there is a benefit to the MNE as a group.[75]

The transfer pricing procedure may need revision where a corporation realizing losses is doing business with another member of a profitable MNE. The guidelines provide that a service charge could be imposed by the party losing money for being part of transactions that realize losses. [76] Obviously this has the same effect as if the party incurring losses gets a discount on the products bought or as if the other party pays slightly more when purchasing products. Funds will be moved to the party which previously showed losses and the profit balance of the two groups within the MNE will be more equal.

One reason why losses may accrue could be because the MNE is trying to increase its market share and therefore has chosen to lower the prices. This

[73] The guidelines, chapter 1, paragraphs 1:45-46
[74] The guidelines, chapter 1, paragraphs 1:49-51
[75] The guidelines, chapter 1, paragraph 1:52
[76] The guidelines, chapter 1, paragraph 1:53

kind of pricing strategy (see chapter 4.2.5) can only be accepted for a limited time. An estimation of how an independent party is expected to behave will provide a baseline for how a dependent group should act. Again, no enterprise will accept losses on a regular basis.[77]

5.4 When should CUP be used?

Revenue Canada has clearly adopted OECD's view that there is a "natural hierarchy in the method" and that the CUP method should be the first choice for a taxpayer. It is the method that clearly provides the most accurate way of finding the price comparable to a price reached by two unrelated parties. A high degree of comparability is reached because the method focuses directly on the price of the transaction. If the CUP method cannot be used, one of the other two traditional transaction methods (resale price or cost plus) should be considered.[78] This hierarchy differs from the US approach. The transfer pricing regulations requires the use of the "best method". No single method is the number one choice; instead the method that provides the most accurate result should be used.[79] In practice there should not be any conflict between the two approaches.[80]

Thus, when a comparable transaction is found the CUP method should be used to price the intercorporate transaction. As stated above it is rare to find a comparable transaction that is exactly the same as the controlled transaction and therefore are adjustments often are required. To know when to use the CUP method, the following question has to be answered: how far should a taxpayer go when making adjustments to a comparable transaction? The availability of CUPs depends on how broadly a comparable transaction is defined.[81] The guidelines provide no direct answer to that question. In fact not much guidance is given at all. The guidelines state that "every effort should be made to adjust data so that it may be used appropriately in a CUP method".

The difficulties that arise when trying to make adjustments should not routinely stop a taxpayer from using the method. Instead, to be able to use the method, the taxpayer must be flexible. The flexibility should not be pushed too far since the reliability of the CUP method is affected by the accuracy of adjustments.[82]

[77] The guidelines, chapter 1, paragraph 1:54
[78] IC 87-2R, paragraphs 49-55 and the guidelines, chapter 2, paragraphs 2:5 and 49, chapter 3, paragraphs 3:49-50
[79] US Internal Revenue Code, section 1.482-1 (c)
[80] Macdonald, Barry and Robertson, Murray, Canadian Tax Foundation (2002), p. 15:10
[81] Arnold, Brian J. and McDonnell, Thomas E., Canadian Tax Journal (1993), p. 906, see also Wiman Bertil, (1987), p. 304
[82] The guidelines, chapter 2, paragraph 2:9

OECD’s view can be summed up as follows; a taxpayer must make a serious effort to make adjustments if needed to use the CUP method but if the accuracy of the method is affected too much, another method must be considered. The issue of making adjustments or choosing another method must be determined on a case-by-case basis depending on the facts and the reliability of the data available.

6 Documentation

It is up to the taxpayer to demonstrate that the transfer price is calculated in a correct way. Thus, the taxpayer bears the burden of proof of the reasonableness of the transfer price. This responsibility is normally fulfilled if he provides sufficient documentation. The Canadian ITA (the 'Act'), as many other tax jurisdictions, requires that a taxpayer prepares contemporaneous documentation to demonstrate that the transfer price is determined according to the arm's-length principle.[83]

Transfer pricing disputes between a MNE and a tax authority arise when the transfer-pricing documentation does not fully address all potential transfer pricing issues. The result of a transfer pricing dispute can be that the tax authorities change the transfer price and thus increase the profit and the income tax for the corporation. This is a state imposed transfer-pricing adjustment. In addition to that the corporation runs the risk of getting hit by a penalty of 10 percent of the transfer pricing adjustment.[84]

To avoid penalty the Act imposes that the taxpayer must have made a "reasonable effort" to follow the arm's-length principle. If the taxpayer has not provided documentation to support the reasonability of the transfer pricing he is deemed not to have made a reasonable effort.[85] The required standard of the documentation is different depending on what the taxpayer wants to accomplish. The requirements are lower if a taxpayer intends to avoid penalties in comparison to what is required if the taxpayer want to avoid a transfer-pricing adjustment. Consequently, documentation that meets only the minimum requirements for penalty protection is often not sufficient enough to provide an adequate defense in the event of a transfer pricing audit. [86]

6.1 What should documentation address?

The more accurate and detailed the documentation is, the smaller the risk that a dispute arises. When studying the Act, it is self-evident that certain information has to be included to satisfy the tax authorities. However, in other cases it could be more difficult to know exactly what should be included. When reading the act together with the guidelines one can find a framework how the documentation should be set up. This framework

[83] Macdonald, Barry and Robertson, Murray, Canadian Tax Foundation (2002), p. 15:1-2
[84] ITA, Subsections 247(2-4) and Macdonald, Barry and Robertson, Murray, Canadian Tax Foundation (2002). P.15:5
[85] ITA, Subsections 247(3-4)
[86] Macdonald, Barry and Robertson, Murray, Canadian Tax Foundation 2002, p. 15:2-5

consists of five parts: the economic analysis, scope of the transaction, functional analysis, financial analysis and the conclusion.[87]

6.1.1 Economic Analysis

The economic analysis is the portion of the documentation that proves that the prices have been determined at arm's-length. This is the most important part. It is fairly clear that this analysis involves showing which method was used and also going through the comparables and adjustments to the comparables. Some other areas should also be examined. Here follows a few examples of the information an economic analysis should provide.[88]

6.1.1.1 Demonstrating what information was used

If an external comparable transaction was used to find the transfer price but there existed internal transactions as well, a clear reason should be provided as to why the internal transaction did not constitute a sufficient comparable.[89] For example, if a transactional profit method was used to find the transfer price because the internal comparable could not be used, it is a good idea to provide information about how the corporation handled the comparables. If sufficient documentation could for example demonstrate that too many adjustments were needed to use the internal comparable, this should limit the risk of a transfer pricing dispute.

6.1.1.2 Demonstrating why a method was not used

As stated above, the view of Revenue Canada is that the CUP method is the method of choice. If the method is not used, should an analysis be included in the documentation explaining why the method was rejected? The guidelines do not explicitly require such an analysis. Instead they stipulate that the taxpayer should not have to perform analyses under more than one method.[90] The Act requires that documentation demonstrate "the data and methods considered and the analysis performed to determine the transfer price".[91] Thus, the Act does not explicitly require an explanation as to why a method is not used. On the other hand, it is hard to think about a situation when the CUP method is not even considered. The only time when that could be the case is when it is obvious that no comparable transaction exists. In any case, it has been shown that an analysis of why a method is not used has provided useful support for the method that has been chosen. This

[87] See Macdonald, Barry and Robertson, Murray,, Canadian Tax Foundation (2002), p. 15:5-18, where this framework is presented. See also ITA 247 (4) and the guidelines chapter 5
[88] Macdonald, Barry and Robertson, Murray, Canadian Tax Foundation (2002), p. 15:9-10
[89] Macdonald, Barry and Robertson, Murray, Canadian Tax Foundation (2002), p. 15:11-12
[90] The guidelines, chapter 1, paragraphs 1:68-69
[91] ITA 247(4)(a)(v)

support, although not required, can minimize the risk for penalties and be useful in transfer pricing defense situations. In those situations it is not only important to convince the tax authorities that the method used is appropriate but it is also helpful to be able to show why another method is not appropriate.[92] For example, if the resale price method is used, it could be a good idea to show why the CUP method was not used. If nothing in the documentation provides information why CUP were rejected it must be a larger risk that the tax authorities react. On the other hand, if the CUP method is used, there is no reason to deal with any other method in the documentation.

6.1.1.3 Explanation of how a price range was found

As stated above it is often difficult to find an exact transfer price and instead a range must be used. Normally, quite a few different independent transactions are investigated especially if external comparables are used. These transactions can lead to different results. This is not surprising since, for example, functional differences may exist between the investigated parties. Another reason why an exact transfer price is rarely found could simply be because corporations may not set the same price for the same product. When applying third-party data, precision suffers. To avoid tax authority involvement, it is important that the MNE provide sufficient documentation about the compared transactions.

