FINAL SECTION 482 SERVICES REGULATIONS: CANADIAN IMPLICATIONS*

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OVERVIEW AND INTRODUCTION

In principle, there ought to have been no need to write this paper. The reasons are threefold.

First, the *principle* comprising the tax rule that governs cross-border intercompany transactions in both Canada and the United States is the same—namely, intercompany prices are to be governed by the arm's-length standard. In the United States, this is expressed as part of the regulations pursuant to section 482 of the Internal Revenue Code.[1] In particular, reg. section 1.482-1(b)(1) states, in part:

> (b) *Scope and Purpose*.—(1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standards of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. . . . The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.[2]

* This paper is based on and contains substantially the same content (with certain updates and modifications) as Nathan Boidman, "The Implications in and for Canada of the Final Section 482 Services Regulations" (November-December 2009) 61:6 *The Tax Executive* 445-47, and is provided here with the permission of the Tax Executives Institute.

[1] The Internal Revenue Code, 1986, as amended (herein referred to as "the "Code").

[2] This foundation "rule" in the regs, however, had taken something of a beating in the decision by the US Court of Appeals in *Xilinx Inc. v. Comr.*, 567 F.3d 482 (9th Cir. 2009), (which reversed the Tax Court decision in *Xilinx Inc. et al. v. Commissioner*, 125 TC 37 (2005)). But the taxpayer then successfully appealed for a rehearing: *Xilinx Inc. v. Comr. 3* (9th Cir., nos. 06-74246 and 06-74269), petition for rehearing or rehearing en banc filed August 12, 2009. In the 2009 decision, the court decided that a mechanical rule in the regs overrode the basic arm's-length standard otherwise required by Code section 482. On March 22, 2010, the court reversed itself (see the case numbers above), restoring the hegemony of the arm's-length principle. See also note 7, infra.

Canada's standard is baked into the basic intercompany transfer-pricing rule of paragraph 247(2)(a) of the Income Tax Act,[3] which states:

> (2) **Transfer pricing adjustment**—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
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> > (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 . . .[4]
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> any amounts that, but for this section and section 245, would be determined for the purposes of the 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,
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> > (c) where only paragraph (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 . . .[5]

Second, credible recognition has been given to the hegemony of facts and circumstances, and examination thereof, in applying the arm's-length standard principle.

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[3] Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act" or "ITA").

[4] Like the US notion of arm's-length pricing, the rules of section 247 apply only to certain affiliated parties, and in Canada it is those who "do not deal at arm's length." See subsection 251(1) of the Act, which deems "related" persons (that is, parent and subsidiary or sister corporations) to not deal at arm's length, and leaves open the possibility that, based on all of the facts and circumstances, unrelated parties also do not deal at arm's length. The concept of related persons is based on the notion of legal control: see *Interpretation Bulletin* IT-64R4 (Consolidated), "Corporations: Association and Control"; *Buckerfield's Ltd. v. Minister of Revenue*, 64 DTC 5301 (Ex. Ct.); and *Duha Printers (Western) Ltd. v. The Queen*, 98 DTC 6334 (SCC). With respect to the second notion (factual non-arm's-length) for the high-water mark on this concept, see the Supreme Court in *Swiss Bank Corp. v. Minister of National Revenue*, 72 DTC 6471 (SCC), which appears to have chosen among competing theories (controlling mind, acting in concert, de facto control, and separate economic interests) the singularly economic-based concept of whether or not the parties to the transactions had separate economic interests with respect to the transaction, so as to provide a market discipline for proper pricing. In transfer pricing, this was found where two 50 percent shareholders of a corporation each charged equal fees for rendering services—that is, fees proportionate to the shareholdings: see *Windsor Plastic Products Limited v. The Queen*, 87 DTC 7171 (FCTD). However, the courts still often revert to the other concepts (controlling mind, etc.). See *William J. McNichol et al. v. The Queen*, 97 DTC 111 (TCC); *MNR v. Sheldon's Engineering Ltd.*, 55 DTC 1110 (SCC); *MNR v. T.R. Merritt Estate*, 69 DTC 5159 (SCC); and *Noranda Mines v. The Queen*, 87 DTC 379 (TCC).

[5] This applies to any transaction or event, including the usual: sale of goods, provision of services, and licensing or rental of intangibles or tangibles, although the requirement with respect to intercompany financings is less clear (see below). For an overview of the Canadian approach to transfer pricing, see inter alia, Nathan Boidman, "Recent Developments on Canada Transfer Pricing" (May-June 2003) 55:3 *The Tax Executive* 208.

This was seen some 47 years ago in a 1962 decision of the Tax Review Board of Canada in *Hofert*[6] (involving sales of Christmas trees by a Canadian subsidiary to its US parent), where the board stated that proper pricing is simply a matter of the particular facts and circumstances of the case. Some 30 years later, in September 1992, the US Treasury International Tax Counsel (ITC) at the time, James Mogle, in announcing that the Treasury and Service were withdrawing from the proposed section 482 regulations (which had been issued in January of that year) the "comparable price method" (CPM) as a mandatory method, was quoted as follows:

> Mogle said he has "a few ideas" as to what might replace CPI [comparable profit interval], but gave no details. The right answer, he believes, is "a great deal more flexibility and broad principles from which you can then go to a *fact and circumstances analysis*."[7] [Emphasis added.]

Then there were similar sentiments expressed in the past year. In *General Electric Capital of Canada Inc. v. The Queen*,[8] discussed below, Mr. Justice Robert Hogan wrote (at paragraph 273): "In the final analysis, transfer pricing is largely a question of fact and circumstances coupled with a high dose of common sense." And US Treasury assistant ITC David Ernick is reported to have stated with respect to the September 2009 OECD draft rewrite of chapters I-III of the transfer-pricing guidelines,[9] in respect of the proposal that there be a new "natural hierarchy of methods," that "the most reliable methods would depend on the facts of the case."[10]

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6 *J. Hofert Limited v. MNR* (1962), 62 DTC 50 (TRB).

7 See "Final Section 482 Rules Likely This Year, Will Not Require Use of CPI Test, Mogle says," *BNA Daily Tax Report* no. 184, September 22, 1992, G-1. Perhaps that is what the US Tax Court had in mind in the 1976 decision in *E.I. DuPont de Nemours & Co. v. United States*, 608 F.2d 445 (Ct. Cl. 1979), cert. denied 445 US 962 (1980), adopting 7801 USTC ¶9633 (Ct. Cl. Trial J. 1978). The court in *DuPont* departed from the purported order of pricing priorities in the 1968 section 482 regulations and rejected the use of the resale method for a Swiss marketing sub, and instead imported the Berry ratio as an "other or fourth method" of testing the particular facts in that case. Although in *Xilinx* (supra note 2) the Ninth Circuit initially seemed to see the regulations as having mechanical-like effects, the court then reversed itself. And in that respect, the notion that US courts might not necessarily slavishly follow mechanical approaches in the section 482 regulations, which tend to depart from or conflict with the essential nature of the underlying arm's-length principle, is also reflected by the decision in early December 2009 in *Veritas Software Corporation & Subsidiaries, et al. (also referred to as Symantec Corporation) v. Commissioner*, 133 TC no. 14 (filed December 10, 2009). In that decision, on the issue of the proper pricing of "buy-in" obligations under a cost-sharing arrangement, the Tax Court rejected government theories contained in the regulations which the court considered to invalidly (arbitrarily, capriciously, and unreasonably) reject and override pricing that, in the court's view, accorded with third-party comparables. The US government did not appeal this decision, although it announced (in an "Announcement on Decision" (AOD)) on November 10, 2010 that it is of the view that the Tax Court was wrong on both the facts and the law. See Tamu N. Wright, "Practitioners Say Veritas AOD Portends More Losses for IRS in Court Cases Involving Intangibles Migration" (December 2, 2010) 19:15 *Tax Management Transfer Pricing Report* 837.

8 *General Electric Capital Canada Inc. v. The Queen*, 2011 DTC 5011 (FCA).

9 See note 18 and related text, infra.

10 See "Today's Update—OECD Draft Proposes Natural Hierarchy of Transfer Pricing Methods, Ernick Says," *BNA Daily Tax RealTime*, March 31, 2010.

These therefore are statements that the arm's-length principle is a matter to be determined by a court according to the particular facts, and thus is not the object of any specific "rules" in the determination of an arm's-length price.[11]

Unfortunately, some 41 years ago, in 1968, the United States started to ignore, overlook, and/or compromise this fact of legal life with the issue of the first set of regulations under Code section 482. The problem started to spread to other parts

