A Comparison of Transfer Pricing Practices in Canada and China

Odette M. Pinto, PhD, MBA, CGA
Assistant Professor
School of Business
MacEwan University
Room 269, 7319 29 Avenue
Edmonton, Alberta
Canada T6K2P1

Abstract

Multinational corporations, as well as countries around the world, regard transfer pricing as one of the most important challenges they face. There has been a substantial increase in foreign direct investment between China and Canada in the past two decades, with an increase in transfer pricing concerns. This qualitative study compares the transfer pricing practices in Canada and China, including an examination of the practices for intangible property. The results indicate that although the Organization for Economic Cooperation and Development issues global transfer pricing guidelines, the choice of transfer pricing practices in a country is dependent on its economic development, and its culture, political and economic systems. In particular, this study finds that transfer pricing for intangibles is a contentious issue, with uncertainty about the definition and the valuation of intangible assets.

Key words: multinational corporations, transfer pricing, country differences, culture, economic development, intangibles, permanent establishment

1. Introduction

Transfer pricing is a major concern for multinational corporations (Chan and Chow, 1997; Li, 2005) and it has been identified as the number one challenge facing the world's leading companies (2010 Global Transfer Pricing Survey, Ernst and Young). Transfer pricing has also been identified as a major issue facing countries around the world, as they strive to retain the tax revenue from multinational corporations conducting business in their countries and step up their efforts in the enforcement of transfer policy legislation and regulations. Chan and Lo (2005) suggest that multinational corporations use international transfer pricing to manipulate prices and choose the countries in which business profits will be reported, and this raises ethical concerns. Furthermore, the choice of transfer pricing methods and transfer pricing practices are very important considerations in the development of corporate strategy and in assessing the long-term sustainability of a multinational corporation. Transfer pricing is a current, contentious issue for multinational corporations.

Trade between China and Canada has increased substantially over the past two decades, with an increase in the number of multinational corporations in the two countries and an increase in the number of cross-border transactions. Multinational corporations face important decisions in establishing transfer prices for the cross-border transfer of goods and services. This study compares and contrasts the international transfer pricing practices for two countries, Canada and China, including an examination of the underlying reasons for differences in transfer pricing practices. China has been selected for this study because of its importance in international trade and the substantial increase in foreign direct investment in China, including an increase in Canadian foreign direct investment in China. In particular, this study compares the current transfer pricing practices of these two countries in regards to transfer pricing of intangible assets, with reference to how the determination of a permanent establishment and business restructuring affects the transfer pricing of intangible assets. Transfer pricing practices for intangible assets are a current challenge facing multinational corporations and tax authorities around the world.

The Organization of Economic Cooperation and Development (OECD) have developed international transfer pricing guidelines to encourage common global transfer pricing policies. The OECD guidelines provide several options and a range of acceptable methods that can be used to compute appropriate prices for the cross-border transfer of goods and services between affiliated corporations. However, business practices differ across nations due to differences in culture, political, economic and legal systems. For example, the legal system in a country is influenced by its political and economic system and the economic development in the country. At present, the legal system and the legal infrastructure in China are not as well developed as the legal system in Canada. This affects the transfer pricing legislation, the enforcement of that legislation and the transfer pricing practices in the country. A country's transfer pricing practices also reflects its economic development and, in particular, the history and development of the transfer pricing legislation, the regulations and administrative practices, as well as the enforcement process for the legislation. For example, Canada is a developed nation and transfer pricing legislation was introduced in 1979 (Section 69 of the Income Tax Act of Canada) while China is a developing nation, which introduced transfer pricing legislation in 1991 (Article 13 of the Income Tax Law of the People's Republic of China). Although the OECD provides transfer pricing guidelines, a country may choose to encourage the use of certain methods because of its culture, political, economic and legal systems.

