The Implications In and For Canada of the Final Section 482 Services Regulations

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Genesis

1

- Based on article for *The Tax Executive* (of the same title), Vol. 61, No. 6, November-December 2009 at pages 445-457
- An updated version of that article is provided as a paper for this seminar:- see draft in seminar binder

Need for this presentation?

2

Need for this presentation?

- "In principle, there ought to have been no need to write this article."
  - TNI Article – page 445
- Why is that?
  - "The reasons are threefold."
    - TNI Article – page 445

Reason Number One

3

Reason Number One:- Common Law on TP in Canada and the U.S.

- Compare Slides 4 and 5, which set out basic/fundamental law in both countries on transfer pricing:- namely the arm's-length standard (ALS)

• Do you see a difference?

5

Reason Number One (cont'd)

4

Reason Number One (cont'd)

- The U.S. "ALS" Rule arises under code section 482 and is expressed in a Regulation as follows:
  - § 482 of the Internal Revenue Code: 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."

6

Reason Number One (cont'd)

5

Reason Number One (cont'd)

- Canada's §247(2)(a) and (c):

> *(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*
> *(a) the terms or conditions made or imposed, in respect of the transaction or series between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm's length...*
> *any amounts that, but for this section and section 245, would be determined for the purposes of 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 an "adjustment") to the quantum or nature of the amounts that would have been determined if,*
> *(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*

7

Reason Number Two

6

Reason Number Two:- Hegemony (and unifying factor) of facts & circumstances

- Three Elements:
  - The notion
    - Basic Inescapable Nature
    - Ultimately, it's all about F&C which cannot be legislated
  - Recognition of notion
    - Slide 7
  - Implications for, and relationship to futile attempt to codify or detail or mechanise the ALS
    - Consider sad history – Slide 8
    - Consider that *Hofert* obviated all that – Slide 9

8

Reason Number Two (cont'd)

7

Reason Number Two (cont'd)

- Key recognition of notion
  - 1962 - The Tax Appeal Board in *Hofert*
    - Slide 7A
  - 1992 – James Mogle, International Tax Counsel, The U.S. Treasury (in dealing with Reg. Proposals)
    - Slide 7B
  - 2009 – Mr. Justice Robert Hogan in *GE Capital*
    - Slide 7C
  - 2010 – David Ernick, Associate International Tax Counsel, of the U.S. Treasury on September 2009 OECD announcement
    - Slide 7D

Reason Number Two (cont'd)

7A

Reason Number Two (cont'd)

- Key recognition (cont'd)
  - 1962 – *Hofert*
    - rejecting government's contention that Canadian Sub should have used prices it was charging Canadian retailers for Christmas trees to price sales – in far greater quantities - it was making to its U.S. parent which was re-selling to U.S. retailers:

      "In The King v. Noxzema… Maclean J (Ex. Crt.) held…that the phrase 'fair price' was a commercial and not a legal term and involved a question of fact into which many considerations might enter."

      – R.S.W. Fordham, Q.C., TAB, in *J. Hofert Limited v. M.N.R.* 62 DTC 50, at 52

Reason Number Two (cont'd)

7B

Reason Number Two (cont'd)

- Key recognition (cont'd)
  - 1992 – In January, Treasury issues proposed 482 Regs. which would make the "Comparable Profits Method" (CPM) mandatory if there are not exact CUPS
    - In September, that is essentially withdrawn and the Treasury's Acting ITC, James Mogle, is quoted in respect thereof as follows:

      "Mogle said he has 'a few ideas' as to what might replace CPI, 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'."

    - 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, p. G-1.

Reason Number Two (cont'd)

7C

Reason Number Two (cont'd)

- Key recognition (cont'd)
  - 2009 – Mr. Justice Robert Hogan in *General Electric Capital Canada Inc. v. The Queen*, TCC, December 4, 2009 (2006-1385 (IT)G) 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."

Reason Number Two (cont'd)

7D

Reason Number Two (cont'd)

- Key recognition (cont'd)
  - 2010 – Treasury's David Ernick (see Slide 7) in discussing the September 2009 OECD proposals (see Slide 8) and noting a new "Natural Hierarchy of Methods" said that "… the most reliable methods will depend on the facts of the case".
    - See BNA Daily Tax RealTime, March 31, "Today's Update – OECD Draft proposes Natural Hierarchy of Transfer Pricing Methods, Ernick Says", posted March 31, 2010 at 5:55 pm ET.

