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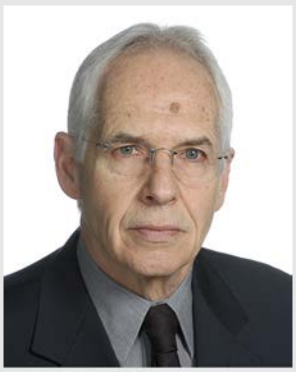

Nathan Boidman

Michael N. Kandev

Nathan Boidman and Michael N. Kandev are with Davies Ward Phillips & Vineberg LLP in Montréal.

In this article, the authors examine Canadian draft legislation that attempts to reconcile conflicts or overlaps between Canada's general transfer pricing rule, which is based on the arm's-length principle, and various specific statutory anti-base-erosion rules that may also apply to non-arm's-length cross-border situations. They also address apparent defects in the proposal that the government should resolve and look at how similar issues are dealt with in nine other countries, including the United States.

It is often said that transfer pricing is the most controversial area of international taxation.[1] This is clearly borne out by the enormous amount of human and financial resources that have been devoted to developing and administering traditional transfer pricing rules and, in recent years, to the OECD-led global reformation efforts.

But that categorization is belied by the simplicity illustrated by Justice Robert Hogan of the Tax Court of Canada who, in the landmark Canadian transfer pricing decision in *General Electric Capital Canada Inc. v. The Queen*, 2009 TCC 563, synthesized the essence of transfer pricing: "In the final analysis, transfer pricing is largely a question of facts and circumstances coupled with a high dose of common sense." To come full circle, perhaps, it is the potential subjectivity inherent in evaluating the facts and circumstances and agreeing on the "common sense" interpretation that sparks the ongoing controversies.

Be that as it may, the ubiquitous potential for controversy in Canadian transfer pricing is sometimes exacerbated by the systemic element of uncertainty that is discussed in this article. In particular, Canada's tax law presents an interpretational dilemma: How does one reconcile and resolve conflicts or overlaps between Canada's general transfer pricing rules based on the arm's-length principle and more specific domestic anti-base-erosion and profit-shifting rules that may apply to the same transaction?

The Canadian government has decided to resolve such conflicts or overlaps in favor of the general transfer pricing rule and recently proposed draft legislation to that effect. This article analyzes the proposal and considers whether other countries face a similar issue.

I. Overview of Transfer Pricing in Canada

Canada enacted its modern transfer pricing rules, which are based on the arm's-length principle, in section 247 of the Income Tax Act

[1] It is also the least understood. Diane Francis, a columnist for a Canadian financial newspaper, once wrote — without qualification — that "transfer pricing is illegal, but difficult to prove." Francis, "Here's Hoping Rae Relents on Corporate Tax," *Financial Post (Toronto)*, Nov. 14, 1990.

(Canada) for tax years that began after 1997. They replaced the preexisting rules in section 69(2) and (3), which were based on a reasonableness standard. Section 69(2) limited deductions for non-arm's-length payments to nonresidents to a reasonable amount, and section 69(3) required non-arm's-length payments from nonresidents to be at least a reasonable amount.

Canada's main transfer pricing rule is found at section 247(2)(a) and (c) ITA. It applies when a taxpayer and a non-arm's-length[2] nonresident engage in a transaction or series of transactions and the terms or conditions made or imposed between them differ from those that would have been made between persons dealing at arm's length. Subsection 251(1) ITA defines non-arm's-length dealings. The general rule requires that amounts otherwise agreed upon by the participants in a transaction (or series) be adjusted to reflect the amounts that would have prevailed for the transaction (or series) if the participants had been dealing at arm's length.

Also, under sections 247(2)(b) and (d) ITA, a non-arm's-length cross-border transaction (or series) may be recast if it would not have been entered into between persons dealing at arm's length and it can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit.[3] This increasingly controversial aspect of Canada's transfer pricing rules codifies paragraphs 136 and 137 of the 1995 OECD transfer pricing guidelines, which deal with the recasting or substitution (but not recharacterization) of non-arm's-length transactions.[4] Only one Canadian decision has considered this slippery provision: *Cameco Corporation v. The Queen*, 2018 TCC 195. The Tax Court of Canada rightly discussed it in terms of commercial reality and irrationality, concluding that it did not apply to a Canadian multinational that had established distribution subsidiaries in Luxembourg and Switzerland.

