

Canadian Transfer Pricing Amendments (2025): The Empire Strikes Back.

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The Canadian Budget of 2025 has the noble bearing of a big spending feudal aristocrat with a rather large public purse.

An estimated C\$200 billion will be spent over the next five years on a variety of infrastructure projects. Much of this spending will come from scaling back existing programs and some from adopting more aggressive tax measures, including an anticipated C\$510 million from transfer pricing adjustments.¹

At the centre of this modest fiscal gain is **the most significant redrafting of the Canadian transfer pricing legislation** in recent history which will confer greater powers to the Canada Revenue Agency (CRA) during transfer pricing audits.

The Canadian transfer pricing history is littered with Herculean labours of the CRA attacking allegedly aggressive transfer pricing policies. These labours were often met with legal objections from large taxpayers which were generally sustained by the Canadian courts in their deference to the Canadian statutes. Through its trials (literal and figurative), the CRA hoped for an overreaching judicial precedent that would expand the powers of its authority to contest transfer pricing arrangements which lacked “substance”. But such a precedent was consistently avoided by all levels of the courts.

The legislative changes proposed in the 2025 Canadian Budget, however, have significantly shifted the balance of power between the CRA and the Canadian taxpayers when it comes to transfer pricing controversy. Canadian taxpayers should understand this shift to prepare for a future that will look very different from the past.²

The proposed transfer pricing rules also give some relief on transfer pricing penalties which should be welcome news.

¹ The transfer pricing adjustments will grow to an estimated C\$ 200 million per year, which will be less than a fraction of 1 percent of the overall Canadian income tax proceeds. This appears to be a highly conservative figure and likely income from transfer pricing audits will be higher than the forecast

² In a pivotal moment of *The Empire Strikes Back*, Luke Skywalker struggles to use his powers because he does not believe in them. To this Yoda sanguinely replies, “this is why you fail”. The CRA may be forgiven for having resigned to such a fate. But the new legislation will unleash new vigor in the CRA's attack which will carry significantly more merit with the Canadian courts.

Before getting into the specific details of the changes, the main take aways are the following:

- ▶ Transfer pricing penalties will only apply after a much higher threshold of potential adjustments (although this relief is only relevant for companies with revenues exceeding C\$ 50 million)
- ▶ The legislation will encode the OECD Transfer Pricing Guidelines into Canadian law, which will harmonize transfer pricing rules between Canada and most foreign jurisdictions, significantly reducing uncertainty and the need to resort to Mutual Agreement Procedures (MAPs)
- ▶ Legal agreements no longer provide a *carte blanche*; actual conduct of the parties will matter
- ▶ Taxpayers will now only have 30 days to provide transfer pricing documentation when requested by the CRA

Canadian Transfer Pricing Rules (Old vs New)

The Canadian transfer pricing legislation was first introduced in 1998 as Section 247 of the Canadian Income Tax Act. Prior to the enactment of Section 247, transfer pricing regulation was imposed through Section 69 of the Income Tax Act which had a broader ambit governing the valuation of exchange of property between related taxpayers – domestic and international.

As enacted, Section 69 did not distinguish between the fair value standard (commonly used in accounting and tax) and the arm's length standard which is a parallel valuation standard **specifically** created for cross border transactions. However, Section 69 introduced the term "arm's length" in Canadian tax legislation which became the central element of Section 247 once it was enacted.

Following in the footsteps of its largest trading partner, the United States, the Canadian legislation adopted a confined approach to legislating transfer pricing rules in its own unique way – borrowing phraseology such as the "arm's length transfer price" and "dealing at arm's length." It did not specifically legislate to connect these definitions to more broadly accepted transfer pricing frameworks (other than the meanings captured in Canadian tax treaties). Some countries, such as the United Kingdom, specifically wrote transfer pricing legislation and codified their interpretation in accordance with the *OECD Transfer Pricing Guidelines* or the *United Nations Practical Manual on Transfer Pricing for Developing Countries*.