Reason Number Two (cont'd)

8

Reason Number Two (cont'd)

- Implication of "F&C Notion" for, and relationship to futile attempts to codify or detail or mechanize the ALS
  - Consider the sad history where this fact of legal life is ignored or overlooked or compromised
    - 1968 US §482 Regs.
    - 1979 OECD Guidelines (really a knockoff of U.S. Rules)
    - 1986 U.S. add-on to §482 of the "Commensurate with Income" Rule
    - 1987 Information Circular 87-R
    - 1988 U.S. Treasury "White Paper" on 1986 amendment
    - [To 8A]

Reason Number Two (cont'd)

8A

Reason Number Two (cont'd)

- 1992 – Proposed U.S. §482 Regs.
- 1994 – Final Revisions §482 Regs.
- 1995 – OECD Revised Guidelines
- 1999 – Revised IC-87-2R
- 2003 – Commencement of CRA's Transfer Price Memo Series
- 2006 – Temporary §482 Regs. on Services
- 2008 – OECD Study: "Transfer Pricing Aspects of Business restructurings" (Sept. 18/08)
- 2009 – Final §482 Regs. on Services
- 2009 – OECD – Proposed Revisions of Chapters I-III of the Transfer Pricing Guidelines (Sept. 9/09) – see Slide 7D
- WHY SAD?: All have done nothing to abate F&C-driven disputes arising from ALS

Reason Number Two (cont'd)

9

Reason Number Two (cont'd)

- Implication of "F&C Notion" (cont'd)
  - Consider that *Hofert* obviated all projects starting with 1968 U.S. §482 Regs.
    - What does this mean?
    - The basic facts in *Hofert* - above
    - Implicit use of the "CUP" notion as the priority testing point (at pg. 52)
    - Implicit consideration of "other methods" where there was no CUP (at pg. 53)

Reason Number Two (cont'd)

10

Reason Number Two (cont'd)

- Other Points
  - Note re hard bargaining (Slide 10A)
  - Note re "Best Method Rule" and OECD September 2009 draft revisions and "a blinding glimpse of the obvious" (Slide 10B)
  - Note re Xilinx (Slide 10C)

Reason Number Two (cont'd)

10A

Reason Number Two (cont'd)

- Other points
  - Note re: Hard Bargaining (HB)
    - I/C prices established by actual negotiations (HB)
    - Studies show 10-15% incidence of HB
      - Prof. Lorraine Eden (Texas A&M)
    - Purest form of ALP
    - All comes down to need to show business reason for HB
    - OECD (to its discredit) expresses conceptual reservation
    - Generally not on T/P discussion radar screen
      - But look for it in matters under review
    - For a discussion, see Boidman, del Castillo, Thomas, et al., 897 T.M., Transfer Pricing: Foreign Rules and Practice Outside of Europe, 897

Reason Number Two (cont'd)

10B

Reason Number Two (cont'd)

- Other Points (cont'd)
  - Note re: "Best Method" Rule and OECD Sept/09 draft revisions and the "blinding glimpse of the obvious"
    - U.S. Regs. – 1994 – "Best Method Rule"
      - i.e. give no priority to any particular method except as it is most suitable
    - OECD – Sept/09 – Draft
      - jettison bias to "traditional methods" over "transactional profit methods"
      - same theme – and as a result, the release states, there should be "…a standard whereby the selected transfer method should be the 'most appropriate method to the circumstances of the case'"
    - Isn't this all simply: a "blinding glimpse of the obvious", an expression attributed to Ross Johnson (the Canadian Prairie accountant who rose to and was President and CEO of RJR Nabisco at the time of its take-over by Kohlberg Kravis Roberts & Co.) in the legendary book, "Barbarians at the Gate – The Fall of RJR Nabisco" by Bryan Burrough and John Helyar, Harper & Row, Publishers, Inc., 1990, at page 22

Reason Number Two (cont'd)

10C

Reason Number Two (cont'd)