Particularly relevant to the discussion in this article, section 247(3) imposes a 10 percent penalty when the total amount of a taxpayer's transfer pricing capital and income adjustments exceeds the lesser of 10 percent of the taxpayer's gross revenue for the year or C $5 million (about $3.55 million). Significantly, the penalty is based on the total transfer pricing income adjustments that fail the reasonable efforts test in section 247(4) ITA, not the amount of additional taxes payable. Thus, transfer pricing penalties may apply even when there is no increase in taxes payable because of the availability of losses, discretionary deductions, and so forth.[5]

Section 247 is considered the ultimate provision of the ITA in Canada today because it applies to any amounts that — but for the transfer pricing rules and the general antiavoidance rule — would be determined for the purposes of the ITA. But the ITA is replete with more specific provisions that directly or indirectly have an impact on cross-border non-arm's-length transactions.

[2] "Related persons," as described in subsection 251(2) to (6) ITA, are deemed not to deal with each other at arm's length for purposes of the ITA, regardless of the factual situation. Relatedness between corporations is essentially a function of legal control. Persons who are not related persons may be found not to deal with each other at arm's length.

[3] *See generally* Siobhan A.M. Goguen, "Recharacterisation of Transactions Under Section 247: Still an Exceptional Approach," Canadian Tax Foundation 2018 Conference Report 21:1-25 (2018).

[4] Brian Bloom, one of the the principal drafters of section 247, has explained the difference between recharacterization of a transaction and recasting and substitution thereof, and the rationale for adopting only the former in Canada. Bloom, "Paragraph 247(2)(b) Demystified," *CCH Tax Topics* No. 1783 (May 11, 2006). He explains that the OECD's guidelines contemplate two departures from a taxpayer's intercompany transactions when determining tax results. One is when excessive debt financing of a subsidiary makes it permissible for tax authorities to recharacterize a part of the debt into equity. Bloom says this was not adopted in section 247 because Canada's thin capitalization rules obviate the need. The other, which Bloom says was the objective of section 247(2)(b) and (d), was to substitute a new transaction when a taxpayer sells the rights to future intangibles it may develop for a lump sum. That transaction would generally be irrational and defy being assessed under basic transfer pricing principles, so the statutory rule gave the government the right to recast or substitute it with a licensing transaction that could be evaluated as such basis.

[5] Section 247(9) provides an antiavoidance provision to stop attempts to avoid the penalty by increasing gross revenues and, in turn, increase the 10 percent gross revenue threshold.

II. Overlapping Transfer Pricing Rules

The more specific provisions of the ITA that affect transfer pricing interact with section 247 in different ways.

First, the ITA contains some rules of general application that provide competing standards to the arm's-length principle embodied in the general transfer pricing rule. Section 247(8) ITA addresses these comprehensively. For example, section 67 ITA provides that deductions are allowed only to the extent that they are reasonable under the circumstances, using the principle that was the basis for the older transfer pricing rules. Likewise, section 68 allows the authorities to reallocate proceeds from the disposition of property, payments for services, and consideration for a restrictive covenant on a reasonable basis; and section 69(1) and (1.2) adjust the pricing of non-arm's-length acquisitions or dispositions of property to reflect the fair market value. The modern transfer pricing rules specifically take precedence over the competing standards in sections 67, 68, and 69(1) and (1.2) in non-arm's-length cross-border situations.