Sometimes when economical analyses are performed, a large sample of comparables is used as a basis for computing the range of arm's-length prices. This can be a dangerous strategy since it could increase the risk for a transfer pricing dispute. Revenue Canada tends to prefer the use of a smaller sample of comparable. With this practice, Revenue Canada is attempting to apply a more stringent criterion for comparables. Revenue Canada finds that a more precise result can be reached by only using the transactions that are most similar to the controlled transaction. Comparables can, for example, be eliminated because the examined corporation has higher or lower sales than the tested party or if the product that is examined differs from the one in the controlled transaction. If this practice provides more sufficient and exact comparables can be discussed. Obviously transactions that differ a lot from the controlled transaction could provide a transfer price that is not sufficient and should therefore not be used. At the same time if a small sample is used there is a risk that for example one examined company had a bad year and that the financial result of that party will affect the transfer price in a way that is not eligible. If the samples are broader one misused comparable will not affect the transfer price that much. In any case, the taxpayer has to be aware that Revenue Canada will carefully examine broad samples of comparables and therefore be prepared to demonstrate that

[92] Macdonald, Barry and Robertson, Murray, Canadian Tax Foundation, (2002), p. 15:10

the used comparables are providing an efficiently comparison to the controlled transaction.[93]

6.1.1.4 Strategies

The taxpayer should present all factors that affected the transfer price. An important part of the presentation is to demonstrate the different strategies and economic assumptions that the parties may have relied on when determining the price. For example, if one party is trying to penetrate a new market and therefore is charging a lower price, this should be demonstrated in the documentation. Other factors that should be documented include, for example, when one market is particularly competitive and the price on that market is lower than other markets.[94]

6.1.2 Other information that should be provided

Scope of transaction

The scope of the transaction can be seen as background information to the transaction itself to create a clear understanding of what is to be analyzed. It should include information about the entities involved and how they are organized, what type of transaction was performed and other general background info such as corporate history, product information and industry information. The scope should also include a statement of which periods are being reviewed.[95]

Functional Analysis

As stated above it is important to know the business of the parties involved in the transaction. The functional analysis is therefore important and often a critical component of the documentation. Many transfer pricing disputes are caused by ill-prepared functional analysis.[96]

Financial Analysis

The financial analysis is performed to demonstrate the effect that the use of a transfer pricing method will have on the annual result of parties involved in the intercorporate transaction. This part of the documentation process is vital when showing that arm's length prices were used. If for example one of the parties can demonstrate a large profit while the other party has made a loss this must be explained in the financial analysis.[97]

Conclusion

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[93] Macdonald, Barry and Robertson, Murray, Canadian Tax Foundation, (2002), p. 15:13-15

[94] Swanewald, Hendrik, Canadian Tax Foundation, (2000), p. 8

[95] Macdonald, Barry and Robertson, Murray, p. 15:6

[96] Macdonald, Barry and Robertson, Murray, p. 15:7-8

[97] Macdonald, Barry and Robertson, Murray, p. 15:8-9

Finally, the documentation should include a conclusion that the pricings of the transactions are arm's-length for all parties involved.

7 Case Law

The first Canadian regulations governing transfer pricing were introduced more than 60 years ago in the Canadian Tax Statute. In spite of that, the provisions have only produced a few cases dealing with transfer pricing. In fact, although other cases are treated as transfer pricing cases by several authors, only two cases deal with the transfer pricing regulations.[98] The Indalex case is one of them and it will be properly surveyed below. In addition to that a few other cases will be examined. These cases deal with other rules but the principles established by the court can, as will be demonstrated, be applied to transfer pricing situations.

Because of this lack of Canadian jurisprudence I will start by examine US case law.[99] The first part of this chapter will go through the most significant US cases were the CUP method is examined. All the cases are decided by the US Tax Court which, although being first instance, is an important source of jurisprudence.[100] It is important to clearly state why the US jurisprudence is examined. It is examined to get an idea about how a tax court deals with, above all, comparables and adjustments to comparable transactions. Since there is an obvious lack of Canadian cases it is vital for the paper to further examine the case law. The US jurisprudence is extensive and the CUP method has been used and discussed several times in the case law.

I have no intentions to apply the facts in the cases to Canadian transfer pricing regulations or to examine if the case would have gotten the same outcome in a Canadian court. On the other hand it must be likely that the outcome would have been similar considering it is the arm's-length principle that prevails in both countries. In any case, as will be demonstrated in the cases, the reasoning by the courts is not unfamiliar to what could be found in the OECD's guidelines.

Before the cases are approached it is necessary to go through some of the US transfer pricing regulations.

7.1 US Transfer Pricing Regulations

Since the old regulations from 1968 are applicable for all the cases dealt with in this paper, these rules will be presented.

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[98] Vincent, Francois, (2002), p. 53-54

[99] Since the thesis is written from a Canadian perspective no thorough examination will be done of the US cases. This means that no literature has been examined and consequently only personal analysis of the cases are included.

[100] Wiman, Bertil, (1987), p. 179-180

When one controlled entity sells tangible property to another controlled entity at other than an arm's-length price, the tax authority has power to make appropriate allocations between the seller and the buyer to reflect an arm's-length price for such sale.[101] Under the comparable uncontrolled price method, the arm's-length price of a controlled sale is equal to the price paid in comparable uncontrolled sales.[102]

Uncontrolled sales for purposes of application of the comparable uncontrolled price method include: (i) sales made by the taxpayer to an unrelated party, (ii) purchases made by the taxpayer from unrelated parties, and (iii) sales made between two unrelated parties.[103] Controlled and uncontrolled sales are deemed comparable if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales, or if such properties and circumstances are so heavily identical that they either have no effect on price, or can be measured and eliminated by making a reasonable number of adjustments to the price of uncontrolled sales. Some of the differences which may affect the price of property are differences in quality, terms of sale, intangible property associated with the sale, time of sale and the level of the market and geographic market in which the sale takes place.[104]

In the old transfer pricing regulation it was specified that use of the CUP method was mandatory if CUPs were to be found.[105] In the new regulation from 1994 "the best-method rule" does not provide such a clear unambiguous preference for CUP, although it still indicates a general preference for the method.[106] This is not of significant interest for this paper since the reason the cases are examined is not to find how to choose between the methods.

It has been suggested that the courts were faced with problems when applying the old regulations. If the court did not find comparables they were faced with a very tough situation to find a transfer price. Consequently inexact comparable were sometimes used. Nevertheless, the courts in several cases, found themselves forced to reject the comparable suggested by the parties.[107] These circumstances should be kept in mind when analyzing the cases.

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[101] Section 1.482-2(e)(1)(i), Income Tax Regs

[102] Sec. 1.482-2(e)(2)(i), Income Tax Regs.

[103] Sec. 1.482-2(e)(2)(ii), Income Tax Regs.

[104] Sec. 1.482-2(e)(2)(ii), Income Tax Regs.

[105] Sec. 1.482-2(e)(1)(ii) See also for example Bausch & Lomb, Inc. v. Commissioner of Internal Revenue, tax Ct. Docket no. 3394-86, Decided: March 23, 1989, Cite(2): 92 T.C. No. 33, Opinion, Introduction

[106] 1.482-3(b)(2)(ii)(A), New rules from 1994

[107] BnaTax Management Library, Foreign Income Portfolios, Transfer Pricing, Portfolio 888, Detailed Analysis, 3:III, C.2

7.2 US transfer pricing cases

7.2.1 Eli Lilly[108]

Eli Lilly manufactured and sold pharmaceutical products. Lilly created and patented the product Darvon in the early 1950s and Darvon-N during the early 1960. In 1965 a subsidiary (Lilly PR) was formed in Puerto Rico and the patents for the drugs were transferred to the subsidiary. The subsidiary manufactured the drugs and sold them to Lilly who in turn marketed the product throughout the US. Lilly PR was the sole manufacturer of the Darvon drugs until 1972, when the first of the patent expired. IRS claimed that the price charged between the related parties during the years of 1971-1973 was not arm' length.[109]

During the years 1971 and 1972 there were no comparable uncontrolled sales of the drugs. Because of the patent no other parties could manufacture or sell the products in US. The record disclosed that some sales took place outside US in markets that were not covered by US patent protection. Those sales were not comparable because they took place in a different unprotected market.[110]

After the expiration of the patent for Darvon in the end of 1972 at least 24 other companies started production of the drug. Because of that, comparables existed for the year of 1973. One of the new competitors was Smith Kline & French Laboratories (SKF) who marketed the drug. The drug was manufactured by Milan Pharmaceuticals (Milan) and sold on arm's length to SKF. The uncontrolled price was $7.55 for a bottle of 500 capsules. This price functioned as the comparable uncontrolled price for the transaction within the Lilly group. Before the transfer price was reached, seven adjustments were made by Lilly to the Milan price and the intercorporate price ended up being $12.17.