[11] The latter reality is relevant to the fact that in Canada there has been only one court decision (*Hofert*, supra note 6) respecting a straightforward transfer-pricing issue between the Canadian unit of a multinational and a unit based in another high-tax jurisdiction such as the United States. (*Central Canada Forest Products Ltd. v. MNR*, 52 DTC 359 (ITAB), also involving Canada and the United States, is of limited value.) And it seems that there has been no such decision by a US court. All other Canadian and US decisions seem to have involved, in one way or another, tax-flavoured transfer-pricing arrangements generally involving units of the multinational operating in less than a high-tax environment. For example, see the 2008 decision of the Tax Court of Canada in *GlaxoSmithKline Inc. v. The Queen*, 2008 TCC 324; 2008 DTC 3957, which saw the court uphold most of the CRA's downward adjustments of prices paid by Glaxo Canada to a Swiss affiliate for the pharmaceutical ingredient for Zantac, but with the taxpayer successfully appealing a critical finding of the TCC (*GlaxoSmithKline Inc. v. Canada*, 2010 FCA 201). In *Glaxo*, a Canadian subsidiary of the Glaxo group procured the various intangibles and operating methods, etc., it required to manufacture and sell the drug Zantac by way of a licence with the UK parent, and purchased the active ingredient required to make Zantac from a sister Swiss corporation. The Federal Court of Appeal reversed the TCC's conclusion, that the licence with the UK parent should not be taken into account in determining whether the price paid for the active ingredient met the arm's-length pricing standard. The Federal Court of Appeal agreed that the terms and pricing of the licensing agreement were relevant in assessing the appropriateness of the price that the Canadian subsidiary paid to its Swiss sister company for the active ingredient. The Court of Appeal sent the case back to the lower court to rehear facts and arguments based on facts—but now including the licence. US observers may wish to compare this litigation with the US-Glaxo settlement: "GlaxoSmithKline To Pay $3.4 Billion To Settle Largest Dispute in IRS History," *Daily Tax Report* no. 176, September 12, 2006: "The Internal Revenue Service and pharmaceutical giant GlaxoSmithKline Holdings (Americas) Inc. announced Sept. 11 that the parties have resolved a transfer-pricing dispute dating back 17 years, with Glaxo paying the service $3.4 billion for 1989-2000 (*GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner*, T.C., No. 5750-04, *settlement announced* 9/11/06)." See also "The Transfer Pricing Tempest—Implications of GlaxoSmithKline's Mammoth IRS Settlement," *Stafford Legal Teleconference Presentations*, October 24, 2006, speakers Brian E. Andreoli, Nathan Boidman, Michel Collet, Alan W. Granwell, Charles S. Triplett, and John P. Warner. Other Canadian court decisions respecting transfer pricing have involved offshore/low-tax jurisdiction elements: see *Indalex Limited v. The Queen*, 86 DTC 6039 (FCTD); 88 DTC 6053 (FCA); *Dominion Bridge Co. Ltd. v. The Queen*, 75 DTC 5150 (FCTD); 77 DTC 5367 (FCA); *Spur Oil v. The Queen*, 80 DTC 6105 (FCTD); 81 DTC 5168 (FCA); and *Irving Oil Limited v. The Queen*, 88 DTC 6138 (FCTD); 91 DTC 5106 (FCA). There was another decision involving a Canada-US multinational, not in the context of tax law but in a minority shareholder oppression claim, in *Ford Motor Co. of Canada Ltd. v. Ontario Municipal Employees Retirement Board*, 2004 DTC 6224 (ON SCJ); *Ford Motor Co. of Canada Ltd. v. Ontario Municipal Employees Retirement Board and Ontario Municipal Employees Retirement Board v. Ford Motor Co. of Canada Ltd.* (January 6, 2006), docket nos. C41312 and C41450 (ONCA); aff'd. and dismissed in part. For a discussion, see Tamu N. Wright, "Ontario Appeal Court Affirms Determination Ford's Transfer Pricing System Was Improper" (February 1, 2006) 14:19 *BNA Tax Management Transfer Pricing Report*.

of the world with the OECD's 1979 issue of its own set of "guidelines,"[12] which in reality were more or less a knockoff of the 1968 US regs. (Query whether OECD ever paid royalties to the United States for use of its ideas.)

Third, and turning now to the object of this paper, *in principle*, aren't intercompany services basically susceptible to reasonably straightforward and uncontroversial treatment under the arm's-length standard (in contrast to intercompany sales of proprietary products or intercompany licensing of proprietary intangibles) as transactions that do not necessarily involve high-value intangibles (the high priest and sacred cow of intercompany transactions and the controversies that swirl today around this area)?

However, notwithstanding the latter factors, there is a need to write this paper. The reasons are fivefold.

First (at least from the standpoint of a lawyer), international intercompany transfer pricing has increasingly become distorted by a distinct de-emphasis of the arm's-length standard *as a rule of law*, and instead emphasis of it as a type of mechanical ("Meccano" set) apparatus to be sliced and diced and dealt with in mechanical-like modules, as though (in the words of the Tax Review Board in Canada, or James Mogle in the United States) varying facts and circumstances never existed. As noted, this really started in 1968, but picked up steam some 20 years later, with the issue by the US Treasury and the IRS of the *Section 482 White Paper on Intercompany Pricing*,[13] written pursuant to the enactment in 1986 of the "superroyalty" add-on to Code section 482.[14] Examination of that voluminous document shows a laboratory-like approach to dealing with the facts and circumstances, although it was with some substantial relief that one came to that part of the report which concluded that where more than one member of a group owned high-valued intangibles, the laboratory-like allocation method suggested by the white paper came down to a profit split, which in reality is nothing but a judgment call.[15]

After that, the flurry of activity by the United States and other countries (whose efforts mainly have been galvanized by the work of the OECD) has more and more led to a disconnect between the essential nature of the arm's-length standard and the mechanical-like way in which legislators and administrators believe that they can deal with it. This unfortunate, perhaps even debilitating, factor permeates all

[12] These guidelines were revised in 1995. See Organisation for Economic Co-operation and Development (OECD), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995).

[13] United States, Department of the Treasury, *Section 482 White Paper on Intercompany Pricing*, in *Standard Federal Tax Reports* no. 53, extra ed. (Chicago: CCH, October 1988) (herein referred to as "the white paper").

[14] That add-on reads as follows: "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."

[15] Supra note 13, at 96-101.

developments in transfer pricing, including the new US services regs under Code section 482.[16] More, of course, on that below.

Second, and not only closely related to the first element, but perhaps the motivating factor thereof, is the almost paranoid view that tax administrators take of the activities of multinationals—the concern that transfer pricing is used as a sword, that seeks to manipulate prices in order to allocate profits in a fashion that reduces overall group tax. This leads to the constant and (in this writer's view) debilitating process of trying to either fine-tune or add radical elements to what at law is a principle that cannot be put into a nice, neat box. Therefore, we have the ongoing studies by OECD of "business restructuring"[17] and the "revelations" in September 2009 proposals to revise chapters I, II, and III of the OECD transfer-pricing guidelines.[18] The nexus noted earlier between OECD and US regs (including the lag time generally involved) has been vividly brought to mind by the essence of these OECD proposals, which would jettison the hegemony of "traditional" transactional methods over "profit-based" methods. The OECD's September 2009 release trumpeted how experience since 1995 indicates that there should no longer be a bias toward (or a presumption in favour of) "the traditional methods" (based on pricing each transaction) over the "transactional profit methods" (which, in this observer's view, are not really pricing methods at all but rather tax authority techniques for evaluating the extent to which the "arm's-length pricing" standard has been met). And as a result, the release states, there should be "a standard whereby the selected transfer pricing method should be the 'most appropriate method to the circumstances of the case.' " Isn't that the US 1994 "best-method" rule?[19]

Third, and another systemic factor more directly affecting the study in this paper, is the vivid contrast between the approaches of Canada and the United States to legislatively applying the arm's-length standard. For Canada, the matter is simple.

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16 Could it be said that this is implicitly acknowledged by the "business judgment" rule (see note 43, infra) in these rules?

17 Organisation for Economic Co-operation and Development, *Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment 19 September 2008 to 19 February 2009* (Paris: OECD, September 2008). The study has now been incorporated into the guidelines as chapter IX. See *OECD Newsletter*, July 23, 2010.

18 Organisation for Economic Co-operation and Development, "OECD Releases a Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines," September 9, 2009. The proposals were finalized on July 22, 2010. See *OECD Newsletter*, July 23, 2010.

19 In 1994, after eight years of arduous work, the United States revised the 1968 Code section 482 transfer-pricing "rules" (that is, regulations made under section 482), with, at their core, the so-called best-method rule. That means taxpayers should select and use the transfer-pricing method that is the most appropriate in the circumstances. Does that mean, without being told, that taxpayers would use the worst method or an inferior method? Or is that not a "blinding glimpse of the obvious"? (This expression is attributed to Ross Johnson, the Canadian prairie accountant who was president and CEO of RJR Nabisco at the time of its takeover by Kohlberg Kravis Roberts & Co., in the legendary book *Barbarians at the Gate: The Fall of RJR Nabisco* by Bryan Burrough and John Helyar (New York: Harper & Row, 1990), at 22.)

The law is the standard and nothing but the standard. (See paragraph 247(2)(a), quoted above.) There are no statutory regulations.[20] Jurisprudence on services has simply confirmed the notion that it's all a question of the facts and circumstances in a particular case.[21] There is a plethora of views, interpretations, and positions of the Canada Revenue Agency (CRA) on transfer pricing,[22] which simply do not make law.[23] And yet, notwithstanding the latter (and in a way somewhat surprisingly)[24] Canadian courts have suggested that the OECD materials (in particular, the OECD model tax convention and the OECD transfer-pricing guidelines) are sources that a court may take into account in dealing with the particular issue before it.[25]

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20 In Canada, regulations may be written by the government (and approved through "orders in council") when specifically provided for in the Act.

21 *Safety Boss Limited v. The Queen*, 2000 DTC 1767 (TCC). See note 34, infra.

22 The CRA administers section 247 as though the OECD transfer-pricing guidelines are part of Canadian law—which to some extent (see note 23, infra) has been expressed by Canadian courts. See the CRA's non-legally binding *Information Circular* 87-2R, "International Transfer Pricing," September 27, 1999 (herein referred to as "IC 87-2R" or the "circular"), which essentially is a regurgitation of the OECD transfer-pricing guidelines. (See also a series of "transfer-pricing memoranda," which began in 2003 as well as "technical interpretations" and rulings issued by the CRA.) Through IC 87-2R, the CRA seeks to impose on the Canadian tax system a "hierarchy" of "transfer-pricing methods" (see paragraph 49 et seq.), based on the OECD guidelines, which *ostensibly* differ from the "best-method"-based approach of the 1994 US Code section 482 regulations. (But see the OECD's September 9, 2009 release, supra note 18.) Both countries start with comparable uncontrolled prices (CUPs) (see paragraphs 64-69). The United States then quickly goes to profit-based methods (CPM), while the CRA advocates sticking with pre-1994 US-style *transaction-based methods* (see paragraphs 52 and 90). These are the resale method (see paragraphs 70-75) and the cost plus method (see paragraphs 76-89). Profit-based methods (profit comparisons in paragraphs 106-119 and profit splits in paragraphs 90-95) *only then* follow (see paragraphs 90-95). And the CRA prefers the OECD-spawned "transactional net margin method" (TNMM: see paragraphs 106-114) instead of its close cousin (parent?), the US CPM method, although IC 87-2R reluctantly concedes a role for CPM in appropriate cases (see paragraphs 114-115). Ironically, with respect to profit splits, the CRA advocates the 1988 US Treasury-IRS white paper approach (supra note 13) of basic arm's-length return allocation, followed by a split of remaining profits based on relative intangibles. (See paragraph 105 of IC 87-2R. For background, see Nathan Boidman, "The American Super Royalty Rule: A Canadian Perspective," in *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Canadian Tax Foundation, 1988), 44:1. For a Canadian perspective on the ensuing 1994 section 482 regs, see Nathan Boidman, "Canadian Perspective on the Final § 482 Regulations" (November 1994) 23:11 *Tax Management International Journal* 553.)