A central tenet of the Canadian transfer pricing interpretation has been the deference placed on legal form. For example, if two related companies enter into a transfer pricing arrangement whereby Company A provides certain services to Company B, and two sign an agreement to this effect, then the intercompany agreement will *generally* prevail as the standard of truth over any other interpretation of what services are provided by Company A to Company B based on actual conduct – even if it differs (tolerably) from what is described in legal form.

It should be mentioned, however, that the Canadian interpretation of transfer pricing rules was different from the one adopted by the United States which looked to the actual conduct (i.e. economic substance), between parties, in determining the appropriate transfer pricing treatment.³

A guiding principle for the respect of legal form can be traced back to a seminal British tax case ***Inland Revenue Commissioners v. Duke of Westminster (1936)*** which enshrined the “rights” of a taxpayer to structure their affairs (i.e. legal form) to minimize their tax liabilities.

If Company A has made an agreement with its subsidiary Company B to supply it with uranium bars at the prevailing market price today for the next 20 years, this arrangement should be respected as long as the market price at the time was considered to be arm’s length and there was no evidence to suggest that the price of uranium bars in the next 20 years would not be different from the prevailing price today – notwithstanding that an arm’s length buyer and seller of uranium bars would not agree to bind themselves to a 20 year commitment given the volatility of the underlying commodity.

The proposed Canadian transfer pricing legislation (2025) puts the respect for “legal form” into the dustbin of history as far as transfer pricing rules are concerned.⁴ Specifically, the proposed legislation introduces some key legislative phrases that unwinds earlier protections to legal form.

The CRA will now be empowered to adjust a transfer price if the purported form of the arrangement “**is different from arm’s length conditions**” and the actual conditions are “**determined not only by contractual terms of the transactions... but by other economically relevant characteristics**” including “**the conduct of the participants**”.

At the epicenter of this redraft are the introduction of new statutory phrases, including “**actual conditions**”, “**arm’s length conditions**”, “**economically relevant characteristics**”, and codification of the “**Transfer Pricing Guidelines**” as the OECD Transfer Pricing Guidelines”

An Example: Lord Bertram Wooster (Bertie) and his resourceful aide Jeeves

The implications of the new rules are best described through an example.

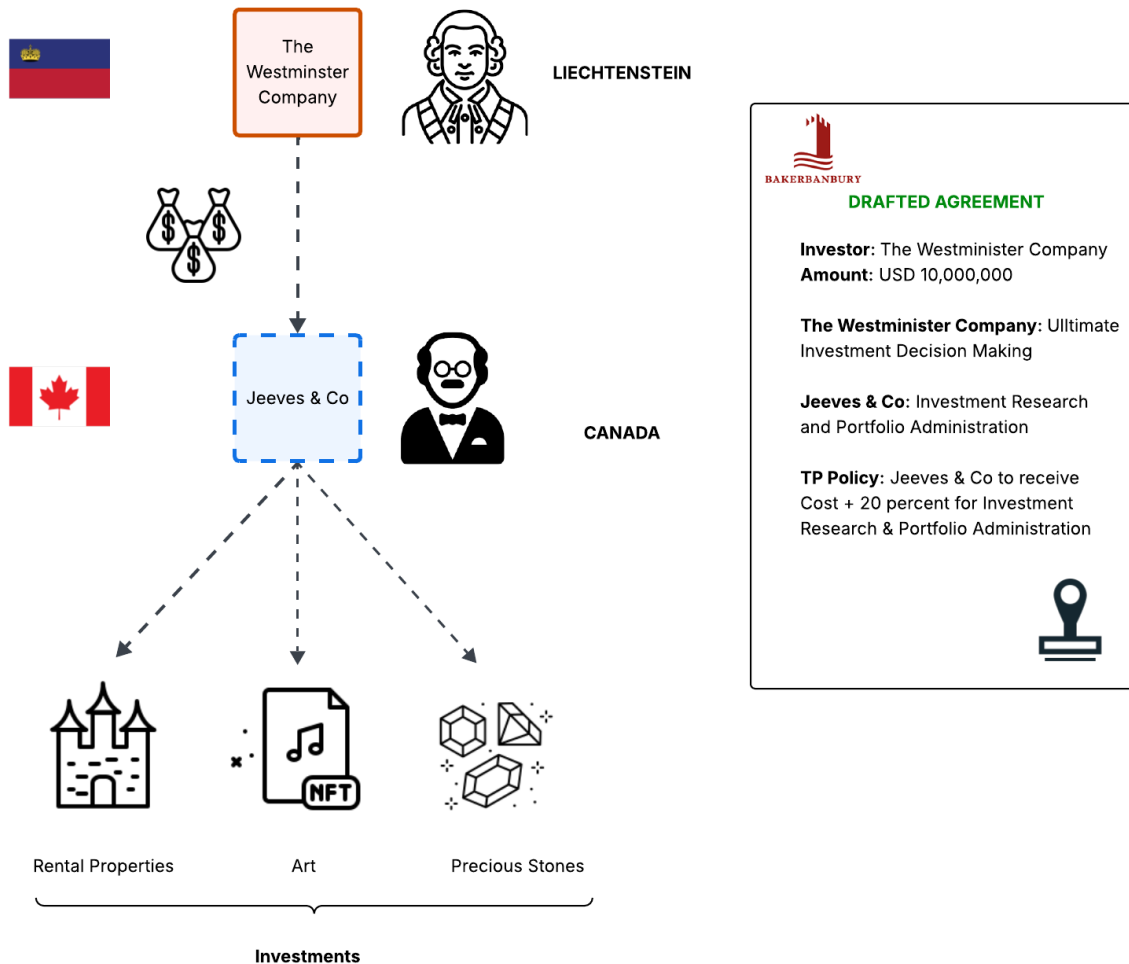
Lord Bertie Wooster is a wealthy Liechtensteiner (resident of Liechtenstein) who runs an investment firm in his home country (The Westminster Company). He has tasked his able aide Jeeves to set up a company in Canada (Jeeves & Co) to invest TWC’s capital into suitable investment opportunities abroad.