1. Lilly PR manufactured its own capsules while SKF supplied to Milan at no charge the empty capsules package inserts, labels and bottle caps. Lilly concluded that Milan's price should be adjusted by adding the costs that Milan would have incurred if it had purchased those materials. The court accepted adjustments for the free raw materials. When deciding the size of the adjustment the court considered the difference in size and sales of Milan and Lilly PR. In

[108] Eli Lilly, v. Commissioner of Internal Revenue, Docket No. 5113-76, Decided: May 28, 1985, Cite(s): 84 T.C. no. 65
[109] Eli Lilly, v. Commissioner of Internal Revenue, See Summary
[110] Eli Lilly, v. Commissioner of Internal Revenue, Opinion, Issue III, Section A.1.a.(i)

the end $0.86 was added to the price of Milan which was slightly less than what Lilly had argued for in court.

2. The credit terms differed between the transactions. Lilly would have saved interest costs if it would have used the credit terms of the comparable transaction and therefore should the saved amount be added to the transfer price. Also in this case the court agreed with Lilly's argument although a different rate of interest was used. When calculating the value of the credit terms Lilly used an eight percentage interest while the court concluded that the value of the terms should be calculated using an interest rate of five percent. The court found that a $0.20 adjustment was necessary.
3. Lilly PR supplied a substantial quantity of free samples to its parent while Milan was charging money for capsules used by SKF as samples. The court made an adjustment for the free samples but it did not agree with the way Lilly had calculated the value of the difference. Lilly had used its own costs when purchasing samples which the court found incorrect. Instead Milan's costs for the samples should have been used. The adjustment the court reached was $0.50 which was significantly less than what Lilly had suggested.
4. Lilly PR owned all its equipment while SKF loaned equipment to Milan at no cost. Therefore the rental value of the equipment loan should be added to Milan's price to reflect that difference. Lilly could not estimate the value of the equipment loan and did not present any estimated value at all. The court did not allow this adjustment since no evidence was presented about the value of the equipment. IRS had showed that the equipment was fairly old and that it was not being used at that moment by SKF.
5. SKF carried out quality control operations for Milan's products at both its own facilities and at Milan's plant. Lilly PR carried out its own quality control. The cost of SKF's control should therefore be added to Milan's price but no exact figure was presented by Lilly. The court found that Lilly had overlooked the fact that Milan was still required to employ and utilize its own quality control personnel. The controls made by SKF did not relieve Milan from any of the costs of providing its own quality control. Accordingly the court did not allow any adjustment.
6. Because of its technical skills, Lilly PR's products were of higher quality and so misuse and odor problems were avoided. Lilly PR bore the cost for developing this technique. Adjustments were necessary to Milan's price because of this quality difference. The court agreed that the product of Lilly PR was of higher quality. However, the court found that it was not demonstrated by Lilly that Milan's price should be that different. The court allowed only a minor adjustment of $0.21.
7. The final adjustment was made with respect of the continued existence of the Darvon-N patent. The value of the patent spread value over all Lilly PR's products. Since Milan had no patent the price had to be adjusted. The court stated that Lilly had not provided

any breakdown of the estimation of the value that the patent added to their products. Despite the lack of proof, the court held that it was clear that an adjustment was necessary. When making the adjustments the court took into consideration the differences between the transactions. SKF's market for Milan's product was significantly smaller than what was transferred within the Lilly group. Other factors, such as market level, risk, technical assistance and research and development, were also considered. The court had to estimate themselves how much the value the patent should affect the transfer price. An adjustment of $0.48 was held appropriate.

The court imposed, adjusted, Milan price ended up being $9.80, a figure well below what was suggested by Lilly.[111]

7.2.1.1 Analysis of the case

The case provides a good example of how adjustments are made to compensate for difference between the comparable transaction and the controlled transaction so a correct transfer price is reached. It demonstrates all the different aspects that have to be considered when valuing the adjustment and what a complicated task it can be. The case also illustrates the importance of demonstrating proper documentation to support that the adjustments are reasonable.[112] Where Lilly only stated that an adjustment was necessary but did not present any suggestion of how much the adjustment should be it was unsuccessful. One could imagine that the court found that this was reconstructions made to the price after IRS had contested the pricing, since no exact figures or documentation were presented. If these facts were considered when deciding the transfer price it would not have been unrealistic to expect that Lilly could present a value of the difference between the transactions. It was this difference that caused the adjustment.

7.2.2 Bausch & Lomb[113]

Bausch & Lomb (BL) and its subsidiaries were engaged in the manufacture, marketing and sale of soft contact lenses and related products. BL organized an Irish subsidiary, BL Ireland, in 1980 to take advantage of certain tax benefits. The agreement between the two related parties granted to the subsidiary use of its parent's technology to manufacture lenses and to use some of its trademarks in the sale of lenses. In return BL Ireland paid its parent a royalty equal to five percent of sales. All the lenses produced by

[111] Eli Lilly, v. Commissioner of Internal Revenue, Opinion, Issue III, Section A.2.a.
[112] Wiman Bertil, (1987), p. 307-308
[113] Bausch & Lomb, Inc. v. Commissioner of Internal Revenue, tax Ct. Docket no. 3394-86, Decided: March 23, 1989, Cite(2): 92 T.C. No. 33

BL Ireland were sold to BL for a price of $7.50 per lens. IRS contested both the royalty agreement and the transfer prices for the lenses.[114]

BL presented evidence of other comparable uncontrolled sales of contact lenses to show that the transfer price of $7.50 was at or below the price that would have been charged in an arm's length transaction. BL presented other uncontrolled transaction of similar lenses made to other distributors, which all took place for a price higher than the price charged in the controlled transaction within the BL group.[115]

IRS contended that the uncontrolled transactions could not be used to produce a transfer price for BL for a few different reasons. To begin with IRS claimed that a functional difference existed between the transactions. BL was not only a manufacture and distributor of lenses with a worldwide sale and marketing force but also an actor with a substantial research and development function. The distributors in the compared transactions were merely performing distribution transactions. BL would therefore, at arm's length, not be willing to pay as much as other distributors since it needed the profit from lenses sales to support these additional functions. Further, IRS argued that difference in the volumes of lenses sold by BL Ireland to BL and those purchased by the compared distributors should affect the transfer price. Since the quantity of lenses purchased by BL was much greater at arm's length BL would have demanded and received significant volume discounts in purchase price. Finally IRS claimed that BL possessed the technology and present ability to manufacture lenses at a cost far below any of its competitors. Because of that they would never have gone into the open market and paid $7.50 per lens when they could produce it for approximately $1.50.[116]

The court held that BL functioned as a distributor with respect to the lenses bought from BL Ireland and the fact that BL was engaged in other functions was of interest. Neither the volume difference should affect the transfer price. The court noticed that many other manufactures offered volume discounts but it also stated at the same time that there was no evidence of any manufacturers offering discounts for annual purchases in excess of 75,000 units. The court found it "unrealistic to presume that comparables discount would be given for purchase at this level". The fact that BL could produce lenses itself at significant lesser costs was irrelevant. It was a decision by the corporate group to manufacture the lenses in Ireland. BL had shown that the price paid for the purchased lenses was a market price and that is enough to avoid a transfer pricing adjustment. The court also stipulates that although BL, as the world's largest marketer of lenses, have the possibility to get a more favorable price from an independent manufacturer, hoping to establish a long-term relationship, this fact should

[114] Bausch & Lomb, Inc. v. Commissioner of Internal Revenue, See Summary
[115] Bausch & Lomb, Inc. v. Commissioner of Internal Revenue, Opinion, Section A
[116] Bausch & Lomb, Inc. v. Commissioner of Internal Revenue, Opinion, Section A

not affect how the CUP method is applied. If the taxpayer always had to consider all possibilities it would be difficult to use CUP.[117]

The court stated that the fact that a foreign subsidiary became in affect an offshore tax shelter due to different tax rates does not in itself justify relocation of income under the transfer pricing section. The same was held in the US Steel corp. case.[118]

7.2.2.1 Analysis of the case

This case clearly demonstrates how important it is to carefully examine the circumstances, the facts and also the economic reality of the case when applying the CUP method. The mere fact that there exist a functional difference it not enough to make an adjustment to the compared price. The functional differences must be relevant to the pricing and therefore constitute a reason why the difference should lead to an adjustment. The same could be said about the volume difference. Just because the volumes are different when comparing two transactions does not mean that an adjustment has to be made. No adjustments should be made if the difference is not relevant to the price.

