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Tax Management
International
Journal™

Application of the Transactional Profit Split Method in Canada

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INTRODUCTION

The Organisation for Economic Co-operation and Development (OECD) recently released its draft public discussion paper on the application of the Transactional Profit Split Method (TPSM) to global value chains (the "Discussion Draft").[1] The Discussion Draft was prepared in response to Action 10 of the 2013 *Action Plan on Base Erosion and Profit Shifting*,[2] which reads:

> Action 10 — Other high-risk transactions
>
> Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterised; (ii) *clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains*; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses. [Emphasis added.]

The TPSM is a multi-sided transfer pricing method. It allocates the profits that result from a transaction by considering an appropriate combination of the functions performed, assets contributed, and risks borne by each party to the transaction.[3] The TPSM is intended to divide the profits between the parties on the basis of how much value each party contributed to the transaction, which is presumed to reflect an arm's-length division.[4]

The Discussion Draft sets out a useful overview of how and why the TPSM might be useful for assessing complex transactions involving many components and interdependent players in the context of multinational enterprises (MNEs). However, the Discussion Draft considers the TPSM from only a theoretical point of view. It does not consider whether the method is compatible with any member country's domestic tax laws, or how it might be applied in such contexts. The OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ("2010 Guidelines") are similarly theoretical, specifying only that the methods it discusses must comply with the OECD *Model Tax Convention on Income and on Capital* (the

* My thanks to my colleague Richard Tremblay for his helpful guidance and suggestions.

[1] OECD, "BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains" (Dec. 16, 2014), online: OECD <www.oecd.org>.

[2] OECD, *Action Plan on Base Erosion and Profit Shifting* (July 19, 2013), online: OECD <www.oecd.org>.

[3] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (July 22, 2010), online: OECD <www.oecd.org>, at ¶2.108 [2010 Guidelines].

[4] For the purposes of this article, and in accordance with the OECD papers discussed herein, all references to profits apply equally to losses.

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"OECD Model").[5] As a result, the underlying assumptions and basis of any recommendations from the OECD regarding which methods can be applied must be examined before such recommendations can be implemented in domestic contexts.

In the case of Canada, the wording of the transfer pricing provision in the Income Tax Act (Canada) ("the Act") means that, in many of the scenarios outlined in the OECD's discussions of the TPSM in the Discussion Draft and the 2010 Guidelines, using the TPSM as a primary transfer pricing method may not fulfill the requirements of that provision.

OVERVIEW OF DISCUSSION DRAFT[6]

The Discussion Draft explores a series of situations and factors where it might be more appropriate to apply the TPSM than a one-sided transfer-pricing method in order to ensure that "transfer pricing outcomes are in line with value creation" (para. 1). Each section, summaries of which are set out below, involves an overview of the situation or factor — many of which overlap — as well as a hypothetical scenario and related questions.

Global Value Chains

The OECD defines "global value chains" as "the full range of activities that firms engage in to bring a product to the market, from conception to final use[:] design, production, marketing, logistics and distribution to support to the final customer."[7] Although global value chains are a common and often essential aspect of MNEs, they complicate transfer pricing evaluations and as a result have been singled out by the OECD for their impact on BEPS. The Discussion Draft acknowledges that "there seems to be very little experience of using a transactional profit split method in a way that could appropriately and comprehensively reflect the range of contributions to value in a diverse value chain" (para. 6), but nevertheless concludes that the TPSM might be a better method where parties within a global value chain are significantly integrated with respect to a transaction (para. 7).

Multisided Business Models

Closely related to global value chains are multisided business models where the value of the products made by one party in the value chain are inextricably tied to the actions of other parties. The hypothetical scenario provided closely resembles the business model of Google, where the services provided to the public for free significantly increase the value of its advertising services, which are the source of Google's profits.

Unique and Valuable Contributions

As previous OECD documents have noted, the TPSM should be considered where multiple parties to a transaction make contributions that are unique — meaning there are no reliable comparables — and valuable — meaning they are key to the transaction's competitive advantage. Where only one party makes such contributions, a one-sided method applied to the party not making such contributions is more likely to be appropriate.

