Canadian transfer pricing and tax considerations for companies in the technology industry

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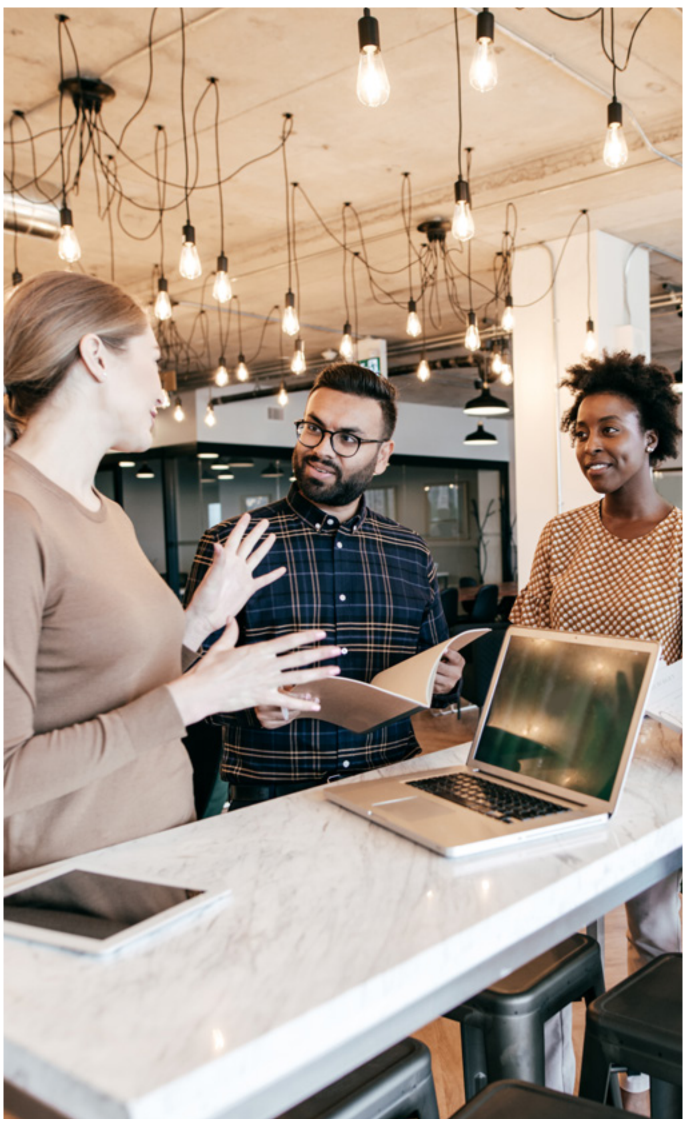

Canada's technology industry has been thriving, with some of the largest global technology companies establishing a presence in Canada. These companies include both Canadian-headquartered *(e.g., Shopify)* and foreign-headquartered companies *(e.g., Amazon, Google, Microsoft, Netflix and Uber)*. The growth in the Canadian technology industry (including fintech, pharma, AI, software development) is primarily driven by the growing pool of highly educated and skilled talent, favourable government tax incentives and initiatives and access to capital. For these reasons, Canada is also home to many technology clusters and high-growth technology start-ups.

Whether you are a large established technology company or a pre-revenue start-up company, it is important to establish a transfer pricing framework that includes processes and policies for your intellectual property (IP), your remote workforce and funding. This article discusses transfer pricing and tax opportunities and challenges commonly encountered by tech companies.

Where is your intellectual property?

Multinational enterprises (MNEs) in the tech industry are unique in that their most valuable asset—their developed technology or IP––is often portable, and often developed by remote teams working in a number of countries. This gives rise to questions about the ownership of the IP and where value associated with the IP should be taxed. From a transfer pricing perspective, there are several things to get right to make sure that multiple tax jurisdictions do not assert rights to taxing business profits. Tax authorities consider economic ownership (driven by who pays for the IP, who manages risk and controls decision making related to the IP) as much as the legal ownership, and the two should be aligned. Where the two do not align, tax authorities use transfer pricing principles to reallocate profits to align with economic ownership, possibly leading to costly reassessments and penalties.

It is critical to identify or designate an entity in the corporate group that economically owns the IP. This is normally the entity that employs personnel who perform and direct the development, enhancement, maintenance, protection and exploitation (DEMPE) of the IP. By performing and directing the DEMPE functions, the entity is entitled to profits related to the IP. That said, it is common practice for another entity in the MNE group to contribute to IP development, creating complexity for your IP ownership and splitting of profits. This can occur when research and development (R&D) activities are performed by employees of a foreign related entity under contract with the IP owner. In this circumstance, economic ownership can be preserved by clearly delineating the roles and responsibilities of the IP owner and contract developer, and by documenting the arrangement and split of profit in an intercompany legal agreement. The contract developer should be compensated based on the functions performed, assets owned and risks assumed by the developer with respect to the IP.

