Finding transfer pricing certainty in uncertain times

When it comes to paying taxes, risk minimization is frequently top of mind. That's certainly true for those multinationals facing transfer pricing risk.

Transfer pricing risk arises when tax authorities disagree with your company's pricing arrangements, which can lead to audits, adjustments and penalties. Notably, transfer pricing has become particularly contentious in recent years. There are several reasons for this, ranging from government efforts to protect their tax bases to more stringent regulatory and documentation requirements. Add in the increased likelihood of prolonged audits resulting in significant penalties and it becomes clear that now, more than ever, multinationals must proactively minimize their transfer pricing risks. One way to do that is through the Advance Pricing Arrangement (APA) program.

The Canada Revenue Agency (CRA) introduced the APA program in 1990 as an alternative dispute resolution forum to help taxpayers avoid transfer pricing disputes related to future tax years. The program's main objective is to provide taxpayers with greater certainty around the transfer pricing methodology for a set of intercompany transactions for a period of future years so they can remain compliant with the Income Tax Act (ITA) and guidance from both the CRA and the Organisation for Economic Co-operation and Development (OECD).

Here we explore what an APA is, its advantages and disadvantages and some factors to consider when deciding if an APA is right for you.

What is an advance pricing arrangement?

APAs are agreements made in advance between a taxpayer and tax authority to determine the appropriate transfer pricing methodology (TPM) for specific intercompany transactions over a set period. There are three types of APAs—unilateral, bilateral and multilateral—depending on the number of tax authorities involved in negotiating the agreement. Just as it sounds, unilateral APAs are between the taxpayer and one tax authority, bilateral APAs are negotiated with two tax authorities and multilateral APAs involve more than two tax authorities.

Obtaining an APA starts with an application and requires multiple steps related to submissions, preliminary reviews, terms and conditions, and critical assumptions. Only once these elements are clarified can a final decision be made regarding the TPM, at which point the APA can be drafted. For detailed guidance on the APA process, see Information Circular 94-4.

What are the advantages and disadvantages of an APA?

The advance acceptance of a TPM is the primary advantage of an APA. It gives the taxpayer certainty that the CRA will not make any adjustments if the terms of the APA are met and that the CRA will not audit transactions covered by the APA for the duration of the term.

As an added benefit, an APA can help taxpayers avoid the expenses associated with producing annual transfer pricing documentation in accordance with subsection 247(4) of the ITA, which is required if Canadian taxpayers hope to avoid the potential penalties associated with CRA adjustments. Once an APA has been reached between the taxpayer and the CRA, the taxpayer is only required to prepare documentation demonstrating compliance with the APA.

Bilateral APAs can also reduce the risk of double taxation. Taxpayers often experience inconsistent interpretation and enforcement of transfer pricing rules from country to country, leading to a risk of double taxation. This exposure can be prospectively eliminated by negotiating a bilateral APA, which protects taxpayers from examinations (other than confirmation of taxpayer compliance with the APA) and adjustments on the covered transactions. Moreover, in light of the OECD's Base Erosion and Profit Shifting (BEPS) initiative designed to close transfer pricing loopholes for multinationals, the benefit of avoiding audits and associated double-tax exposure through negotiation of a bilateral APA may become even more valuable.

Simply stated, by providing a level of certainty and protection, APAs can help taxpayers reduce the risk of transfer pricing adjustments, avoid substantial understatement penalties, limit exposure to double taxation and duties, and eliminate the expenses associated with certain reporting and documentation requirements. Furthermore, all these benefits can be enhanced by a rollback, a renewal or the opportunity to use the APA analysis or outcome to address similar transfer pricing issues in another country.

Yet, despite these advantages, an APA is not suitable for every entity. Disadvantages of APAs include the user fees, other financial costs and effort spent to get an APA, the disclosure requirements and the unpredictability of economic events.

It can take an average of two to five years to obtain an APA, from the time of application to the time of approval. Additionally, there are costs associated with preparing the APA application, including the fees paid to transfer pricing professionals, fees associated with submitting the application and renewal fees. In some cases, a company's transactions may not be significant enough to warrant such an investment. In addition, an APA requires full disclosure of business information, including any corporate information that may be deemed sensitive. Lastly, an APA makes critical assumptions about a business and its transactions and assumes that these facts will not change over the term of the arrangement. If these assumptions do change, then the APA may become void or require renegotiation. These factors can become an issue when there are unpredictable events that impact a business's operations and profitability.

A perfect example of a recent occurrence of this nature is the COVID-19 pandemic, which likely led to the voiding of numerous APAs.

What taxpayer-specific factors should you consider?

The attractiveness of an APA and the ease with which a company can pursue an APA are influenced by several taxpayer-specific factors, beginning with a company's risk tolerance. Without some risk of a transfer pricing examination and dispute, company management would generally not expend the cost and effort required to obtain an APA unless their risk tolerance was extremely low.

In addition, the industry in which the company operates usually has some impact on the decision of whether to engage in the APA process. Some industries, notably the automotive and pharmaceutical industries, are encouraged by their inherent size, global exposure and uncertainty of transfer pricing outcomes to seek the certainty of an APA. According to the 2020 APA Program Report issued by the CRA in 2020, more than three-quarters of open APA cases involved taxpayers with operations in the following sectors: arts and entertainment; automobile and other transportation equipment; chemical and allied industries; computer and electronics; construction equipment and materials; health; petroleum; technical, scientific and professional services; and utilities.[1]

Another important factor to consider is which countries are involved and the negotiating relationship between those countries. Unless a treaty exists, no bilateral APA is possible.

The type of transfer pricing issue and the nature of intercompany transactions should also be considered when deciding on whether to pursue an APA and if that APA should be bilateral or unilateral. According to the 2020 APA Program Report issued by the CRA, in 2020, the largest percentage of APAs involved cases of transfer

of tangible property (42% of total cases) followed by transfer of intangible property (27% of total cases) and intra-group services (26% of total cases).[2] Overall, the size and complexity of a company's intercompany transactions affects the benefits it can reap from an APA. The benefits are readily apparent when the cost and effort of regular transfer pricing compliance and defense exceed the cost and effort of an APA.

Next steps

As the number of transfer pricing disputes rises globally, the nature of the disputes evolves and business disruptions continue to challenge established transfer pricing policies, certainty has arguably become more important than ever. If the pros of obtaining an APA outweigh the cons for your organization, the time may be ripe to obtain an APA.

1 Advance Pricing Arrangement Program Report 2020, The Canada Revenue Agency.

2 Ibid.

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