The valuation of inter-company transfers of tangible and intangible assets is of critical importance to countries as it affects a country's tax revenue. The OECD guidelines for transfer pricing for tangible assets was introduced in 1979. Since then transfer practices for tangible goods have evolved and developed, particularly in developed nations where transfer pricing legislation has been in effect for over thirty years. An increase in globalization has led to an increase in the inter-company transfers of intangible property between multinational corporations as their business operations have spread over several countries. The transfer pricing practices pertaining to intangible property has been identified as one of the major challenges facing multinational corporations. The valuation of inter-company transfers of intangible property is complex as it is more difficult to determine a comparable price for intangible assets than for tangible assets, particularly if the intangible asset has been developed within the multinational corporation and there is no comparable arm's length price. The OECD guidelines for intangible property were introduced in 1996 to provide guidance to countries and to achieve some consistency in the pricing of cross-border transfers of intangible property.

Income taxation is generally based on the tax jurisdiction of the taxpayer. Transnational foreign direct investment has seen substantial growth in the past thirty years, with business operations sometimes spread across many nations. The OECD suggests that the taxation of business income should be based on the presence of a "permanent establishment" in a country i.e. income earned through a permanent establishment located in a country should be subject to income tax by that country. The definition of what constitutes a permanent establishment and the determination of the location of one or more permanent establishments has become more difficult as the structure of multinational corporations becomes more complex. Furthermore, the business structures of multinational corporations are dynamic with multinationals restructuring as they strive to establish a global competitive advantage. In response to this concern, the OECD has recently conducted special projects to investigate and establish guidelines for the determination of a permanent establishment in a country and acceptable transfer pricing methods and practices; more recently, this has been extended to address the implications of transfer pricing of intangible assets in the case of a business restructuring.

The rest of the paper is structured as follows: Section 2 examines the underlying reasons for country differences in transfer pricing methods, Section 3 compares the transfer pricing methods used for tangible assets in Canada and China, Section 4 focuses on the transfer pricing methods used for intangible assets, Section 5 examines important issues related to the transfer pricing of intangible assets, Section 6 summarizes the key implications for multinational enterprises and Section 7 provides concluding remarks, including recommendations for future research.

2. Country Differences

Transfer pricing is a major challenge for multinational corporations and it is an important component of corporate strategy (Li, 2005). Transfer pricing is also a major taxation issue for many countries, as they strive to ensure that business profits earned in their tax jurisdictions is correctly reported and subject to income taxation.

The Organization for Economic Development and Cooperation (OECD) is the international body that provides guidelines in transfer pricing, including an outline of the two main categories for transfer pricing, transaction cost-based methods or transactional profit-based methods. The method selected should be the one that best approximates an arm's length price. However, the transfer pricing methods used across countries differ, with differences identified both across developed countries (Borkowski, 2001) and in comparisons of developed vs. developing countries (Li, 2005). In Canada transfer pricing methods are primarily cost-based methods while in China the methods used, particularly prior to 2001, are more market-based, negotiation oriented methods. It is important to examine the underlying reasons for this overall difference in the methods used in Canada and in China.

In Canada, the culture, as well as the political and economic system, has developed from an ideology that focuses on individualism. On the other hand, the culture, the political system and the economic system in China have developed from an ideology of collectivism, which focuses on the group and society rather than the individual. These ideological differences are reflected in the political and economic systems of the country, as well as in corporate strategy and business practices. Differences in ideology (individualism vs. collectivism) affect management decision making and practices (Borkowski, 1997a). Li (2005) compared international transfer pricing practices in Australia and New Zealand to those in China and found that cultural differences provide explanations for differences in transfer pricing practices. For example, Australia and New Zealand are influenced by their British colonial history, with British norms and practices and with individualism being a central ideology. Canada also has a British colonial history. On the other hand, China's ideology of neo-Confucianism is collectivist in nature and tends to favor business practices that are negotiation based (Li, 2005). It has also been suggested that differences in the culture and its political and economic ideology have led to differences in transfer pricing methods being used in China, as opposed to western nations. Lo and Wong (2007) suggest that western countries (like Canada) tend to favor cost-based methods for transfer pricing while China tends to lean toward more market and negotiation oriented methods. The ideology of collectivism is tied to the use of negotiation-oriented methods.

In Canada, the underlying ideology has led to democracy and a market economy. Individualism is central to market economies, as it promotes innovation and entrepreneurship. However, to encourage and support individuals in innovation and entrepreneurship it is essential that the government has a system that protects property rights, including the rights related to intangible property and intellectual property. On the other hand, China's history of communism and a command economy were entrenched for many years, with a move toward a market economy commencing in 1979. In a command economy property rights are not as important, as the government directs the production of goods and services; therefore, until the 1980s there has not been a need for legislating property rights and for the enforcement of property rights. China's change from a command economy to a free market economy has been gradual and the economic system continues to evolve and develop.