Second, the ITA also contains some more specific rules that overlap with the transfer pricing rule in section 247 ITA but that the transfer pricing regime only partially addresses. Most notably, section 17 ITA ensures that a Canadian corporation includes a prescribed rate of interest — currently 2 percent, according to regulation 4301 — on debt that any nonresident, not just non-arm's-length nonresidents, has owed to it for more than one year. This rule contains an exception in section 17(8) that applies when the loan is to a controlled foreign affiliate (as defined in section 17(15) ITA) and either the affiliate uses the money to earn active business income or the amount owing arose in the course of an active business carried on by the affiliate. If this exception applies, section 247(7) permits a corporation resident in Canada to make an interest-free loan or to charge no interest on an amount owing to it without section 247(2) applying, which would otherwise deem arm's-length interest to be payable on the amount owing. However, section 247(7) ITA does not deal with cross-border loan situations comprehensively; it does not cover loans to non-arm's-length nonresident corporations that are not controlled foreign affiliates and do not qualify for the relatively narrow exception in section 17(8). It also does not cover situations in which section 17(1) does not apply because the one-year threshold has not been passed. Further, section 247 does not address at all the relatively new sister provision to section 17 ITA, section 17.1 ITA, which provides interest-deeming rules for the elective pertinent loan or indebtedness (PLOI) regime used in sections 15(2) and 212.3.[6] PLOI loans are specifically carved out from section 17, but nothing in section 247 deals with them.

Third, the ITA contains various rules that affect cross-border non-arm's-length transactions or overlap with section 247 but that the transfer pricing regime does not address at all. One example is Canada's thin capitalization limitation on interest deductibility for debts outstanding to specified nonresidents found in section 18(4) ITA. As noted previously, this rule seeks to prevent excessive related-party cross-border debt financing, and it was viewed as obviating the need for a debt-equity recharacterization rule in section 247 ITA.

In light of the above, this is the question: When the transfer pricing rules do not fully address the issue, what is the appropriate relationship between the more specific rules and the more general transfer pricing rule?

This has been a particularly controversial issue in relation to section 17 ITA.[7] Section 247(2)(a) through (c) would apply if a Canadian corporation made a non-interest-bearing loan to a foreign subsidiary, and it would require that an arm's-length rate (say, 5 percent) be recognized. But section 17 — a more specific rule dealing with loans by Canadian corporations to nonresidents — may also apply, and it would require the recognition of a prescribed rate of interest (currently, 2 percent), which invariably is much lower than the arm's-length rate. Which rule should take priority? In other words, does the section 17 rate serve as a safe harbor that excludes

[6] The PLOI regime generally requires the interest inclusion for a corporation resident in Canada from a PLOI to be at least the interest calculated under reg. section 4301(b.1), which is 4 percentage points higher than the prescribed rate for section 17 (without rounding up).

[7] The Canada Revenue Agency has taken the view that the transfer pricing rules may still apply. *See* CRA Doc. 2003-0033891E5. *But see* CRA Doc. 2007-0240241C6. For criticism of the CRA's position, see Bloom, "A Policy of Disengagement: How Subsection 247(2) Relates to the Act's Income-Modifying Rules," *CCH Tax Topics* No. 1957 (Sept. 10, 2009).

the application of section 247, or does it merely set a threshold rate?

Surprisingly, neither the legislature nor the judiciary addressed the apparent conflict between these rules, and the issue remained unsettled for more than 50 years. But in the 2019 budget, the government of Canada started the process to legislatively address the issue and resolve the conflicts in favor of the general section 247 transfer pricing rule, making the more specific section 17 rule virtually moot. However, the government's initiative has stumbled in light of the apparent difficulties in legislating this policy.[8]

III. Proposed Reordering Solution

A. Proposal and Department of Finance Examples

The mechanism that the Canadian government proposes to use to resolve the conflict between section 247 and other overlapping rules in the ITA is found in new section 247(2.1), which would operate in tandem with amended section 247(2) and the repeal of section 247(8).[9] After initially announcing its proposal in the 2019 budget, the government issued revised proposals July 30, 2019, addressing concerns expressed by the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada in a letter dated May 24, 2019.

New section 247(2.1) ITA imposes a three-step process:

- first, identify an "initial amount," which the proposed amendment to section 247(2) defines as the amount of the transaction after taking into account all provisions of the ITA other than section 247 or the GAAR in section 245;
- second, adjust the initial amount in accordance with section 247; and
- third, use the adjusted amount when applying any other relevant rule in the ITA.

