Canadian federal budget 2021-2022: Proposed transfer pricing measures and the impact on taxpayers

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On April 19, 2021, the Deputy Prime Minister and Minister of Finance, Chrystia Freeland, introduced *Budget 2021: A Recovery Plan for Jobs, Growth and Resilience*. In it, the government proposed a number of measures related to international transfer pricing that, collectively, will likely raise the risks of scrutiny of taxpayers' intercompany transactions and the likelihood of disputes going forward.

Several of the proposals are the direct result of recommendations from the Organisation for Economic Cooperation and Development's (OECD) Actions on Base Erosion and Profit Shifting (BEPS), which were released in 2015. All 38 OECD member states, including Canada, plus 101 other countries have committed to implementing tax rule changes consistent with the principles of the OECD's BEPS Actions. This article provides a brief outline of the transfer pricing-related measures and some commentary on what we believe will be the likely impact of the proposed measures on taxpayers.

Transfer pricing rules

In the coming months, the government will release a consultation document proposing enhancements to Canada's transfer pricing rules.

Implications:

This measure is largely the result of the government's loss at the Federal Court of Appeal in the Cameco tax case (2020 FCA 112)—a decision the government views as limiting the applicability of the recharacterization provision of Canada's transfer pricing rules in paragraphs 247 (2)(b) and (d) of the Income Tax Act.

The government is likely to propose amendments to widen the circumstances in which the recharacterization provision can be applied successfully to address what the government believes is an abusive use of the transfer pricing rules. A likely outcome will be an increased and more aggressive application of the recharacterization provision by the Canada Revenue Agency in future transfer pricing audits.

Interest deductibility

Canada will implement interest deductibility limits based on BEPS Action 4, focusing on limiting international parties' ability to deduct interest from debt. Essentially,

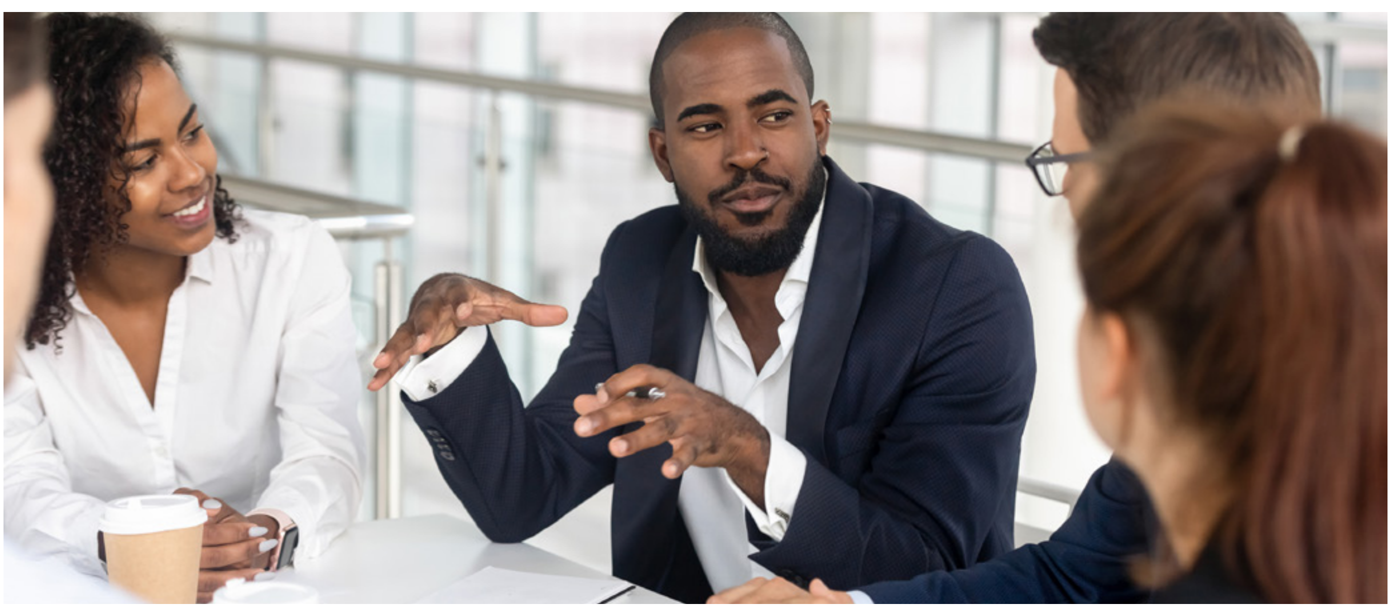
- interest from debt from related parties will be capped at 40 percent of EBITDA for tax years before January 1, 2024, and 30 percent of EBITDA afterwards;
- non-deductible interest will be able to be carried forward up to 20 years or back three years;
- different rules will apply for banks and financial institutions; and
- the provision will apply to limit interest deductibility on existing debt, not just new debt.

Implications:

This measure will limit the use of tax-deductible debt in Canadian international tax planning, which was already circumscribed by Canada's thin capitalization limit of 1.5:1 related party debt to equity, and the back-to-back loan rules. This measure will bring Canada in line with many other jurisdictions, particularly certain European Union (EU) countries, which implemented measures based on BEPS Action 4 in 2018.

Hybrid mismatch rules

Canada will implement hybrid mismatch rules based on BEPS Action 2 that will phase in in stages from July 1, 2022.