23 *A.W.C. Parsons et al. v. MNR*, 83 DTC 5329 (FCTD), per Cattanach J: "An Interpretation Bulletin is precisely what it is stated to be. It is nothing more than some departmental officer's interpretation of subsections 159(2) and (3) of the Act and has no legal effect whatsoever other than it is directed to employees of the Department responsible for assessing taxpayers who will follow it without question. The limit of their discretion is to do what they are told."

24 In Canada, international agreements affecting taxation (for example, "tax treaties") require parliamentary enactment in order to take effect. Why should OECD pronouncements be any different?

25 In the recent decision of the Tax Court of Canada in *Glaxo*, supra note 11, Rip CJ can be seen to have followed the guidelines as though they were baked statutorily into the Canadian Income Tax Act. See also *General Electric Capital Canada*, supra note 8.

The United States, on the other hand, has had "regulations" since 1968, and now with respect to "services" there are the new July 2009 final regulations, which are voluminous (running to 158 pages) and detailed.[26] This paper focuses on the impact of those rules in and on Canada, and in the context that, at the other end of the telescope, in Canada, *there are no rules* (other than what a Canadian court might decide to read in from the OECD).

Fourth, now turning specifically to the question at hand, there is the difficulty that the notion of "services" as used in a plain, generic, commercial context—that is, one person renders a service to another—in fact masks and belies the range of factors and issues that may arise under that term. In particular, this area of intercompany relations (as dealt with in the new regs and that are addressed by the CRA in its writings and by the OECD in its musings) extend far beyond the straight notion of a consenting person with the ability to render a service, rendering that to another consenting person with ability to contract and receive and acquire the service.

Included, as well, are the following factors and elements that give this area much of its difficulty, complexity and controversy. There is a question of the nature of the business deal and relationship where the arrangement isn't simply a service by one person to another, or one member of the group to another, but rather a de facto and/or legal sharing of an employee. This may also raise the difficult question of "secondments," the boundaries and full implications of which may be less than clear under contract and/or employment law, quite apart from the issues arising under tax law.[27] Separately, there is the almost totally different question (in relation to the notion of intercompany services) of whether a particular activity carried out by one corporation, generally a parent, is intended and/or (whether or not intended) does operate to provide a service (with a monetary value) to another member, say a subsidiary—or whether instead the activity is carried out for the purposes and benefit of the parent. This, of course, is the issue of "shareholder" or stewardship or custodial activities. An added difficulty, and closer to the core of issues over pricing, arises where (in the context of either the sharing of an employee or the rendering of a service), the base for an intercompany payment is "cost," whether simple "cost" or cost plus a markup. The determination of "cost" can be contentious and controversial (as seen in the separate "cost-sharing" case of *Xilinx*[28]). Then there is the question of whether certain arrangements can be seen as constituting the provision of the service or something totally different—the best example perhaps being

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[26] Final US (Department of the Treasury and IRS) Regulations on Intercompany Services, TD 9456, 74 Fed. Reg. 38830, August 4, 2009.

[27] The fifth protocol makes changes to article XV of the Canada-US treaty that may exacerbate the issues. The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007.

[28] Supra note 2.

intercompany guarantees. In particular, proposed legislation in Canada and the fact that the final services regs punted on this question (and in a fashion which left it in doubt whether or not a guarantee does in fact comprise the rendering of a service) are part of the specific issues that will be addressed in this paper.

Fifth, there is the almost quaint, and perhaps unique, US approach, adopted in 1968, to considering that some services need not be charged at a market price or markup, but simply at cost. Given that Canada has no rules per se (apart from the arm's-length standard principle), the notion is not known within the four corners of the Income Tax Act. But it is one that has both been pondered by the OECD as far back as 1984[29] (and felt to be appropriate, where there was no so-called entrepreneurial risk involved in rendering the services) and, as a matter of administrative practice (and/or influence of the latter OECD musings in 1984), adopted by the CRA and many other countries. While that should be viewed favourably by taxpayers, where the components of cost can lead (as they have in some instances in Canada) to absurd claims by tax administrators for charges that would be far in excess of any arm's-length price for the service, matters can turn nasty and controversial.

The balance of this paper will examine, within the framework of the foregoing factors, key aspects of the Canadian implications of the final services regs, and in at least one area—guarantees—the full story has yet to be fully told in light of the Treasury's decision to defer rules in respect thereof.

COMPARATIVE EXAMINATION OF KEY ASPECTS OF THE REGS AND CANADIAN PERSPECTIVE

Overview: Basic Divergence Under the 1968 Regulations

In principle, and as already noted, the most destabilizing aspect of the Canada-US intercompany transfer-pricing comparative is the disparate approaches to pricing services. This long pitted the 1968 US "cost" approach (for many, if not all, situations) against the orthodox Canadian arm's-length price approach. But the advent of the July 31, 2006 Code section 482 temporary services regulations[30] (effective as of 2007) and now the final regulations[31] serves to partially dissolve the con-

[29] "Transfer Pricing and Multinational Enterprises, Three Taxation Issues," *Reports of the OECD Committee on Fiscal Affairs* (1984), at 2.4 (section on the allocation of central management and services costs).

[30] The temporary regulations (TD 9278), for tax years beginning after 2006, were issued on July 31 by the US Treasury Department and the Internal Revenue Service, 71 Fed. Reg. 44466-44519, August 4, 2006, and published in *Internal Revenue Bulletin*, 2006-34 IRB 256, August 21, 2006. The regs had a sunset of August 4, 2009 and were replaced by final regs on July 31, 2009. See "Testimony on New § 482 Services Regulations" (November-December 2006) 58:6 *The Tax Executive* 481 (reproducing testimony by Janice L. Lucchesi, on October 27, 2006, on behalf of the Tax Executives Institute) (see related TEI submissions, infra note 39). See Leonard B. Terr, "Temporary US Transfer Pricing Services Regulations" (December 11, 2006) 44:11 *Tax Notes International* 861.

[31] Supra note 26.

ceptual incoherence and mismatch in this area between the two countries because the United States has moved to an arm's-length approach. But the "services cost method" (SCM) aspect of the temporary and then final regs (which continues pricing at cost in certain circumstances[32]) will, at least in theory, retain an element of conceptual conflict. On the other hand, as discussed below, certain aspects of (1) relevant arrangements and (2) the CRA administrative approach long ago provided for substantial convergence of the conceptually different regimes.

Ambit of the Ostensible Divergence (Conflict) Under the 1968 Regulations

If it can be said that the final regs will serve to unify the two countries' approaches to pricing services, to what extent is that truly required—or to what extent were there true divergences? The short answer is that it has been more in theory, than in practice, that the two systems have been totally different since the 1968 US regs were adopted.

Unlike the 1968 reg notion of pricing intercompany services at cost (except in certain specified circumstances[33]), Canada considered (logically enough) that there is no reason that pricing services should differ from pricing anything else—that is, at an arm's-length price that may be quite different from the cost of the service rendered. But several factors tended to bridge the conceptual gap, and this can best be seen in bifurcating those factors into an inbound-outbound discussion.

Basic Factors and Inbound Bias/Predilection

In principle, the Canadian orthodox arm's-length price approach meant (1) a theoretical determination is made as to whether there is any service being provided that must be priced, and (2) if there is, to price it on an arm's-length basis.[34] But, also in principle, where the arrangement is only nominally a service by one party to the other, and is rather, in fact, a sharing of an activity (and its cost), then an arm's-length price becomes cost. (See further specific discussion below.) The latter factor has often been caught up in the CRA's natural predilection to be alert to *excessiveness or overcharges in the inbound intercompany price*. That, in turn, has spawned searches by the CRA for factors that justify denying markups and asserting cost-based approaches. That inbound bias or predilection is facilitated by, first, challenging the taxpayer on a threshold factor.

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[32] See section 1.482-9(b).

[33] Under the 1968 regs, the cost safe harbour applied to "non-integral services" (reg. section 1.482-2(b)(3)), relating to relatively narrow circumstances.

[34] Perhaps the only Canadian court decision fully on point (that is, dealing with services), *Safety Boss*, supra note 21, involved a low-tax jurisdiction, was decided on its own particular facts and simply confirmed that, at the end of the day, arm's-length pricing (whether for a service or anything else) is determined by a Canadian court based on its appreciation of the particular facts and circumstances, which include looking at the context established by prior-year factors.

The threshold factor sees the CRA questioning whether the service itself is really *required* by the Canadian recipient and/or whether it provides any particular benefit to the recipient. That, in turn and in part, raises the issue of whether a parent company's activity is "stewardship or custodial" in nature—which therefore does not comprise or convey a service to any subsidiary.[35] If that hurdle is overcome, then, with respect to inbound prices, the CRA looks for reasons why any markup over cost (profit margin) would not confirm with market realities. This, in concept, should only be the case where there is a *shared employee-type dynamic at play rather than a spot-type service being performed*. The first version of *Information Circular* 87-2 spoke about this in terms of lack of entrepreneurial risk with respect to the underlying service (essentially mimicking language in a 1984 OECD study[36]), although that language does not appear in the present circular (IC 87-2R),[37] which reflects the absence of it in the 1995 revised OECD guidelines.

Impact of Predilection on Outbound Services: The CRA Hoisted on Its Own Petard?

Naturally, where the service provider is Canadian, in respect of a foreign sub, the CRA would like to make its inbound predilections and biases somehow magically disappear and see all services as crown-jewel-type activity, entailing a narrow view of what is in the interest of the Canadian parent, an expansive view of what is being performed for the foreign sub, and a very generous view as to the value of the services and markups required. But the CRA is, at times, inhibited by its inbound predilections and (figuratively) cannot keep a straight face without (reluctantly) accepting a cost-based approach for outbound services.

Sometimes the notions blend, as in a recent situation where the CRA, with respect to an outbound service, contended that all-in "cost" (including stock-related compensation) of certain senior executives was an appropriate benchmark for the alleged service provided, even though such cost bore no relationship to the type of prices that might be found in the market for similar services performed by such personnel.[38]

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[35] See the discussion below under the heading "The 'Shareholder (Stewardship) Activity' Factor in Canada-US Groups" and, inter alia, paragraphs 155-156 of IC 87-2R, which set out the CRA's views as to whether a service in fact has been rendered.

[36] Supra note 29.

[37] Paragraphs 165 through 171 deal indirectly (and in a rather confusing way) with shared service arrangements, *which essentially involve developing proper principles to share costs*. See the discussion below.