Another important lesson that should be learned from this case is that when applying the CUP method, it is not required to pay attention to the most economical favorable opportunity for the MNE. The facts that buying corporation could use its purchasing power to strike a long-term deal with an independent manufacturer and purchase a product for a lesser price does not automatically mean that the transfer price is wrong. What matters is that the existing market price.

The fact that the parent can produce the product cheaper than the subsidiary is not important. The court will not question the taxpayer's business judgment. The mere power of deciding who in a controlled group will earn income is not enough to challenge the transfer price. The MNE can thus chose to locate a subsidiary in a country with lower taxes and let a large part of the profit of the group end up at this subsidiary as long as the arm's length principle is followed. The economic planning by the MNE should not be second guessed, it is the way the MNE prices its intercorporate transactions that should be investigated.

7.2.3 Sundstrand[119]

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[117] Bausch & Lomb, Inc. v. Commissioner of Internal Revenue, Opinion, Section A

[118] United States Steel Corporation v. Commissioner of Internal Revenue, docket Nos. 79-4092, 79-4112, Decided: March 12, 1980, Cite(s): 80-1 USTC Para. 9307

[119] Sundstrand Corporation and Subsidiaries v. Commissioner of Internal Revenue, Tax Ct. Dkt. No. 26230-83, Decided: February 19, 1991, Cite(s): 96 T.C. 226,

Sundstrand Corp., among others manufactured and sold constant speed drive (CSD), an extremely complex device used to drive an airplane's generator. Under a license agreement Sundstrand gave its subsidiary in Singapore, Sundstrand Pacific ltd. (Sunpac), the exclusive right to use its property rights for manufacture of CSD parts and the right to sell these parts anywhere in the world. The transfer price charged by Sunpac for the parts sold to its parent was challenged by IRS.[120]

Sundstrand either resold the purchased parts to airline companies or used them in its own manufacture or in repair activities. Generally Sundstrand could not buy the product from an unrelated vendor due to the complexity and the high startup costs. Around 300 different types of parts, for a total sum of $18,605,000, were sold to Sundstrand during 1978. In addition to that sale, Sunpac also sold around 80 different spare parts to an unrelated party, Sabena, for a total sum of $247,786. It was examined if these transfers could be used as comparables.[121]

The court found that the parts sold differed in the two transactions. The parent accepted all the parts its subsidiary was manufacturing, while Sabena only purchased parts that could be used by airline customers in Europe, the Middle East and Africa. Further Sabena only accepted finished parts. Sundstrand had the same discount rate for finished and unfinished parts and therefore the court was not able to determine the separate transfer price for finished and unfinished parts. A comparison was therefore problematic.

The court moved on to examine if the circumstances relating to the transactions were so similar that the differences stated above did not affect the transfer price or at least could be measured and eliminated by making adjustments. The court found some important elements to consider. To begin with, Sundstrand had inventory carrying costs attributed to Sunpac's parts. Proper adjustments for these costs were not made. Further, no adjustments were made to the comparable for the difference in what parts were accepted by the parties. Sabena was, as mentioned above, only accepting parts that were suited for its business while Sundstrand accepted all parts manufactured by Sunpac. The court believed that these differences should affect the transfer price but at the same time, the court was not convinced that the difference could be properly measured or eliminated by making adjustments. The information available was not considered sufficient enough for such measurements. Third, Sabena could return the parts it no longer could use. Sundstrand did not have the same opportunities and bore therefore a larger risk. Again the court admitted the difficulties in measuring the difference. Fourth, the court found that the difference in how the parties used the parts must be considered. Sundstrand intended both to resell the parts to airline companies and to use them in its production of

[120] Sundstrand Corporation and Subsidiaries v. Commissioner of Internal Revenue, See Summary
[121] Sundstrand Corporation and Subsidiaries v. Commissioner of Internal Revenue, See Part VIII Sales of Sunpac parts

other products. Sabena on the other hand only intended to use the parts as spare parts or to sell them to other airlines as spare parts. This difference would have been considered when unrelated parties determined the discount rate and thus, must be considered when pricing an intercorporate transaction. The court concluded that, considering the different circumstances involved, the Sabena transactions could not be used as comparables.[122]

IRS suggested on difference between the transactions that was rejected by the court. IRS claimed that Sunpac was acting merely as a contract manufacturer for its parent while the relationship with the unrelated party was different. Thus, it was suggested that a functional difference existed. The court rejected this argument because there was no guarantee that the taxpayer would purchase all production from its subsidiary and therefore no contract manufacturer relationship existed.[123]

7.2.3.1 Analysis of the case

The case demonstrates the difficulties in finding comparables when the transferred products have unique characteristics. There is no discussion about any external comparables, probably because it is difficult to find data for such specific, complex items. The subsidiary has one other customer than the parent and even though the differences between the transactions are significant, using these transactions as comparables is the only way the CUP method can be applied. In the end, the court found that the differences between the transactions were too significant to use the Sabena transactions as a comparable. The most important difference seems to be that Sundstrand and Sabena were using different parts and that the parties were using the parts in different ways. When using the CUP method, it is important that the same kinds of products are involved in the transactions. Differences require adjustments. The differences between the transactions in the case made it too complicated to make necessary adjustments to neutralize the existing differences among the compared products. All the three aspects of the functional differences mentioned in OECD's guidelines (see chapter 4.2.1) were of interest in the case. Since Sundstrand were involved in the process of manufacturing of Sunpac and were therefore using different assets. This involvement in the manufacturing demonstrates a different activity. In addition to that Sundstrand were taking larger risks because of this involvement and because of the differences in how the contracts were drawn up.

It is interesting to notice that the court did not comment on the fact that Sundstrand was purchasing products from Sunpac for an amount

[122] Sundstrand Corporation and Subsidiaries v. Commissioner of Internal Revenue, See Opinion , B Transfer price determination

[123] Sundstrand Corporation and Subsidiaries v. Commissioner of Internal Revenue, See A, The section 482 adjustment in general

significantly greater than Sabena spend. This has been considered in other cases.

7.2.4 Seagate[124]

Seagate was a leading manufacturer of hard disk drives for personal computers. A subsidiary, Seagate Singapore (SS), was organized to manufacture component parts for use by Seagate in the manufacture of hard disk drives in US. Shortly after SS's operations were expanded to include the manufacture of complete disk drives. The subsidiary paid a royalty for the use of Seagate's property rights. IRS contested the price for both the transfer of the component parts and the completed disk drives.[125]

SS sold some components to a third party but the court held that these transactions could not constitute comparables for the intercorporate transaction. The main reason for that conclusion was the insignificant volume of the third party sales. The unrelated party represented only two-hundredths of one percent of all of SS's sales.[126]

SS sold large volumes of disk drives to various unrelated parties. The court found that these transactions, although the disk drives involved in the transactions were identical, were not useful as comparables since the circumstances between the controlled and the uncontrolled transaction was too different. The taxpayer used a weighted average sale price for all third party sales as the comparable price for the controlled transactions. The average price often differed significantly from one third party customer to another although these customers could be on the same level of market. For example the price of one particular model ranged from $450 to $219.43. Such disparate prices indicate that a number of factors were involved in setting the prices for the uncontrolled transactions. The taxpayer did not provide the court with any data showing how to identify and quantify the differences in circumstances between the uncontrolled sales. Since the court therefore could not identify why the different uncontrolled transactions differed so much, it could not apply the CUP method. The differences were too great and no data was provided to allow for necessary adjustments. There was no evidence that the taxpayer had tried to identify one or a more comparables with sufficiently similar circumstances to the controlled sales. The court interpreted this lack of data as if no comparables existed.[127]

The court further stated that the price for disk drives generally changed during the year. The controlled transaction occurred throughout the year but

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[124] Seagate Technology, Inc. v. Commissioner of Internal Revenue, Tax Ct. Dkt. No. 11669-90, decided: February 09, 1994, Cite(s): 102 T.C. 149

[125] Seagate Technology, Inc. v. Commissioner of Internal Revenue, See Summary

[126] Seagate Technology, Inc. v. Commissioner of Internal Revenue, See Part IV, Opinion Section 2.a

[127] Seagate Technology, Inc. v. Commissioner of Internal Revenue, See Part V, Section 2.a

no information was provided when the uncontrolled transactions took place. This timing issue could affect the price and should therefore have been examined. The court also stipulated that other circumstances such as volume of sale, level of market and geographic market did play some part in determining the uncontrolled sales prices but it did not comment any further on these circumstances.[128]

7.2.4.1 Analysis of the case

The case demonstrates what was stipulated in the chapter about documentation; the importance of choosing the right comparable. It is not a good idea to just randomly pick all uncontrolled transactions that has similar characteristics as the controlled transaction. It is important to choose the transactions that are most similar to the controlled transaction and not include the other transactions when trying to find an accurate transfer price. The documentation must provide proper data about the examined transactions. That was not done by the taxpayer in this case. The court could therefore not decide which transactions were similar enough and thus the CUP method could not be used.