- Other Points (cont'd): Note re: *Xilinx*
  - Factual context
    - Determining role of stock-based compensation in developing "cost" for a cost-sharing arrangement
  - IRS §482 Reg. issue
    - Does a particular reg. apply even if it overrides ALS?
  - Tax Court
    - Rejected government's position: *Xilinx Inc. et al. v. Commissioner* 125 T.C. 37 (2005)
  - Ninth Circuit – First time
    - The U.S. Court of Appeals in *Xilinx Inc. v. Comr.* 567 F.3(d) 482 (9th Cir. 2009)) reversed the Tax Court. The Court decided that a mechanical rule in the Regs overrode the basic arm's-length standard otherwise required by Code § 482
      - Second time
    - The taxpayer appealed for a re-hearing. Xilinx Inc. v. Comr. 3 (9th Circuit, Nos. 06-74246 and 06-74269), Petition for Re-hearing or Re-hearing en banc filed Aug. 12, 2009. In late March, the Ninth Circuit reversed itself – No. 06-74246, dated 3/22/2010
  - Tax Notes International Debate
    - Reuven S. Avi-Yonah, "*Xilinx Revisited*", Tax Notes International, Vol. 57, No. 13, March 29, 2010 at page 1141
    - Response in part:: Nathan Boidman "Xilinx: Revisiting the Intent and Effect of U.S. Transfer Pricing Regs" (letter to the editor), Tax Notes International, Vol. 58, No. 1, April 5, 2010, page 59
  - See also Dec./09 decision in *Veritas Software Corp. v. Comr.* 133 T.C. No. 14

Reason Number Three

11

Reason Number Three

- The Third reason that this presentation should not have been necessary is reflected in the following:
  - aren't inter-company services basically susceptible to reasonably straightforward and uncontroversial treatment under the arm's-length standard (in contrast to inter- company sales of proprietary products or inter-company licensing of proprietary intangibles) as transactions which do not necessarily involve high-value intangibles (the high priest and sacred cow of inter-company transactions and the controversies that swirl today around this area)?

21

But Why Presentation is Needed (Five Reasons)

12 (1/4)

But notwithstanding the three reasons why this presentation should not have been needed, there are five reasons why it is

- FIRST, international inter-company 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 ("mecchano" 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 U.S. or Hogan, J), varying facts and circumstances never existed.
  - [see above]
- SECOND, and not only closely related to the first element, but perhaps the motivating factor thereof, is the almost paranoia fashion in which tax administrators view the activities of multinationals—the concern that transfer pricing is used as sword, that seeks to manipulate prices in order to allocate profits in a fashion that reduces overall group tax. This leads to the constant, in this writer's view, debilitating process, of trying to either fine tune or add radical elements to what at law is a principle which cannot be put into a nice, neat box.

22

But ... five reasons ... (cont'd)

12 (2/4)

But ... five reasons ... (cont'd)

- THIRD: Canada has no "regs." (and *Safety Boss Limited*, 2000 D.T.C. 1707 simply follows FACTS) But (since 1968) the U.S. has had Regs.
  - The temporary regulations [TD 9278], for tax years beginning after 2006, were issued on July 31st by the U.S. Treasury Dept. and Internal Revenue Service— 71 FED. REG. 44466-44519 (Aug. 4, 2006) and published in August 21, 2006 issue of the Internal Revenue Bulletin (2006-34 I.R.B. 256). The Regs. had a sunset of August 4, 2009 and were replaced by final Regs. on July 31, 2009
  - Final U.S. (Department of the Treasury and IRS) Regs. on Intercompany Services – T.D. 9456, 74 Fed. Reg. 38830, dated 8/4/09

But ... five reasons ... (cont'd)

12 (3/4)

But ... five reasons ... (cont'd)

- 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 inter-company relations (as dealt with in the new Regs and that are addressed by the CRA in its writings and by OECD in their 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.
  - Is it instead a sharing of an employee?
    - Issues of "secondments"
  - Is it an activity for benefit of performer (e.g. a "parent" – "stewardship or custodian") or instead does activity convey benefit for other party (e.g. a subsidiary)
  - If a service – should there be a mark-up on cost?
  - What is "cost" [see below: CRA issues]
  - Where do guarantees fit in?

But ... five reasons ... (cont'd)

12 (4/4)

But ... five reasons ... (cont'd)

- FIFTH, there is the almost quaint, and perhaps almost unique U.S. approach adopted in 1968, to considering that some services need not be charged at a market price or mark-up, but simply at cost. Given that Canada has no rules *per se* (apart from the ALS 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 OECD as far back as 1984 (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 in practice by CRA and many other countries.
  - "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).

Basic divergence between Canada and the U.S. on pricing services

13

Basic divergence between Canada and the U.S. on pricing services

- Basic divergence between Canada and the U.S. on pricing services
  - Under the U.S. 1968 Regs
    - "Cost" approach in most (but not all cases)
    - Under the '68 Regs, the cost safe harbour applied to "non-integral services" [Reg. § 1.482-2(b)(3)] with the latter notion ("integral") relating to relatively narrow circumstances.
  - But divergence narrows under the July 31, 2006 Temporary S482 Regs (see above) and then the August 4, 2009 final Regs.
    - Narrows – Basic ALS Adopted
    - But divergence remains: The "Services Cost Method" Exception: Reg S1.482-9(b)

Divergence under ’68 Regs

14A

- Ambit of the ostensible divergence (conflict) under the 1968 Regs?
  - Was it more in theory than in practice?