The legal system in a country develops to support its political and economic systems therefore ideological differences also lead to differences in the legal system of a country. This has implications for transfer pricing practices since a strong legal infrastructure is required to enforce the transfer pricing legislation and regulations of a country. In Canada, legal rights of individuals and corporations are entrenched with well developed legislation to support property rights, including intellectual property rights. Furthermore, the legal infrastructure in Canada ensures that such rights can be enforced through legal processes. In China, the legal system has developed substantially in the past two decades; however, the legislation to support property rights is has been developed more recently. Furthermore, the legal infrastructure is still developing and thus there continues to be difficulty in the enforcement of property rights legislation and regulations. Chinese tax legislation and regulations are still developing and there continue to be differences between Chinese transfer tax practices and those in western countries e.g. the United States (Lo and Wong, 2007).

In Canada, transfer pricing legislation (Section 69 of the Income Tax Act) was introduced in 1979, but significant revisions in 1998 resulted is the introduction of Section 247 of the Income Tax Act. The government's interpretation of the legislation and acceptable transfer pricing methods is described in Information Circular 87-2R (IC87-2R). Canada's transfer pricing legislation embodies the arm's length principle and this is reflected in the recommended transfer pricing methods (IC87-2R). These methods are categorized as traditional transaction methods and transactional profit methods.

The comparable uncontrolled price (CUP) method is considered to be the method that best represents the arm's length principle.

In China, transfer pricing legislation was introduced in 1991 (Article 13 of the Income Tax Law of the People's republic of China for Enterprises with Foreign Investment and Foreign Enterprise). The arm's length principle has also been adopted in the country's transfer pricing legislation. However, the economic development in the country has played a major part in the development of transfer pricing legislation and it was not until China's entry into the World Trade Organization in 2001 that the country adopted the OECD transfer pricing guidelines.

Differences in transfer pricing methods between developed and developing nations have also been identified (Chan and Chow, 1997), with evidence that developed nations have developed transfer pricing methods from the OECD guidelines, which works well for such nations as they have well developed legal infrastructures. On the other hand, there is evidence of more market-based transfer pricing methods and more pricing manipulation in developing nations. Chan and Chow (1997) suggest that with the legal infrastructure being weaker it is difficult to monitor and enforce transfer property legislation; changes occur as the legal and general infrastructure develops. The economic development in Canada and China has been different. Canada is a developed nation, with an established market economy, while China is still regarded as a developing nation, even though substantial changes have occurred in China in the past three decades.

China's legal infrastructure continues to develop, with the transfer pricing legislation and regulations continuing to evolve, particularly after China's entry into the World Trade Organization in 2001. The transfer pricing legislation and regulations are influenced by the uniqueness of the country's political and economic system (communist political system and a market economy) and its significant economic development and progress, particularly in the past twenty years.

Another important difference between Canada and China is the type of multinational corporations that are subject to the transfer pricing rules. In Canada, the transfer pricing legislation applies to "associated enterprises", using the 50% ownership rule. On the other hand, in China the transfer pricing legislation applies to "affiliated enterprises", using the 25% ownership rule. This difference could be related to the difference in the current stage of economic development in the country e.g. the substantial foreign direct investment in China in the past three decades.

3. Transfer Pricing for Tangible Property

The OECD transfer pricing guidelines indicate that an arm's length price should be determined for intra-company transfers of goods and services. The OECD guidelines also outline several acceptable methods that can be used to determine an appropriate arm's length transfer price for both tangible and intangible property. The suggested methods can be classified under two main categories, cost-based methods and profit-based methods. The arm's length principle is the underlying principle for transfer pricing legislation in both Canada and China, which is the basis of the OECD guidelines. However, the transfer pricing methods used to achieve an arm's length price differ in the two countries.