[38] Is this similar to issues in the United States respecting cost contribution arrangements and the new SCM rule? The Tax Executives Institute (infra note 39) had noted, in 2006, that requiring stock-based compensation conflicted with the Tax Court decision (since reversed) in *Xilinx*, supra note 2. TEI was concerned about the "staggering amount of work" involved with certain types of calculations respecting stock-based compensation.

Do the New Regs Provide Complete Convergence— In Theory/Concept?

The new US approach should draw the two systems closer together, because the new regs require a greater percentage of intercompany service arrangements to be priced at market and not at cost.

But in concept, SCM will continue a conflict.[39] However, since SCM will be *restricted* to services that either are simply shared activities or are very basic and commodity-like and deliver the least amount of value to the recipient and where, *as a practical matter*, the cost may not be much less than what the thing is worth, there may not be much room for real dispute with Canada.[40] The latter presumably formed the basis for both the 1968 regs and the informal approaches of the CRA (to accept or insist on cost) referred to above.

In theory, the new US approach with respect to those services that might or must be priced at market simply becomes an extended application of possible competing theories of proper transfer-pricing methods in arriving at an arm's-length price— where Canada has no rules and where only the trial judge will be able to tell us for sure what the right answer is.[41]

The issues of embedded intangibles should present no conceptual conflict between the two countries within the ambit of the essence of proper arm's-length pricing. The CRA's views respecting "bundled" transactions provide that platform.[42]

Finally, it will be interesting to see how the new US "business judgment"[43] rule related to SCM will dovetail with the CRA's existing predilections to see or not see the basis for markup in intercompany services.

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[39] On December 20, 2006, Rev. proc. 2007-13 was released, containing a revised and expanded list of specified covered services for SCM—that is, eligible to be priced at cost. The original list in Announcement 2006-50 had designated 48 activities or tasks, while the new publication designates over 100 tasks. A submission by the Tax Executives Institute to the Internal Revenue Service, November 21, 2006, respecting the temporary regs, and one on November 15 recommending an expanded list of SCM activities, were reflected in the December 20 IRS announcements and release. See "IRS Postpones Temporary Services Rules Except for 'Business Judgment' Provision," *BNA Daily Tax Report* no. 245, December 21, 2006, GG-2.

[40] The SCM method does not apply if the same services are rendered at a markup of greater than 7 percent to third parties. It also does not apply to manufacturing, production, extraction, constructing, reselling, distributing, research and development engineering, and financial transactions, including guarantees and insurance and re-insurance.

[41] In this respect, a factual finding of the Tax Court of Canada would only be overturned by an appeal court (the Federal Court of Appeal) if there had been an error in law, which includes a "palpable error" in the appreciation of facts or a fundamental error in thinking or analysis. That is the jurisdiction of the Federal Court of Appeal in reviewing decisions of the Tax Court of Canada.

[42] See TPM-06, "Bundled Transactions," May 16, 2005, and paragraphs 36-43 of IC 87-2R.

[43] For SCM to apply, the "business judgment" rule under reg. section 1.482-9(b)(5) requires that the taxpayer "reasonably [conclude] in its business judgment that the service does not contribute significantly to key competitive advantages, core capabilities or fundamental risks of success or

US Outbound-Canada Inbound

Overview

With respect to those inbound prices from a US parent to a Canadian sub that may be priced under SCM, there is no reason, in theory, why the CRA will oppose; no different from those circumstances where, under the 1968 regs, only a cost-based charge was required. In non-SCM cases, in theory there need not be conflict.[44]

Straight Services

This section treats an activity carried out or performed by a US member of a Canada-US group (regardless of which is the parent) that results in a service being received or enjoyed by a Canadian member of the group where, (1) if the service were not made available by the US member, it would be purchased from a third party by the Canadian member, and, as such, (2) it does not involve the sharing of an employee (or similar arrangement) (as discussed in the next section), nor an activity that is undertaken for the purposes and benefit of the US member—that is, a “shareholder activity” (as detailed under the heading “The ‘Shareholder (Stewardship) Activity’ Factor in Canada-US Groups,” below).

Viewed from the standpoint of comparative corporate tax rates, there should be a preference for, or bias toward, minimizing prices for intercompany services northbound to Canada, within a Canada-US group. The standard US federal corporate rate is 34 or 35 percent, and with state (or both state and city) corporate taxes (which are deductible for federal tax purposes), the effective overall US corporate tax rate could be in the mid-40s percentage range. In Canada, on the other hand, the interrelated effects of the phasing in by 2012 of a net federal corporate rate of 15 percent for profits also subject to provincial taxes (the federal rate in 2010 being 18 percent), and the adoption by many provinces of an add-on rate in the 10 percent area, mean that comparative effective overall Canadian corporate tax rates for 2010 are in the area of 28-30 percent, and by 2012 in the area of 25 percent.[45]

Accordingly, at the extreme, on the basis of present legislation, the highest US effective overall rate—some 47 percent, applicable to corporate profits earned in New York City—will be double the 23 percent effective overall rate payable in 2012 and subsequent years in New Brunswick. And the New York City rate will

failure in one or more trades or businesses of the controlled group.” The reasonableness of the conclusion will be assessed on “all the facts and circumstances.”

[44] But bear in mind the CRA predilection with respect to inbound parent company services—where the CRA looks for “stewardship” factors, which would be viewed as not delivering a service to a Canadian sub. See the discussion below under the heading “The ‘Shareholder (Stewardship) Activity’ Factor in Canada-US Groups.”

[45] In 2010, the rates in oil-rich Alberta and Canada’s two largest provinces, Ontario and Quebec, will be 28 percent, 30 percent, and 29.9 percent, respectively. By 2012-2013, those rates will be 25 percent, 25 percent, and 26.9 percent, and New Brunswick will have the lowest corporate rate in North America, 23 percent.

almost double the 25 percent rate payable in Canada's largest province, Ontario, starting in 2013.

That pricing preference will be obviously facilitated where the SCM is available for northbound services. And, leaving aside any issues respecting the determination of cost, prices based on the SCM should be welcomed by the CRA. Here, issues (if any) would presumably arise with the IRS, not with the CRA, in the form of whether or not the SCM is, in fact, applicable. Where the SCM is not applicable and that pricing preference must be dealt with in the context of "normal" arm's-length pricing, two factors arise.

Comparing the Methods

First, the basic question is whether the arm's-length pricing methods set out in reg. sections 1482-9(c) to (h) conflict with Canadian requirements. Those requirements, as discussed above, are, (1) as a matter of law, the basic arm's-length pricing principle, unadorned by any statutory or regulatory rules (but augmented by the uncertain role of OECD guidelines), and, (2) as a matter of non-binding CRA views and assessing practice, the combined effect of the approaches set out in IC 87-2R and in the OECD guidelines. The section 482 reg methods are: (1) the "comparable uncontrolled services price" (CUSP) method, (2) the "gross services margin" (GSM) method, (3) the "cost of services plus" method, (4) the "comparable profits" (CPM) method, (5) the "profit split" method, and (6) "unspecified methods." Overlaid on those methods are the rules in reg. section 1.482-9(i) for "contingent-payment contractual terms for services."

Except possibly for the GSM method, there is nothing in the nomenclature of the six specified methods that should either be considered novel from the Canadian standpoint or raise concern or uncertainty (of concept). The CUSP method is simply the holy grail of transfer pricing,[46] and, if found to the satisfaction of a court, would normally govern in both Canada and the United States. In this respect, the CRA's views on comparables in relation to services are set out in paragraphs 160 and 161 of IC 87-2R as follows:

> 160. Where a service is rendered by arm's length parties or the service supplier, as part of its ordinary and recurring activities, renders the service for arm's length parties, the price charged in those circumstances is a good indication of the arm's length price. Thus, the CUP method should be used, assuming sufficient quality data for its application is available.

[46] In concept, the best and priority situation—one hardly ever given heed or attention—is where intercompany prices have actually been established by "hard bargaining." For a discussion, see Boidman, del Castillo, Thomas, et al., "Transfer Pricing: Foreign Rules and Practice Outside of Europe," 897 TM, 897.

> 161. This presumes that:
>
> - the services are substantially the same in terms of their nature and quality as well as the quantity or extent to which these services are provided;
> - the markets are similar; and
> - the services are provided on comparable terms.

Underlying those comments is a discussion at paragraphs 53-56 and 64-69 of IC 87-2R of the CUP method.

The GSM method appears to be a hybrid-type application to services of the "resale price" method, traditionally used, in respect of intercompany sales of goods, as the second-ranking "transactional" method. Although the concept makes basic sense, this approach is not, per se, seen in the CRA's discussion of intercompany services in IC 87-2R.[47] (But that is no reason it might not be viewed as appropriate by a Canadian court.)

The "cost of services plus" method is both familiar in concept from a Canadian standpoint and specifically addressed by the CRA in IC 87-2R in relation to services in the following terms in paragraph 162:[48]

> 162. Where the CUP method cannot be applied, the taxpayer should consider the cost plus method. The cost plus method is appropriate where, after the appropriate functional analysis, the taxpayer can verify comparability (including the functions performed, the assets used, and the risks assumed) with uncontrolled transactions. The taxpayer must ensure that the costs incurred by the service supplier are

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[47] For the CRA's views on the resale price method, see paragraphs 56-58 and 70-75 of IC 87-2R.

[48] In a way, paragraphs 163, 164, and 165 are relevant to both this approach to arm's-length prices and to the separate discussion of shared employees. They read, in part, as follows:

> 163. Arm's length service suppliers would usually expect to recover their costs plus an element of profit. However, in determining an arm's length charge for service, one must also take into account the economic alternatives available to the recipient of the service. Often, the price the recipient is willing to pay for the service does not exceed the cost of supply to the service supplier. [The circular then gives an example discussing arrangements that are administrative or ancillary in nature.]
>
> 164. Determining whether a mark-up is appropriate and, where applicable, the quantum of the mark-up, requires careful consideration of factors such as:
>
> - the nature of the activity;
> - the significance of the activity to the group;
> - the relative efficiency of the service supplier; and
> - any advantage that the activity creates for the group.
>
> 165. As discussed in paragraph 7.36 of the OECD Guidelines, it is important to distinguish between the situation of:
>
> - a taxpayer who renders services for the other members of a group; and
> - a taxpayer who acts solely as an agent on behalf of the group to acquire services from an arm's length party.

> substantially the same as those incurred in the comparable transactions. If not, appropriate adjustments must be made.