The Department of Finance's explanatory notes[10] on the changes to section 247 ITA provide two examples of how the reconfigured transfer pricing rules would operate.

Example 1 deals with the interaction between section 247(2) ITA and the thin capitalization rule in section 18(4) ITA.[11] The hypothetical facts of the example involve a corporation resident in Canada that owes a debt of C $1,000 to a non-arm's-length nonresident. The annual interest rate on that debt is 10 percent, but the interest rate that would have been agreed to if the parties were dealing at arm's length is 7 percent. Also, the corporation has an equity amount (as defined in subsection 18(5)) of C $600, and therefore the debt financing exceeds the 60/40 debt-equity ratio by C $100. In other words, this example involves both excessive interest and excessive debt principal. According to the government's analysis, the "initial amount" is the C $100 of interest (that is, 10 percent of C $1,000). The C $100 of interest payable in the tax year would be adjusted down to C $70 to reflect the 7 percent arm's-length rate of interest. Finally, the provisions of the ITA would be applied to that adjusted amount (C $70): The 60/40 debt-equity ratio in section 18(4) would limit the interest deduction so that C $7 of interest would be denied (that is, C $70 (1,000 – 600 x 1.5)/1,000)). In summary, C $30 of interest deduction is denied based on the transfer pricing rules, and another C $7 is denied in accordance with the thin capitalization ratio. The explanation concludes that the intended effect of new subsection 247(2.1) is to clarify that the adjustment under subsection 247(2) is made before the application of subsection 18(4).

However, Example 1 seems inconsistent with the wording of section 247(2.1). It begins with an "initial amount" of C $100. However, if the initial amount is supposed to take into account all provisions of the ITA other than section 247 and the GAAR in section 245, then the initial amount should factor in the section 18(4) limitation to deny deductibility of C $10 of the C $100 of

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[8] *See* Ryan Finley, "Stalled Canadian Transfer Pricing Proposals Still Cause Concerns," *Tax Notes Today Int'l*, Feb. 28, 2020.

[9] Canadian Department of Finance, Legislative Proposals Relating to Income Tax and Other Legislation and Explanatory Notes (July 30, 2019) (proposed to apply to tax years that begin after March 18, 2019). *See also* Marc Roy, "Proposed Transfer Pricing Ordering Rules," 109 *Wolters Kluwer Int'l Tax* 2 (Dec. 2019).

[10] Canadian Department of Finance, Explanatory Notes Relating to the Legislative Proposals Relating to Income Tax and Other Legislation (July 30, 2019).

[11] In essence, Canada's thin capitalization rule denies (that is, does not defer) the deduction of interest on the portion of the outstanding debts to specified nonresidents that exceeds a 60/40 debt-equity ratio.

interest. Then, section 247(2.1)(b) would adjust the interest to C $70 for all relevant purposes. Finally, when section 247(2.1)(c) is applied, the deductibility of another C $20 of interest would be denied generally and C $7 would be denied by section 18(4).

While the above analysis of Example 1 shows that the reordered application of section 247 does not seem to cause any conflict with section 18(4) — the denied interest in both cases is the same (C $37) — the concern is that the Department of Finance's approach yields a higher transfer pricing penalty: Under the Department of Finance's analysis, the transfer pricing rules adjustment is C $30, while our analysis shows that only C $27 should be the transfer pricing adjustment.

Example 2 considers the interaction between sections 247 and 17 ITA with a scenario in which a corporation resident in Canada has a C $100 loan receivable from a non-arm's-length nonresident corporation that is not a controlled foreign affiliate of the Canadian corporation. Interest is payable on the loan at a rate of 1 percent. The interest rate that would have been agreed to if the parties had been dealing at arm's length with each other is 3 percent. In the Department of Finance's analysis, the initial amount in this scenario is the C $1 of interest on the loan. This amount is adjusted to reflect the 3 percent arm's-length rate of interest, and the adjustment under section 247(2) is C $2. When the ITA is reapplied to the adjusted amount of interest, section 17 has no incidence based on the assumption that a 3 percent rate of interest is reasonable — that is, because the condition in paragraph 17(1.1)(c) would not be met, subsection 17(1) would not apply.