The issue of timing discussed by the court clearly demonstrates the importance of looking at the facts and the circumstances of each separate case. The court claimed that adjustments were needed depending on when during the year the transactions were performed.

7.2.5 National Semiconductor Corporation[129]

National Semiconductor Corporation (NSC) was a manufacturer and marketer of semiconductors, the fundamental building blocks of modern electronic equipment and systems. In total over 5,000 different integrated circuits were manufactured. NSC had six subsidiaries in Southeast Asia who performed semiconductor packaging and associated activities. The majority of the subsidiary's products were sold to NSC but some finished semiconductors and related devices were purchased by unrelated parties. NCS then resold the products to original equipment manufacturers, independent distributors, NCS's foreign subsidiaries and the US Government. During each of the years 1976-81 NSC obtained substantial losses from the sale of semiconductor. Over the same period the Asian subsidiaries reported large profits. IRS challenged the transfer prices used by the NSC group.[130]

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[128] Seagate Technology, Inc. v. Commissioner of Internal Revenue, See Part V, Section 2.a

[129] National Semiconductor Corporation, v. Commissioner of Internal Revenue, tax Ct. Dkt. No. 4754-89, Decided: May 02, 1994, Cite(s): T.C. Memo. 1994-195

[130] National Semiconductor Corporation, v. Commissioner of Internal Revenue, See Summary

NSC claimed that it had presented comparable transactions between US fabricators and Asian contract packagers and that it therefore had satisfied the arm's-length principle. IRS argued that because of differences in volume, market level and type of customer, these comparables did not provide an acceptable transfer price.[131]

The court found that the NSC documentary evidence was insufficient to establish whether the transactions were comparable to the controlled transactions, whether the adjustments made by the taxpayer were appropriate and whether any further adjustments were needed. For example when examining the manufacturing methods as benchmarks for adjusting the material costs, the most expensive method was used even though it was rarely used by the Asian subsidiaries. The court also rejected IRS's suggestion how to apply the CUP method. The court actually stipulates that neither party provided the court with sufficient evidence to satisfy any transfer pricing method under the transfer pricing regulations. Instead, it was simply held that NSC should not have sustained losses during the years while the subsidiary was making profits and therefore an adjustment to the transfer price was necessary. At arm's-length, no corporation would have accepted annual losses while there unrelated trading partner were making profits. The purpose of the adjustment was to bring the pricing relationship closer to what would have occurred at arm's length. For example NSC was attributed a large part of the R&D costs although the costs were related to products manufactured by the subsidiaries. This would not have happen between parties dealing at arm's length.[132]

7.2.5.1 Analysis of the case

If a corporation suffers losses while its subsidiaries are profitable it seems extra important to demonstrate that the transfer price is correct by providing sufficient documentation. If this is not done there must be a large risk that not only the tax authorities will not accept the pricing but also that the court will reject the pricing.

In this case the taxpayer could not demonstrate sufficient evidence that the transfer prices were reasonable and therefore the court clearly stated that it could not accept the losses occurred by the parent. What conclusion would the court have reached if the facts were different? If the taxpayer would have presented documentation demonstrating the reasonableness of the transfer prices because they were similar to other comparable transactions, but at the same time the same uneven results between the corporations within the group existed, what would the outcome have been? From the reasoning in the case, the outcome should be the same. Arm's-length prices do not create so uneven results. A comparison must be made between the

[131] National Semiconductor Corporation, v. Commissioner of Internal Revenue, See Opinion, Part III, Section B
[132] National Semiconductor Corporation, v. Commissioner of Internal Revenue, See Opinion, Part IV, Section C and D

transaction and the compared transactions and if the same uneven results do not exist between the parties in the uncontrolled transactions and it thus seems to be normal, adjustments are required to comply with the arm's-length principle.

7.2.6 Compaq[133]

Compaq Computer Corp. (Compaq US) purchased printed circuit assemblies (PCA) from a subsidiary (Compaq Asia). A PCA consists of a printed circuit board, the communication platform to which components are attached and any number of combinations of chips, resistors and capacitors. Compaq US manufactured the PCAs itself as well and also bought them from unrelated subcontractors that were primarily located in US. In 1991 and 1992 approximately half of Compaq US's requirement of PCAs were fulfilled by these subcontractors. When pricing the intercorporate transaction Compaq was first using a cost plus approach. The mark-up that created the profit for Compaq Asia was not accepted by IRS. In court Compaq changed its pricing strategy and argued that the CUP method should be used to determine the transfer price.

To show that the arm's length principle was followed Compaq US was using the unrelated transactions with the subcontractors as comparables. Compaq Asia purchased its own material and components and Compaq US paid for the complete PCAs. In contrast, Compaq US provided raw material and components to the unrelated subcontractors and the price paid only compensated for the labor and overhead costs plus a profit. Although this functional difference, the court accepted the transactions as comparables. Obviously adjustments were needed. The transfer price was reached in two steps. The first part of the transfer price was the price paid to the subcontractors. The Compaq US's standard material costs was added to the first part. The latter part was the necessary adjustment that was required because of the functional difference.[134] The transfer price that Compaq US paid its Asian subsidiary was thus computed by using American cost for labor and American costs for material. Since Compaq Asia's actual costs arose in Asia a large part of the profit ended up at the subsidiary. All the savings that the Compaq group accomplished by moving part of the production abroad was thus, attributed to the foreign subsidiary.[135]

Adjustments are necessary if the geographic market in which the sales take place has an effect on price. Compaq Asia plant was located in Singapore while the subcontractors primarily were located in US. The reason why no adjustments were necessary was that they all competed on the same market,

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[133] Compaq Computer Corporation, v. Commissioner of Internal Revenue, Docket No. 24238-96, Decided: July 02, 1999, Cite(s): T.C. Memo. 1999-220

[134] Compaq Computer Corporation, v. Commissioner of Internal Revenue, See Paragraphs 62-74

[135] Hannes, Steven, Tax Management Transfer Pricing Report, (1999)

the US. Compaq Asia did not compete with unrelated subcontractors in Singapore because no one else there had the same technology or equipment that was required.[136]

A few other adjustments (for differences in payments terms, quality, risk, freight costs etc) were made as well.[137]

7.2.6.1 Analysis of the case

An obvious first reaction when analyzing this case must be that although there were significant differences between the comparable transaction and the controlled transaction, the court held that the CUP method could be used. The most important difference must be the functional difference.

One might find it strange that the tax payer was allowed to use US figures to calculate the transfer price from an Asian corporation. The court stated that when making adjustments, because of differences on the market, it is where the product is sold that is decisive. Thanks to this, a large part of the profit was taxed in Singapore. The new regulations require that adjustments be made for cost differences resulting in an uneven profit allocation.[138] The guidelines stipulate that adjustments should be made because of different economical circumstances (see chapter 4.2.4). Costs of production are one of the aspects mentioned there and thus it should be required for a Canadian taxpayer to make adjustments in these kinds of cases.

It is also interesting to notice that the court allowed the taxpayer to "construct" a CUP from other comparable transactions although these comparables were not even considered at the time when the price was set.[139]

7.3 The Canadian judicial process

A taxpayer which disagrees with an assessment of his tax liability can appeal Revenue Canada's decision to the Tax Court of Canada (Tax Appeal Board as it then was in the Hofert case) or to the Federal Court, Trial division. The second instance is the Federal Court of Appeal. The Supreme Court of Canada is the ultimate arbitrator of income tax matters.[140]

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[136] Compaq Computer Corporation, v. Commissioner of Internal Revenue, See Paragraph 75

[137] Compaq Computer Corporation, v. Commissioner of Internal Revenue, See Paragraphs 76-78

[138] Sec. 1.482-2(d)(4)(ii)(C), See also Bnatax; Tax Management Library, Foreign Income Portfolios, Transfer Pricing, Portfolio 887-1: Transfer Pricing the code and the regulations, Detailed analysis, 1:11. The 1994 Regulations, D. Comparability, 3c Location savings

[139] See, Hannes, Steven, Tax Management Transfer Pricing Report, Volume 8, Number 8, for a detailed comment on the case.