But that then has to be read in light of the more detailed statement of this method in relation to both the sale of goods and the provision of services, set out in paragraphs 76-79 and 86 of IC 87-2R. In contrast to the CRA's simply and briefly worded views, the US final regs have seven pages of detailed "rules" and examples. But there is no apparent clear conflict between the real potential effects of the two approaches.

Neither the CPM nor the profit split method in the final regs find any counterpart in the CRA's views on services, set out in paragraphs 152 to 171 of IC 87-2R. But those methods (and the OECD counterpart to CPM—the "transactional net margin method" (TNMM)) are treated in the circular as part of the approaches generally available for pricing intercompany transactions.[49] In that respect, those two methods, as set out in the final regs, basically piggyback their counterparts in respect of sale of goods in section 1.482-5, in respect of CPM, and section 1.482-6, in respect of profit splits. Therefore, no particular conflicts need arise in this area.

Finally, with respect to the notion of unspecified methods, two points may be noted. First, that notion simply reflects the essential "facts and circumstances" nature of arm's-length pricing, and so is therefore part of its basic fabric and is acknowledged by the CRA in its circular.

Second, it is interesting to revisit, in the context of a statement in the regs, the comment above[50] that the recent OECD proposals to rewrite the guidelines seem to be adopting "the best-method" rule in the section 482 regulations. Reg. section 1.482-9(h) states:

> As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See § 1.482-1(c).

Given the absence of anything but the simplest (in terms of legal analysis) case law in Canada respecting pricing for services, and given that (as just noted) there does not appear to be anything on the face of the six specified methods in the US final regs that necessarily conflicts with the notion underlying arm's-length pricing, there is no reason why a Canadian court would necessarily reject, as conflicting with ITA paragraph 247(2)(a), prices for inbound services based on those methods.

Would the CRA, separately, see the matter differently—and thus, ultimately, throw the matter into treaty-sponsored competent authority procedures, or into the new treaty-based binding arbitration procedures (stemming from the fifth protocol to the treaty, signed in September 2007 and brought into force in December 2008),

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[49] Paragraphs 47-63 (overview), 90-95, and 106-119 deal with CPM/TNMM and paragraphs 96 to 105 deal with profit splits. See also note 22, supra.

[50] See note 16 and related text, supra.

or into litigation? That would not be a new or unusual possibility in Canada-US transfer-pricing matters. Canada-US transfer-pricing disputes—generally spawned by CRA assessing initiatives—have been seen frequently over the past 30 years (if not longer),[51] and thus have predated and continued through the 1986 US enactment of the superroyalty rule; the 1994 US section 482 regs and concomitant US enactment of transfer price-related penalties and contemporaneous documentary requirements; the advent of APAs in both countries; the 1998 re-enactment of Canada's arm's-length pricing standard and first enactment of its own version of transfer-price-related penalties and documentation requirements; both the 1979 and the 1995 OECD guidelines; the CRA's original IC 87-2 in 1987 and its update, IC 87-2R, in 1999; and the 2006 temporary section 482 services regulations.

Therefore, in that context, there is really no reason to think that the six US pricing methods will particularly reduce or increase issues raised by the CRA respecting pricing of Canada-US intercompany services. But that is a segue to the second factor, to be considered next.

The Effect of Tax Rate Arbitrage

If the clear tax rate arbitrage in favour of reducing US income and increasing Canadian income does see attempts to interpret and apply the six methods so as to minimize prices for northbound services, the result should be more disputes with the IRS and fewer with the CRA.

This is not an easy matter to forecast and assess because it has, in a way, been an evolving *inversion*—from a time when either there was a tax rate arbitrage in favour of the United States, or little, or none at all. That, together with other factors, often saw pricing for northbound transactions on the high rather than the low side—or, at least, it was seen that way by the CRA. And in that context, it was the IRS that had no concerns.

But with the presumably irresistible unfolding allure of the substantial corporate rate differential outlined above, a predilection for pushing the pricing envelope toward optimizing Canadian corporate profits should take hold. And if it does, the respective positions and concerns should reverse, and it presumably will be the IRS, not the CRA, that brings a jaundiced eye to examining Canada-US transfer pricing.

Shared Employees/Cost Sharing

The notion of shared employees discussed below contemplates a situation with the following characteristics:

- Two or more members of a group have recurring requirements that a particular function or activity be performed (say, bookkeeping).

[51] Until recent years, most were routinely resolved through competent authority. In this respect, see note 70, infra.

- Neither member requires the full time of the one or more persons who are capable of meeting that requirement, but together are prepared to commit to financing the engagement of the one or more relevant persons and to share their available time and efforts and share—pro rata—their costs.
- It is impractical for each member to hire, as its employee(s), the one or more persons on a part-time (or partial) basis. Instead, one member employs the relevant person(s) and, either as a matter of an explicit agreement or otherwise, that member makes available that person or persons to the other, and charges an aliquot or pro rata portion of the costs to the other, in such fashion as is a proxy for the overall results for each member, as though the person had been part-time employed by each member.
- The arrangement does not entail any sharing—or transfer—of other property or resources (such as valuable intangibles) between the parties, and therefore does not raise the ubiquitous issues surrounding "cost-sharing" arrangements related to developing proprietary intangibles.
- The arrangement does not entail a situation where one member has a core/constant need for the function and activity and would engage one or more full-time (or perhaps part-time) persons in relation thereto, while the other has no such need, but only an occasional need—one in respect of which the timing and duration are unpredictable—and would therefore enter into no full or part-time employee relationship, but instead would look to either another group member or to an outside service provider and purchase on a "spot"-market basis the required service/function/input. (This is, in fact, the situation dealt with in the prior section.)

How do the US final regs treat the foregoing situation where one member is a US party and the other is a Canadian party? Does it matter which member is the employer of the shared employee? Bearing in mind that in Canada there would be no specific applicable law per se, what are the views of the CRA and would they conflict with the US notions and approach? One would expect, having regard to the essence of the fundamental governing rule in both countries (arm's-length pricing) that both countries would see a non-controversial simple requirement—namely, that the costs of the employed person(s) be shared either pro rata to a predetermined and agreed allocation (based on the reasonable expectation of the proportionate use to be made) or pro rata to the actual proportionate use made. Is that what the US rules provide for?

The short answer is that it depends. The "Explanation of Revenues and Summary of Comments" section of the final regs states that there has been inclusion of "the shared services arrangement provision in the SCM Rules."[52] That is a shorthand

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[52] See the final regs, at 4. The notion of a "shared service arrangement" (SSA) is dealt with in reg. section 1.482-9(b)(7). (See also sections 1.482-9(j), "Total Services Costs," and (k), "Allocation of Costs.")

reference to the notion that costs can be shared as a proper arrangement. But the fine points restrict the ambit. In particular, a US member, as the employer of the shared employee, can charge the Canadian member, as the user of the shared employee, a pro rata amount of the employee's cost, as the arm's-length price, *only* if the employee's functions are a "specified covered service" (SCS) for purposes of SCM.

If the activity either does not meet the SCS requirement, or does meet the requirement but involves an "excluded service," neither the SCM nor the shared services arrangement (SSA)—which allows sharing based on "reasonably anticipated benefits" (as defined in paragraph (1)(3)(i))—is applicable.

Therefore, two distinct employee-sharing situations arise, distinguished by the SCS factor. Assume that a US parent and a Canadian sub each need half the time of one full-time bookkeeper. They agree that USco will be the "employer" and pay the bookkeeper $50,000 a year and that Canco will pay $25,000 to USco. Rev. proc. 2007-13 lists the activities of a bookkeeper as a specified covered service. That will meet the requirements of being a SSA (with SCM at its core), and therefore the cost sharing will be accepted.

But if both companies also need half the time of a nuclear physicist to carry on their separate research programs and USco again employs the party, pays the party $1 million a year, and recovers $500,000 from Canco, will that be accepted? It may not be, because it will *not* be a qualified SSA, because either it is not covered by 2007-13 or, even if it is, it is disqualified from SCM as an "excluded activity." Therefore, the IRS could try to use any of the six other pricing methods to allocate to the US parent an amount greater than the $500,000.

Obviously, in the second scenario, the issue would be avoided if each corporation hired its own nuclear physicist and there was no cross-corporation dealing. But would that also be the result if they shared one person, alternating use of the person on a monthly basis (that is, with each corporation directly employing that person every other month) so that there was no intercompany transaction or payment?

In Canada, the principles suggested above are at the core of the CRA's brief comments on the matter in IC 87-2R. As part of that[53] is paragraph 7.36 of the OECD guidelines, which reads:

> 7.36 When an associated enterprise is acting only as an agent or intermediary in the provision of services, it is important in applying the cost-plus method that the return or mark-up is appropriate for the performance of an agency function rather than for the performance of the services themselves. In such a case, it may not be appropriate to determine arm's length pricing as a mark-up on the cost of the services but rather on the costs of the agency function itself, or alternatively, depending on the type of comparable data being used, the mark-up on the cost

53 As noted earlier in note 48 respecting paragraphs 163-165 of IC 87-2R.

> of services should be lower than would be appropriate for the performance of the services themselves. For example, an associated enterprise may incur the costs of renting advertising space on behalf of group members, costs that the group members would have incurred directly had they been independent. In such a case, it may well be appropriate to pass on these costs to the group recipients without a mark-up, and to apply a mark-up only to the costs incurred by the intermediary in performing its agency function.

The bottom line is that the implied requirement to do more than share costs of shared employees who do not fit Rev. proc. 2007-13 and the SCM could clearly conflict with the arm's-length pricing principle or lead to uncertainty and disputes between Canada and the United States.

Parent-Sub Stewardship and Custodial

For a discussion, see the section below, under the heading "The 'Shareholder (Stewardship) Activity' Factor in Canada-US Groups."

Canada Outbound-US Inbound

Overview

In outbound Canadian parent-US sub arrangements, as a matter of theory, there apparently need not be any conflicts, because (as Notice 2007-5 confirms) SCM is not mandatory. As well, as noted above, the pre-existing Canadian situation often sees the CRA accepting cost as a basis for an outbound charge as well as an inbound charge.