Integration and Sharing of Risks

Reflecting aspects of the sections on global value chains and multisided business models, transactions involving "highly integrated operations" (para. 22), including transactions where important functions and risks are strongly interdependent, are good candidates for applying the TPSM.

Fragmentation

Fragmentation is where the separate legal entities comprising a value chain are divided by specialty — for example, having separate parties for "logistics, warehousing, marketing, and sales functions" (para. 26). When parties to a transaction are fragmented in this manner, it is difficult to find reliable comparables, particularly ones that account for the interdependence between the fragmented entities. The Discussion Draft suggests that in such circumstances the TPSM can be used to identify suitable comparables.

Lack of Comparables

The unavailability of appropriate or reliable comparables is a common thread running between many of the above situations. One-sided methods can sometimes adjust for the lack of comparables, but only up to a point. In such circumstances, the TPSM might provide a better arm's-length outcome that accounts for all aspects of the transaction (para. 29). It might also help in situations where a one-sided method offers a range of potential arm's-length values; used in combination with a one-sided method, the TPSM could allow a specific value within that range to be identified (para. 32).

Aligning Taxation with Value Creation

The TPSM has the potential to achieve one of the main goals of transfer pricing: allocating profits according to value creation, thereby approximating an arm's-length outcome. However, the Discussion Draft acknowledges that applying the TPSM so as to achieve this outcome can be difficult in practice. When applying the TPSM by comparing the functions performed by each party to a transaction, factors such as the party's role, bargaining power, and realistic available alternatives should be considered.

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[5] 2010 Guidelines at ¶¶2.6 and 2.56; OECD, *OECD Model Tax Convention on Income and on Capital*, online: OECD <www.oecd.org>.

[6] Unless otherwise noted, all references in this section are to the Discussion Draft.

[7] OECD, *Interconnected Economies: Benefiting from Global Value Chains* (2013), online: OECD <www.oecd.org>, p. 8.

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Hard-to-Value Intangibles

Partially developed intangibles pose a particular problem for applying the TPSM, even though this method is recommended in such cases, as the cost of inputs will not necessarily track the value of the intangible.

Ex Ante vs. Ex Post Results

Transfer prices determined before a transaction occurs can differ significantly from those that would have been determined had they been calculated after — for example, where an unexpected event takes place such that the ratio of the actual contribution of each party differs from the projected ratio. The TPSM can be a useful method for allocating profits in advance in a defensible manner. Parties can agree how profits will be split in the aggregate, or will sometimes be able to use the TPSM to determine a concrete price — for example, working backwards from the total expected profits from a transaction to calculate the royalty that will achieve the desired split. Applied in this manner, the TPSM serves to allocate risk in an arm's-length manner, even if unexpected events occur such that the outcome would otherwise appear to be not arm's-length.

TPSM IN THE CANADIAN CONTEXT

The Value of the TPSM

The Discussion Draft presents a useful summary of hypothetical situations where the TPSM might be the most appropriate method. Although it can be burdensome to apply, the complex nature of sophisticated global transactions can make applying a one-sided method difficult. One-sided methods assume that a transaction can be split between the different parties involved, after which one party can be singled out and examined on its own. While such an analysis might usually be possible, lack of sufficient information and complicated interactions between parties will at times make it impractical, if not impossible.

The TPSM has the additional benefit of focusing on the substance of a transaction rather than artificially dividing a transaction into component parts that, when examined using a one-sided method, risk never adding up to the whole. It aspires — however difficult it might be in practice — to align the profit received by each party with the value it contributed to achieve that profit. The TPSM can also provide taxpayers with more certainty in the face of unexpected events if applied properly before a transaction takes place.

The Discussion Draft acknowledges that the TPSM is often criticized for allocating profit in a manner that is insufficiently or not verifiably objective (at para. 35).

