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Transfer pricing in times of tariff turmoil

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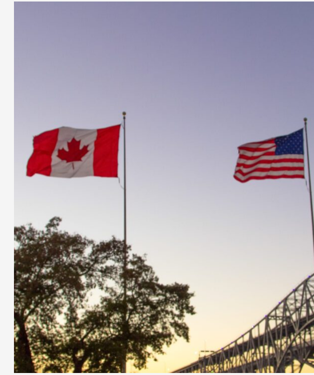

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The evolving landscape of U.S. tariffs and Canadian countermeasures presents significant challenges for multinational groups, including in the realm of intercompany transfer pricing. As businesses navigate the sudden shifts and reversals of the developments regarding the U.S. and Canadian tariffs, they must grapple with the interaction between tariffs and transfer pricing.

One critical question is how to allocate and absorb the increased costs associated with tariffs across the global value chain. Businesses may need to revisit their intercompany arrangements to ensure they address key risks and continue to reflect arm's length terms and conditions. Tariffs can also significantly affect the comparability of transactions used in transfer pricing analyses. Companies may therefore need to reassess their benchmarking and potentially adjust their comparable sets.

In this Update, we discuss these key considerations.

Tariff turmoil

Tariffs between the U.S. and Canada continue to evolve at a rapid pace, with changes occurring almost daily. From the sweeping 25% tariffs set out in President Trump's February 1, 2025, executive order (which were initially paused for 30 days) to targeted exemptions and reciprocal countermeasures, the situation remains highly unpredictable. While temporary relief has been granted for certain products (e.g., reduced rates for Canadian energy products and potash and a temporary pause for goods under the Canada-U.S.-Mexico trade agreement (CUSMA) until April 2, 2025), the long-term outlook regarding tariffs and countermeasures remains uncertain. See the Updates from our International Trade Group on "Trump tariffs: the U.S. first strike and Canada's retaliation" and "Trump tariffs: second strike hits steel and aluminum" for more information.

As of the time of writing, April 2, 2025, has emerged as a critical date:

- The temporary pause on CUSMA-compliant goods from Canada and Mexico is set to expire.
- President Trump plans to implement "reciprocal tariffs" on trading partners, including Canada. See the prior Update from our International Trade Group, "Trump tariffs:

President Trump proposes new measures on trading partners to address 'non-reciprocal' trade," for more information on President Trump's "Reciprocal Trade and Tariffs" memorandum.

A fact sheet accompanying the Reciprocal Trade and Tariffs memorandum identified Canada's digital services tax (DST) as a measure that is unfair to U.S. commercial interests and therefore a target of the policy.

Consistency between transfer pricing and customs

The cloud of uncertainty surrounding U.S. tariffs and Canadian countermeasures necessitates a review of existing transfer pricing policies. Transfer prices, which are the prices set for transactions between related parties, often serve as the customs value for duty used to calculate tariffs. This creates a direct link between the two, as the transfer price not only affects the allocation of taxable income but also establishes the cost base for tariffs and customs duties. Moreover, administering agencies may use a Canadian taxpayer's customs reporting to validate its reporting of intercompany transactions for income tax purposes and vice versa, so that consistency in such reporting is critical.

Transfer pricing and customs valuation share a common goal: ensuring that intercompany transactions are not influenced by the relationship between the parties, thereby reflecting true market conditions. However, they serve different purposes and are governed by different frameworks as summarized in the table below:

Aspect	Transfer pricing	Customs
Governing legislation	*Income Tax Act*, which requires taxpayers to use the arm's length principle and the most appropriate transfer pricing method to determine the income or loss from transactions with non-resident related parties.	*Customs Act*, which generally requires importers to declare the customs value of imported goods on a transactional basis.
Administering agency	Canada Revenue Agency (CRA), which may push for lower transfer prices on imports, or higher prices on exports, in order to increase taxable income in Canada.	Canada Border Services Agency (CBSA), whose primary goal is to prevent undervaluing the imported goods and may push for higher transfer prices on imports.

Methodology approach	Flexible approach using the most appropriate method to reflect prices that would be agreed by arm's length parties. There is no rigid hierarchy of methods for transfer pricing.	Strict hierarchy of methods, with the transaction value method being preferred.

How tariffs impact intercompany pricing

Tariffs can significantly affect transfer pricing. Generally, the importer of record pays any import tariff and/or customs duties. The choice of Incoterms in the governing contract may play a crucial role in determining where goods are considered to be delivered and which party initially assumes the responsibility and risk for tariffs and customs duties. The impact of tariffs on transfer pricing (which in turn determines the tariff chargeable) depends on the allocation of risk between the parties. One factor is whether the intercompany agreements contemplate responsibility for and allocation of tariff risk. In addition to identifying the importer of record, these may contain contractual provisions that pass on or allocate a portion of the tariffs and customs duties (i.e., where the parties agree to a specific allocation that is not 100% borne by the importer of record, such as a situation where the parties agree that if tariffs are imposed in the future, the seller's price will be decreased by 50% of the tariff).