Divergence under ’68 Regs (cont’d)

14B

- Ambit of the ostensible divergence (conflict) under the 1968 Regs (cont’d)
  - Factors which tend to bridge gap
    - CRA’s inbound bias/predilection
    - Is there really a service (see GE Capital)
    - If so – are there factors which make “cost” the ALS? (1984 OECD Report)
    - Impact of predilection on outbound services?
      - Slide 14C

Divergence under ’68 Regs (cont’d)

14C

- Ambit of the ostensible divergence (conflict) under the 1968 Regs – factors which bridge gap (cont’d)
- Impact of predilection on outbound services?
  - CRA hoisted on its own petard?
    - Obvious “Dynamics” Problem for CRA: Need for consistency
      - This can lead to pressure on what is cost
      - Is this similar to issues in the US respecting cost contribution arrangements where stock-based compensation is involved and the new SCM rule?

Do the new Regs provide complete convergence – in theory/concept?

16A

- Do the new Regs provide complete convergence – in theory/concept?
- As already noted: in theory there is not total convergence
  - Services cost method (SCM)
    - Reg. S 1.482-9(b)
    - But restricted to services which either are simply shared activity 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 that what the thing is worth, so that there may not be much room for real dispute with Canada.

Divergence – New Regs (Cont'd)

16B

- Do the new Regs provide complete convergence – in theory/concept – SCM (cont'd)
  - The SCM method does not apply if the same services are rendered at a mark-up of greater than 7% to third parties. As well, it does not apply to manufacturing, production, extraction, constructing, reselling, distributing, research development engineering, financial transactions, including guarantees and insurance and re-insurance (i.e. "excluded services" (ES)).
  - On December 20. 2006, Revenue Procedure 2007-13 was released containing a revised and expanded list of specified covered services (SCS) 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 one hundred (100) tasks. A submission by Tax Executives Institute, Inc. to the Internal Revenue Service, dated November 21, 2006 respecting the Temporary Regs, and one of Nov. 15 recommending an expanded list of SCM activities have been reflected in the Dec. 20 IRS announcements and release, *Daily Tax Report*, No. 245, Thursday, December 21, 2006, ISSN 1522-8800. See "IRS Postpones Temporary Services Rules Except for 'Business Judgment' Provision", BNA *Daily Tax Report*, No. 245, Page GG-2, Thursday, December 21, 2006.

Divergence – New Regs (Cont'd)

17

- Do the new Regs provide complete convergence – in theory/concept (cont'd)
  - "Business Judgment" Rule Aspect
    - A limitation on using SCM:
      - That rule, under **Reg.** § 1.482-9(b)(5) requires (in order that SCM apply) that the taxpayer "reasonably concludes in its business judgment that the service does not contribute significantly to key competitive advantages, core capabilities or fundamental risks of success or 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".
      - Will the "business judgment" dovetail with CRA's existing predilections to see or not see the basis for mark-up in inter-company services?

US Outbound-Canada Inbound Overview

18

US Outbound-Canada Inbound

- Overview
  - In general – where SCM applies (and is chosen)
    - No reason for conflict with CRA
    - Where SCM D/N apply
      - Usual disputes may arise
  - Straight (market – type) Services
    - Parameters (Slide 19)
    - Comparing the methods (Slide 20)
    - The effect of tax rate arbitrage (Slide 21)
  - Shared-Employees/Cost Sharing (Slide 22)
  - Parent Sub-stewardship and Custodian: separate section below

33

US Outbound-Canada Inbound Straight (market – type) Services

19 (1/2)

US Outbound-Canada Inbound

- Straight (market – type) Services
  - Parameters
    - Nature
      - This section treats an activity carried out or performed by a U.S. member of a Canada-U.S. 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 U.S. 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 which is undertaken for the purposes and benefit of the U.S. member, that is, a "shareholder activity" (as detailed below).