[140] Krishna, Vern, (1985), First Edition, p. 93 and Seventh Edition, (2002), p. 27 and CCH Canadian limited, Canadian master Tax Guide, 24th Edition, (1969), p. 322-323

7.4 Canadian case law

7.4.1 J. Hofert Limited[141]

The facts:[142] J Hofert Corporation (hereinafter referred to as Hofert US) was an American firm in the Christmas tree business, with a Canadian subsidiary (hereinafter referred to as Hofert Canada) located in British Columbia. The dispute arose over the transfer price for the trees sold by Hofert Canada to its parent corporation.

The Christmas tree business was a fairly simple business, with a readily ascertainable price for the trees, depending on height, type and quality. Thus, a comparable uncontrolled price was available. Hofert Canada harvested and shipped trees under long-term contract to its parent. The contract obliged Hofert Canada to sell and deliver each November as many Christmas trees of "merchantable quality" and "subject to inspection by the buyer which should have the right, prior to shipment thereof, to reject any trees not in conformity with the specifications". The parent company paid its subsidiary for the cost of buying, keeping and loading the trees plus a mark-up of eight percent over cost. Hofert US paid for the costs of cutting down the trees plus ten percent mark-up when the trees originated from the land of the subsidiary. In addition, Hofer US supplied its subsidiary with twine, labels and staples free of charge.

Hofert Canada also sold Christmas trees to unrelated buyers in Canada but for a higher price. This is the reason why the dispute arose. Hofert US paid between $2.00 and $2.04 per bale[143] which was significantly lower than the price charged to the unrelated Canadian customers (between $2.75 and $3.19 per bale). Revenue Canada claimed that the price paid by the US parent was less than fair market value.

The Tax Appeal Board's decision began by defining fair market value as a "commercial and not a legal term … (that) involved a question of fact into which many considerations might enter". Judge R.S.W. Fordham continued by stipulating that the prices paid by the unrelated Canadian corporations were not fair market value since the circumstances were "entirely different from those that prevailed where the American purchaser was concerned". He continued by outlining the differences between the transactions. All of the Canadian buyers were retailers while Hofert US was a middleman, buying the trees and reselling them to distributors. About 60 percent of the

[141] J. Hofert Limited. V. Minister of National Revenue, 62 DTC 50 (T.A.B.), p. 50-53
[142] J. Hofert Limited. V. Minister of National Revenue, p. 50-51
[143] A bale contained between one and Eight trees depending on the size of the trees

parent's sales were to retailers. Because of this difference, the selling expenses (distribution, wholesale costs) to Canadian customers were higher for the subsidiary. The additional costs included costs for distribution and wholesale and accounted for almost 80 percent of the average price difference. A second difference was the volume sold. Since about 80 percent of Hofert Canada's sales were to its parent this should affect the price. Bulk buying normally offers discounts. Third, in spite of the contract, in reality the parent paid for all trees no matter what the quality of the trees was. The Canadian customers, on the other hand, obviously did not pay for unsatisfactory trees. Fourth the parent paid for part of the production costs and also paid for part of the trees in advance. Finally the judge noted that the profit rate for Hofert Canada were not higher for the trees sold to the Canadian customers than for the transactions to the parent. He found in favor of the taxpayer and concluded that the price paid by the US company was the fair market price.[144]

7.4.1.1 Analysis of the case

Even though this case does not involve the transfer pricing regulations and the judge is talking about fair market value and how differences between transactions can affect what is a fair market price, this case is really about the arm's length price and what adjustments that have to be made to make products comparable.

The case clearly illustrates that it is the facts and the circumstances of the case that will decide the outcome and it also illustrates very well how adjustments have to be made when economical differences between transactions affect the price. Although the fact that the parent pays approximately 30 percent less than other customers could seem like an attempt to move profits out of Canada, there is an explanation for the price difference. One recognizes a few of the judge's arguments from chapter 4.2 dealing with adjustments. First the functional differences between Hofert US and the Canadian customers are significant. The parent is dealing on another level of the business scheme since it is a middleman and not a retailer. Furthermore one has to look at the reality of the contract when deciding the risks the parties involved are taking. The court also held that an adjustment was needed because of the difference in volumes of trees purchased in the two compared transactions.[145]

The Hofert case is a good example of a transaction of a non-complicated product, where internal comparable exists, however, the differences between the transactions are so significant that a CUP cannot be found. Since the judge is not using transfer pricing methods to conclude if the price is arm's length, it is difficult to transform his arguments into terms used in this paper. He seems to reject the CUP method since a comparison of the

[144] J. Hofert Limited. V. Minister of National Revenue, p. 51-53
[145] Eden, Lorraine, Taxing Multinationals, (1998), p. 57-59

prices paid by the unrelated parties is ”irrelevant”. Instead judge Fordham is comparing the ratio of annual net profit of the transactions and thus, a transactional profit method must have been used.

If this case would have reached the Tax Court today and the transfer pricing regulations would have decided the outcome it seems unlikely that the court would have rejected the CUP method. The differences between the transactions are not that great and it does not seem inconceivable that a court could have made necessary adjustments for the differences. The court was able to identify the cost differences between the transactions and should therefore be able to make adjustments for these differences. Thus, the outcome would probably been the same since the price difference between the transactions could be explained by the different circumstances of the transaction.

7.4.2 Indalex[146]

The facts:[147] Indalex was a Canadian subsidiary with a U.K. parent (Pillar) engaged in the aluminum business. Pillar International (hereinafter referred to as PI) was a subsidiary to Pillar based in Bermuda, thus a sister company of Indalex. Indalex always purchased aluminum through PI. The supplier of aluminum was a Canadian corporation, Alcan. Indalex obtained a discount when purchasing aluminum because of an agreement between Alcan and the Pillar group, affecting the price of aluminum for all the corporations within the group. PI benefited from part of the discount and this is the reason why the tax dispute arose. Revenue Canada argued that these amounts belonged to Indalex and were therefore subject to Canadian tax.

The aluminum industry in the 1970s was an oligopoly of six well integrated MNE and these multinationals basically set the prices for aluminum. Alcan was one of the six. The discount deal was originally struck between Alcan and Pillar. A few years later it was renegotiated and the new agreement was signed between PI and Alcan. The result of the new deal was that ten percent of the discount that earlier went to Pillar now was to go to the sister affiliate PI. A few years after the new deal the actual figures were closer to 15 percent than the original ten.

Revenue Canada argued that PI only played the function of a “middle-man” and that the only reason it existed was to avoid tax. It was Indalex purchasing from Alcan and PI served only as a “virtual trans-shipment point” and had nothing to do with the transactions. Indalex disagreed with these arguments. It argued that the discount earned by PI was due to the worldwide purchasing power of the whole corporation group. Furthermore

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[146] Indalex Ltd. v. Revenue of Canada [1986] 1 C.T.C. 219, 86 D.T.C. 6039 (Fed. T.D.);rev’d (1987), [1988] 1 C.T.C. 60, 88 D.T.C. 6053 (Fed. C.A.)
[147] Indalex Ltd. v. Revenue of Canada [1986] 1 C.T.C., p. 219-220

Indalex argued that the economical benefit that it received as a result of the agreement justified that part of the discount should be credited to PI.

The Federal Court, Trial Division Decision (1986)[148]

When finding the arm's length price for the transaction between PI and Indalex, Judge Justice Reed first tried to find other comparables. Since the aluminum industry was highly integrated, it was difficult to find arm's length transaction. Two other corporations were found also buying from Alcan. One of them had financial problems and the other one was purchasing significantly smaller amounts of aluminum and therefore none of the comparables were useful. Since PI was dealing at arm's length with Alcan, when purchasing aluminum, this was the best existing comparable.[149]

The next question was whether any adjustments should be made to translate the price negotiated between PI and Alcan into the price paid by Indalex to PI. To be able to determine the size of the adjustments, a functional analysis of the economical contribution was made by PI. This was done by comparing the profit margin on sales earned by firms performing similar functions as PI dealing on arm's length. The investigation showed that the profit earned by PI was significantly higher than normal. PI's profit margin was between three and five percent while the comparables on average could reach a profit margin of less than one percent. Judge Reed found that the analysis was "useful as a bottom line approach" but it was insufficient evidence to prove that the transfer prices were not reasonable.[150]

Two key questions had to be answered; 1) if PI involvement in the negotiations actually had an economical impact for Indalex and 2) if so, how much was it worth. Judge Reed concluded that Indalex could have negotiated the advantages for itself and she did not accept the argument that PI was able to negotiate a discount significantly higher than Indalex would have been able to. Although PI did not add any value for Indalex, PI did the actual negotiating and therefore it made an economical contribution. Judge Reed did not exclude the possibility that Alcan had taken into account the purchasing power of the group when determining the price to Indalex. The contribution that could be attributed to PI was much lower than Indalex was claiming. Therefore a small adjustment should be made on the comparable price but only 20 percent of the total discount that PI was first attributed.[151]

The Federal Court of Appeal Decision (1988)[152]

The Federal Court of Appeal agreed in principal with the trial court's decision. The main difference was that the appeal court found that the bargaining power that had affected the price paid by Indalex should be credited to the group and not to PI. There was no evidence that PI itself

[148] Indalex Ltd. v. Revenue of Canada [1986] 1 C.T.C. 219
[149] Indalex Ltd. v. Revenue of Canada [1986] 1 C.T.C. 230-231
[150] Indalex Ltd. v. Revenue of Canada [1986] 1 C.T.C. 233-235
[151] Indalex Ltd. v. Revenue of Canada [1986] 1 C.T.C. 233-235
[152] [1988] 1 C.T.C. 60, 88 D.T.C. p. 6053-6059

contributed to the purchasing power. The court therefore disallowed the last 20 percent of the allocated discount to PI. No adjustments should be made to the comparable price. The court stipulated that the transaction was artificial in its nature. The only reason PI was involved was to move funds to a tax haven.