MNEs may require use or transfer of valuable IP within the corporate group. IP can be sold or licensed through intercompany transactions between the IP owner and related parties. Transfer pricing analysis is required to identify a reasonable arm's length price for the sale or license of IP. Valuations (done for accounting or other non-tax purposes) can be useful to determine a sale price for the IP but may not satisfy the requirements of a transfer pricing analysis. A transfer pricing analysis of an intercompany sale of IP should also include the following:

- Clear delineation of the transaction: functions, assets and risks before and after the transfer
- Business reasons and expected benefits from the sale of the IP
- Description of other options realistically available to the parties and reasons why these options are not suitable
- In addition to the consideration for the IP sale, also consider whether other aspects of the IP transfer require compensation, *e.g., termination or renegotiation of existing arrangements like R&D*
- Documentation of the decisions and intentions regarding the restructuring, in particular decisions to assume or transfer economically significant risks, as well as evaluation of the consequences on the profit potential of risk reallocations

Similar to an intercompany sale of IP, intercompany licensing should reflect not only arm's length pricing (license rate) but also other commercial terms and conditions that would be agreed to between arm's length parties.

Valuable IP can be expensive to move within an MNE group. It can trigger a substantial capital gain that may not be fully sheltered by tax attributes. Ideally, IP should be moved at a point in time before it achieves its full potential. Periods of economic disruption or downturn (for example, during the COVID-19 pandemic) when valuations can be depressed may also be an opportune time to move IP to minimize tax impacts.

Governance relating to mobile directors and workforce

Remote workforces are common among companies in the tech industry, as the market for educated and skilled talent is highly competitive and companies recruit talent globally. The COVID-19 pandemic has also driven a trend toward remote or hybrid workforces. Remote employees of a Canadian company working outside of Canada could trigger significant tax implications and foreign compliance. Specifically, employees or directors can create a taxable presence in a foreign jurisdiction or impact the tax residency of a Canadian company.

The tax residency of a company in Canada is determined by reference to its place of incorporation. A company incorporated in Canada is generally deemed to be a resident of Canada. A foreign company *(e.g., a foreign affiliate (FA) of a Canadian company)* can also be a resident of Canada under common law principles. Common law establishes that a company is a resident of the country in which its central management and control is exercised, which is generally the location where its board of directors meets to exercise strategic decision making. This is critical in light of the increased trend toward remote workforces, which has made it more challenging for board members to physically meet in one location, especially in circumstances where some members may be working remotely outside of the country in which the FA operates. This may trigger tax consequences for the FA as strategic decision making is being exercised in another country (i.e., Canada). To mitigate such risks, best practices may include: ensuring that control of the board of directors is not located in Canada; holding board meetings outside of Canada, preferably where the FA operates; documenting minutes and agendas of the board meetings; maintaining statutory records and banking accounts/facilities in the local country; and executing contracts and major business documents in the local country. Companies are encouraged to review and, if needed, establish governing policies, especially after the disruptions caused by the COVID-19 pandemic.

Canadian employees working remotely outside of Canada could give rise to a permanent establishment (PE) in that foreign jurisdiction. Subject to the tax treaty between Canada and the foreign jurisdiction, a PE is a fixed place of business through which the business of a company is wholly or partly carried on, and may include a place of management, a branch and an office. To give rise to a PE, the fixed place of business must have a degree of permanency and not be purely temporary in nature (generally more than six months).[1] A PE can also exist where an employee of a company has the authority to conclude contacts on behalf of the company and habitually exercises that authority in a foreign jurisdiction. This could also extend to the negotiation of contracts. For these reasons, to mitigate the risk of creating a PE, it is preferable to have contracts negotiated and signed in the name of the Canadian company in Canada. PEs can be avoided when remote employees are hired by a related corporation in the foreign jurisdiction. It is important to identify any intercompany transactions that may arise between the Canadian company and foreign related corporation (for example, rendering of services) and ensure that these intercompany transactions are implemented at appropriate arm's length prices.

Where a foreign PE of a Canadian company exists, the profits of the Canadian company attributable to that PE would generally be taxable in the foreign jurisdiction. The exercise of attributing profits to a PE can be complicated and cumbersome and may expose the company to double taxation in the absence of a tax treaty between Canada and the foreign jurisdiction. It is therefore critical for Canadian companies to proactively monitor the activities of remote employees (especially employees who are key decision makers) in foreign jurisdictions to make sure these activities do not rise to the level of a PE.

