Former Canadian Official Shares CRA Views on Cost Sharing, Other Issues; Responds to U.S. Criticism of Some Practices

Phil Fortier, former director of the Canada Revenue Agency’s International and Large Business Directorate, shares the agency’s views on cost sharing, services, aggregation, and other matters in a Feb. 20 interview with BNA Tax Management reporter Molly Moses. The former official, who left the CRA in January to join Deloitte in Ottawa, also responds to various criticisms of Canadian practice by the American Bar Association tax section.

Cost Sharing

BNA TAX MANAGEMENT: What impact, if any, do you think the new U.S. temporary cost sharing rules will have on Canadian practice? Do you see the rules influencing Canadian policy?

FORTIER: The United States has concerns about the use of cost sharing strategies to migrate intellectual property offshore and the resulting potential for abuse. As Commissioner Shulman stated in his remarks last December, ‘Cost sharing involves those taxpayers aggressively pursuing transfer pricing schemes to shift income out of the U.S. to low- or no-tax jurisdictions. One of the most common is to transfer a valuable intangible for less than arm’s-length compensation.’

Canada shares those concerns. The United States has dealt with its concerns through the temporary and proposed cost sharing regulations and by attacking what it considers to be questionable transactions (17 Transfer Pricing Report 579, 1/8/09).

Canada presently does not have a formal cost sharing regime, but it is looking to establish one. Canada will look to the U.S. approach for inspiration as well as looking to other countries for best practices.

One of the major issues in establishing an approach is that to the extent countries have different views and adopt different approaches, it will lead to more double-tax scenarios. And double-tax issues with respect to IP are among the most difficult to resolve.

At present in Canada there are many approaches in the field with respect to this issue. There have been some preliminary steps to centralize views on cost sharing, but there are divergent views within the CRA as to how to approach this issue. One possible approach is to take the view that a Canadian company in fact would never allow an arm’s-length party to gain ownership of its most significant intangible property, and therefore every transaction that results in offshore ownership of significant IP should be recharacterized.
Other viewpoints would vary the treatment depending upon the particular fact situation and respect the form of the transaction but scrutinize the valuations used with a high degree of skepticism. It would not be surprising to see the CRA propose to recharacterize some of these transactions in the near future.

**Economic Downturn**

**BNA TAX MANAGEMENT:** What transfer pricing issues tend to arise in an economic downturn in Canada?

**FORTIER:** The down economy will generate many thorny issues. Some of the most difficult will be ‘loss importation,’ conversations around plant closings (both closure costs and compensation for transfer of intangible assets), and distributor losses.

One of the not-so-obvious implications is that a significant swing in the economy is likely to be viewed by the CRA as a ‘material change’ in the underlying facts and therefore taxpayers should revisit and revise their transfer pricing policies and documentation, not just update their comparable sets.

**BNA TAX MANAGEMENT:** One practitioner has said the recent economic downturn likely will cause a shift in the normal arguments between the CRA and practitioners. During good times, he said, it is common for taxpayers to argue the distributor should earn no more than the taxpayer to argue that argument against taxpayers—that is, to argue that because the distributor bears little risk, it is entitled to a year-end adjustment to give its distributors a profit and therefore foreign tax authorities may well take issue with this approach depending on the facts.

One of the additional difficulties for the next few years is that the comparables sets used each year by necessity lag the taxation year at the time the taxpayer prepares its documentation. So at least initially, relatively healthy 2008 results will get used to benchmark 2009 disasters. As the economy continues in a downturn, the comparables sets will begin to reflect the business distress, and that will make the whole thing more interesting.

There may be more situations where we will advise the taxpayer under audit to update its comp sets to the year in question to illustrate that the issues were prevalent throughout its industry. One can foresee situations where a taxpayer makes a year-end adjustment ‘to get within the range,’ but when the other tax authority audits the year using the actual comparables for that year, the actual range is much lower and the distributor is in fact above the range as a result of the adjustment. The other tax authority then will certainly reassess.