Straight Services

As in the converse case, discussed above (of straight services rendered by a US member of a group to a Canadian member), this section addresses and treats an activity carried out or performed by a Canadian member of a Canada-US group (regardless of which is the parent) that results in a service being received or enjoyed by a US member of the group where, (1) if the service were not made available by the Canadian member, it would be purchased from a third party by the US member, and, as such, (2) it does not involve the sharing of an employee (or similar arrangement) (as discussed in the next section), nor an activity that is undertaken for the purposes and benefit of the Canadian member—that is, it is a "shareholder activity" (as detailed under the heading "The 'Shareholder (Stewardship) Activity' Factor in Canada-US Groups," below).

It was noted in that discussion above of the converse case that comparative tax rates should raise a predilection or bias to minimize prices for intercompany services northbound to Canada within a Canada-US group. It necessarily follows that the same corporate tax rate comparative reverses the preference or bias for pricing southbound—Canada to the United States—intercompany services—to one of seeking to maximize prices for southbound services.

The US final regs will affect any such bias or preference in six distinct ways. First, the CRA will be happy. Second, the IRS will be unhappy. Third, the clear choice (provided by the final regs) of *not* adopting SCM means the road will be clear to seek arm's-length prices for any type of straight service, a choice that would normally be expected to produce prices in excess of cost.[54] Fourth (and discussed further below), the obverse of the effects discussed above of the restrictive ambit of SSAs could even see markup being claimed for employee-sharing arrangements. Fifth (and discussed further below), the obverse of the effects discussed above and below of the restrictive view in the final regs of "shareholder activity" could be seen to provide wider latitude than may otherwise seem appropriate to make charges to US subs for Canadian parent company activity. Sixth, and finally, the detailed "methods" noted earlier may or may not be seen to provide latitude to push the envelope on the quantum of prices determined.

Shares or Employees/Cost Sharing

The discussion above of shared employees (which sees the relevant employee engaged by a US member of the group and then shared with a Canadian member) applies equally where the roles of the two group members are reversed *and* the employee (on the books of the Canadian member and made available to the US member) is one whose activities comprise specified covered services (SCS) under the final regs.

But where the activities do not comprise SCS, the analysis potentially differs in that it is unlikely, for the reasons set out above, that the CRA would see a requirement that the amount to be charged to the US member exceed cost (whereas in the northbound case that might be asserted by the IRS), and there does not appear to be any particular reason the IRS would object to such cost-based pricing to the US member.

Parent-Sub Stewardship and Custodial

See the discussion in the next section.

The "Shareholder (Stewardship) Activity" Factor in Canada-US Groups

The issue of whether an activity by a parent corporation is undertaken for its own purposes and benefit and does not constitute a service conveyed to a subsidiary (so that there is no basis to charge a fee or allocate a related cost to a subsidiary), or whether instead the contrary case holds, in whole or in part, is a contentious matter in both countries. The US final regs denote the first case as comprising a situation where the activity meets the regs' requirements of being a "shareholder activity." In

[54] But issues respecting cost could arise and lead to claims by the CRA for cost-based prices that exceed market prices. This can particularly arise where highly paid senior executives are involved.

contrast, the administrative views of the CRA, as expressed in IC 87-2R, do not use that, or any other, identifying terminology, although the initial version of IC 87-2 did invoke the notions of "custodial" and "stewardship" activities and costs. The OECD 1995 guidelines (on which the CRA relies) use the US terminology (in paragraph 7.9) in relation to an activity that "would not justify a charge to the recipient companies." The guidelines then say:

> It may be referred to as a "shareholder activity," distinguishable from the broader term "stewardship activity" used in the 1979 Report. Stewardship activities covered a range of activities by a shareholder that may include the provision of services to other group members, for example services that would be provided by a coordinating centre. These latter types of non-shareholder activities could include detailed planning services for particular operations, emergency management or technical advice (trouble shooting), or in some cases, assistance in day-to-day management.

Paragraph 7.10 then provides three examples of what "will constitute shareholder activities, under the standards set forth in paragraph 7.6." They are activities relating to the (1) corporate governance of the parent, (2) financial statement reporting of the parent, and (3) the raising of capital used to acquire subsidiaries. The standards set forth in paragraph 7.6 are as follows:

> 7.6 Under the arm's length principle, the question whether an intra-group service has been rendered when an activity is performed for one or more group members by another group member should depend on whether the activity provides a respective group member with economic or commercial value to enhance its commercial position. This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself. If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle.

The latter standards are reflected in IC 87-2R.[55]

The final regs reflect similar principles, although controversy has raged since the temporary regs were issued in 2006. Both the principles and the controversy are neatly summarized by the introductory notes to the final regs, which read in part:

> Paragraphs (l)(3)(ii) through (v) provide guidelines that indicate the presence or absence of a benefit. Section 1.482-9T(l)(3)(iv) of the 2006 temporary regulations

[55] Paragraphs 154-156. Paragraph 154 focuses on whether a benefit is received, while paragraph 155 asks whether there is a service that would have been purchased from a third party. Paragraph 156 deals with costs that are incurred for the sole benefit of shareholders. In paragraphs 157 and 158, the treatment of "duplicative services" is discussed. These views may be compared to the US "sole benefit" rule in the new regs, as discussed below.

> provides that an activity is a shareholder activity if the sole effect of that activity is either to protect the renderer's capital investment in the recipient or in other members of the controlled group, or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, or both.
>
> The Treasury Department and the IRS received comments on shareholder activities. Some commentators asserted that the "sole effect" language is too restrictive and that the language should be replaced by a "primary effect" standard. . . .
>
> The Treasury Department and the IRS believe that the "sole effect" language is appropriate. The "primary effect" language in the 2003 proposed regulations could inappropriately include activities that are not true shareholder activities and may even consist of substantial activities that are non-shareholder activities.[56]

There appears to be an equivalence between paragraph 7.6 of the OECD guidelines, paragraphs 154-158 of IC 87-2, and reg. 1.482-9(l)(3)(i), which reads as follows:

> 3) Benefit—(i) In general. An activity is considered to provide a benefit to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position, or that may reasonably be anticipated to do so. An activity is generally considered to confer a benefit if, taking into account the facts and circumstances, an uncontrolled taxpayer in circumstances comparable to those of the recipient would be willing to pay an uncontrolled party to perform the same or similar activity on either a fixed or contingent-payment basis, or if the recipient otherwise would have performed for itself the same activity or a similar activity. A benefit may result to

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[56] At 21 and 22. It is likely that the "comments" referred to were those of TEI, which, in a letter of November 27, 2007 addressed to the Treasury (John L. Harrington, International Tax Counsel) and the IRS (Steven A. Musher, Associate Chief Counsel (International)), wrote:

> TEI recommends that paragraph (iv) be clarified because there are few activities that literally meet the "sole effect" criterion. Consider, for example, the activities of an audit committee of a public company's board of directors, which is charged with ensuring that the internal controls of the company are adequate and effective. Such oversight arguably benefits the operations of the subsidiaries of the public company, but the primary reason for the activity is to meet the regulatory requirements applicable to the parent corporation. TEI therefore recommends that "sole" effect be changed to "primary" effect. In the alternative, TEI recommends that paragraph (iv) be changed to provide that a shareholder activity shall be considered to have such a sole effect if the only benefits provided to other controlled group members are either (i) indirect or remote, or (ii) duplicative. For example, this would cover the circumstance where a parent corporation engages an auditing firm to prepare annual reports for its public shareholders. As part of the engagement, the firm provides comments with respect to certain accounting processes of the controlled group members. These comments are incorporated in the group's accounting system and allow for certain minimal efficiencies that would be considered indirect or remote. Accordingly, this activity is considered a shareholder activity.

Although the first recommendation was not followed, the second seemingly was: see the next note.

> the owner of intangible property if the renderer engages in an activity that is reasonably anticipated to result in an increase in the value of that intangible property. Paragraphs (l)(3)(ii) through (v) of this section provide guidelines that indicate the presence or absence of a benefit for the activities in the controlled services transaction.

But the difficulty in the Canada-US context is the threshold divergence of approach. The Act has no rule other than the arm's-length standard principle, and the CRA (like the OECD) has a few simply stated views.

Aside from the basic approach in the reg cited above, the US final regs have nearly 10 pages of "rules and examples." The latter number 21 in total, and run 6½ single-spaced pages.

But on examination, the detailed rules in the final regs, beyond the basic principles excerpted above[57] and the 21 examples, provide no particular assistance in many situations that may commonly arise. All that remains—as it should—is the basic facts-and-circumstances dynamic comprising the arm's-length principle.

For example, a client of this observer was faced with a proposed adjustment by the CRA to add a service fee to its income under paragraph 247(2)(a) in the following situation (modified to maintain client confidentiality).

- Canco is widely held and publicly traded, with a group of operating US subsidiaries that engage senior executive-level personnel.
- The US subsidiaries prepare and operate in accordance with detailed operational and financial budgets.
- Senior executives of Canco analyze the US operational and financial budgets and prepare reports for the sole purpose of informing the CEO, the CFO, and the board of directors.
- These reports are not provided to nor discussed with the US subsidiaries and therefore do not entail or result in any advice or other input being conveyed to the US subsidiaries.

[57] The detailed rules are (1) the definition of a "controlled services transaction" in paragraph (l)(1) as an activity "that results in a benefit . . . to one or more other members of the controlled group"; (2) the definition of "activity" in paragraph (l)(2); (3) the exclusion in paragraph (l)(3)(ii) for benefits that are sufficiently "indirect or remote"; (4) the exclusion in paragraph (l)(3)(iii) for "duplicative activities"; (5) the exclusion in paragraph (l)(3)(iv) for "shareholder activities" (as described above) involving "the sole effect" thereof as being "either to protect the renderer's capital investment in the recipient . . . or to facilitate compliance by the renderer with reporting, legal or regulatory requirements . . . ," (6) the notion, in paragraph (l)(3)(v) that benefits of having status as a member of a group may be ignored and (7) the notion in paragraph (l)(4) that transactions may be bifurcated ("disaggregation") to determine how to best apply the arm's-length principle.

- The CRA, upon examination of this situation, initially took the position that the activities resulted in valuable services to the US subsidiaries and commanded a charge of a fee, comprising the costs of the Canadian personnel involved plus an appropriate profit markup.
- The CRA subsequently withdrew from this position when confronted with the sheer matter of the facts that did not entail either the rendering of any service to the US subs or the conveyance of any benefit to the US subsidiaries.
- There is no reason that the answer would be any different under section 482 of the Code, whether or not expanded by regulations thereunder and whether or not under the original 1968 regs, the 2003 proposed regs, the 2006 temporary regs, or the final regs.