Financial support and funding

Tax incentives

Securing financial support and funding, especially in the start-up phase, is a large hurdle for tech companies, without which they are unlikely to attract the best talent, develop and commercialize their product, invest in ongoing innovation or maintain their competitive position. Fortunately, a range of government assistance is available to financially support tech companies. In Canada, the Canada Revenue Agency's (CRA) Scientific Research and Experimental Development (SR&ED) program provides tax incentives to companies conducting business in Canada. These incentives are provided in the form of an income tax deduction or refundable and non-refundable investment tax credits (ITC). To be eligible, the SR&ED work must

1 Organization for Economic Cooperation and Development's (OECD) Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention.

be performed for purposes of advancing scientific knowledge or achieving technological advancements.[2] Companies should be mindful of treatment of incentive programs in the calculation of intercompany pricing. Pricing should be such that the benefits from incentives remain in Canada rather than be exported to foreign jurisdictions through transfer pricing.

A Canadian-controlled private corporation (CCPC) can receive a refundable ITC of 35 percent on certain qualifying SR&ED expenditures of up to CA$3 million and a non-refundable ITC of 15 percent on expenditures over CA$3 million. A CPPC that is a qualifying corporation can also receive a refundable ITC of 15 percent on expenditures over CA$3 million and 40 percent of the ITC is refunded. Non-CCPCs (foreign controlled and/or publicly-owned corporations) can receive a non-refundable ITC of 15 percent on qualifying expenditures.

Eligible expenditures include wages/salaries, materials, contracts for SR&ED, overhead/other expenditures and third-party payments. Note that a portion of salaries/wages paid to employees engaging in SR&ED activities outside of Canada is also eligible for the SR&ED claim, providing that the individuals are employees of the Canadian company and the work forms part of the SR&ED work carried out in Canada by the Canadian company. It is therefore important for Canadian companies to monitor where SR&ED work is being performed to maximize the tax benefit.

Intercompany debt financing

A tech company expanding into another jurisdiction, through for example a newly incorporated subsidiary, would likely need to transfer funds across borders to finance the start-up activities of the subsidiary. The subsidiary could be financed by the parent company through equity, debt (initially sourced by the parent company from third-party banks) or a combination. In circumstances where the subsidiary is financed through debt (*e.g., intercompany loans*), the terms of these loans need to be consistent with those between independent parties dealing at arm's length. In establishing these terms, the tax and transfer pricing legislation in the relevant jurisdictions need to be considered. In the context of a parent company providing an intercompany loan to a subsidiary, important considerations include thin capitalization rules, withholding tax and tax deductibility of interest paid by the subsidiary. Note that these considerations have been evolving, with many jurisdictions—including Canada—recently proposing local legislation that limits interest deductions under certain circumstances.[3] Change in the tax environment such as this is prompting tech companies to review and potentially adjust their intercompany lending. Such review also aligns with recent guidance presented by the OECD recommending the review of pricing and other terms of intercompany loans on an annual basis.[4]

In conclusion…be ready for exit

M&A in Canada's tech industry has experienced strong growth to date in 2022.[5] The main reason for the rapid pace is buyers seeking to acquire technology and IP. Technology developed by companies in Canada's tech industry is garnering increased attention from inside and outside Canada.

Amid the robust M&A activity, some tech companies may consider accelerating an exit plan. It is imperative to review the status of your tax structure, including transfer pricing implementation and documentation, as part of the exit plan. Incomplete transfer pricing manifested in mis-priced transactions or missing documentation will undoubtedly be flagged during the buyer's due diligence processes. Transfer pricing is top-of-mind for corporate boards and management, leading to increased scrutiny during a deal. In fact, transfer pricing is frequently the top tax risk in a due diligence process, often with consequences for the value of the deal. Further, the CRA's normal reassessment period is extended by three years for non-arm's length cross-border transactions, creating a longer window for audits to open and heightening a taxpayer's historic risk if its transfer pricing has been neglected.

A complete M&A to-do checklist should include transfer pricing documentation. Having documentation will ease the tax due diligence process as the buyer will clearly understand your transfer pricing processes, policies and procedures related to your IP, your workforce and your funding. Seeking assistance from your transfer pricing advisor to have your transfer pricing properly implemented and documented will pay off at exit time.

2 A non-refundable ITC can only be applied to reduce income tax otherwise payable and can be carried back three years and forward indefinitely.

3 On February 4, 2022, the Canadian Department of Finance released a package of draft legislative proposals which include measures announced in the 2021 Federal Budget. They include proposed limitations on the deductibility of interest and other financing expenses.

4 The OECD introduced new guidance for financial transactions in February 2020. The most recent edition of the OECD Transfer Pricing Guidelines (January 2022) includes this guidance as a new Chapter X.

5 Business Development Bank of Canada, "Tech Industry Outlook: What's Next for the Technology Sector in Canada," 2022.