Canada's Domestic Law

However useful the TPSM might be, applying it in the Canadian context is potentially problematic. Paragraphs 247(2)(a) and (c) of the Act read:

> (2) Where a taxpayer or a partnership and a non-resident person with whom the taxpayer or the partnership, or a member of the partnership, does not deal at arm's length (or a partnership of which the non-resident person is a member) are participants in a transaction or a series of transactions and
>
> > (a) *the terms or conditions* made or imposed, *in respect of the transaction* or series, between any of the participants in the transaction or series *differ from those that would have been made between persons dealing at arm's length*
> >
> > . . .
>
> any amounts that, but for this section and section 245, would be determined for the purposes of this Act in respect of the taxpayer or the partnership for a taxation year or fiscal period shall be adjusted (in this section referred to as an "adjustment") to the quantum or nature of the amounts that would have been determined if,
>
> > (c) where only paragraph 247(2)(a) applies, *the terms and conditions* made or imposed, *in respect of the transaction* or series, between the participants in the transaction or series *had been those that would have been made between persons dealing at arm's length* [Emphasis added.]

In other words, in order to defend against or support a transfer pricing adjustment, the taxpayer or the Canada Revenue Agency (CRA) — Canada's taxing authority — must be able to, respectively, justify why the specific terms and conditions relating to the *transaction* are arm's-length, or identify the specific terms and conditions that are not at arm's length and set out appropriate replacements. In practice, the main term usually at issue is the price of a product or service related to the transaction at issue.

In contrast with the Canadian transfer pricing provision, its counterpart in the U.S. Internal Revenue Code reads as follows:

> 26 U.S.C. §482 — Allocation of income and deductions among taxpayers
>
> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, *the Secretary may distribute, apportion, or allocate gross income*, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is neces-

ISSN 0090-4600

> sary *in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses*. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. [Emphasis added.]

Unlike the Canadian transfer pricing provision, the American provision only requires the taxing authority to conclude that an allocation of amounts is necessary to prevent evasion or to clearly reflect the parties' income or profit. No specific terms or conditions relating to individual transactions need be identified; the situation can be assessed on an aggregate entity profit level.

Also standing in contrast with the Canadian transfer pricing provision is Article 9 of the OECD Model:

> 1. Where
>
> a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
>
> b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
>
> and in either case conditions are made or imposed between the two enterprises *in their commercial or financial relations* which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. [Emphasis added.]

As with the American provision, Article 9 does not require consideration of particular transactions but rather the overall commercial or financial relations between two enterprises.

The requirement under the Canadian provision that specific terms and conditions in relation to individual transactions be identified and adjusted present a potential barrier to using the TPSM in the Canadian context. In some circumstances it may be possible to allocate profits resulting from a particular transaction using the TPSM and then work backwards to determine an arm's-length price for the particular product or service at issue. However, in the complex transactions for which the TPSM is particularly suited, it will not always be possible to use the TPSM to reverse-engineer specific prices, terms, and conditions for each transaction and participant in the manner required by paragraphs 247(2)(a) and (c). In practice, taxpayers or tax authorities attempting to apply the TPSM might be forced to combine multiple transactions or even assess only at the entity level,[8] or may not be able to determine particular arm's-length terms and conditions.

Although the TPSM is theoretically applicable to individual transactions, in practice it is often sought to be applied to assess profits and contributions at an aggregate transaction or even enterprise level due to the lack of granularity in the available financial data. In such cases, it will often be unsuitable for use as a primary method in the Canadian context as it will fail to comply with the requirements of paragraphs 247(2)(a) and (c) to provide transaction or series-of-transactions level data. However valuable the TPSM might be on a theoretical level, even when not applied at a transactional level, as the Supreme Court of Canada pointed out in *GlaxoSmithKline*, the OECD Guidelines (and by extension, other OECD documents) "are not controlling as if they were a Canadian statute and the test of any set of transactions or prices ultimately must be determined according to s. 69(2) [the predecessor of s. 247] rather than any particular methodology or commentary set out in the *Guidelines*."[9]

As a result, when applied on an aggregate basis, or when it is not possible to derive particular arm's-length terms and conditions for the transaction(s) at stake, it will often be inappropriate to use the TPSM in Canada as a primary transfer pricing method. If used as a sanity check — to ensure that the results produced by a one-sided method are reasonable — or if used, as suggested by the Discussion Draft, to identify comparables that can be used to apply a one-sided method, the TPSM can be helpful in Canada even at the aggregate enterprise level. However, if it cannot produce an arm's-length price for particular transactions or series of transactions, it seemingly cannot be used as a primary method.

