**Cross-border Transactions and Transfer Pricing**
**Case Study: Sales Operations in Canada - Part I**

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***Cross-border Transactions and Transfer Pricing***

Is your company selling goods in Canada that were purchased from your German parent company? Or manufacturing goods in Canada and selling them to your German affiliates?

Are you providing services for clients of a foreign affiliate company, or are your clients receiving services from one of your foreign affiliates?

Such situations are common examples of what is referred to as cross-border transactions. Cross-border (or intercompany) transactions are governed by local and international tax rules, including the prices at which the goods (tangible or intangible) or services being sold to, or purchased from, foreign affiliates are set. The setting of these prices is known as "transfer pricing", which refers to the allocation of profit between entities that are part of a same multinational company. Transfer pricing can therefore have significant tax implications for the countries in which these entities reside.

According to local and international rules and regulations, transfer prices should be set according to the "arm's length principle", i.e. as if the parties taking part in a cross-border transaction were not related, and thoroughly documented to avoid transfer pricing adjustments and associated penalties by tax authorities. In Canada, for example, the Income Tax Act ("ITA") imposes a penalty equal to 10% of the net result of transfer pricing adjustments. If the taxpayer has not made reasonable efforts to determine and use arm's length prices, the ITA does not permit a reduction of the amount subject to the penalty unless the taxpayer has documented its intercompany transactions. This documentation must include specific items listed in the ITA and must be prepared by the company's tax returns due date for the fiscal year in which a transaction is entered into (i.e., within six months after the company's year end in the case of a corporation).

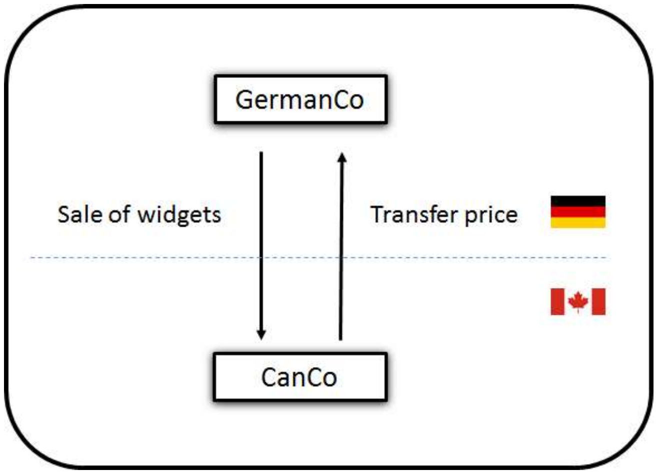
Transfer pricing has been at the heart of a debate on Base Erosion and Profit Shifting ("BEPS") at the OECD/G20 for the past two years, which will have significant impacts on companies taking part in intercompany transactions. This article presents a case study that can help companies that take part in such transactions understand the basic concept determining if the pricing of their intercompany transactions comply with local and international rules.

***Case Study: Sales Operations in Canada***

Let's take for example a company that is incorporated in Canada ("CanCo") and is the subsidiary of a parent company located in Germany ("GermanCo"). For the purpose of this case study, we will assume that GermanCo is a developer and manufacturer of widgets, while CanCo purchases some of these widgets from GermanCo for sale in the Canadian market. Both entities have a December 31st fiscal year end. In fiscal year 2015 ("FY2015"), CanCo purchased for $20 million of widgets from

GermanCo. CanCo does not purchase widgets from other suppliers, while GermanCo sells widgets to CanCo and to end-clients.

The intercompany transaction that takes place between CanCo and GermanCo can therefore be illustrated as follows:




According to the arm's length principle, the price at which GermanCo sold the widgets to CanCo should have been set as if these companies were unrelated, i.e. if they were not part of the same multinational group.

Different methods can be used to determine the arm's length nature of the transfer price in the context of such transaction. For example, a traditional transaction method referred to as the Comparable Uncontrolled Price ("CUP") method would compare the price charged for the widgets by GermanCo to CanCo to the price charged for the same, or similar, widgets in a comparable uncontrolled transaction in comparable circumstances. To be able to apply this method, we would need to obtain pricing information on sale of widgets by GermanCo to unrelated clients operating at the same level as CanCo, or on the purchase of widgets by CanCo from unrelated suppliers. Such information is unavailable to the company given that CanCo does not purchase widgets from other suppliers and that GermanCo only sells widgets to end-clients, which is at a different level than its sales to CanCo[1], which is a wholesaler in our example.

Given the unavailability of this information, a profit method such as the transactional net margin method ("TNMM") can be used. The TNMM compares the net profit margin of a taxpayer arising from a non-arm's length transaction with the net profit margins realized by other arm's length companies on similar transactions. This net profit margin can be examined relative to an appropriate base such as costs (e.g., return on total costs) or sales (e.g., operating margin). This method is applied to only one entity that takes part in the intercompany transaction (the "tested party"). As it is more difficult to find comparable data on the more complex functions performed, the tested party used will be the entity with the least complex functions and that does not contribute significant valuable intangibles to the transaction.

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[1] By « at a different level », we mean that in the case of sales to CanCo, GermanCo sells to a distributor that will incur further expenses before widgets are sold to end-clients.

In the case at hand, we would choose CanCo as the tested party, since it only performs routine distribution functions, while GermanCo acts as a developer and manufacturer of widgets. Therefore, to determine the arm's length nature of GermanCo's sales of widgets to CanCo during FY2015, we compared the net profit margin earned by distributors similar to CanCo that purchase goods from unrelated entities to the net profit margin realized by CanCo on its distribution of widgets purchased from GermanCo during FY2015.

There are specific databases in the market that can be used to find data such as the net margin earned by distributors comparable to CanCo. These databases can be searched according to industry classification codes, particular financial indicators, specific economic characteristics, etc.

In the next segment, we will cover the basic ins and outs of a request for contemporaneous transfer pricing documentation.

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