The preferred transfer pricing method for tangible property, in both Canada and China, is the Comparable Uncontrolled Price (CUP) method, as a comparable market price most closely embodies the arm's length principle (Canada Revenue Agency IC87-R2, 1997). In keeping with the OECD guidelines, the Canadian tax authorities indicate a preference for the traditional transaction cost-based methods, more specifically the CUP, resale price or cost plus methods. For transfers of tangible assets, the CUP method provides the most direct and reliable means of establishing an arm's length price (Canada Revenue Agency IC87-2R, 1997). The use of transactional profit methods, more specifically the profit split and transactional net margin (TNMM) methods, are only recommended if no data is available to apply the cost plus or resale price methods (Canada Revenue Agency IC87-2R, 1997; Wilkie, 1998). The Chinese tax authorities' preference is also for transaction-based methods (similar to the OECD and Canada).

In western nations, including Canada, a hierarchy of transfer pricing methods has developed, as certain methods provide more reliable results than others. In developing nations like China, there is more flexibility as to the method used. Political and economic changes provide an explanation for China's flexibility.

For example, with the change from a command economy toward a market economy in 1979, China's economic policy was focused on attracting foreign direct investment to China and tax incentives were provided to encourage foreign direct investment. Therefore, transfer pricing was not a major concern at the time. Although transfer pricing legislation was introduced in 1991, for the next twenty years the Chinese tax authorities did not enforce the legislation and there was flexibility in the transfer pricing methods used by multinational corporations located in China. Transfer prices were determined based on negotiation between the multinational enterprise and the tax authorities. Subsequent to China's entry to the WTO in 2001, the Chinese tax authorities have introduced regulations to enforce the 1991 transfer pricing legislation. China is moving more toward the OECD guidelines. However, while Canada accepts both externally and internally developed cost-based transfer prices, the Chinese tax authorities' preference is for internally generated comparable prices (Guoshuifa (1998) No. 59) and for manufacturing enterprises the cost-plus method is preferred. The Chinese tax authorities have also stepped up enforcement of the transfer pricing legislation and regulations, with rules for transfer pricing audits, requests to local tax authorities to conduct audit follow-ups and to conclude more Advance Pricing Agreements (APAs) with taxpayers (Guoshuifa (2004) No. 70).

4. Transfer Pricing for Intangible Property

Transfer pricing for intangible property is one of the most difficult issues facing both the tax administrators of countries around the world and multinational corporations with operations in foreign countries. The OECD transfer pricing guides were substantially revised in 1996 to include a whole chapter devoted to intangible property. Furthermore, the number of Advance Pricing Agreements (APA) related to transfer pricing for intangible property has increased substantially in the past decade.

The definition of intangible property and what constitutes intangible property needs to be clear e.g. what is "know-how and other intellectual property" (Tax Executive, 2010). Intangible property is difficult to define because of its very nature and the uniqueness of each intangible asset. For example, there continues to be a debate on the recognition and valuation of intangible assets in the absence of "real world" transactions, with a current contentious debate on marketing intangibles (Farag, 2011; Feinschreiber and Kent, 2012). The OECD recent project (July 2010) focused on the definition and valuation of intangibles. However, the tax authorities in some countries have not fully accepted the 2010 OECD guidelines. For example, the Internal Revenue Service in the United States is not in full agreement on the valuation of intangibles, with highly uncertain valuation, using the "anticipated benefits approach" (Feinschreiber and Kent, 2012). Furthermore, the definition of intangible property may be different in developed and developing countries. In developed countries, particularly western nations, individualism and innovation are highly emphasized and there is a legal infrastructure to protect intellectual property rights. Therefore, the value of intangible assets is recognized. In a developing nation, without a strong legal infrastructure, intangible assets are often not recognized and therefore valuation is difficult, if not impossible.

In Canada, with an ideology of individualism and democracy, the legal system has developed to protect property rights and, although intellectual property rights are a more recent phenomenon, the underlying property rights legislation is highly developed. Furthermore, the legal system is structured for the enforcement of such rights. The enforcement of property rights is important as beneficial and legal ownership of an intangible asset serves to determine is an enforceable property right exists (Tax Executive, 2010). In China, the definition of intangible assets and intellectual property rights is limited to legally-protected intellectual property and the Chinese tax authorities take a more narrow view of other intangible property (Chandler et al., 2006). Furthermore, with its history of collectivism and communism, the protection of property rights has not been a major concern in the past hence the definition of what constitutes property rights, and more recently intellectual property rights, are still unclear as they have not evolved through the courts and legal system.