It can be seen that pure logic in relation to the arm's-length pricing standard produces the right answer. Nobody has to be assisted by "rules" couched in terms of "sole effect" or "solely for the benefit of." And, conversely if there were something more than "solely for" in the above situation, *business logic* would dictate a different answer. For example, if, in that situation, senior management of Canco used its analysis of the US subsidiaries' operating and financial budgets to provide any feedback intended to be assessed and perhaps acted upon with the objective of increasing bottom-line profit, there would arise a totally different dynamic from the standpoint of analyzing a cross-border intercompany service arrangement. That added factor would at least raise the possibility that there should be recognized an intercompany (Canco to its US subs) service. And the proper final determination would turn on assessing each element of the dynamic: Do the US subs wish to have advice from their parent? Or instead is advice being foisted upon them? Is the advice actually adopted and acted upon? If so, does it produce any measurable benefits to the US subs? Is the dynamic comparable to one that may have been effectuated with a third-party business consultant? All of these (and others that could arise) are questions of fact and circumstances for which there are no prepackaged answers. And no amount of "rules" writing (like the final regs) can encapsulate all of the questions, let alone the "right" answers. In fact, the scope of the 21 examples in this area is limited to considering whether or not there is a service/benefit being conveyed without, where there is, taking the matter further. For example, of the 21 examples, the closest (but not necessarily truly pertinent) to the foregoing discussion appears to be example 6, which deals with a situation where the activities of the parent could be seen to be largely "duplicative" but, at the same time, "confer" a benefit.

At the end of the day, whether it is a Canadian parent-US subsidiary or the converse situation, the question of determining whether a particular activity by a particular parent results in a service (with a benefit) to the cross-border sub, one for which there should be a fee charged in order to comply with the arm's-length standard of either country (leaving aside whether the SCM election may apply from the US perspective), will turn on an assessment, in a reasonable, logic-based manner, of the particular facts and circumstances. And it appears that a true conflict could

only arise where the IRS seeks to consider that one of the 21 examples governs the situation and the result is one that does not comport with the arm's-length standard, logically applied.

The Special Case of Guarantees

Pre-Existing Situation

Intercompany guarantees, and their pricing, are a black hole in Canada-US intercompany pricing arrangements, and it is not clear whether certain pending legislative developments and at least one pending court case in Canada[58] and/or the final regs will unify the approach of the two countries.

There had been no necessary problem with respect to an inbound (northbound) guarantee (that is, a guarantee by a US parent of the debt of the Canadian sub). Under the 1968 regs and certain case law (*Bank of America*),[59] it appeared well settled from a US perspective that no charge needed to be made by the guaranteeing US parent to the guaranteed Canadian sub.[60] Of course, the CRA liked it that way.[61] But when US groups have chosen to charge fees, disputes have arisen, with one decided case, *GE Capital Canada*,[62] and one pending.[63] *GE Capital Canada* entailed a dispute over the deductibility of certain guarantee fees paid by that company to its US parent, and was decided by the TCC in favour of the taxpayer. The court found that, as a matter of fact, the guarantees provided by the US parent operated to reduce the borrowing costs to the Canadian subsidiary by at least 183 basis points (per dollar of borrowing); and, as a result (and in the overall factual context), the fee paid of 100 basis points (per dollar of debt guaranteed) met the requirements of comprising an arm's-length price. The court rejected evidence put forward by the government that the Canadian subsidiary's borrowing costs would have been no greater had guarantees not been provided by the US parent. The decision was upheld by the Federal Court of Appeal.[64]

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58 See *HSBC Bank of Canada and Her Majesty the Queen*, 2010 DTC 1159 (TCC).

59 See note 64, infra.

60 See the discussion in note 69, infra.

61 Note that an outbound guarantee fee is deemed to be interest for purposes of Canadian withholding taxes (which, in general, apply to interest paid to affiliated non-residents). That rule (subsection 214(15)), together with provisions of article XI of the Canada-US treaty, as they read prior to the September 2007 fifth protocol, permitted a 10 percent tax on guarantee fees paid to a US person. But the fifth protocol now provides an exemption in article XXII(4).

62 Supra note 8.

63 Supra note 58.

64 An important mixed factual and legal question raised by the case was the role of "implicit support" in determining an arm's-length fee. For a detailed discussion of this factor, see Nathan Boidman, "Pricing Canada-US Guarantees After GE: Still Evolving" (February 10, 2011) 19:19 *Tax Management Transfer Pricing Report* 1042; Molly Moses, "ABA Panellists Debate Consideration of Implicit Support in Pricing Guarantees," 19 *Transfer Pricing Reports* 58; David D. Stewart, "U.S. Officials Engage Practitioners on Pricing of Guarantee Fees" (May 10, 2010) *Tax Analysts*; David

In an outbound (southbound) situation, where a Canadian parent guarantees the debt of a US sub, the potential for controversy has existed, and in fact has led to an initiative, acceded to by the Canadian Department of Finance, to amend section 247 to coordinate the pre-existing US approach and Canadian transfer-pricing rules. Pursuant to a comfort letter issued on March 11, 2003, section 247 is to be amended by adding subsection 247(7.1) to *except*, from arm's-length pricing standards, guarantees by a Canadian parent of certain debt[65] of a foreign sub (which therefore require no charge or fee with respect thereto). Presumably, the IRS will be happy with that result.

Note that cross-border guarantees by a subsidiary of its foreign parent's debt potentially raise Canadian issues that will not be resolved by proposed subsection 247(7.1).[66]

Under the New Regs?

But what of a US parent guarantee of a Canadian sub under the final regs? Will a fee have to be charged? Both the 2006 temporary regs and the 2009 final regs have deferred dealing with that question.[67] If a guarantee fee becomes a required

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A. Ward, "Commentary, General Electric Capital Canada Inc. v. Her Majesty The Queen" (2010) 12 ITLR 509; Murray Clayson, "GE Verdict Will Set International Precedent" (February 2010) *International Tax Review* 34; Erik Kamphuis, "How To Deal with Affiliations in Interpreting the Arm's Length Principle: The GE Case Reviewed" (July-August 2010) *International Transfer Pricing Journal* 292; Peter Menyasz, "Tax Court Ruling Favours GE Capital in Landmark Transfer Pricing Case" (December 17, 2009) 18:15 *Tax Management Transfer Pricing Report* 845; Peter Menyasz, "Consideration of 'Implicit Support' Worrisome in GE Capital Ruling, Practitioners Say" (December 17, 2009) 18:15 *Tax Management Transfer Pricing Report* 847; François Vincent, "GE Capital Canada After GlaxoSmithKline" (September 9, 2010) 19:9 *Tax Management Transfer Pricing Report* 607; Peter Menyasz, "Canada's Federal Court of Appeal Upholds Landmark Ruling in GE Capital" (January 13, 2011) 19:17 *Tax Management Transfer Pricing Report* 906; and Peter H. Blessing, "Divergence of Third Party Pricing from Arm's Length Results," in *Tax Polymath: A Life in International Taxation: Essays in Honour of John F. Avery Jones* (Amsterdam: IBFD, 2011), at 153.

[65] The main requirements are, loosely speaking, that (1) there be a written agreement, (2) the guaranteed party essentially be a controlled subsidiary, and (3) the guaranteed obligation be related to an active business carried on by the guaranteed subsidiary. But, two years later on January 24, 2005, the department issued a second comfort letter that would modify the proposal by eliminating the requirement for written agreements.

[66] This also involves subsection 15(1) shareholder benefit issues.

[67] The introductory portion of the 2006 temporary regs, under the heading "Controlled Services Transactions: d. Guarantees, including financial guarantees," states:

> The proposed regulations appear to have created confusion on the part of some taxpayers regarding the appropriate characterization of financial guarantees for tax purposes. The provision of a financial guarantee does not constitute a service for purposes of determining the source of the guarantee fees. See *Centel Communications, Inc. v. Commissioner*, 920 F.2d 1335 (7th Cir. 1990); *Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1980). Nevertheless, some taxpayers have suggested that guarantees are services that could qualify for the cost safe harbour and that the provision of a guarantee has no cost. This position would mean that in effect guarantees are uniformly non-compensatory. The Treasury

> Department and the IRS do not agree with this uniform no charge rule for guarantees. As a result, financial transactions, including guarantees, are explicitly excluded from eligibility for the SCM by §1.482-9T(b)(3)(ii)(H). However, no inference is intended by this inclusion that financial transactions (including guarantees) would otherwise be considered the provision of services for transfer pricing purposes. The Treasury Department and the IRS subsequently intend to issue transfer pricing guidance regarding financial guarantees, in particular, along with other guidance concerning the treatment of global dealing operations. See Section A.12.e of this preamble for a discussion of coordination with global dealing operations. Such guidance will also include rules to determine the source of income from financial guarantees.

Query the significance of the fact that the introductory notes to the 2009 final regs, which similarly defer rules for financial guarantees, are much more briefly worded and read as follows:

> Financial transactions, including guarantees, are exclusively excluded from eligibility for the SCM by §1.482-9(b)(4)(viii), however, no inference is intended that financial transactions (including guarantees) would otherwise be considered the provision of services for transfer pricing purposes. The Treasury Department and the IRS intend to issue future guidance regarding financial guarantees.

It is interesting to note that back in 2007 (on January 19), Steven Musher, IRS Associate Chief Counsel (International), was quoted as saying that the regs will address sourcing and pricing of guarantees. See "International Taxes: Hicks, Musher Outline Guidances, Tax Treaties," *BNA Daily Tax Report* no. 14, January 23, 2007, G-3. But almost three years later, there still has been no specific action on this matter. The latest word? From the May 10, 2010 *Tax Analysts Report*:

> IRS and Treasury officials participating in a discussion of the transfer pricing aspects of financial guarantees offered insight into how the government may approach future guidance on the issue. At a May 7 Transfer Pricing session of the American Bar Association Section of Taxation meeting in Washington, Steven Musher, IRS associate chief counsel (international), and David Ernick, Treasury associate international tax counsel, suggested that future guidance may seek to value guarantees in terms of the reduction in borrowing costs relative to borrowing costs of an affiliated company absent a guarantee rather than the cost of debt for the subsidiary as if it had been an unaffiliated company. . . . The situation the panel [which included Peter H. Blessing of Shearman & Sterling] analyzed involved a company that had borrowing costs of 200 basis points over the London Interbank Offered Rate (LIBOR) before being acquired by a larger corporation with lower borrowing costs. Immediately after the transaction, the new subsidiary could borrow at 160 basis points over LIBOR, and after the parent gives it an explicit guarantee, its borrowing costs fall to 25 basis points over LIBOR." Not particularly surprisingly, the two government spokesmen suggested both that "the arm's-length standard does not require 'hypothesizing' related companies as if they were completely unrelated . . . [and therefore] . . . the correct result would be to price the guarantee as it reduces the borrowing costs of an affiliated entity. In the hypothetical situation, the pricing would be based on the 135 basis-point reduction rather than the 175 basis-point reduction." This, in part, was supported, they contended, by an example (example 19) on volume discounts in the Services Regs. Blessing, on the other hand, "suggested that rather than try to quantify the market benefits of affiliation, the price should be determined by the difference between borrowing costs as an independent entity and the costs following the guarantee." And in this respect he "pointed out that the standalone company borrowing costs are easily provable, while the value of implicit support is not readily ascertainable.