34

US to Canada –Straight Services (Cont'd)

19 (2/2)

US Outbound ... Straight (market – type) Services (cont'd)

- Parameters (Prior Slide Page)
- Context arising from comparative Corporate Tax Rates
  - By 2012
    - Canadian Fed/Prov 23% – 27% (one or two higher provinces aside)
    - US Fed/State/City
    - 35% - 47%
  - Obvious Pricing Preference
    - Minimize price
    - SCM (where applicable) will accommodate
    - In other cases disputes more likely with IRS

US to Canada –Straight Services (Cont'd)

20 (1/6)

US Outbound-Canada Inbound - Straight Services (cont'd)

- Comparing the methods (when SCM D/N apply)
- Basic Q: Do methods in Reg 1.482-9(c) to (h) conflict with Canadian requirement?
- Given that "Canadian" Requirements are simple ALS, in theory no conflict provided these Regs do not conflict with ALS
- But CRA, of course, has "views": As per IC-872R – paragraphs 152-171 - and the OECD Guidelines
  - But these views should not be treated by a court as "law" (although Mr. Justice Rip in *Glaxo* could be seen as putting that in question)

US to Canada – Straight Services (Cont'd)

20 (2/6)

US Outbound-Canada Inbound - Straight Services (cont'd)

- Comparing the methods (cont'd)
  - What are US "methods" under Reg. 1.482-9(c) to (h) and brief comments thereon in relation to ALS
    - "Comparable uncontrolled services prices" (CUSP) method
      - Nothing new here, no conflict (IC-872R, paragraphs 160 and 161, 53-56 and 64-69)
    - "Gross services margin" (GSM) method
      - This is odd. 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 CRA's discussion of intercompany services in IC-87-2R: paragraphs 56-58 and 70-75 of IC-87-2R. (But that is no reason why it might not be viewed as appropriate by a Canadian court)

US to Canada –Straight Services (Cont'd)

20 (3/6)

US Outbound-Canada Inbound - Straight Services (cont'd)

- Comparing the methods (cont'd)
  - "Cost of services" plus method
    - Nothing new here (See IC-87-2R, paragraphs 162-165, 76-79 and 86)
  - "Comparable profits method" (CPM)
    - Presumably will raise same issues as WRT its applicability elsewhere (see IC-87-2R, paragraphs 47-63, 90-95, 106-169)
  - "Profit split" (same as prior) (see IC-87-2R, paragraphs 96-105)
  - "Unspecified methods" (i.e. chaos)

US to Canada –Straight Services (Cont'd)

20 (4/6)

US Outbound-Canada Inbound - Straight Services (cont'd)

- Comparing the methods (cont'd)
  - Other Point
    - Overlaid on those methods are the rules in Reg. 1.482-9(i) for "contingent-payment contractual terms for services."
    - With respect to "Unspecified Methods", two points may be noted.
      - First, that notion simply reflects the essential "facts and circumstances" nature of the ALP, is therefore part of its basic fabric and is acknowledged by CRA in its Circular.
      - Second (next page)

US to Canada –Straight Services (Cont'd)

20 (5/6)

US Outbound-Canada Inbound - Straight Services (cont'd)

- Comparing the methods (cont'd)
- Other Points (cont'd) – Re "Unspecified Methods":-
  - Second, it is interesting to revisit, in the context of a statement in the Regs., the comment above that the recent OECD proposals to rewrite the Guidelines seem to be adopting "the best method" rule in the section 482 regulations in the context of the following statement (in Reg. §1.482-9(h)) that:

    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).

US to Canada –Straight Services (Cont'd)

20 (6/6)

U.S. Outbound … Straight Service (cont'd)

- Comparing the Methods (cont'd)
  - Summary Comment – Views
    - No reason for Canadian court to reject prices based on these methods
      - But always subject to F&C
    - No reason to think CRA will be more or less mollified by these methods than by those U.S. Regs applicable to other types of I/C transactions

US to Canada –Straight Services (Cont'd)

21

U.S. Outbound – Canadian Inbound

- Straight (market-type) services
  - The effect of tax rate arbitrage
    - See basic parameters = Slide 19 (2/2)
      - Predilection to minimize prices
    - More IRS / Less CRA conflicts
    - But it is an evolving inversion / paradigm shift
      - Historical perspective?
        - U.S. Parent companies strip Canadian subsidiaries
        - Now: reverse gears

US Outbound-Canada Inbound
Shared employees / Cost sharing

22

U.S. Outbound – Canadian Inbound

- Shared employees / cost sharing
  - Parameters – notion = Slide 23
  - New U.S. treatment = Slide 24
  - Canadian practice = Slide 25

US to Canada Shared employees (Cont'd)

23A

U.S. Outbound – Canadian Inbound

- Shared employees / cost sharing
  - Parameters – notion
    - two or more members of a group have a recurring requirements (say "bookkeeping");
    - neither member requires a bookkeeper full time but together are prepared to engage one and share—pro rata—their costs;
    - [cont'd next page]

US to Canada Shared employees (Cont'd)

23B

U.S. Outbound – Canadian Inbound (cont'd)

- Shared employees / cost sharing (cont'd)
  - it is impractical for each member to hire, as its employee on a part-time (or partial) basis and instead one member employs the person and either as a matter of an explicit agreement or otherwise the use and cost thereof is shared, as though the person had been part-time;
  - the arrangement does not entail any sharing—or transfer—of other property or resources (such as valuable intangibles) between the parties and thereof does not raise the ubiquitous issues surrounding "cost sharing" arrangements related to developing proprietary intangibles;
  - the arrangement is the opposite of the straight service situation where one member has a core/constant need for the function and activity while the other has no such need, but only an occasional and unpredictable need.