Dealing with these issues will be very interesting. Under these conditions, taxpayers who have robust business plans and budgets, properly documented transfer pricing policies, and can explain to their advisors why the losses arose and what their plans are to deal with them, will give their advisers the raw material we need to deal effectively with the CRA. Dealing with advance pricing agreements also will be interesting as the overall profitability on which the APA was built erodes.

**Stock Options**

**BNA TAX MANAGEMENT:** At the American Bar Association tax section meeting in September of 2007, you said the conflict over the U.S. and Canadian treatment of stock options had not yet made its way into competent authority cases at the time (16 Transfer Pricing Report 482, 10/18/07).

**FORTIER:** Has that changed?

The scenario given at the conference was that of a U.S. parent providing a service to a Canadian subsidiary and seeking a deduction for stock option compensation when the service was appropriately charged at cost—or at cost with some small plus—and the company has stock options that affect the cost base as viewed by the Internal Revenue Service. In this situation, would Canada admit to that as a cost? How have such cases typically been resolved in competent authority?

**FORTIER:** CRA International Audit has continued to take the position that paragraph 7(3)(b) of the Income Tax Act applies when stock option costs are allocated or charged to a Canadian company. The IRS since 2007 very clearly has required stock option costs to form part of the cost base that is allocated as part of a management cost allocation. The first cases are starting to come before the Competent Authority and also the APA Program.

This is an example of divergent positions that can’t easily be reconciled. If a stock option cost is incurred di-
rectly by a Canadian company, it is clearly not deductible by virtue of a clear statutory provision. One argument for indirect stock option costs has always been that when various cost elements including option costs are melded into a charge for management services rendered, the underlying costs become a service fee, and that you should not look through to the underlying costs, any more than you would look at the underlying costs when you receive a bill for professional services from your advisers, such as my firm Deloitte.

Under this approach the taxpayer and tax authorities by necessity on audit must look at the value of the service rather than the underlying costs. Auditors should ask the question, ‘Does the value of the service support the charge made?’

One of the issues the CRA has faced with management cost allocations on many occasions is that some of the stock option costs allocated have been extremely large. It is rather unlikely an arm’s-length party would agree to pay the kind of billing rates implied when some of the more enormous stock option benefits are included in the base. So one possible resolution of this issue will be for the CRA to limit the quantum of stock option costs bundled in a service fee to a ‘reasonable’ amount rather than taking an all-or-nothing approach. If the issue is valuation of the service, then this is an issue that could go to arbitration. By contrast, the deductibility of a stock option charge per se is a matter of clear Canadian law and is not susceptible to resolution by arbitration.

Form T106

**BNA TAX MANAGEMENT:** Can you explain the changes to Form T106 as they relate to transfer pricing? Why did the CRA believe changes were needed?

**FORTIER:** Form T106 is one of the CRA’s prime risk assessment tools and is used to select taxpayers of interest for audit. The CRA has recognized that financial products are a key area of concern, and as a result there is an increased focus at the agency on financial products. Anecdotally, it seems to the CRA that when these financial products give rise to losses, the losses somehow always stay in Canada, but when profits arise they are often earned offshore.

The CRA has taken a number of steps to start to address this concern. First, it formed a special group in Ottawa to gear up to be able to deal effectively with the technical issues involved. Without this expertise, the CRA found it difficult to deal effectively with these transactions. This group is developing an in-depth understanding of the products and the issues they raise. Typically in the past, when dealing with financial products, the only issues considered by CRA auditors were whether the results of the transactions were on the capital or the income account. CRA auditors are now focusing on the use of the financial products to shift income outside Canada.

Second, the CRA identified the need to change Form T106. In fact, it was the field audit staff responsible for the audit of financial institutions that pointed out the existing Form T106 did not provide enough information to carry out an appropriate risk assessment and efficiently identify the issues of the financial products of a particular financial institution. The new form should enable the audit teams to improve their risk assessments and efficiently identify areas of concern for in-depth audit. Taxpayers can expect to see significant action on the audit front in the near future.