See Stewart, supra note 64. Compare *GE Capital Canada*, supra note 8.

The most recent US development in this area is the February 17, 2010 decision in *Container Corporation (Vitro International Corporation) v. Commissioner*, 134 TC no. 5, which held that for US withholding tax purposes, in respect of outbound guarantee fees, although a guarantee arrangement is not per se the provision of a service, it should be viewed (for withholding tax purposes) as more analogous to a service than a financing arrangement.

concept, it should be accepted in principle by the CRA, given its predilection to consider a guarantee to be a service[68] that is to be priced at some market amount. The proposed amendment to section 247 would arguably provide conceptual support for the notion that, in general, a guarantee is a transaction that has to be compensated by a fee priced in some fashion in the market.

In general, therefore, the results of the proposed change in Canada (to subsection 247(7.1)) and possible future US regs (or even how the new US regs, absent specific rules, are viewed) may narrow conceptual gaps between the approaches of the two countries and as a practical matter eliminate any issues on southbound guarantees (previously a potential source of dispute[69]); but at the same time may open gaps on northbound guarantees, previously an area where disputes would not necessarily have arisen, because the 1968 regs did not require that a guarantee be compensated.

OTHER MATTERS AND CONCLUDING COMMENTS

Some Canadian tax issues, apart from those arising under transfer-pricing rules (that is, subsection 247(2) of the Act), may arise on northbound services (for a Canadian member of a group) that are performed in Canada, by employees or other representatives of a US member of the group. These are beyond the scope of this paper,[70] but may be briefly noted as follows:

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[68] The Canadian jurisprudence that has involved guarantee fees has not specifically and conclusively addressed that question, because it was either assumed away or it was not relevant to the issues before the courts. For a discussion of those cases and this overall matter, see Nathan Boidman, "Canada Announces Safe Harbour Respecting Certain Inter-Company Guarantees" (November 14, 2003) 32:11 *Tax Management International Journal* 606.

[69] An added element of potential dispute respecting guarantee fees paid to a Canadian parent stems from US case law on the deductibility of such fees. The case law has, in fact gone both ways. See *Seminole Thriftway, Inc.*, Fed. Cl., 99-1 USTC 50.155; *Tulia Feedlot, Inc. v. United States*, 513 S. 2d 800 (5th Cir. 1975); cert. denied, 96 Sup. Ct. 362 (1976); and *A.A. & E.B. Jones v. Commissioner*, 19 TCM 1561 (1960). The latter two are discussed in two 30-plus-year-old IRS technical advice memos in relation to whether the 1968 section 482 regs required that a US parent charge a fee to a foreign subsidiary for guaranteeing its debts. See TAM 77-12-2289960A, December 28, 1977, and TAM 7822005, February 21, 1978. Both memoranda took the position that there should be a fee, but that it should not exceed the actual costs (out-of-pocket expenses) to the US parent of providing it. In that respect, James Croker, Alston & Bird LLP, personal correspondence, noted that under the section 482 regs in place prior to August 2006 (when the temporary "services" regs were issued and then replaced in August 2009 by final regs), most companies took the position that giving guarantees was not an integral part of their businesses (or the businesses of the guaranteed subs), and accordingly they were permitted to charge their services at cost, of which there was none. The new regs expressly except financial guarantees from the services cost method (which continues to allow, in quite limited circumstances, the pricing of intercompany services at cost). In Canada, there are specific rules permitting the deductibility of guarantee fees (not specifically identifying the status of the guarantor). See paragraph 20(1)(e.1) of the Act. In *GE Capital Canada*, supra note 8, there was no suggestion that there is any generic impediment to deducting an outbound fee paid to a shareholder.

[70] Also beyond the scope of this paper are a number of other elements of the overall Canadian transfer-pricing scene, such as: (1) secondary adjustments where there are overcharges to a Can-

- The US member would engage nexus to the Canadian tax system, as "carrying on business in Canada," but normally would be expected to be exempt from Canadian tax under the combined effects of the permanent establishment article (article V) and the business profits article (article VII) of the treaty. Note, however, that potential issues arise under the new "services PE" rules of article V(9), added by the fifth protocol.
- Even if there is exemption from Canadian tax, hassles may arise under advance withholding tax rules of section 105 of the Income Tax Regulations (and, in the case of Quebec, under similar requirements in its tax statutes).
- Substantive and procedural (for example, withholding) employee-related tax rules would apply to US employees or other representatives of the US member, and the substantive effects may not necessarily be eliminated by the rules of article XV of the treaty.
- Canadian federal, provincial, or harmonized (federal and provincial) goods and services tax (GST) or more traditional sales tax may apply, although in a commercial context they are supposed to impose no net burden.

Returning to transfer-pricing rules in respect of Canada-US cross border intercompany services, the foregoing discussion makes clear at least the following points.

- In many, but not all, respects, the final regs will see the principles underlying the transfer-pricing rules of the two countries for cross border services draw

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adian affiliate, arising under subsections 15(1), 56(2), 212(2), and 212(13) and section 246 of the Act; (2) the transfer-price-related penalty rules of subsection 247(3), which levy a penalty equal to 10 percent of underreported income, which is roughly the midpoint of the two levels of US penalties (for example, 20% × 35%, or 7%; and 40% × 35%, or 14%) and, *unlike* the US approach, is payable even when there is no net taxable profit; and accompanying contemporaneous documentation rules of subsection 247(4); (3) the new fifth protocol binding arbitration rules set forth in articles XXVI(6) and (7), together with annex A to the fifth protocol (see also the competent authority-related June 3, 2005 "Memorandum of Understanding Between the Competent Authorities of Canada and the United States Regarding the Mutual Agreement Procedure Fact Sheet," *CCH Tax/Federal Income Tax/Tax Topics/2005/Report* no. 1744, August 11, 2005; "Second U.S.-Canada Memorandum of Understanding on Competent Authority Cases, Released by Internal Revenue Service, Canada Revenue Agency" (July 27, 2005) 14:7 *Tax Management* 288; and "Memorandum of Understanding Between the Competent Authorities of Canada and the United States Regarding Factual Disagreements Under the Mutual Agreement Procedure," signed December 8, 2005, reproduced in (December 21, 2005) 14:17 *Tax Management Transfer Pricing Report* 686)); (4) advance pricing arrangements (see, inter alia, Nathan Boidman, "Revenue Canada Releases Details of Advance Pricing Arrangements Program" (July-August 2001) 53:4 *The Tax Executive* 272); (5) the paragraph 247(2)(b) recharacterization rule (for an excellent discussion of both the history and purpose of this rule, by its principal author, who was a member of the Tax Legislation Branch of the Department of Finance at the time, see Brian Bloom, "Paragraph 247(2)(b) Demystified," *CCH Tax Topics* no. 1783, May 11, 2006, 1-5); (6) Canada's adoption of US-style (Code section 5472) reporting (see section 233.1 and form T-106); (7) section 231.6 of the Act, which mimics US requirements respecting information demands for foreign-based information and documents; and (8) rules for "qualifying cost contribution arrangements" in section 247 of the Act and paragraphs 120-138 of IC 87-2R.

closer together. This particularly stems from the new restrictions on (though not the total abolition of) the use of cost-based pricing.

- The partial continuance of cost-based prices (under SCM), the choice that can be made whether or not to use SCM, and comparative Canadian-US corporate tax rates should see effective efforts be made to minimize prices for northbound services and maximize them for southbound services.
- There appears to be nothing in the six "methods" (beyond SCM) for pricing services that necessarily conflicts with Canadian law.
- In the case of shared employees, the final regs may promote dispute between the two countries.
- In the case of parent company activities, there is nothing in the final regs that necessarily conflicts with the relevant Canadian law—notwithstanding that the US approach sets up pages and pages of "rules," whereas the Canadian approach is really simply the arm's-length pricing principle (possibly buttressed in non-mechanical or specific ways by OECD musings in the form of the OECD 1995 guidelines).
- Finally, in the potentially controversial area of cross-border guarantees, the story will not really be told unless and until the United States issues specific regs, Canada enacts proposed subsection 247(7.1), and the pending litigation has been completed.[71]

In summary, the two countries are driving from different ends of the spectrum. The United States is trying to depart from the notion of services being charged at cost toward services being charged at whatever cost arm's-length pricing theology would provide. Canada often drives from the latter theology toward—where the service is inbound to Canada—finding reasons why the arm's-length price is cost. At what point these two different initiatives intersect and arrive at a consensus will be but one of the interesting issues to focus on as Canada-US matters evolve under the final regs.

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[71] Reference may also be had to current European Commission views respecting the pricing of intercompany services. In particular, see a work of the EU Joint Transfer Pricing Forum (European Commission, Directorate-General, Taxation and Customs Union), "Working Document on Intra-Group Services Taking Into Account the June JTPF Meeting," issued for the October 27, 2009 meeting, Brussels, September 2009, Taxud/E1/, DOC: JTPF/014/2009/EN. This document surveys current thinking in Europe on the matter in the context of considering issues that might be developed further, which *unremarkably* states, in a "blinding glimpse of the obvious" (pace Ross Johnson of *Barbarians at the Gate* fame: see note 19, supra), that the commission's starting point for its current work (and the point upon which that work will be based) are the questions identified in chapter 7 of the OECD transfer-pricing guidelines as to "whether services have been provided by one member of a MNE group to other members of that group and, if so, [the issues] in establishing arm's length pricing for those intra-group services." This document, which runs 23 pages, includes in annexes I and II a listing of possible services and associated costs that extend beyond those in the OECD guidelines.