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# Extensive analysis protects transfer-pricing efforts

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"Sometimes what counts can't be counted,
and what can be counted doesn't count" - **Albert Einstein**

Individuals involved in transfer-pricing design, implementation, documentation or controversy resolution all have a view on the extent that art and science contribute to the transfer-pricing analytical process. Individuals that think the artistic component of the transfer-pricing analytical process exceeds the scientific component are likely to be involved with transfer-pricing transactions of intellectual property (IP). The inherent uniqueness of each piece of IP creates difficulty in applying the arm's length principle in any analysis. The lack of an observable structured analytical process leads the observer to the conclusion that the process is laden with artistic creativity. The view is even more pronounced from a Canadian perspective, given that Canadian transfer-pricing laws and practices are, for the most part, principles-based, as opposed to the rules-based approach of the US and some other countries.

Focusing on the Canadian perspective, this article addresses IP issues and the transfer-pricing concerns of Canadian tax authorities. The discussion will follow a structured analytical approach. By understanding this approach, the reader may be able to apply this approach to their transfer-pricing efforts to minimize controversy while furthering their business objectives. This article also includes an analysis of a recent transfer-pricing court case. There is little Canadian jurisprudence of transfer pricing of IP and this case identifies several transfer-pricing considerations on how the assignment of intangibles intersects and is a big component of an enterprise's transfer-pricing system.

One should not dive into implementation or documentation of transfer prices before gathering upfront information that allows for a strong analysis, followed by design, of the intercompany transactions. Through this approach, documentation becomes a by-product of tax planning, and transfer prices will be better protected when scrutinized by tax authorities, shareholders and other interested parties.

### Analyze: what IP exists?

The only guidance on transfers of IP from Canadian tax authorities is provided in the Canada Revenue Agency's (CRA's) Information Circular 87–2R (IC 87-2R), which generally follows the OECD guidelines. IC 87-2R identifies IP as a subset of intangible property and loosely refers to know-how and trade secrets as IP. The CRA definition of IP differs from the more common definition of IP, which generally is restricted to property that is protected under patents. So one can safely infer that transfers of IP will receive similar treatment to transfers of intangible property.

Transfers of IP are of big concern to the CRA because a vast amount of IP enters and leaves Canada through related-party transactions. The value of intangible property within many enterprises is often greater than observable tangible property.

Furthermore, Canada is a net importer of capital and a net exporter of goods. So IP is probably being simultaneously transferred with the movement of capital and goods.

A detailed review of an entity's value drivers and core competencies (the collective learning and coordination skills behind a firm's product lines) provides a valuable starting point in identifying inherent IP. Core competencies are either those products not sold to end-users or processes that are used to build products that are sold to end-users. For example, the design of motors and engines are a core competency of Honda. Honda uses its competency in building motors and engines to build a wide array of end-user products including: automobiles, motorcycles, watercraft, all terrain vehicles, lawn mowers, personal watercrafts, outboard motors, snow blowers, and generators. Honda's expertise allows it access to many markets while remaining difficult to imitate.

### Analyze again: what is the value of the IP?

The valuation of IP used by, or transferred from, Canadian taxpayers is the source of much friction between taxpayers and the CRA. From the CRA's perspective, improper IP valuation could erode the tax base. This risk is compounded by the vast amount of trading engaged in by Canadian taxpayers. Because Canada is a great importer of IP, the CRA's pronouncements are skewed towards the economic ownership versus the legal ownership when valuing IP used in Canada. The preamble to IC-87-2R's discussion on intangible property states that:

> Applying the arm's length principle to transfers of intangible property raises specific issues associated with the difficulty and uncertainty sometimes encountered with attributing an arm's length value to such transfers. In most cases, both the supplier and the recipient share the risks and the benefits associated with using an intangible.

This is interesting when compared to the general viewpoint of US authorities, where legal ownership of IP takes on greater emphasis. The contrasting perspectives have created a lot of transfer-pricing controversy.

In practice, Canadian authorities have been approaching the valuation of IP from two perspectives. This is not surprising given their position in IC 87-2R. The circular states that:

> Arm's length pricing for the transfer of intangible property must take into account the perspective of both the transferor of the property and the transferee. A transferor attempts to recover the costs associated with developing an intangible and to earn a reasonable return. However, to the recipient, the value of an intangible is based solely on the expected benefits (additional profits) that the intangible would generate. The overall expected benefit to the recipient is usually a key consideration in determining the transfer price of an intangible to both parties.