US to Canada Shared employees (Cont'd)

24A (1)

U.S. Outbound – Canadian Inbound

- Shared employee / Cost sharing
  - New U.S. treatment
    - Does it reflect essence of above?
      - It depends! [Governing Acronyms: SCM, SSA, SCS, ES]
      - 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". (See page 4 of the Final Regs. The notion of a **"shared service arrangement" ("SSA")** is dealt with in Reg. §1.482-9(b)(7). [See also (j) – "Total Services Costs" and (k) – "Allocation or Costs".) That is a shorthand reference to the notion that costs can be shared as a proper arrangement. But the fine points restrict the ambit. In particular, a U.S. member, as the employer of the shared employee can charge the Canadian member, as user of the shared employee, a pro rata amount of the employee's cost, as the ALP, only if the employee's functions are a **"specified covered service" ("SCS")** for purposes of **SCM**. If either the activity does not meet the **SCS** requirement or does, but involves an **"excluded service" ("ES")**, neither the **SCM** nor the **SSA** - which allows sharing based on "reasonably anticipated benefits" [as defined in paragraph (1)(3)(i)] - are applicable.

US to Canada Shared employees (Cont'd)

24A (2)

U.S. Outbound – Canadian Inbound (cont'd)

- Shared employee / Cost sharing (cont'd)
  - New U.S. treatment (cont'd)
    - Does it reflect essence of above? (cont'd)
      - Therefore a bookkeeper is O.K.
        - See Rev Proc 2007-13
        - Bookkeeping is SCS
        - But a nuclear physicist is NOT
        - Not qualified SSA because either not covered by 2007-13 or even if it is, it is disqualified from SCM as an excluded activity.

US to Canada Shared employees (Cont'd)

25A

U.S. Outbound – Canadian Inbound

- Shared employee / Cost sharing
  - Canadian reaction?
  - In Canada, the view (reasonably by a court) would likely reflect the basic principles suggested above and which are at the essence of CRA's brief comments on the matter in IC-87-2R. As part of that (as noted earlier in note 43 respecting paragraphs 163-165 of IC-87-2R) is paragraph 7.36 of the OECD Guidelines which reads:

US to Canada Shared employees (Cont'd)

25B

U.S. Outbound – Canadian Inbound

- Shared employee / Cost sharing

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 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.

US to Canada Shared employees (Cont'd)

25C

U.S. Outbound – Canadian Inbound

- Shared employee / Cost sharing
  - 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 ALP or lead to uncertainty and disputes between Canada and the U.S.

Canadian Outbound – U.S. Inbound Overview

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Canadian Outbound – U.S. Inbound

- Overview
  - Because SCM is optional – need not be conceptual conflict
  - Straight services = Slide 27
  - Shared employees / cost sharing = Slide 28

Canada to US Straight Services

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Outbound Canada – Inbound U.S.

- Straight services
  - See above (Inbound Canada …) for definitional parameters
  - Pricing bias – predilection?
    - Converse of inbound Canada situation
    - Comparative tax rates favour maximizing prices
  - Final Regs affect such bias in six ways
    - Slide 27A

Canada to U.S. Straight Services (cont'd)

27A

Outbound Canada … Straight Services (cont'd)

- – Six effects of Regs on pricing bias
  - CRA – happy
  - IRS – unhappy
  - SCM need not be adopted
    - – But issues respecting cost could arise and lead to claims by CRA for cost-based prices which exceed market prices. This can particularly arise where highly-paid senior executives are involved.
  - Obverse of restrictive ambit of SSA (above and below) may permit claims for mark-up on shared employees
  - Latter dynamic may also affect "shareholder activity" – see below
  - Detailed methods may facilitate pushing envelope on prices

Outbound Canada to U.S.