**Staff Levels**

**BNA TAX MANAGEMENT:** Recent statistics on the number of mutual agreement procedure cases concluded show a decline—something Patricia Spence, director of the Competent Authority Services Division, attributed to the number of new hires who were not yet fully trained (17 Transfer Pricing Report 413, 9/25/08).

Do you expect these numbers will start to climb again next year? Is the CASD fully staffed currently, as far as you know?

**FORTIER:** International tax has been a focal point for the CRA in recent years and the level of resources in the field program has increased substantially since the 2005 Federal Budget. Staffing levels in both the International Tax Division and in CASD in headquarters have not increased proportionately. We can expect to see more staff increases in both the international tax and the competent authority group in the future. The ramping up of the number of staff on the enforcement side will lead to even more disputes and more taxpayer demand for APAs.

The FIN 48 rules in the United States will also continue to drive an increase in number of APAs initiated by taxpayers to gain tax provision certainty. Moreover, with the advent of arbitration in the new Canada-U.S. protocol, there will be hard deadlines that need to be met by the competent authorities to avoid arbitration, adding still more pressures on the competent authority group. I know Patricia Spence understands very well the practical need to find solutions and resolve cases, and is very cognizant of these additional pressures—I have had a close working relationship with Patricia since she joined the International and Large Business Directorate and I have every confidence that under her leadership the group will move forward with the necessary practical steps to resolve cases on a timely, efficient basis.

At the same time, I would echo the need for the CRA to provide CASD with the necessary resources to meet these upcoming increased service needs.

**Services**

**BNA TAX MANAGEMENT:** A Dec. 19, 2008, letter from the ABA tax section written in response to an April 2008 consultation paper by the Advisory Panel on Canada’s System of International Taxation said the CRA ‘commonly disallows, in whole or in large part, the payment of reasonable services fees from Canadian service-recipients to U.S. service providers,’ leaving the service recipient with the practical burden of proving with significant detail what service was received, what the benefit was, and the appropriate amount of compensation (17 Transfer Pricing Report 590, 1/8/09).

Is this an accurate description of CRA practice, and can you comment?

**FORTIER:** On this one, beauty is largely in the eye of the beholder. From the CRA’s point of view, the agency generally has taken a reasonable, practical approach provided the taxpayer has demonstrated up front that the benefit test is met and has documented that fact. I would say that just as many cases have been resolved on a favorable basis as have been disputed.
BNA TAX MANAGEMENT: Asked about the U.S. temporary services rules issued in 2006, a practitioner said the United States takes a more prescriptive approach than Canada and also said that while the CRA does not object to allocation keys per se, unless a good correlation exists between sales and indirect costs, keys based on a percentage of sales or head count are not appropriate because Canada could be too easily whipsawed. Is this still the prevailing view? Can you elaborate?

FORTIER: The CRA does insist that the charge be supported with some factual indication of the tie of the service to the Canadian organization. If the taxpayer can’t demonstrate any benefit to the Canadian organization, an arm’s-length party would not pay. The CRA has seen many cases where there is no indication that there was any significant benefit to the Canadian organization from the services costs being charged.

By the way, it is common for the CRA to see studies prepared in other countries that spend a great deal of effort supporting a markup, but make virtually no attempt to demonstrate that there actually was a service that benefited the Canadian organization and therefore whether there was anything an arm’s-length party would actually pay for in the first place.

Regarding the second part to the question, there has been no change in the CRA’s approach since 2005 prior to the new U.S. regulations. The CRA commonly accepts both sales and head count as reasonable allocation keys. CRA policy would be to use whatever allocation key best matches the particular benefit. Overall, I would say the key for services charges is to document the service in the appropriate manner up front, before the CRA starts to audit it, with the appropriate level of factual support. Most Canadian advisers have become very sensitive to the type of support that minimizes disputes with the CRA on this, particularly concerning the benefit test.