The OECD guidelines suggest various methods for transfer pricing of intangible property and they appear to be generally accepted by multinational corporations. A survey conducted by Borkowski (2001), which examined five developed countries, Canada, USA, Japan, Germany and the UK, found that although transnational corporations agree in principle on transfer pricing methods for intangible property these methods are not in accordance with those prescribed by the OECD guidelines or the Internal Revenue Service (IRS) in the United States. Transfer pricing practices in developed vs. developing nations also differ (Chan and Chow, 1997; Lo and Wong, 2007).

For example, as transfer pricing legislation and regulations were not introduced in China until 1991 and therefore lagged behind those in western countries like Canada. However, since joining the WTO in 2001 China has moved toward adopting the more common international transfer pricing practices and the incorporation of OECD guidelines. On the other hand, the recognition and valuation of appropriate transfer prices for intangibles continues to be a contentious issue for western nations like Canada as well as developing nations like China.

The underlying principle for transfer pricing legislation and regulations in most countries, including Canada and China, is the arm's length principle. However, this principle is difficult to follow for intangible assets as there is often no comparable arm's length price. The OECD guidelines recommend that multinational enterprises continue to use the arm's length principle in the determination of the transfer price for intangible assets. Borkowski (2001) examined the actual and preferred intangible transfer pricing methods and found that of the Canadian firms surveyed 30% actually used the Comparable Uncontrolled Price (CUP) method and 30% used the cost-sharing method, while the profit-based Transactional Net Profits Methods (TNMM) accounted for 20%, with other methods accounting for the remaining 20%.

The determination of a suitable transfer price for intangible property is a difficult process for both multinational enterprises and the tax authorities of a country, as intangible property is often developed within a firm, is often unique to the firm and is not transferred to independent third-parties, making it difficult to ascertain a comparable arm's length price. As there is seldom a comparable price, the tax authorities have a difficult time in the determination of an arm's length price. Borkowski (2001) points out that there is a "lack of incentives for transnational subsidiaries or affiliates to engage in arm's length negotiations and contract for an arm's length royalty". Canada Revenue Agency IC87-R2 indicates that traditional transaction (TNMM) methods would generally not be appropriate for transfer pricing of intangible property as such property is generally "highly valuable and unique". The nature of intangible property has led to the development of unique cost-sharing methods for allocation of transfer pricing costs.

For example, IC-87R2 issued by Canada Revenue Agency discusses qualifying cost contribution arrangements (QCCA) in detail, indicating that a QCCA may be appropriate when there is a joint development of intangible property. Chandler et al. (Tax Executive, 2006) indicate that cost-sharing arrangements are "a good approach to the inherent tension of the low marginal cost of sharing innovation and the need for arm's length transfer pricing". Unlike Canada Revenue Agency's IC-87R2, the Chinese transfer pricing regulations have not yet included the cost-sharing method as an alternative for transfer pricing of intangible property (Chandler et al., 2006). The Chinese tax authorities continue to examine the cost-sharing arrangements used by other countries, including Canada, but have not yet developed their own cost-sharing rules. Although the Canadian tax authorities suggest the use of the cost-sharing method for intangible assets, there continue to be difficulties in the recognition and valuation of intangible assets. The Chinese tax authorities have yet to indicate if the cost-sharing method is appropriate for the transfer pricing of intangible assets.

5. Important Issues in the Transfer Pricing Debate

Income taxation of foreign business income in most countries is based on whether the business income is earned through a permanent establishment in the country. The taxation of intra-company transfers of goods and services is generally based on the existence of a permanent establishment in a country and in the determination of the location of intangible assets and property rights (*Tax Executive*, 2010). Therefore, the definition of a permanent establishment is of critical importance.

In Canada, "residence" determines the liability for income tax. Residents are subject to tax on their world income i.e. income earned anywhere in the world at any time in the year. Non-residents are subject to income taxation on certain sources of income, which includes business income. In Canada, the income taxation for non-residents and the taxation of foreign business income earned in Canada depend on the existence of a permanent establishment located in Canada. Section 253 of the Income Tax Act of Canada indicates that business income earned through a permanent establishment located in Canada is subject to income tax in Canada. Therefore, the definition of what constitutes a permanent establishment is of critical importance to the income taxation of foreign direct investment in Canada. In Canada, a permanent establishment is defined in Section 253; a permanent establishment includes a physical location (e.g. an office or a warehouse) but also includes a situation where an agent of a foreign corporation is resident in a country and can contract on behalf of that corporation.