Implications:

These measures will seek to deny tax benefits from arrangements that take advantage of the disparate characterization across jurisdictions of hybrid entities (e.g., treatment as corporations or partnerships, of hybrid securities, or as debt or equity). CRA auditors will largely be watching for double-dip and non-inclusion arrangements to deny tax benefits.

The writing was on the wall for these types of arrangements when the OECD introduced BEPS Action 2, which wasn't considered controversial and was therefore likely to be adopted widely by OECD member states.

Mandatory disclosure rules

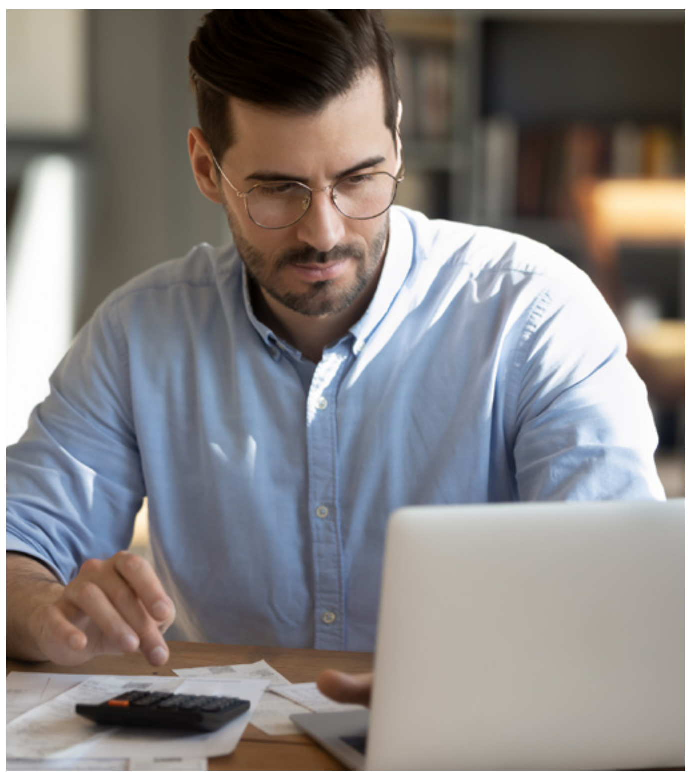
Canada will implement mandatory disclosure rules inspired by BEPS Action 12 that will take effect in 2022. Public consultations are open and interest parties may submit comments until September 3, 2021. These rules will require the disclosure of three types of tax positions:

- **Reportable transactions** – It's proposed that under Canada's existing mandatory disclosure regime, the definition of "reportable transactions" will be loosened to require only one hallmark for a transaction to be reportable. The definition of "avoidance transaction" will also be amended.
- **Notifiable transactions** – Canada will create a class of transactions referred to as "notifiable transactions" similar to Quebec's "specified transactions" or mandatory disclosure rules in the United States, United Kingdom, European Union and Australia. Taxpayers and promoters (e.g., tax advisors) will be required to report notifiable transactions. Penalties will apply for failing to disclose the required information.
- **Uncertain tax positions** – Corporate taxpayers with assets of at least $50 million will be required to disclose to the CRA uncertain tax positions that are already required to be disclosed in financial statements under International Financial Reporting Standards (IFRS) or US General Accepted Accounting Principles (GAAP). The disclosure will include the quantum of taxes, description of facts and tax treatment taken. Penalties will apply for failing to comply.

Implications:

The government believed the existing reportable transaction regime did not provide sufficient information on transactions and arrangements for its auditors. The net impact of these rules will be to increase the number of potential matters for CRA auditors to investigate. Taxpayers will need to prepare for automatic disclosure of notifiable transactions or arrangements. This means understanding what arrangements they have that might be reportable or notifiable, and understanding who has the reporting or notification obligation (i.e., the taxpayer or their advisors). Taxpayers should also understand the timeline for reporting and ensure they are notified when their advisors are required to disclose information to the CRA.

Uncertain transfer pricing positions often make up a large portion of uncertain tax positions by value. Taxpayers can expect the CRA to use the uncertain tax positions disclosures to target their audit efforts. Taxpayers should consider reducing the scope of uncertainty in their intercompany transactional arrangements by maintaining contemporaneous transfer pricing documentation and seeking advance pricing arrangements where there is significant risk of controversy.



Reassessment period changes as a penalty

The government proposed that failure to comply with reporting requirements under the enhanced mandatory disclosure rules will result in the relevant tax year not becoming statute barred, leaving it open for CRA auditors to investigate.

Implications:

These proposed provisions will ensure that the CRA has all the time it needs to investigate suspicious transactions or arrangements if the taxpayer failed to disclose them, regardless of whether it was deliberate or in error. The provisions reinforce the importance to taxpayers of getting a handle on what information will be disclosed under the strengthened mandatory disclosure regime and minimizing what needs to be reported by reducing the uncertainty or unwinding potentially reportable arrangements.

Tax audit procedures

The government proposed that the CRA will have the authority to require cooperation in providing oral and written information during audits.

Implications:

These provisions are, in part, a response to a recent case related to the aforementioned Cameco case, in which Cameco offered written responses to the CRA queries and the CRA sought to compel compliance with its oral interview request, which the government lost at both the Federal Court and the Federal Court of Appeal levels (2019 FCA 67). Taxpayers can expect that, in future, managers and employees may need to submit to verbal questioning by CRA auditors. Taxpayers should expect the costs of defending against a CRA audit will increase (e.g., the costs of management and employee time).

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