28

Shared employees / cost sharing

Outbound Canada …(cont'd)

- – Shared employees / cost sharing
  - Shared employee on books of Canadian affiliate
  - Where activity of employee comprises "Specified Covered Services" (SCS)
    - – Same discussion as above in "Inbound Canada" context
      - No conflict – just share cost (which however may be contentious)
  - Where activity does not comprise SCS
    - – CRA not likely to require price in excess of cost (which however may be contentious)
    - – But IRS, under Regs, may accept mark-ups
      - This simply would feed bias

The "Shareholder (Stewardship) Activity" Factor in Canada – U.S. Groups

29

The "Shareholder (Stewardship) Activity" Factor in Canada – U.S. Groups

- Issue respecting an activity by a parent corp.:
  - Is it undertaken for its own purpose and benefit exclusively?
    - In which case no basis to charge a fee to a subsidiary
  - OR – does it convey a benefit to and therefore constitute a service to a subsidiary?
    - In which case there is basis for a fee or charge
  - In Canada
    - As always simply question of the facts and circumstances
    - See CRA views – below
  - In the U.S. final Regs
    - Contentious issues under Reg 1-482-9(1)

55

The Shareholder Activity Factor (Cont'd)

30

The "Shareholder (Stewardship) Activity" Factor in Canada – U.S. Groups (cont'd)

- The final Regs – threshold issue
  - For the activity to meet first category and therefore not constitute a service to a sub it must meet test of being a "shareholder activity"
- The introductory notes to the final Regs, at page 21 and 22 sum up the matter as follows
  - See Slide 30A

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The Shareholder Activity Factor (Cont'd)

30A (1)

The "Shareholder (Stewardship) Activity" Factor in Canada – U.S. Groups (cont'd)

– The final Regs – threshold issue – page 21/22:

...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 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.

– Then read latter in light of Reg. 1.482-9(1)(3)(I) – Slide 31

The Shareholder Activity Factor (Cont'd)

31

The "Shareholder (Stewardship) Activity" Factor in Canada – U.S. Groups (cont'd)

– The final Regs – threshold Issue

• Definition of benefit for purposes of determining whether there is a service to a sub

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 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.

The Shareholder Activity Factor (Cont'd)

32

The "Shareholder (Stewardship) Activity" Factor in Canada – U.S. Groups (cont'd)

- Canada – on threshold issue
  - No specific rules
  - See IC-87-2R – paragraphs 154-158
  - See 1995 OECD Guidelines
    - Paragraph 7.9 – (referring to "shareholder activity")
    - Paragraph 7.10 – (three examples of S.A.)
    - Paragraph 7.6 – (establishing guidance respecting S.A.)
      - See Slide 32A

The Shareholder Activity Factor (Cont'd)

32A

The "Shareholder (Stewardship) Activity" Factor in Canada – U.S. Groups (cont'd)

- Canada – on threshold
  - OECD paragraph 7.6

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 Shareholder Activity Factor (Cont'd)

33(A)

The "Shareholder (Stewardship) Activity" Factor in Canada – U.S. Groups (cont'd)

- The Regs have 7 rules and 21 examples
  - But these provide no particular assistance in many situations which may commonly arise—and all that one remains with—as it should be—is the basic facts and circumstances dynamic comprising the ALP.

The Shareholder Activity Factor (Cont'd)

33(B)

The "Shareholder (Stewardship) Activity" Factor in Canada – U.S. Groups (cont'd)

- The Regs have 7 rules and 21 examples
  - The 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 ALP.

The Shareholder Activity Factor (Cont'd)

34

The "Shareholder (Stewardship) Activity" Factor in Canada – U.S. Groups (cont'd)

- Bottom line – at the end of the day?
  - At the end of the day, whether it is a Canadian parent-U.S. 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 ALS of either country (leaving aside whether the SCM election may apply from the U.S. perspective) will turn on assessing, in a reasonable, logic-based manner, the particular facts and circumstances. And it would appear that only circumstances where a true conflict could arise is if the IRS seeks to consider that one of the twenty-one examples governs the situation and the result is one which does not comport with the ALS, logically applied.

The Special Case of Guarantees

35

The Special Case of Guarantees

- Pre-existing situation
  - In the U.S.
    - The 1968 Regs did not generally require a fee be charged for outbound guarantees
      - For financing groups, (e.g. G.E. Cap.) the general rule may not have applied
    - Certain domestic case law put into doubt whether a fee for an inbound guarantee could be deducted by the guaranteed U.S. party (see discussion in:- Nathan Boidman, "Canada Announces Safe Harbour Respecting Certain-Inter Company Guarantees", Tax Management International Journal, Vol. 32, No. 11, November 14, 2003, p. 606)
    - In Canada – Slide 36

Guarantees (cont'd)

36

The Special Case of Guarantees (cont'd)

