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TPM-07

Referrals to the Transfer Pricing Review Committee

August 2, 2005

Please note that the following Transfer Pricing Memorandum, although correct at the time of issue, has not been updated to reflect subsequent legislative changes since the date of issue. As a result, some information may no longer be valid.

This memorandum does not replace the law found in the *Income Tax Act* and its Regulations. It is provided for your reference. As it may not completely address your particular situation, it would be advisable to refer to the *Income Tax Act*, any applicable Regulation, and relevant case law. You may also want to contact a tax services office of the Canada Revenue Agency for more information.

Introduction

This document cancels and replaces TPM-01 dated March 26, 2003. This document provides an update to the guidelines for referrals to the International Tax Directorate (ITD) and to the Transfer Pricing Review Committee (TPRC) regarding possible assessments under paragraph 247(2)(b), penalties under subsection 247(3), and Qualifying Cost Contribution Arrangements (QCCA) under subsection 247(1) of the Income Tax Act (ITA).

This document does not deal with the fact situations required to raise a penalty or assess using the recharacterization provision. These are dealt with in the information circular [IC87-2R](#) *International Transfer Pricing*. This document discusses referrals to the TPRC, and these referrals would contain information about the fact situation under review.

Background

The CRA's policy regarding transfer pricing legislation is found in IC87-2R. In the paragraphs reproduced below, the CRA states that before any assessment under paragraph 247(2)(b) or subsection 247(3) is issued, the file will be referred to the TPRC for review to ensure the law is applied fairly and consistently.

46. **All** proposed assessments to recharacterize a transaction under paragraph 247(2)(b) will be referred to the Transfer Pricing Review Committee before the assessment is issued, to ensure fair and consistent application. (Emphasis added)

178. Tax services offices are responsible for identifying taxpayers who may have failed to make reasonable efforts to determine and use arm's length prices as part of the normal audit review. However, the Department [now the CRA] recognizes the importance of applying the transfer pricing penalty provisions in a fair and consistent manner. Thus, before a penalty is assessed, tax services offices will refer **all** cases to the Transfer Pricing Review Committee for review. (Emphasis added)

The concept of reasonable efforts is also contained in the definition of QCCA found in subsection 247(1). A cost contribution arrangement will not be defined to be a QCCA if the taxpayer does not make reasonable efforts to match the contributions of the participants to their respective expected benefits. Transfer pricing adjustments made to cost contribution arrangements are aggregated with other transfer pricing adjustments for purposes of the penalty calculation. Therefore, cases involving potential QCCAs should also be referred to the TPRC for review.

The TPRC is coordinated within ITD by the International Tax Operations Division (ITOD).

Committee Membership

The committee members will vary depending on the type of referral under review.

For recharacterization referrals, the committee will consist of:

- The director of ITOD - the Chairperson of the TPRC (the Chairperson)
- A senior economist from ITOD
- A manager of a Field Advisory Services (FAS) unit in ITOD
- A representative from the International Tax Service Team within Legal Services

For penalties referrals and QCCA referrals, the committee will consist of:

- The director of ITOD - the Chairperson
- The director of Competent Authority Services Division (CASD)
- A senior economist from ITOD and/or CASD
- A manager of a Field Advisory Services (FAS) unit in ITOD
- A representative from the International Tax Service Team within Legal Services

The Chairperson may invite other CRA or non-CRA individuals to sit on the TPRC as appropriate. For example, a manager from the Tax Avoidance and Special Audits Division generally will be asked to sit on the TPRC to hear recharacterization cases involving the application of paragraph 247(2)(b) of the ITA. Similarly, representatives of the Audit Directorate, the Income Tax Rulings Directorate within the Policy and Planning Branch, and the Department of Finance may be asked to participate, where appropriate.

Referral Procedures

Recharacterization Referrals

In situations involving potential recharacterization of a transaction, the TPRC uses a three-

stage approach: (1) initial consideration, (2) consideration of a formal referral and (3) final consideration.

Initial consideration:

As soon as it becomes apparent that paragraph 247(2)(b), which provides the authority to recharacterize a transaction, may be recommended as an assessing position, the auditor must seek assistance from the appropriate FAS unit. The FAS case officer assigned to work with the auditor will provide direction on preparing an initial referral report to the TPRC. The early referral will result in a more timely evaluation of whether the auditor should continue with an in-depth audit of the potential recharacterization.

The Chairperson will provide advice as to whether the potential recharacterization issue should be pursued. Where the Chairperson is of the view that recharacterization may be applicable, the auditor will carry out an in-depth examination to establish the recharacterization. At that time, the auditor should advise the taxpayer that recharacterization under paragraph 247(2)(b) is being considered with respect to the transactions under review. The taxpayer should be encouraged to bring forward facts for consideration during the review. It is important that the taxpayer is aware of the transactions and the facts that are being taken into consideration by the auditor during the review.

Consideration of a Formal Referral:

Once the audit is complete, but before the auditor sends a proposal letter, the auditor must formally refer the case to the TPRC. Prior to the formal referral, the auditor must have given the taxpayer a copy of the fact portion of the referral, and provided an opportunity for the taxpayer to submit additional information, in order to seek agreement on the facts. When complete, a copy of the formal referral report would normally be given to the taxpayer. Where possible, formal referrals should be made at least three months before the returns become statute barred. If there is a potential statute-barred problem, this should be highlighted in the referral.

The FAS case officer will review the formal referral to ensure it contains all necessary information. This includes a copy of the auditor's recharacterization referral report, the draft proposal letter, and any representation the taxpayer sent to the auditor. The FAS case officer may request additional information from the auditor or taxpayer prior to scheduling the review of the file by the TPRC.