Aggregation

BNA TAX MANAGEMENT: The ABA also noted that U.S. and Canadian published guidance recognizes that transactions should be aggregated if they are so linked that they cannot be evaluated adequately on a separate basis, but said that in practice, ‘there is a recurring audit issue in Canada regarding whether a transaction is more appropriately characterized as a transfer of services or intangibles, each with different pricing consequences.’ The ABA also said the CRA ‘appears to be moving further from OECD practice’ in issuing guidance indicating that ‘even if bundled transactions are derived by commercial considerations, each property and service should withstand individual testing.’

First, does this refer to TPM-06 of May 2005? Second, do you agree with this characterization? What do you see as the key differences, if they exist, between the U.S. and Canadian positions on aggregation—in practice if not in public guidance?

FORTIER: I think the practical differences are not that significant, based on my discussions with my IRS counterparts. The CRA does have a focus on royalties. It wants to ensure that the amount of royalty paid is justified by the value of the specific benefits provided under the license or other royalty agreement. In an arm’s-length situation, parties would be unlikely to agree on a royalty rate without discussing the specific services or entitlements to be provided and what they are worth, either in aggregate or as a sum of the worth of each separate entitlement.

The CRA’s main concern with respect to aggregation is to ensure that the total amount paid can be justified on an arm’s-length basis. There is also a secondary concern as to whether the taxpayer is attempting to take a payment that would be subject to nonresident tax, and, by bundling it with other payments, convert it to a payment that avoids nonresident tax.

In some cases the parent company is charging both a royalty and service fees. It may appear to the CRA that the parent company is justifying both the royalty and the service charge with the same factual support, and of course the CRA does not want the Canadian organization to pay twice for the same service.

The aggregation issue in practice becomes most contentious where a taxpayer seeks to convert a service fee into a royalty by bundling the service fee into the package of other entitlements covered by the royalty. The taxpayer may no longer maintain detailed documentation of the specific services and benefits to support the royalty charged, certainly not the same detailed documentation they should keep if they were charging a specific services fee. These cases are very difficult and are very fact sensitive.

It may be very difficult to find comparables for either approach—no comparables for each of the components if the transaction were unbundled and no reliable comparables for the aggregated transaction. If comparables can be found for each element of the unbundled transaction but not for the aggregated transaction, then the CRA will use the information that is available in order to build up a value for the aggregated transaction. This has been characterized by some as ‘not respecting the form of the transaction,’ but it really isn’t the same thing.

Given the difficulty and fact-sensitive nature of the issues, often the better approach is to get an APA. A particular fact pattern may be very difficult to resolve on audit whereas the APA Program will find solutions.

Collection

BNA TAX MANAGEMENT: There have been complaints by Canadian taxpayers as well as in the ABA letter about the CRA’s practice of demanding 50 percent of the assessed amount up front even in double tax disputes. How does this policy affect the dynamics of negotiations? Can you elaborate?

FORTIER: This is a common misunderstanding. The requirement to pay 50 percent of the tax owing is not a CRA policy or practice. It is a specific requirement in the law. Administratively, the Debt Management Division may allow the posting of security rather than require immediate payment.

The other common misconception is that the payment of the tax could affect the dynamics of negotiations. There is no such effect, at least in Canada. The Canadian parties involved in the negotiations don’t care about payment of the tax, that’s not their department. And in Canada, unlike some other countries, the payment of tax is completely divorced from the dispute procedures.

Incidentally, Canada pays refund interest at a rate 200 basis points higher than Canada’s 90-day T-bill rate (the average rate for the first month of the preceding quarter). Many advisers recommend that their clients pay the full assessed amount up front in order to ben-
efit from the high interest rate. As a risk-free interest rate it’s tough to beat as an investment. And since Canada charges interest at 400 basis points higher than the 90-day T-bill rate, and then compounds the interest daily, and since such interest is not a deductible expense for tax purposes, most taxpayers would be very well advised to pay the full amount immediately both to minimize the risk of large amounts of nondeductible interest and to earn high interest rates on the amount when it is subsequently refunded.

In December 2008, an independent Advisory Panel on Canada’s System of International Taxation recommended to the government that the law with respect to payment of tax and deficiency interest be amended to be different for transfer pricing cases, since the taxpayer has already paid tax to one tax authority on the income (17 Transfer Pricing Report 638, 12/18/08).

