Canada Federal Court rules on “How much ‘Information requirement’ is too much”

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Taxsutra extends sincere thanks to **CA Bhavya Bansal Goyal Tax & Transfer Pricing Litigation Practitioner**

In a recent judicial review by Canada’s Federal Court (“the Court”) in the case of Bayer Inc Canada (“Bayer Canada”), the Court set a limit to the information request issued by the Canada Revenue Agency (“CRA”) during the transfer pricing audit of Bayer Canada on the grounds that it was unreasonable.

Even though this judicial review was in favour of Bayer Canada, the final outcome shows that the CRA has broad authority to seek information related to affiliated entities outside of Canada. Taxpayers must manage the initial information requests during a transfer pricing audit to reduce the risk of the CRA issuing a formal Requirement notice under section 231.6 (2) of the Canadian Income Tax Act.

Background

Bayer Canada is a wholly-owned subsidiary of Bayer AG, a multi-national group of pharmaceutical and life science corporations. The CRA has been auditing Bayer Canada’s taxation years 2013-15 since 2016. Their main concern has been review of Bayer Canada’s transfer pricing arrangements with related parties outside of Canada. Between December 2017 and August 2018, the CRA made a series of requests to Bayer Canada for copies of several agreements negotiated at arm’s length relating to the activities that are being examined in the audit.

Bayer Canada consistently took the position that the requested documents were not relevant to the tax audit, and were neither in its possession nor under its control. Discussions between the CRA and the taxpayer resulted in a narrowing of the information requested, but ultimately failed to resolve the impasse.

The CRA thereafter issued a "Requirement" to provide foreign-based information and documents, pursuant to section 231.6(2) of the Canadian Income Tax Act. The Minister of National Revenue (“Minister”) has wide-ranging powers under section 231.6 of the Income Tax Act to gather information. It allows the CRA to require any Canadian resident or a non-resident, carrying on business in Canada, to provide any foreign-based information or document.

In one of the requests, the CRA required agreements between Bayer AG and other members of the Bayer Group and 21 named pharmaceutical and life science companies that operate at arm's length with Bayer Group.

The CRA’s initial requests were not restricted to the year under audit, or the geographical locations for which the agreements were to be provided. Following representations made on behalf of Bayer Canada, the CRA

narrowed and refined the request to encompass only “agreements made between any member of the Bayer Group with third party(s) in force during the 2013 and 2014 taxation years”, and only with respect to certain activities. Nine criteria were provided, including location in an OECD member state, and the performance of tasks related to research, development and distribution. Bayer Canada was asked to provide a **matrix of no fewer than 50 contracts** that met some or all of the criteria to enable the CRA to select certain contracts for further review.

Since this request seemed unreasonable, Bayer Canada applied for a judicial review before the Federal Court with respect to the CRAs section 231.6(2) Requirements. A judicial review is a process where a court can review the decision of a government body, such as the tax authorities, to ensure that they complied with all the applicable laws and that their decision was reasonable. Section 231.6(4) allows the person who is served with a Requirement to ask a judge for a judicial review within 90 days.

Bayer Canada's representatives took the position that the request by the CRA was excessive and the information contained in the documents was irrelevant to the transfer pricing tax audit. They also maintained that they could not produce documents which were not in their possession and to which they had no legal rights of access.

The application for Judicial review before the Federal Court raised following four issues:

A. What is the standard of review?
B. Was the Requirement procedurally fair?
C. Was the Requirement reasonable?
D. What is the appropriate remedy?

The Federal Court noted that the Requirement was subject to a standard of reasonableness. The Court further noted that the Requirement was procedurally fair, since Bayer Canada was aware of what information the CRA wanted as well as the consequences of non-compliance.

The representatives of Bayer Canada argued that the Requirement was unreasonable because the connection between the information sought and the subject-matter of the transfer pricing tax audit was too remote. Bayer Canada also emphasised that the dramatic increase in the scope of the Requirement demonstrated that the CRA wholly disregarded the legitimate concerns it raised.

The Federal Court agreed that the information sought is outside Bayer Canada’s control and exclusively concerns transactions to which Bayer Canada was not a party. It also noted that "**a rational connection must exist between the information sought and the administration and enforcement on the Income Tax Act**".

Findings

The Federal court observed that the CRA has offered no explanation for the dramatic increase in the scope of the information sought in the Requirement. No reasons or rationale may be discerned from the record. The CRA’s failure to explain its abandonment of the pragmatic limits placed on the scope of the preceding requests renders the Requirement unreasonable.

The application for the judicial review was allowed by the Federal Court.

It was held that the CRA was previously content to limit its request for information in accordance with the nine criteria included in its Query No 17. Also the representative of Bayer Canada indicated during the hearing that if the Requirement were limited to the agreements with the 21 named pharmaceutical and life sciences companies, then its scope would be more manageable.

Hence, even though extensive, the scope of the Requirement was limited to the agreements with the 21 named pharmaceutical and life sciences companies that operate at arm’s length from the Bayer Group.

Key takeaways

The primary point of contention in this ruling was related to the unreasonable and inaccessible information requirement by the tax authorities of Canada during the transfer pricing tax audit. The Tax Authorities asked for information which was impossible to be made available by Bayer Canada. Hence, the Court finally accepted the review and allowed the tax authorities to only ask for information which they had originally asked for, inspite of the fact that such an information request was also very wide. In Canadian context, dealing with formal 'Requirements' under a transfer pricing tax audit is usually riskier, more expensive and more time-consuming for a taxpayer when compared to more conventional forms of tax audit queries, so it is best to avoid them where possible.

In the Indian context, the Indian Taxpayer is required to maintain transfer pricing documentation in accordance with the Income Tax Act and Rules. The initial requests of the Indian Tax authorities usually begin with a lengthy questionnaire wherein they try to gather elaborate information related to the international transactions. However, the Tax authorities usually ask for requirements which are within the Indian Income Tax Act and Rules specifically prescribed under Rule 10D/DA/DB. Also the related party agreements directly related to the international transactions, are often called for by the Indian Tax authorities. Though, if some inaccessible information is sought, the assessee could make a representation to not submit such information which is realistically not available with the taxpayer in India.

Chapter V of the OECD Transfer Pricing Guidelines provides general guidance for tax administrations to develop rules or procedures on documentation to be obtained from taxpayers in connection with a transfer pricing inquiry. It also provides guidance for taxpayers to identify documentation that would be most helpful in establishing that their controlled transactions satisfy the arm's length principle and hence facilitating tax examinations. **There is substantial emphasis in Chapter V of the guidelines on the need for reasonableness in the documentation process from the perspective of both taxpayers and tax administrations**, as well as on the desire for a greater level of cooperation between tax administrations and taxpayers in addressing documentation issues "*in order to avoid excessive documentation requirements while at the same time providing for adequate information to apply the arm's length principle reliably*"

Further, BEPS Action plan 13 also mandates ".. *The rules to be developed will include a requirement that **MNEs provide all relevant governments with needed information** on their global allocation of the income, economic activity and taxes paid among countries according to a common template*."

The intent of the legislations across the world seem to be to ask for information which is required to compute the arm's length price. Though in cases where the information asked for is not realistically available, with proper representations the same can be appropriately dealt with. However, asking for information which is not directly relevant to the arm's length computation or transfer pricing audit is something which does not seem to be in line with the intent of the OECD transfer pricing guidelines.