A permanent establishment by a foreign enterprise in Canada results in the taxation of profits earned through that permanent establishment. In China, the income tax of foreign direct investment has evolved since 1979, when China shifted from a command economy to a market economy. In 1979, when China opened its doors to foreign direct investment, the approach taken by the Chinese government was structured. For example, the government created special economic zones for different industries and tax incentives were provided to encourage foreign direct investments; foreign firms were required to form joint ventures with Chinese firms. The goal of the Chinese government was to attract in-bound foreign direct investment, to gain access to technological and managerial expertise through joint ventures. In this environment, the taxation of a permanent establishment located in China was not as important as encouraging foreign direct investment into the country.

Therefore, the entry of foreign direct investment was controlled by the government and various tax incentives were provided to encourage foreign direct investment. At that time, transfer pricing issues and the location of a permanent establishment were not major concerns of the Chinese tax authorities. However, with rapid economic progress and development in China, the government is concerned with the loss of tax revenue through transfer pricing manipulations of multinational enterprises based in China. Furthermore, the entry into the World Trade Organization in 2001 has stimulated the Chinese tax authorities to adopt the OECD guidelines in its transfer pricing legislation. The State Administration of Taxation adopted the principle of a permanent establishment in 2006 and profits earned by a foreign enterprise through a permanent establishment are subject to income tax in China. However, there continues to be difficulty in the recognition of a permanent establishment in some situations e.g. when employees of a foreign enterprise are solely providing services in China but there is no clear presence of a (physical) permanent establishment. The Chinese State Administration of Taxation continues to issue statements of clarification but this issue has not yet been resolved.

The transfer and ownership of intangible property should be based on beneficial and legal ownership of the intangible (Chandler et al., 2006). The ownership of intangible property dictates that the location of the intangible property is in the permanent establishment of the business; furthermore, in order to “own” an asset, the owner of the intangible property should have an enforceable property right. The location of the intangible property could thus be tied to a corporation’s permanent establishment as often intangible property is centralized in a corporation’s head office. If there is a cross-border transfer of intangible property, the question that arises is whether the legal property rights have been transferred or does the ownership and location of such rights continue to be located at the multinational corporation’s head office (permanent establishment). This issue has not been clarified in either the Canadian or Chinese transfer pricing regulations. The OECD is currently (2011) reviewing the transfer pricing of intangible assets, as it has been identified as an area of concern by both taxpayers and the tax authorities (Farag, 2011). The OECD has indicated that the project will include an examination of the definition of intangible property; the OECD intends to clarify whether a legal, enforceable right is required to establish when a “transfer” of an intangible asset occurs. The clarification of this issue is also relevant to the transfer of intangible assets in business re-restructuring. Business re-structuring often involves the transfer of intangible assets, yet intangible assets are difficult to identify and it is difficult to ascertain the value of such intangible assets. The OECD’s current project to review transfer pricing of intangibles in 2011 should shed light on the tax consequences arising from the potential transfer of intangible assets during business re-structuring. In particular, it is hoped that the OECD will issue guidelines to clarify when intangible assets have been “transferred” between corporations, which intangible assets have been developed during the business re-structuring, the location of the permanent establishment, the valuation of the intangible asset and the process for determining which jurisdiction has the right to tax the transfer of intangible assets.

6. Implications for Multinational Corporations

Multinational corporations, with cross-border transactions between Canada and China, should be aware of the key differences in transfer pricing methods between the two countries. First, Canadian multinational corporations should study the Chinese transfer pricing legislation and the contemporaneous documentation required to support transfer prices for cross-border transfers of goods and services (Nelson et al., 2003; Coronado et al., 2011). Second, multinational corporations should be cognizant of the difference in the application of the transfer pricing legislation and the definition of associated or affiliated multinational corporations. In Canada, transfer pricing legislation applies to “associated enterprises”, using the 50% rule while in China transfer pricing legislation applies to “affiliated enterprises”, using the 25% rule.