Even if related parties had agreed to allocate future increases to tariff or customs duties in a way that does not fully fall on the importer of record, it is crucial to consider whether this risk was foreseeable when the contract was signed. The current tariff landscape may not have been reasonably anticipated. This unforeseen injection of cost might necessitate a review of existing arm's length contracts.

If the risk of future changes to tariffs and customs duties was previously contractually allocated at less than 100% to the importer of record, it is crucial to assess whether the respective tax authorities are likely to respect that allocation. Consider, for example, a Canadian manufacturer that sells products to its U.S. subsidiary on an EXW (Ex Works) basis so that the subsidiary is the importer of record. If a 25% tariff is imposed on the goods, the parties might have initially agreed that the additional cost should be shared between buyer and seller via a lower price. However, the CRA may dispute the effective allocation of a portion of the tariff cost to Canada. The relevant customs authorities may also have issues with price reductions, and their policies need to be considered in this context. Changes to the price implemented after importation (e.g., through the use of end-of-year transfer pricing adjustments) will generally not be accepted by CBSA unless they fall within the CBSA guidance.

Most contracts typically allocate responsibility for customs duties and tariffs to the importer of record. The primary issue is not the identification of the importer of record but rather the unforeseen materialization of sweeping 25% tariffs. Parties may not have been concerned about who the importer of record was initially when they entered into the contracts because the goods were historically duty-free. However, with a sudden 25% tariff, this becomes significant.

Where there has not been a contractual allocation of who bears the risk of future changes to tariffs and customs duties, it becomes necessary to determine what terms can be implied or

are consistent with arm's length transactions. As always, this determination depends on an analysis of the functions performed, assets owned and risks assumed by the parties (i.e., a functional analysis); an examination of the terms of comparable arm's length transactions; and an understanding of supply and demand factors. If demand for a product is high and supply is limited, the seller may be able to pass on the cost of tariffs to the buyer. Conversely, if demand is low and supply is plentiful, the seller may have to absorb the cost of tariffs in order to remain competitive. In any case, the allocation of tariff cost between related parties transacting cross-border carries a high risk of audit scrutiny and controversy.

Impact of tariff volatility on comparables

Comparability to arm's length transactions or enterprises — fundamental to transfer pricing — is a nuanced exercise even in simple scenarios, but the introduction of tariffs adds new layers of complexity. Companies may be required to make time-sensitive determinations about how to comply with transfer pricing rules based on imperfect insight into how tariffs are affecting previously comparable transactions or enterprises. Without a clear understanding, it is difficult to determine whether adjustments are necessary to account for the impact of tariffs on prices or profitability. Companies must assess whether their comparables accurately reflect their own circumstances, considering factors such as geographic exposure, industry-specific impacts and contractual risk allocation.

The CRA generally discourages the use of multi-year data, preferring to examine comparables and to examine data on an annual basis rather than relying on multi-year averages. In their guidance on the subject, the CRA cautions that inappropriate use of multi-year data can lead to errors about both the sustainability of comparable transactions and the resulting transfer price.

In the current environment, however, multi-year data may in some instances provide a more stable and representative picture of arm's length conditions, smoothing out short-term disruptions caused by the changes. Given the CRA's historic reluctance to accept multi-year data, taxpayers should be prepared to justify its use where appropriate in this context, demonstrating how it more accurately reflects the economic realities of the relevant industry.

Using financial data from this period in future reports may not be reliable. Some companies will pass on the tariff costs, while others will absorb them, potentially altering margins by up to 25%.

Tariff mitigation strategies

The interplay between material tariffs and transfer pricing can create challenges, as companies may also be incentivized to lower transfer prices on imports to minimize tariff liability. However, reducing transfer prices without making corresponding operational changes is likely to attract increased scrutiny from both tax authorities and customs agencies. It is crucial that any pricing changes defensibly reflect arm's length pricing, including to align with operational changes or evolving market factors, to minimize the risk of challenges.

Tariff mitigation strategies include updating commercial arrangements to reflect the increased costs associated with tariffs, allocate/share the burden of tariffs and/or unbundle the pricing of goods and services to isolate the transaction flows that attract tariffs. However, any change in transfer pricing policies should be made with a mid- to long-term perspective and not merely as a temporary measure in response to tariffs. Companies must also be mindful of the high potential for transfer pricing disputes with respect to any tariff mitigation strategies.