7.4.2.1 Analysis of the case

The case shows how difficult it can be to find a CUP in some markets. The aluminum market was highly concentrated and dominated by a few multinationals. Since most of the aluminum transactions took place within the well integrated MNEs and under long-term contracts, it was problematic to find comparables. With Alcan as the only major supplier of aluminum, Indalex could probably not have found an alternative supplier that could have worked as a CUP. Alcan's other Canadian customers were much smaller than Indalex. The circumstances were thus too different for these transactions to serve as comparables. The best available CUP was between Alcan and PI.[153]

After finding a CUP the court could move on to the adjustments. The question was whether Indalex could have gotten the same price from Alcan by itself. If not, how much of the discount should be credited to PI or the whole group? The two courts both agree that part of the discount should not be attributed to Indalex because of the bargaining power of the group. The Court of Appeal determined that it was the group as a whole that should earn the part of the discount that should not be credited to Indalex. No adjustment should therefore be done to the comparable since the fact that PI was involved in the transaction did not affect the price. It seems likely that the fact that PI was situated in a tax haven affected the decision. PI was used as a part of the transactions merely because the group wanted to move profits to a tax haven. The group negotiated the discount but the advantage was put in the tax haven. This was not accepted by the court.

As was the case in Hofert it is difficult to find a comparable although aluminum is a common natural resource that is traded on regular basis. The facts and circumstances in the case are specific and decide how the arm's-length principle should solve a transfer pricing issue.[154]

7.4.3 Irving Oil[155]

Irving Oil was a Canadian company purchasing oil from its Bermuda subsidiary, Irvcal. The subsidiary was purchasing the oil from the Middle

[153] Vincent, Francois, (2002), p. 54-57
[154] Eden, Lorraine, (1998), p. 546
[155] Irving Oil Limited v. The Queen, 1988 Carswell Nat 281, [1988] 1 C.T.C. 263, 16 F.T.R. 253, 88 D.T.C. 6138

East. Irving Oil was paying a higher price than Irvcal, creating a profit in the tax haven. This set-up was challenged by the tax authorities. The tax authorities gave several reasons for challenging the transactions. To sum up the authorities found that the transaction was a sham since Irvcal lacked a "bona fide business purpose" and that the profit earned by Irvcal belonged to Irving Oil. Thus the rules governing transfer pricing were not used by the authorities.

The Federal Court (Trial Division) held that the market price of oil was the relevant issue in the case and undisputed evidence demonstrated that the price charged by Irvcal was reasonable in comparison to other similar transaction performed on arm's-length. The subsidiary had a business purpose and the transaction was not a sham.

7.4.3.1 Analysis of the case

Although the case does not deal with the transfer pricing regulations it still clearly demonstrates that taxpayers are allowed to set up a subsidiary in a country with low income tax rate or no income tax at all to save tax costs, as long as the pricing between the company and the Canadian corporation is correct. When comparing the case with Indalex one might find the decisions inconsistent. The difference between the cases is that the pricing in Indalex was not correct. The corporation in the tax haven did not perform for what they were paid for.

7.4.4 SmithKline[156] and two other pharmaceutical cases

In the pharmaceutical industry three cases has moved their way through the Canadian court system and are on the way to make case law.

In SmithKline, the Canadian subsidiary to the American pharmaceutical giant bought an active ingredient, cimetidine, from two related non-resident affiliate in the Bahamas and Ireland. Cimetidine was used to manufacture the drug Tagamet. SmithKline paid its subsidiaries $400 per kilogram for cimetidine while other Canadian generic manufactures were purchasing it for between $50 and $250 per kilogram. Thus, it is likely that Revenue Canada will be arguing that a CUP exists in this case. The case has been up in court a few times but so far the only thing that has been dealt with is procedure matters.[157]

[156] SmithKline Beecham Animal Health Inc. v. The Queen, No. 86 Court File No. 95-1077(IT)G, T.C.

[157] See, Vincent, Francois, Tax Management Transfer Pricing Report and Vincent, Francois (2002) p. 70-73

The circumstances are similar in the cases Glaxo Wellcome Inc. v. R.[158] and Hoffman-La Roche Limited v. R.[159] In the former case Glaxo argued that the transfer pricing analysis should be based on an adjustment of the sale price of the ingredient in finished form which it sells to an unrelated party. Thus, it seams like the taxpayer will argue for a resale price method instead of the CUP method. The taxpayer in the Hoffman case argues that the price paid for the ingredient is irrelevant. What matters is instead the price Hoffman sells the prepared ingredient and related services. Thus, also in this case the taxpayer seems to be arguing that the resale price method should decide the price.[160]

[158] Glaxo Wellcome Inc. v. The Queen, TCC file number 98-712(IT)G
[159] Hoffman-La Roche Limited v. The Queen, TCC file number 2000-935(IT)G
[160] See, Vincent, Francois, Tax Management Transfer Pricing Report, (2000),

8 Summary and conclusions

The rules in ITA provide only a general and basic framework for the transfer pricing regime in Canada. If a taxpayer wants guidance on how to price an intercorporate transaction he has to check somewhere else. Revenue Canada provides its interpretation of the legislation in the information circular IC 87-2R. This circular constantly refers to OECD's guidelines which is the number one transfer pricing source for Canadian taxpayers.

The guidelines state several time that transfer pricing is not an exact science. No exact answers are provided by the guidelines about how to price intercorporate transactions because it exists no such answers. The guidelines are just what the name says, guidelines and nothing more. Despite the complexity of transfer pricing the guidelines provide a fairly clear picture about how a taxpayer should price the transactions within a MNE. The arm's-length principle should decide the pricing. This principle states that the price should be set as if the parties were not connected. Thus, the market forces should decide the price as it does when unrelated parties are doing business. Because of the special characteristics of the MNE with it can be a very complicated task to apply the principle. The MNE is a group of closely intergraded corporations with the mutual goal of maximizing the profit for the group. On some occasions decisions are made that would never be made among unrelated parties since the interest of the group comes first, not the interest of the corporation that are affected by the decision. The parties exchange services, intangible property, etc, which further complicates the issue choosing what the arm's-length price really is. All these circumstances make the arm's-length principle very hard to apply. In the end it is always the facts and the circumstances in each separate case that decides how the pricing should be done. Consequently there are no exact answers to the questions posed in the beginning of this paper.

How is the CUP found?

The first step when using the CUP method is to find potential comparables. This is done by examining other transactions made by the MNE to unrelated parties or by two other third parties. Since the economically relevant circumstances that should decide the price of a transaction are rarely the same in the controlled and the uncontrolled transactions adjustments are normally are needed. It is not before adjustments are made to the price of the comparable transaction to regulate these differences that the comparable can be used to price an intercorporate transaction.

To begin with, a very important thing to point out, which was clearly illustrated in two of the cases, is that the existence of differences between the transactions is not enough to make adjustments. These differences must

affect the price of the product otherwise no adjustments should be made. In Bausch & Lomb the tax authorities argued that there existed both a functional difference (since the examined parties were involved in different activities) and a difference in the characteristics of the property since the amount of transferred products in the controlled transaction was much larger than in the comparable transaction and that this should have led to a volume discount). The court rejected these arguments because it found that these differences were not relevant in that case since they did not affect the price. It is thus not enough to show that differences exist but it is also necessary to demonstrate how they affect the price. This was also well illustrated in the Eli Lilly case. In that case it was the taxpayer that argued for the existence of differences. The taxpayer tried to demonstrate seven differences that had affected the price. The court accepted all these differences but still adjustments were not made for all them. For some of the differences the taxpayer could not estimate how large adjustment that should be made. The court had to estimate themselves the value of the differences. When it found that no proof was presented that the difference had affected the price no adjustment was allowed. The adjustments that were made by the court were significantly smaller than what the taxpayer was arguing for. The reason for that was that the court did not agree with the way the taxpayer had calculated the adjustment. The case illustrates how accurate the taxpayer has to be with proper documentation when showing the reasonableness of the adjustments made.