Third, multinational corporations should be aware of the different transfer pricing methods that are acceptable in the two countries. In Canada, the tax authorities recommend the use of the comparable uncontrolled price (CUP) method, with the alternate being cost-based methods. Although the Chinese tax authorities also recommend the use of the CUP method, the alternate methods recommended are market and negotiation-based methods

Another tricky issue for multinational corporations is the transfer pricing of intangible property. The transfer pricing legislation for intangible property continues to evolve, with the OECD project still in progress. Contentious issues continue to arise in regards to the definition and valuation of intangible property. Furthermore, some countries may not accept the OECD guidelines, most notably the current debate between the United States IRS and the OECD in terms of the valuation of intangibles with highly uncertain valuation (Feinschreiber and Kent, 2012). Currently, there is also considerable debate about the recognition and valuation of marketing intangibles. Multinational corporations should be extremely careful of the application of the transfer pricing legislation for intangible assets that arise and can be identified in the process of business restructuring.

As the taxation of business income in host countries is generally dependent on the existence of a permanent establishment in the country, multinational corporations need to examine the definition of what constitutes a permanent establishment very carefully. The issues raised in regards to whether legal, enforceable rights are transferred with the cross-border transfers of intangible property is unclear and multinational enterprises should continue to maintain contemporaneous documentation to support their valuation of intangible property, keeping in mind that the OECD is currently reviewing the transfer pricing of intangibles.

On a broader scope, all multinational corporations, with business operations in any foreign country, should be knowledgeable of transfer pricing practices, in particular how such practices are affected by the culture, the political, economic and legal systems, and the economic development of that country. Currently, transfer pricing issues related to intangibles are particularly contentious and multinational corporations need to keep abreast of progress in the development of the OECD guidelines for intangible property and examine whether a particular country follows the OECD guidelines in actual practice.

7. Concluding Remarks

Transfer pricing has been identified as one of the key challenges facing multinational corporations. Trade between Canada and China has grown substantially and will continue to grow in the future, with a significant increase in both in-bound and out-bound foreign direct investment between the two countries. China is a key player in international trade and although its foreign direct investment in Canada is currently limited this will change in the future, as Chinese corporations expand their operations globally. There are both similarities and differences in the transfer pricing practices of the two countries and the underlying reasons for such differences are tied to the differences in culture, in the political and economic systems, and in the economic development of the two countries. Canada has adopted the OECD guidelines and generally recommends cost-based methods for the transfer pricing of tangible assets, and although China has shifted to cost-based methods it continues to recommend negotiation-based methods as an alternate method. However, since its entry into the WTO in 2001, China's transfer pricing practices are gradually evolving to be more similar to those outlined in the OECD guidelines.

Transfer pricing for intangible assets is more contentious than for tangible assets as it is difficult to determine a comparable arm's length price. The definition and valuation of intangibles continues to be a difficult and ambiguous issue for both the tax authorities of a country and the foreign multinational corporations located in a country. The recent OECD study on intangible assets has attempted to address the concerns of taxpayers and tax authorities, but the contentious issues have not yet been settled e.g. the recognition and valuation of marketing intangibles. The issue of what services should be included as intangible assets and whether a permanent establishment exists when employees of a foreign enterprise provide services in a country is also a difficult issue. The implications of transfer pricing for intangible assets are significant for multinational corporations. Furthermore, business restructuring often involves a "transfer" of intangible assets but the identification and valuation of such intangible assets can be very difficult. Multinational corporations will be following the progress of the OECD project on transfer pricing for intangibles closely. Transfer pricing also raises ethical concerns for multinational corporations, as ethical practices are necessary in determining an arm's length transfer price, the manipulation of transfer prices to shift income to lower tax jurisdictions, etc.

Transfer pricing affects the profitability and the long-term sustainability of multinational corporations and future research in transfer pricing issues would be highly beneficial. A survey of Canadian and Chinese multinational corporations to determine their transfer pricing practices would shed further light on the issues and concerns raised in this qualitative study. Future research could also examine the ethics of transfer pricing in multinational corporations more closely.