Again, we believe that the Department of Finance's analysis in Example 2 does not follow the plain wording of proposed section 247(2.1) ITA. In our view, when determining the initial amount under section 247(2.1)(a), one would need to apply the section 17 prescribed rate of interest (currently, 2 percent) if the loan had been outstanding for more than one year and did not qualify for the section 17(8) exception. Next, section 247(2.1)(b) would require an upward adjustment of the interest to C $3. Finally, section 247(2.1)(c) would bring the analysis back to section 17. With the adjusted rate, however, the loan bears a reasonable rate of interest and no further adjustment would be required. Again, while the result appears to be the same, the difference in analysis is potentially material because specific transfer pricing penalties under section 247(3) apply only to adjustments made under section 247. In the Example 2 scenario, the Department of Finance's incorrect view would double the amount potentially subject to penalties under section 247(3).

B. Additional Concerns

This difference of opinion regarding the application of the first step in proposed section 247(2.1) is not our only concern with how the government intends to regulate conflicts or overlaps between section 247 and other provisions of the ITA. Returning to the relationship between section 17 and section 247, the proposed addition of section 247(2.1) and particular aspects of the antiavoidance provisions in section 17 may result in double taxation of some loan arrangements involving Canadian corporations and nonresident borrowers. Suppose that the lender in Example 2 did not lend directly to its foreign subsidiary but rather funded a partnership that made the loan to the subsidiary or settled a Canadian trust that made the loan to the subsidiary. In either case, under the ITA with the proposed addition of section 247(2.1), it appears that there would be an addition to the income of the Canadian corporation amounting to both 5 percent on the loan and 2 percent of the loan.[12]

Moving away from the most common scenario of cross-border loans (the subject of both examples), the explanatory notes to the proposed amendments, unfortunately, do not provide any examples of the impact of the repeal of section 247(8). This raises a question: In other cases, will proposed section 247(2.1) always yield the intended results and give section 247 ITA priority when other provisions also directly govern the amount of a transaction?

[12]These conclusions are not without doubt. This may not necessarily be the government's intent, and ameliorating amendments may arise. It is also unclear that only section 247 would apply when the partnership or trust structure used preexisting funds to make the loans; they may be governed by section 17(4) and (6) rather than section 17(2).

Consider a Canadian corporation that acquires property from a foreign parent at the cost of C $100 when its FMV within the meaning of section 69(1) ITA is C $95, and its arm's-length price within the meaning of section 247 is only C $90. For purposes of the ITA, section 69(1)(a) deems a person to have paid the FMV for property purchased from a non-arm's-length person (regardless of residency) if the amount actually paid exceeds FMV. That rule, applicable without regard to section 247, would reduce the purchase price from C $100 to C $95.

But the analysis changes with new section 247(2.1). In the first step, the initial amount is either C $100 — if the government's view as expressed in Example 1 and Example 2 is adopted — or C $95 — if the authors' view is adopted. Either way, in the second step, section 247(2) adjusts the cost down to C $90. The third step refers (either again or for the first time) to section 69(1) ITA; and, since the adjusted price of C $90 does not exceed the FMV of C $95, no further adjustment is required. The cost for Canadian tax purposes is the arm's-length price under section 247, which is the result the government apparently wants.

Now, if we reanalyze the situation when the FMV is C $85 and not C $95, the initial amount would be either C $85 (the authors' approach) or C $100 (the government's approach). Then the section 247 adjustment would either go up to C $90 (subject to the government's right to deny the step-up under section 247(10) ITA) or down to C $90. Again, this would seem to fulfill the government's objective, subject to the uncertainty section 247(10) might produce.

What if the FMV is C $100? There should be no uncertainty here: Regardless of the approach, the initial amount will be C $100 and the end cost will be C $90.

And what are results if the FMV is C $100 but the arm's-length price is C $105? As in the previous case, the initial amount under either approach is C $100. Then, assuming section 247(10) is not invoked, the price increases to C $105. This brings us to a conflict the government presumably did not foresee. When the third step in section 247(2.1) is applied, the C $105 price is subject to section 69(1), which would seem to reduce the price for tax purposes to C $100 — which is not the true arm's-length price.