OECD’s guidelines provide five different categories of adjustments. In every category several different kinds of differences is presented. It is important to state that this is not a non-exclusive list. The complexity of the businesses implies that there exist so many possible differences that it is not possible to get a complete list. In Seagate, for example, the court held that adjustments were necessary depending on when during the year a product was sold since the price fluctuated during the year. Another good example of the diversity of adjustments is provided in the Eli Lilly case. Adjustments were made because one corporation had a patent for a similar product to the compared product and the value of this patent spread value over all the products of the corporation. These are two examples of all different adjustments that could be required.

The most fundamental of the categories is the characteristics of the product. Adjustments are needed to compensate for differences in the quality of the product, the amount of the product that has been transferred, etc. Between unrelated parties it is common that the more a party is purchasing the less he pays per article. The same should apply to related parties. Adjustments were made because of such volume discount in several of the cases examined in this paper. In the Eli Lilly case the adjustments were made because the quality of the product transferred between the related parties was slightly higher than the quality of the product in the uncontrolled transaction. In The Sundstrand case it was not exactly the same products transferred in the controlled and the uncontrolled transactions. The court did not manage to

make adjustments for these differences. In that case, several other differences existed.

The most commonly made adjustment in the cases examined was done because of functional differences. The price that the purchasing corporation should pay depends partly on what activities the parties involved in the transaction are performing. If the parties involved in the two transactions are performing different activities adjustments must be made. Another functional difference is the risks the parties are taking. The Hofert case illustrates well how a taxpayer should deal with the functional differences. The buying corporations in the uncontrolled transactions were retailers while the buyers in the controlled transactions were acting as a middleman reselling the product to the other retailers. Because of this difference the related party had more costs which explained a large part of the price difference between the transactions.

The other categories of adjustments are differences in contractual terms, economical circumstances and business strategy. When it comes to the contractual terms of a transaction one has to investigate the true meaning of the contracts. The wording of the contract may not properly convey the true meaning. In Hofert, for example, the parent corporation had the right to return unsatisfactory Christmas trees. However, in reality this never happened. Adjustments because of differences in economical circumstances are done if the markets in the transactions differ. Business strategies could affect the way a product is prices. If for example a corporation is trying to increase its market share it could choose to lower the prices.

Adjustments could also be needed for other reasons. In the NSC case the taxpayer was suffering losses while its foreign subsidiaries were making profits. The court held that this would not happen between unrelated parties since no corporation would accept such uneven allocation of the profits. Therefore it can not be accepted between related parties and the court made adjustments on the transfer price to allocate the profits more evenly.

One thing that the cases clearly demonstrated is that the court will not second guess the business decisions of the taxpayer. If a MNE decides to locate part of the production in a country with low income tax rates this fact itself is no reason for transfer pricing adjustments. Furthermore, the fact that the taxpayer could manufacture the product cheaper himself matter. The only interesting fact is if the taxpayer is paying the price arm's-length parties would pay.

To sum up, the following is required by the taxpayer when finding the CUP. For every difference between the controlled and the uncontrolled transactions that affect the price the taxpayer must make an adjustment to compensate for this difference. The taxpayer must provide sufficient proof that the adjustments made were correct by the documentation.

<u>In what cases can and should the CUP method be used?</u>

Half the answer to that question is easily found. The method should be used when the taxpayer can use it. This statement need to be further explained. It seems fairly clear that the taxpayer should use the CUP method whenever it is possible at least according to Revenue Canada and the guidelines. The highest degree of comparability is reached because the focus is directly on the price of the transaction. The goal of the arm's-length principle, to price an intercorporate transaction as if no connections existed, is best reached by making a comparison to how parties on arm's-length are pricing the same transaction. It is the One must keep in mind that this is only Revenue Canada's opinion and that this opinion has not been stated by a court. So the interesting part of the question is still left to answer; in what cases can the CUP method be used?

To be able to answer the question one has to at least get an idea about how far a taxpayer is supposed to go to make necessary adjustments. The guidelines do not provide much guidance at all to this issue. The only way to identify some rules or at least some guidance is to go to the jurisprudence. Unfortunately the Canadian transfer pricing case law is nothing but exhaustive. Therefore I found it necessary to examine the much more extensive US jurisprudence. Even though only around ten cases were examined one can see some patterns from the outcome in the cases how the MNE should handle comparables and thus, when the CUP method can be used.

Comparables will generally be accepted when they involve the same product as in Bausch & Lomb, Compaq and in Eli Lilly. In two other cases the outcome was different although it was the same product involved, but there is an explanation to this. In both the Seagate and the NSC cases the taxpayer did not provide sufficient documentation to support the transfer price. In the ladder case the differences between the transactions were significant and it was thus hard to demonstrate the necessary similarities. In the former case the taxpayer's documentation contained too many imprecise comparables. The Sundstrand case is a good example of how difficult it is to use to find a comparable when the transferred product differs in the two transactions. Since the CUP method focuses on the price of the product it is very difficult to adjust for differences in the quality of the product and if the products in the transactions are not exactly the same. One can imagine how difficult it must be to place a value on such a difference. It is probably one of the must problematic adjustments to make. The Hofert case involving non-complex Christmas trees can be seen as an exception to the discussion above. The court found that an internal comparable could not be used since the functional differences were too great. The case did not involve the transfer pricing rules and one should therefore be a little bit careful when interpreting the outcome. The court was able to identify the differences and how to value these differences. Therefore I find it likely that a tax court today would have held that the comparable was sufficiently similar and thus, the CUP method would have been used.

Another pattern that could be noticed from the cases is that when the product at issue is a relatively simple commodity-like one it is easier to find adequate comparables. Contact lenses and standard drugs are example of such products. In Sundstrand and NSC it was a complex products traded that was supposed to be part of manufacturing of another product. No comparables were found. A similar kind of product was at issue in the Compaq case but in that case an internal comparable existed and the CUP method could be used. Among the Canadian cases, the Hofert case again is the exception but because of the above mentioned reason the importance of that outcome should not be exaggerated. In Indalex the well integrated aluminum industry did not create any external comparables. The only way to find a comparable was through other trades made by the involved related corporations.

Generally, it is easier to find comparables if other transactions are made by one of the controlled parties involving the same product. When these internal comparables exist the taxpayer has required data in his own control and can thus provide a more sufficient documentation. When examining the US cases one can see one clear pattern. In the three cases involving complex products the taxpayer was using internal comparables when trying to demonstrate the CUP. External comparables were not even mentioned in the cases, almost certainly because data from such transactions did not exist. The reason for that must be that since it is a complex unique product no external transactions were done product was not manufactured anywhere else. The taxpayer is thus, left only with the possibility of using internal comparables. If a foreign subsidiary is set up to provide the parent with the product it is not always sure that there exists any transactions to third parties at all. As demonstrated in the thesis in practice internal data rarely exists. With no existing internal comparables and large problems to find external comparables it is extremely difficult to use the CUP method. These circumstances probably explain at least partly why it is easier to find a comparable when it is a non-complex product at issue. The taxpayer has often both internal and external comparables to choose from.

One must keep in mind, when examining the possibility to find a comparable, that the taxpayer is trying to avoid getting penalized. Therefore examining the possibility to find a comparable that when a case reaches the court. This motivation can affect the possibility to find a CUP. In a few of the cases (Hofert and the pharmaceutical cases) examined in this paper it is actually the tax authorities arguing that there existed a CUP. In the other cases it was the taxpayer trying to demonstrate the CUP but a CUP that suites them. Maybe the CUP method easily could have been used if the taxpayer would have like to but the result was not what he preferred. This incentive issue must be recognized when looking into the cases.

To sum up what was concluded from examining the cases one can reach the following conclusions. The best chance to use the CUP method is when it is a simple product transferred. The taxpayer has a good chance to provide documentation since it is fairly easy to find potential comparables. The

taxpayer has a better opportunity to use exactly the same product as comparable which is crucial. If it is a complex product the taxpayer principally has to find the comparable among other transactions of the product made by the MNE. It is harder to find an exactly similar comparable because of the complexity of the product.

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