References

Anonymous. 2005. The OECD Project: Transfer Pricing Meets Permanent Establishment. *Canadian Tax Journal,* 53, 2: 401-408

Anonymous. 2010. Recommendations to OECD on Intangibles Transfer Pricing. T*ax Executive,* 62, 5: 309-317

Anonymous. 2010. OECD has work to do on APA guidelines. *International Tax Review,* 2010

Borkowski, S. 1997. Factors Motivating Transfer Pricing Choices of Japanese and United States Transnational Corporations. *Journal of International Accounting, Auditing & Taxation*, 6 1: 1-26

Borkowski, S. 1997a. The Transfer Pricing Concerns of Developed and Developing Countries. *The International Journal of Accounting*, 32, 31: 321-336

Borkowski, S. 2001. Transfer pricing of intangible property: Harmony and discord across five countries. *The International Journal of Accounting*, 36 (2001): 349-374.

Canada Revenue Agency. 1999. International Transfer Pricing. *Canada Revenue Agency Forms and Publications, Information Circular 87-2R*: 1-23

Chan, H., D. Semenov, C. Finnerty and J. MacArthur. 2011. Tax Planning for Funds Investing in CHINA: New Opportunities and Challenges. *Journal of International Taxation,* 2011, 2: 34

Chan, K.H. and L. Chow. 1997. International Transfer Pricing for Business Operations in China: Inducements, Regulations and Practice. *Journal of Business Finance and Accounting,* 24, 9: 1269-1289.

Chan, K.H., A. Lo and P. Mo. 2006. Managerial Autonomy and Tax Compliance: An Empirical Study on International Transfer Pricing. *The Journal of the American Taxation Association,* 28, 2: 1-22

Chandler, C., S. Foley, E. Skarstad and S. Tseng. 2006. Sharing Intellectual Property with Affiliates in China: Status of Chinese Cost-Sharing Rules and Other Observations. *Tax Executive,* 58, 6: 463-468.

Coronado, L., P. Cheung, J. Tien and J. Su. 2011. *Tax Management International Journal*, 2011 edition: 259-269.

Elliffe, C. 2011. Canadian Tax Court on the Meaning of “Permanent Establishment” in Treaties. *Journal of International Taxation,* 22, 4: 26

Farag, R. 2011. OECD to Review Transfer Pricing of Intangibles in 2011. *Journal of International Taxation*, 22, 4: 8

Feinschreiber, R and M. Kent. 2012. OECD Transfer Pricing Guidelines and the “Highly Uncertain” Valuation of Intangibles. *Journal of International Taxation,* 23, 2: 47

Ho, D. and P. Lau. 2002. A tax study if transfer pricing in China. *The International Tax Journal,* 28, 4: 62-78

Ho, D. 2009. An Empirical Study of International Transfer Pricing by Multinationals in the People’s Republic of China. *The International Tax Journal*, 35, 3: 47-53

Krupsky, K. 2009. OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings: When May the Taxpayer’s Transaction Not Be Recognized? *Tax Management International Journal*, 2009

Li, J. 2005. Transfer Pricing and Double Taxation: A Review and Comparison of the New Zealand, Australia and the OECD Transfer Pricing Rules and Guidelines. *International Tax Journal,* 31, 3: 49-62

Li, J. 2005. A Comparative Study of International Transfer Pricing Practices in Australia, New Zealand and China. *Asia Pacific Journal of Economics & Business,* 9, 2: 22-36

Lo, A. and R. Wong. 2007. Tax Compliance and Audit Adjustment – An Investigation of the Transfer Pricing Methodologies. *The International Tax Journal,* 33, 5: 59 - 70

Li, Y. 2011. Learning to share in China. *International Tax Review,*

Nelson, S., M. Levey and V. Lo. 2003. China steps up transfer pricing enforcement. *Journal of International Taxation,* 14, 2: 4-45

Ng, C. 2010. The New Transfer Pricing Rules and Regulations in China – Impact on Foreign Investors. *The International Tax Journal*, 35, 2: 49-56

Tremblay, R. and S. Suarez. 2009. Canadian Tax Perspective: The OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings – Canadian Considerations. *Tax Management International Journal,*

Wilkie, J.S. 1998. Canadian transfer pricing rules keep pace with International Developments. *Tax Executive*, 50, 2: 113-127