So in the more common occurrence where a Canadian taxpayer has licensed the use of IP in Canada from a non-resident related party, the CRA has been evaluating the costs incurred to develop IP from the transferor's perspective, and from the Canadian transferee's perspective the additional profits earned in Canada. Often, there is a discrepancy between the value of IP when analyzed from the two perspectives. Where these discrepancies occur the CRA has been attempting to use a proportionate allocation of costs incurred to develop the IP as a valuation method. Effectively, the CRA has been imputing a cost-contribution arrangement where one does not legally exist. Lacking convincing documentation, Canadian taxpayers are faced with a time and resource-consuming resolution process.

### Analyze once more: can the IP be transferred?

From a Canadian perspective, IP, similar to any other asset, can be transferred into or out of the country. But CRA's pressing concern is unintended transfer of IP, especially during the restructuring of an entity's supply chain. Unintended transfer of IP could occur when opening and closing manufacturing operations in Canada and through conversion of an entity that changes its characterization. (A conversion occurs when the functional and risk profile of an entity changes. For example, a full-fledged manufacturing operation becoming a low-risk toll manufacturer.) The CRA has taken the position in certain cases that a taxpayer's decision to close a Canadian plant and increase manufacturing capacity at a related company's plant in another jurisdiction is a deemed disposition of manufacturing or product-related intangibles. In these situations, the CRA has attempted to identify and seek a return to the Canadian taxpayers for their foregone manufacturing-related profits. None of these cases has made their way to formal court proceedings at this time.

The resolution of unintended deemed dispositions of IP are extremely difficult and will depend on the facts and circumstance of each case. However, a good starting point would be to go back to the analytical phase and determine the interaction, if any, of the foregone manufacturing processes and their relation to the core competencies and competitive advantages inherent in the company. This approach often identifies the nature and extent of the value-contribution of the manufacturing processes to the company as a whole.

### Design: how will IP be transferred?

The transfer of IP can be accomplished through an outright sale, a licensing arrangement or through a cost-sharing arrangement. No specific methods of transfer are addressed in Canadian transfer-pricing law or guidelines. Generally, all transfers of IP are required to be made under arm's-length terms and conditions.

The outright sale of IP would require a determination of the cost base and the fair market value at the time of transfer to fully evaluate the tax effect of the sale. Because of the often negative, and immediate, tax consequences, outright sales between related parties rarely occur.

From a Canadian perspective, IP is more frequently transferred using licensing and cost-sharing arrangements. To lessen the tax consequences of IP transfers out of Canada, taxpayers typically freeze Canadian ownership at a point in time and continue further development outside of Canada. A non-resident related party would assume the risks, ownership and rewards of IP development and pay a declining licence fee to the Canadian company for the rights to further develop. Many contentious issues arise from transfers that effectively change the future ownership of Canadian-sourced IP. To the extent that future developments can be linked in some form to the original Canadian IP, the CRA may claim that the Canadian entity has at least an economic interest in the new IP. The success of these transfers will be evaluated by determining whether arm's length parties would engage in a similar transaction under similar conditions. The CRA's position is outlined in IC 87-2R:

- In determining a transfer price for an intangible, whether for sale or for use, a taxpayer must consider the terms and conditions that arm's-length parties would insist on to protect their respective positions.
- For example, where the value of an intangible is uncertain, one needs to consider whether an arm's-length transferor would permit the long-term exploitation of the intangible by an arm's-length party.

As protection, an arm's length transferor may insist on an agreement that:

- has a relatively short term;
- includes a price adjustment clause; or
- sets variable royalty rates tied to profits.

If the exploitation of the intangible proves highly profitable, the transferor would enjoy a reasonable share of that financial success.

## Implement

Similar to the US and other jurisdictions, the use of intercompany agreements that identify the nature and extent of IP that is being used is highly recommended. An agreement is required, but not necessarily enough, if a cost-sharing arrangement wants to be considered a qualified cost contribution arrangement under Canadian tax laws.

The implementation of IP usage must also be considered in light of other intercompany transfers of goods or services. A classic example occurs where a Canadian company licenses product-related IP from a related non-resident party. However, the non-resident party also provides engineering services to the Canadian company under a services arrangement. The CRA may take the position that the engineering services should be included as part of the IP arrangement and disallow a deduction for the engineering services in Canada.

It is also important to monitor a transfer-pricing design over time, to make certain that its outcome is delivering its initially intended results. This situation is illustrated in the recent Ontario Superior Court decision of *Ford Motor Co of Canada Ltd v OMERS* (January 22 2004), now being appealed by both parties, that found the transfer-pricing system used for transactions between Ford Canada and Ford US prejudiced the rights of the minority shareholders of Ford Canada.