A legal agreement is drafted between TWC and J & Co with Lord Bertie and Jeeves the sole directors, respectively. The agreement outlines the specific roles and responsibilities of the Canadian and the Liechtenstein company with the former responsible for investment research, deployment and investment management and the latter responsible for making the decision to take or decline an investment opportunity.

³ The Internal Revenue Code adopted the Economic Substance Doctrine (Section 7701) in 2010.

⁴ The Duke of Westminster may as well be the Duke of York.

Exhibit 1 – The world according to the Duke



But this is the narrative of legal form alone.

In substance, Lord Bertie has delegated significant powers to Jeeves, including accepting and declining investment opportunities as they come (on behalf of TWC).

J & Co has adopted transfer pricing policies consistent with the legal form. Under this arrangement, J & Co will receive a compensation of cost-plus 20 percent for its research and oversight function, and all residual investment earnings will flow to TWC.

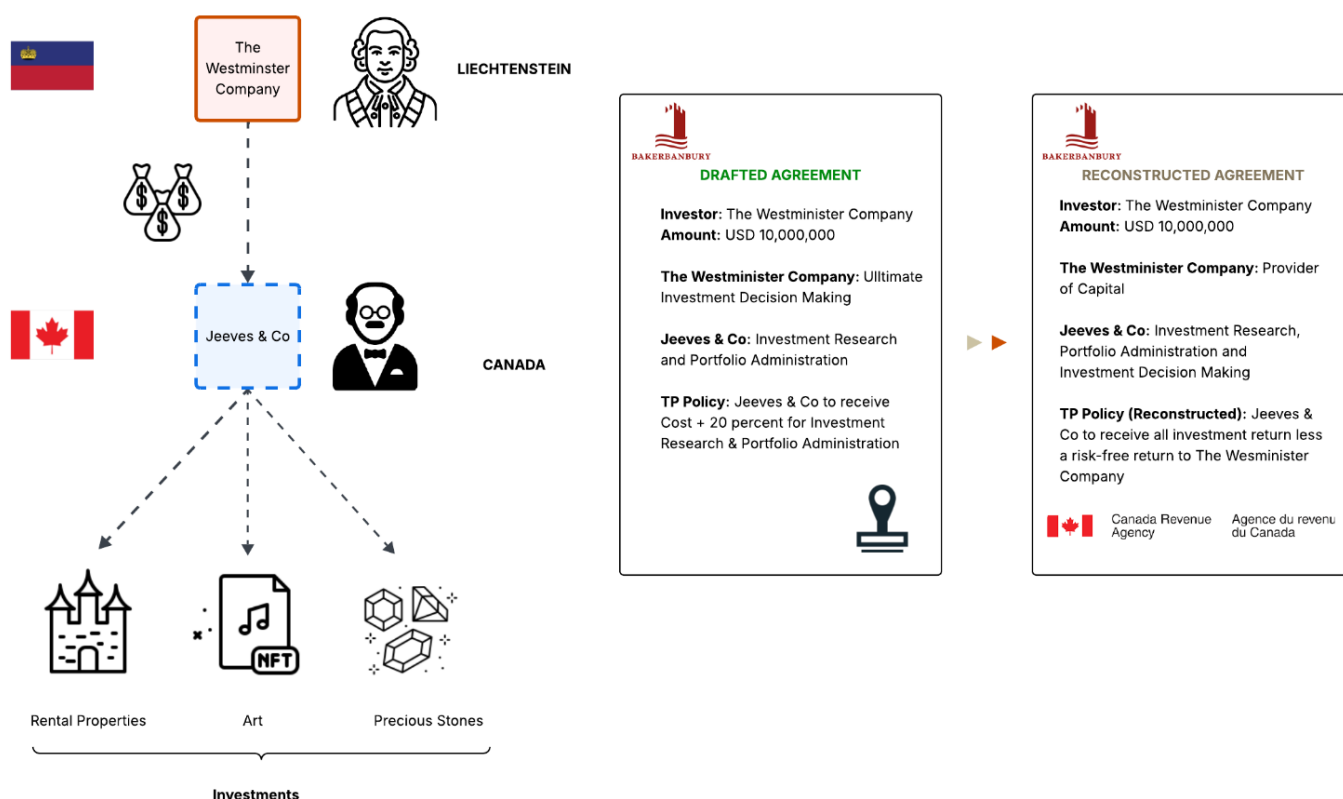
In a particular year, the deployed capital of \$10,000,000 achieves a 10 percent return (\$1000,000). In accordance with the intercompany agreement, J & Co retains a fee of \$120,000 while the remaining earnings of \$880,000 are passed to TWC to be taxed in Liechtenstein.

Under the old transfer pricing regime, J & Co pays Canadian income taxes on its income of \$20,000.

Under the proposed transfer pricing rules, the CRA will now look through the purported legal form of the transaction and identify the *arm's length conditions* that would have prevailed between TWC and J & Co.