The government has indicated that it will study the recommendations.

APAs

BNA TAX MANAGEMENT: The ABA letter asserted that Canada’s Advance Pricing Agreement program might be in jeopardy and criticized the CRA practice of recovering all out-of-pocket expenses rather than charging a flat user fee. What is your feeling about this policy, and how does it affect negotiations with tax authorities having a different policy? Is the policy likely to change?

FORTIER: There is some logic to the argument that the location of the taxpayer in Canada should not affect the cost of obtaining an APA (and that the location of the parent company should not affect it either). Perhaps that is a policy the CRA should revisit. But it is difficult to understand why someone who thinks the APA Program is the right way for them to approach their transfer prices would let their decision be affected by an IRS flat fee of US$50,000 versus out-of-pockets.

Arbitration

BNA TAX MANAGEMENT: When do you expect the first case to go forward under the arbitration provision of the new U.S.-Canada protocol, and what are the largest issues to be worked out?

FORTIER: The goal of the competent authority group is to resolve all the disputes presented to it if possible. Accordingly, it can be expected that only very difficult issues and cases will go to arbitration. The arbitration procedures are currently being developed. Responsibility with the CRA for agreeing the procedures rests with the Legislative Policy Division, which is completely separate from the international tax and competent authority groups, so I can’t really comment on the probable timing. But I do know based on meetings I have attended that this is a major priority for all parties involved, so I expect it will proceed fairly soon.

BNA TAX MANAGEMENT: To what degree do you think a U.S.-Canada agreement on arbitration will resemble the recent agreement between the United States and Germany, which, among other things, provided that no current or recent government officials should serve as arbitrators and also provided for separate treatment of multiple issues within a case?

FORTIER: It is probably reasonable to expect the U.S. negotiators would like to maintain one consistent set of procedures for every arbitration clause in their many treaties. So they probably will press for procedures similar to the German agreement. In my personal view, separate treatment of multiple issues within a case makes sense, and it conforms to the way International Audit deals with an audit which has multiple issues. If there are three or four completely separate issues on an audit, International Audit tries to resolve each issue separately on its own merits. Of course, if the issues are sufficiently interrelated what initially appears to be multiple issues may be one larger issue.

I am looking forward to the interesting strategy considerations that will arise with the existence of the new arbitration alternative—when to pursue an APA, when to use competent authority, and when to opt to move on to arbitration. These strategy decisions will become critical.

Areas of Dispute

BNA TAX MANAGEMENT: The original 2005 memorandum of understanding between the United States and Canada listed several common areas of dispute, including:

- arm’s-length compensation for consignment manufacturing operations;
- whether a business is integrated to the point where a profit split method is appropriate;
- the presence of nonroutine intangible assets and the determination of an arm’s-length value;
- whether a permanent establishment exists and the amount of profit to be attributed to the entity;
- whether a transaction is properly characterized as a service or a license of intangibles; and
- the amount of compensation, if any, upon either the closure or relocation of a business and the allocation of associated closing costs (14 Transfer Pricing Report 91, 6/8/05).

Are all of these areas still subject to disagreement between the competent authorities? Has any progress been made on reaching consensus since the MOU was executed?

FORTIER: The issues listed in the original 2005 memorandum of understanding are great examples of difficult issues that both the international audit staff and the competent authorities struggle to resolve. These are the most controversial issues, and there is a reason for that. They are difficult and challenging not only from the perspective of the CRA and the IRS but also from the perspective of other tax authorities.

It was decided by both tax authorities that the MOU approach would not result in general solutions to such issues. The problem with attempting to develop a process for dealing with each of these issues is that the fact patterns all differ to one degree or another. Adopting too prescriptive an approach in dealing with these issues could cause more problems than it would solve and restrict the ability of the competent authorities to resolve double tax. Reasonable people are working on these issues, and they know that eventually they have to resolve them. Resolution of cases involving some of these specific issues will probably come through the new arbitration procedure.