Examples of Application of the TPSM in Canada

The TPSM has yet to be applied in Canada in a tax case that has gone before the courts. It has twice been applied by non-tax courts in the context of oppression

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[8] Although combining transactions is permissible according to the 2010 Guidelines under certain circumstances (see ¶3.9), such combined transactions will not necessarily satisfy the "transaction or series [of transactions]" accepted by ¶¶247(2)(a) and (c). The more transactions to which the TPSM is applied, the more difficult it will be to satisfy the requirements of ¶¶247(2)(a) and (c). Recall that, in contrast, the American counterpart and Article 9 of the OECD Model permit assessment at an aggregate entity level rather than of a particular transaction or series of transactions.

[9] *Canada v. GlaxoSmithKline Inc.*, [2012] 3 SCR 3, 2012 SCC 52 at ¶20 [*GlaxoSmithKline*].

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claims, where paragraphs 247(2)(a) and (c) had no application.[10]

A recent tax dispute involved an application of the transactional net margin method (TNMM) that did not assess the taxpayer on a transactional level. In *Elk Trading Co. Ltd. v. Her Majesty the Queen*, the CRA applied the TNMM to arrive at the overall yearly return on total costs percentage that it viewed as being arm's-length, with an accompanying aggregate adjustment to the taxpayer's income. As admitted by the Crown, their application of the TNMM did not permit them to specify the arm's-length commission rate for each type of product at issue in the appeal.[11] In its Answer to the Reply (the CRA's pleading), the taxpayer argued that paragraph 247(2)(c) had not been satisfied because:

> That paragraph requires a determination of the terms and conditions of the specific transactions between Elk and Emachu to which they would have agreed had they been dealing at arm's length. By using the TNMM, the Minister purportedly determined the profit Elk that [sic] would have earned for the taxation years in issue *as a whole* had Elk and Emachu been dealing at arm's length. The Reply does not state what specific commission Elk would have earned on each transaction with Emachu had they been dealing at arm's length, because the TNMM does not allow for that kind of determination to be made in Elk's circumstances.
> [Emphasis added.]

It appears that the Crown in *Elk Trading* agreed with the taxpayer's argument and acknowledged that it could not determine the relevant terms and conditions of each transaction involved therein and therefore abandoned its defence of the reassessments.[12] However, as the matter was settled before trial we cannot know for certain what the Tax Court of Canada would have determined.

The same argument can arise with respect to the TPSM if it is not applied at a transactional level or if it does not permit the calculation of arm's-length terms and conditions. Taxpayers and the CRA alike should be wary of relying solely on this method unless it can be reliably applied so as to determine specific terms and conditions for the transaction at issue.

CONCLUSION

The TPSM is generally regarded as a less desirable method that falls lower than others on the natural hierarchy of transfer pricing methods. However, the Discussion Draft suggests that the OECD might view the TPSM as having value under certain circumstances relating to global value chains and complex transactions. Regardless of the merits of the method, Canada's domestic laws appear to render it inappropriate to use the TPSM as a primary method in circumstances where it cannot be used to establish arm's-length terms and conditions — such as the price — relating to particular transactions entered into by taxpayers. Canadian taxpayers seeking to establish arm's-length terms and conditions in advance of a transaction and taxing authorities seeking to challenge terms and conditions of a transaction should exercise caution in relying solely on the TPSM unless it can be applied so as to permit this kind of transaction-by-transaction determination.

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[10] *Ford Motor Co. of Canada Ltd. v. Ontario (Municipal Employees Retirement Board)*, 2014 DTC 6224 (Ont SC) at ¶402, *aff'd* on this point by 79 OR (3d) 81 (Ont CA); *Re Nortel Networks Corp. et al.*, 2014 ONSC 6973.

[11] In the Examination for Discovery of Tanya Fleck, Court File No. 2012-3423(IT)G (Vancouver: July 5, 2013), the Crown's representative admitted that in assessing the taxpayer using the TNMM, the CRA never made any assumption as to the specific commission rate that should have been used for the transactions at issue, and indeed that the TNMM would not have permitted the taxpayer to have calculated a specific rate (at pp. 43–44).

[12] *See* Jules Lewy and Joel Nitikman, *Important Developments in Canadian Transfer Pricing* (2014) 2185 Tax Topics 1 at 4.

ISSN 0090-4600