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Transfer Pricing – One Step Ahead – January, 2006

In any international setting, transfer pricing issues arise where transactions are entered into between non-arm's length parties. Without transfer pricing rules, a multinational group of corporations could set intercompany prices to unduly shift taxable income from high-tax jurisdictions to low-tax jurisdictions. Many high-tax countries attempt to limit tax leakage through transfer pricing rules requiring taxpayers to charge a fair arm's length price for goods and services received from, or provided to, related non-resident parties.

Affected Transactions

The transfer pricing policies of most countries are concerned with intercompany purchases and sales of goods and property; transfers of technology, rights, patents and intangibles; the rental of property; the use of intellectual property; and the providing of technical assistance. Management fees and other payments for services as well as payments resulting from research and development cost-sharing arrangements or expense allocations are also areas of concern.

Arm's Length Principle

The arm's length principle is generally based on the prices or margins obtained by arm's length parties engaged in the same or similar transactions. In order for such price or margin comparisons to be useful, the economically relevant characteristics of the transactions being compared must be sufficiently similar so as to permit reasonably accurate adjustments to be made for any differences in such characteristics.

For example, where services are an integral part of the business activity, an arm's length charge would normally include an appropriate mark-up or profit element based on mark-ups charged by unrelated parties providing similar services. In other words, the price to be charged to related parties should equal the price charged by unrelated parties rendering the same services. Simply charging for services based on cost plus a small mark-up – say 15% - does not meet the standard in many - or even most - situations.

Transactional Basis

In establishing transfer prices, generally taxpayers must set prices separately for **each transaction** they enter into with a non-arm's length party. This means that taxpayers cannot simply wait until year-end to "true up" their intercompany transactions. Procedures must be in place to identify situations involving the cross-border transfer of goods and services, ensure the appropriate transfer pricing method has been determined, and to record each and every transaction using that method.

Documentation Requirements

In addition to comprehensive rules addressing the quantum of the transfer prices, many countries require taxpayers to complete contemporaneous documentation setting out factors such as:

- The property or service to which the transaction relates.
- The terms and conditions of the transaction.
- The identity of the parties and their relationship.
- The functions performed, the property used or contributed and the risks assumed by the parties.
- The data and transfer pricing methods considered and the analysis performed to determine the transfer prices.
- The assumptions, strategies and policies, if any, that influenced the determination of the transfer prices.
- An overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of its goods or services.

Severe penalties for failure to comply with these requirements may be imposed. Fortunately it is normally possible to prepare a single analysis which can be used to satisfy the requirements in multiple jurisdictions.

Many jurisdictions also require taxpayers to annually report the nature and amount of non-arm's length transactions. For example, the Canada Revenue Agency requires the filing of form T106 and the US Internal Revenue Service requires the filing of form 5472.

UHY Can Help!

The global presence of UHY is critical in assisting multinational clients deal with complicated, and sometimes conflicting, requirements.

Our goal is to reduce the potential for double tax, while taking advantage of appropriate planning measures to minimize the client's worldwide income tax burden. We can work closely with clients to ensure that the transfer pricing methods selected comply with the requirements of the applicable jurisdictions, and provide the best overall result for the client. We can also help to ensure that the contemporaneous documentation and reporting requirements are met. Should the need arise; we can assist at the time of audit by taxation authorities.

In situations where it is difficult to apply the arm's length standard, or where the dollars are significant, UHY firms can assist the client in applying to the applicable tax authorities to obtain a bilateral or

multilateral Advance Pricing Agreement (“APA”). An APA is a binding agreement between a taxpayer and the relevant taxation authorities setting out the transfer pricing method to be used in advance of the transactions. The obvious advantage of an APA is that it can provide certainty for the client and can avoid potential double taxation and penalties. However, the APA can be a time-consuming and expensive process – most tax authorities charge for this service.

A Recent Example

Recently, Goldfarb, Shulman, Patel & Co. (the UHY Toronto affiliate) and the UHY London England offices worked together to assist a Canadian client expanding to the UK. Our Canadian client, a subsidiary of a Swiss conglomerate, was given the go ahead by their Swiss management to acquire a substantial portfolio of UK commercial rental properties. The UHY London office was instrumental in helping our client set up their UK operations. We worked together to determine the best structure for the UK ownership and to ensure the transfer pricing rules were met in each jurisdiction – Canada, the UK and Switzerland. Not only was it necessary to address the appropriate charges by the Canadian corporation for finding the properties, arranging the acquisition and managing the ongoing UK operations, but various related companies also provided financing and guarantees, which had to be considered. Through our coordinated efforts, we were able to help our client to establish the appropriate transfer pricing system, assist with the documentation requirements, determine the optimal ownership structure and facilitate the set up of the UK operations.

For further information, please contact:

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