According to the case, Ford Canada had three functional divisions: manufacturing, assembly, and sales. Ford's transfer-pricing system applied a profit mark-up to the costs incurred when products were transferred from the manufacturing and assembly divisions. The selling division purchased vehicles from the assembly division (both Ford Canada's and Ford US's assembly divisions) and resold the vehicles to independent car dealers. The selling division was also allocated a portion of design and engineering development expenses performed by Ford US.

### Biography

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Merv Edwards is a principal of Ceteris, a global economic consulting organization specializing in transfer pricing and tax valuation issues. He has more than12 years of transfer pricing experience through which he has crossed virtually every industry and type of transaction. His experience includes five years as Senior transfer Pricing Auditor with the Canada Revenue Agency's (CRA) Toronto Tax Service Office.

While at the CRA, Edwards was involved in more than 100 transfer-pricing cases. In addition to typical compliance engagements, he participated in a bilateral advance pricing arrangement (APA) and led a CRA/Internal Revenue Service simultaneous audit engagement.

Edwards has spent the last seven years consulting to clients on a wide range of transfer-pricing engagements including: compliance, planning and implementation, audit defence, competent authority procedural, and APAs. His unique experiences makes him an extremely valuable resource to clients in need of advice when planning and implementing cross-border transactions and when facing controversy from tax authorities.

Edwards has spoken at numerous conferences and seminars on various transfer-pricing matters.

An inherent assumption in the transfer-pricing documentation was that if the manufacturing and assembly divisions used a profit mark-up reflective of arm's-length terms and conditions, then the financial results of the selling division must also be reflective of arm's-length terms and conditions as the residual claimant to profits. Ford Canada's selling division incurred a cumulative loss of C$5.954 billion ($4.852 billion) and Ford Canada, as a whole, had a cumulative loss of C$709 million between 1985 and 1995. The judge in the case reasoned that one possibility in this situation is that an independent party in the position of Ford Canada would have demanded reformulation of the intercompany arrangements. Regardless of the final outcome of this matter, it points to the need to continuously monitor the results of a transfer-pricing system and to be mindful that many interested parties have the benefit of 20/20 hindsight when evaluating intercompany arrangements.

### Document

Transfer-pricing penalties might be imposed if certain transfer-pricing adjustments are greater than the lesser of 10% of the Canadian taxpayer's revenues or $5 million. Transfer-pricing penalties can be avoided, regardless of the quantum of any transfer-pricing adjustment, if the Canadian taxpayer makes reasonable efforts to determine and use arm's-length transfer prices or arm's-length allocations and have supporting documentation available six months after the end of the taxation year and within three months of a request from the CRA. The transfer-pricing penalty is 10% of certain transfer-pricing adjustments. Because the penalty is on the adjusted amount, the penalty is payable even if the taxpayer is not be taxable as a result of losses in prior years. Also, interest and penalties relating to adjustments made by the CRA are not deductible for tax purposes.

The *Income Tax Act of Canada* provides a general list of information that should be included in transfer-pricing documentation:

Records or documents that provide a description that is complete in all material respects of:

- the property or services to which the transaction relates,
- the terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the participants in the transaction,
- the identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into,
- the functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction,
- the data and methods considered and the analysis performed to determine the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction, and
- the assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocations of profits or losses or contribution to costs, as the case may be, in respect of the transaction.

There is no safe harbour set of transfer-pricing documentation requirements. The nature and extent of documentation depends on the facts and circumstances pertaining to the transactions. For intangible property, the CRA does recommend that additional information be provided. The items include:

- a description of the intangible property, potential market application, and advantages the intangible property provided in the particular market;
- the prevailing industry royalty rates;
- the terms of the licence, including geographic limitations, time limitations, and exclusivity rights;
- the singularity of the invention and the period for which it is likely to remain unique;
- technical assistance, trade marks, and know-how provided along with access to the patent;
- profits anticipated by the licensee; and
- benefits to the licensor arising from sharing information on the experience of the licensee.

Documentation of transfer-pricing transactions is of utmost importance in Canada. The CRA is considered to be one of the most aggressive tax authorities when scrutinizing transfer-pricing transactions. Adequate documentation will not only reduce the likelihood of penalties, but also reduce the chance of a prolonged review of the transactions.

### Protect

The extent to which IP transfer-pricing transactions can be protected is a reflection of the quality of the analysis and documentation to support those transactions. By following the analysis outlined in this article, the risk of challenge to one's transfer-pricing system may be reduced.