As advisers we need to work each case appropriately with each client to resolve such issues in the most practical, most effective manner for the specific fact situation, rather than taking a one-size-fits-all approach to any particular issue such as assuming that the issue will necessarily end up in arbitration.
Accomplishments

**BNA TAX MANAGEMENT:** What are some of the accomplishments you are particularly proud of during your CRA career?

**FORTIER:** During my 23 years at the CRA, particularly my two years as Director of International Tax and six years as Manager International Advisory Services, I worked hard with the taxpayer community, the TEI community, and the adviser community to create a better, more involved relationship with those stakeholders. And I like to think we found practical, effective ways to reach resolution of very difficult audit issues in ways that all the parties perceived to be fair, if not perfect.

As a member and later chair of the Transfer Pricing Review Committee, which considers whether to impose penalties on taxpayers with significant transfer pricing adjustments or whether to approve recharacterization of transactions, my colleagues and I developed an approach to these issues that I believe will continue to serve the TPRC well as it addresses future cases. I worked hard with our team of 465 international tax auditors and enjoyed my interactions with them.

The CRA has a group of bright, dedicated individuals who want to reach fair, reasonable resolutions to complex issues if the taxpayer will work with them in the appropriate way and engage them in a constructive process rather than a confrontational approach. Not that the CRA doesn’t have a few challenges—rapid growth in the program has created challenges in developing and retaining qualified auditors and it is difficult politically being the tax auditor in a down economy.

Policy development has been a weak point with the program. My greatest disappointment is that under my watch we were unable to issue more formal guidance to clients and auditors on many contentious issues. I am confident that my replacement, Jennifer Ryan, will be up to those challenges. But I really do look forward to working with my former colleagues again to resolve taxpayers’ issues, only from the other side of the table.

Predictions

**BNA TAX MANAGEMENT:** What do you see coming down the pike from the CRA in the next 12 months?

**FORTIER:** Some predictions are easy. There will be greater international audit activity, and many taxpayers will feel that they are seeing the headlight of the freight train. Realignment of the Large File Program and improvements in risk assessment will result in some very significant businesses in Canada that have never had an intensive transfer pricing audit getting their first ‘opportunity’ in the near future.

In fiscal 2006-07, the International and Large Business Directorate was formed and that brought together the international tax, large business, and aggressive tax planning areas, first under the leadership of Fred O’Riordan and presently under Jean-Jacques Lefebvre. Through the efforts of both gentlemen and the staff the three areas have learned to work better together and we can expect to see the result of this cooperation in terms of more coordinated audit activity. Rather than the ‘stove pipe’ approach that traditionally existed, corporations can expect to see specialized international tax and aggressive tax planning auditors working closely together to decide the best approach to challenge transactions they find offensive. This audit activity will also extend to the personal tax affairs of significant shareholders.

As all the new resources that have been added in the past few years get more experience, their ability to conduct more insightful and rigorous audits will be felt. The projected federal deficits will put a greater emphasis on the CRA’s role in protecting Canada’s tax base. Auditors will be on the lookout for techniques used to import losses and to export valuable intangibles. Businesses will need to restructure to survive in these difficult economic times and the CRA will be on guard to ensure that proper recognition is given to the effect of these restructurings.

As I stated in answer to your question on the T106, the CRA has made a significant investment in training staff in financial products and a group was formed in the International Tax Division to develop this expertise. This group also provides support to the field offices conducting audits of banks and insurance companies.

I expect these sectors to experience more detailed audits of their international transactions. This specialized approach will be expanded to other areas. Some natural specialization has developed in the oil and gas and pharmaceutical area and I expect this to be formalized.

The Organization for Economic Cooperation and Development has been working very hard on a number of initiatives, which should soon be reflected in enforcement activity at each member country. In particular, the eventual result of the OECD initiative on business restructuring will find its way into Canadian enforcement activity. In my view, Canadian taxpayers are generally becoming pretty good at documenting their transfer prices. With these difficult economic times, however, they will need to rethink that documentation to reflect new business realities. The tax consequences of any restructuring transactions undertaken must be carefully considered and documented.