A plausible arm's length condition would have been to reward J & Co with the entirety of the investment income less a risk-free return payable to TWC of 5 percent. Under this interpretation, J & Co pays Canadian income taxes on \$500,000 (instead of \$20,000)

Exhibit 2 – The Brave New World



Next Steps

The proposed legislation will become law upon receiving the Royal Assent. And Canadian taxpayers need to prepare themselves for this reality:

1. All major intercompany transactions (exceeding C\$1,000,000) should be reviewed against the legal form of the arrangement (if one exists) to ensure that the transfer pricing policies are aligned with the facts and not just the legal agreements per se.

2. Have good evidence of the actual conduct between parties – e.g. correspondence of decision making arising from the designated decision makers
3. Prepare your transfer pricing documents at the time of the tax return. The window for providing the CRA with transfer pricing documentation is considerably shorter – it is no longer realistic to begin preparing transfer pricing documentation upon receiving a request from the CRA. Transfer pricing documentation is still the best protection against penalties save an APA.
4. Maintaining Intercompany Agreements is still important. An intercompany agreement is still the primary evidence of your transfer pricing arrangement unless the facts are in visible conflict with the terms. Audits can happen many years after an intercompany transaction has occurred and aligning the facts as they existed at the time can be difficult. An intercompany agreement provides the primary narrative of your position if the facts are difficult to discern or recall. The Code of Hammurabi is still the best evidence we have of how King Hammurabi governed his kingdom 4000 years ago.

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