- Pre-existing situation (cont'd)
  - In Canada
    - There has been dispute whether S247 requires a fee be charged by Canadian parent outbound guarantee
    - The disputes, under old section 69(3) and in part under S247 included whether a guarantee constitutes a services. The Canadian jurisprudence that has involved guarantee fees has not specifically and conclusively addressed that question, as it was either assumed away or it was not relevant to the issues before the courts.
    - (To Slide 36A)

Guarantees (cont'd)

36A

The Special Case of Guarantees (cont'd)

- Pre-existing situation - Canada (cont'd)
  - With respect to inbound guarantees
    - Does GE Capital tell it all?
      - The appeal to FCA may tell us more
      - See Rob O'Connor's preceding commentary

Guarantees (cont'd)

37

The Special Case of Guarantees (cont'd)

- Under the new Regs?
  - Will they now mandate a fee for an outboard guarantee or overcome domestic cases for an inbound guarantee?
  - But both the 2006 temporary Regs and the final Regs have punted on this question:
    - See Slide 37A

Guarantees (cont'd)

37A (1)

The Special Case of Guarantees (cont'd)

- Under the new Regs? (cont'd)
  - The Regs punt:
    - The introductory portion of the 2006 Temporary Regulations under the heading: "Controlled Services Transactions (d) Guarantees, including financial guarantees" states:

[*To next page*]

Guarantees (cont'd)

37A (2)

The Special Case of Guarantees (cont'd)

– Under the new Regs? (cont'd)

"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."

Guarantees (cont'd)

37A (3)

The Special Case of Guarantees (cont'd)

– Under the new Regs? (cont'd)

- What is the significance that the introductory notes to the (2009) Final Regs, which similarly defer rules for financial guarantees, is much more briefly worded and reads 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."

Guarantees (cont'd)

37A (4)

The Special Case of Guarantees (cont'd)

- Under the new Regs? (cont'd)
  - The latest word?: From May 10/10 Tax Analysts Report
    - The reported views of senior members of the Treasury and the IRS at a May 7/10 ABA meeting are of interest.

"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." (Parenthetical words added.)

Guarantees (cont'd)

37A (5)

The Special Case of Guarantees (cont'd)

- Under the new Regs? (cont'd) The latest word? (cont'd)

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." (Parenthetical words added). 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 stand-alone company borrowing costs are easily provable, while the value of implicit support is not readily ascertainable." [May 10, 2010 – TaxAnalysts, U.S. Officials Engage Practitioners on Pricing of Guarantee Fees by David D. Stewart]

Finally, compare to GE:- see Rob O'Connor's preceding commentary

Guarantees (cont'd)

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The Special Case of Guarantees (cont'd)

- Final point
  - WRT to Q in prior excerpts as to whether a guarantee is a service and the statement in the introductory notes to the 2006 temporary Regs that for sourcing purposes case law said a guarantee is not a service
    - See 2010 decision in *Container Corporation (Vitro International Corporation) v. Commissioner* 134 T.C. No. 5 (filed February 17, 2010) which concluded that it should be treated for that purpose as a service even thought it is not, but is analogously closer to a service than to interest

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Summary

39A

- 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 closer together. This particularly stems from the new restrictions on (but not 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-U.S. corporate tax rates should see effective efforts 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 which necessarily conflict with Canadian law.
  - In the case of shared employees, the Final Regs may promote dispute between the two countries.

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SUMMARY (cont'd)

39B

- The foregoing discussion makes clear at least the following points (cont'd).
  - In the case of parent company activities, there is nothing in the Final Regs which necessarily conflicts with the relevant Canadian law – notwithstanding the U.S. approach sets up pages and pages of "Rules", whereas the Canadian approach is really simply the ALP (possibly buttressed in non-mechanical or specific way by OECD musings in the form of the 95 OECD Guidelines).
  - Finally, in the potentially controversial area of cross-border guarantees, the story will not really be told unless and until the U.S. issues specific Regs, Canada enacts proposed section 247(7.1) and the pending litigation has been completed.

SUMMARY (cont'd)

39C

- The foregoing discussion makes clear at least the following points (cont'd).
  - In summary, the two countries are driving from different ends of the spectrum. The U.S. is trying to depart from the notion of services being charged at cost towards services being charged at whatever arm's length pricing theology would provide. Canada often drives from the latter theology towards, where the service is inbound to Canada, finding reasons why the arm's length price is cost. At what point do these two different initiatives intersect and arrive at a consensus will be but one of the interesting points to focus on as Canada-U.S. matters under the Final Regs evolve going forward.

End Slide

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