The TPRC members will review the formal referral and discuss whether the facts and circumstances support the application of the recharacterization provisions. The TPRC may refer the case back to the auditor if further audit work is needed before a recommendation to the Chairperson can be made. Once the TPRC considers the facts and circumstances, it will make a recommendation to the Chairperson. The Chairperson will then make a decision. The decision, along with the reasons for the decision, will be communicated by memorandum to the director of the TSO. This memorandum will be issued within 45 days of receiving a referral that contains all the necessary information to allow the TPRC to make a recommendation to the Chairperson. The TSO will be responsible for communicating the decision, and the reasons for the decision, to the taxpayer.

Final Consideration:

Where the Chairperson decides that the auditor should proceed with recharacterization, the auditor will issue the proposal letter. Where additional representations are made by the taxpayer in response to the proposal letter, the auditor will forward the additional representations along with the auditor's comments, to the FAS case officer for the TPRC's final consideration. If no changes result, the director of the TSO will be informed that the decision remains valid and that the assessment may proceed.

Penalty Referrals

The application of penalties under subsection 247(3) **must** be considered in all cases where the

total of transfer pricing capital and income adjustments for a taxation year,

- exceed \$5,000,000 **or**
- exceed 10% of gross revenue for the year as calculated under subparagraph 247(3)(b)(i).

Taxpayers must be made aware of the transactions under review and the potential for subsection 247(3) penalties. This should be done through the proposal letter. The proposal letter should provide taxpayers with a reasonable opportunity to submit any additional information they wish to have the TPRC consider. This will be the taxpayer's only opportunity to submit additional information to be taken into consideration by the TPRC. A penalty referral should be sent to the TPRC after the proposal letter is issued and the taxpayer representations have been received.

When a referral is being made to the TPRC, a referral report should accompany the referral. A copy of the formal referral report would normally be given to the taxpayer. Referrals to the TPRC first will be assigned to a FAS case officer within ITOD. The case officer will review the referral to ensure sufficient information has been provided to proceed with a formal referral to the TPRC.

After the TPRC has reviewed the referral and evaluated whether reasonable efforts were made, the recommendation of the TPRC will be made to the Chairperson. The Chairperson will then make a decision. The decision, along with the reasons for the decision, will be communicated by memorandum to the director of the TSO that is responsible for the file. This memorandum will be issued within 45 days of receiving a referral that contains all the information necessary to allow the TPRC to make a recommendation to the Chairperson. The TPRC review will be limited to a determination of whether transfer pricing penalties are applicable to the transfer pricing adjustments raised. The TPRC's role is not to question or review the adjustments that gave rise to the penalty referral. The TSO will be responsible for communicating the decision, and the reasons for the decision, to the taxpayer.

When considering the application of transfer pricing penalties, auditors should be aware that taxpayers may choose to use the Pacific Association of Tax Administrators (PATA) Transfer Pricing Documentation Package in order to avoid the imposition of PATA member transfer pricing penalties with respect to a transaction. Taxpayers that use this package need to satisfy three operative principles. First, they need to make reasonable efforts, as determined by each PATA member tax administration, to establish transfer prices in compliance with the arm's length principle. Second, they need to maintain contemporaneous documentation of their efforts to comply with the arm's length principle. Third, they need to produce, in a timely manner, the contemporaneous documentation upon request by a PATA member tax administrator. The documentation package provides an exhaustive list of documents that the PATA tax administrations view as necessary to provide transfer pricing penalty relief. This listing of documentation includes the documentation referred to in subsection 247(4). However, referrals would still be required to be made to the TPRC where the threshold for the application of penalties has been exceeded, in order for a decision to be made as to whether the first operative principle has been satisfied. See [Pacific Association of Tax Administrators \(PATA\) Transfer Pricing Documentation Package](#) for more information.

QCCA Referrals

Taxpayers must be made aware that the cost contribution arrangement is under review and of the evaluation of whether it can be defined as a QCCA by the TPRC. Taxpayers should be provided with a reasonable opportunity to submit any information they wish to have the TPRC consider.

When a referral is being made to the TPRC, a referral report should accompany the referral. A copy of the formal referral report would normally be given to the taxpayer. Referrals to the TPRC first will be assigned to a FAS case officer within ITOD. The case officer will review the referral to ensure sufficient information has been provided to proceed with a formal referral to the TPRC.

After the TPRC has reviewed the referral and evaluated whether reasonable efforts were made, the recommendation of the TPRC will be made to the Chairperson. The Chairperson will then make a decision. The decision, along with the reasons for the decision, will be communicated by memorandum to the director of the TSO that is responsible for the file. This memorandum will be issued within 45 days of receiving a referral that contains all information necessary to allow the TPRC to make a recommendation to the Chairperson. The TPRC review will be limited to a determination of whether the taxpayer made reasonable efforts to match the contributions of the participants to their respective expected benefits. The TSO will be responsible for communicating the decision, and the reasons for the decision, to the taxpayer.

Referrals of Large File Cases

In dealing with Large File cases, all audit issues presented to the taxpayer, including the potential application of the transfer pricing penalty, recharacterization, and/or a QCCA, are to be routed through the Large File Case Manager. The international auditor will attend all meetings with the taxpayer to discuss any aspect relating to the international audit. The LFCM must be informed of potential referrals under this document and be provided with an opportunity to review the referral, in order to ensure agreement with the facts stated in the referral and to add any other information relevant to the referral, prior to the referral being made to the TPRC. Similarly, this approach may be appropriate for small and medium file cases as well.

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