Our analysis indicates that the government has more work to do.

IV. How Other Countries Address Overlap

With the controversy in Canada regarding overlapping transfer pricing rules, we wondered whether other countries have faced similar issues. We surveyed practitioners in several countries (listed alphabetically) using the following questions[13]:

1) Has your country adopted general transfer pricing legislation based on the arm's-length principle?

2) Has your country adopted specific anti-BEPS rules (sometimes called mini transfer pricing rules) applicable to some common scenarios? For example, does your tax law contain a rule that requires a prescribed rate of interest to be recognized on related-party loans with nonresident persons? If yes, is that prescribed rate less than an arm's-length rate?

3) If the answers to both 1 and 2 are yes (that is, the fundamental base question in each), which rule takes precedence: the general transfer pricing rule or the specific rule? In other words, is the specific rule a safe harbor that eliminates the need to refer to the transfer pricing rule (and obtain a transfer pricing study), or does the specific rule effectively set a minimum rate, which the general transfer pricing rule can increase?

A. Australia

Australia has general transfer pricing legislation based on the arm's-length principle. Generally, Australia's tax law does not contain

[13]We offer thanks and appreciation to the practitioners who responded to our query and provided the information summarized below: Prashanth Kainthaje, partner with Johnson Winter & Slattery (Australia); Pierre-Henri Durand, avocat à la cour with Bredin Prat (France); Klaus Herkenroth, partner with Jones Day (Germany); Dhaval J. Sanghavi, partner with Jitendra Sanghavi & Co. (India); Aurelio Massimiano and Francesco Ricci with Maisto e Associati (Italy); Yushi Hegawa, partner with Nagashima Ohno & Tsunematsu (Japan); Omar Zúñiga, partner with Creel (Mexico); Jeremy Everett with Yulchon (South Korea); Dominic Robertson, partner with Slaughter and May (United Kingdom); and Peter Glicklich and Gregg Benson with Davies (United States).

specific rules that conflict with the transfer pricing provision. However, there are two sets of rules that that have unusual transfer pricing implications: a set of rules known as Division 7A and the thin capitalization rules.

The Division 7A rules apply only to private companies. In very broad terms, the rules deem an unfranked dividend to be paid to a shareholder (or associate of a shareholder) if the private company makes a loan to the shareholder (or associate). The reason Division 7A exists is that the corporate tax rate is lower than the marginal tax rate of business owners; absent these provisions, private companies would pay corporate tax and then lend money to shareholders (who ordinarily pay tax at progressive rates of up to 47 percent). There are exceptions to Division 7A, including when the loan is a "Division 7A complaint loan." This category of loan requires a specific term, a specific interest rate, and minimum annual repayments. It is premised on the currency being Australian dollars, but if a loan to a nonresident of Australia is made in a currency other than Australian dollars, the prescribed interest rate must still apply to it — regardless of the currency. This creates a conflict between Australia's transfer pricing rules and the Division 7A provisions because the prescribed interest rate is generally higher than the arm's-length interest rate in most non-Australian currencies.

The second conflict is between Australia's domestic thin cap rules and the arm's-length transfer pricing rules. This presupposes there is an arm's-length debt amount that is less than the thin cap limit — 60 percent debt, 40 percent equity. The concern is that the tax authority can argue that the borrower's debt capacity mandates a lower amount of debt than that authorized under the thin cap ratio. The Australian Taxation Office issued a public ruling (TR 2010/7) favoring the thin cap rules insofar as the debt amount is concerned.

B. France

Article 57 of the French Tax Code is based on the arm's-length principle. The French legislation does contain some more specific anti-BEPS rules applicable to several common scenarios.

For example, while there are no specific rules that apply when a French taxpayer lends to a non-related nonresident, if the French entity borrows funds from its shareholders, then a statutory rate — a rate the French tax authorities publish quarterly (currently, 1.21 percent) — applies. This statutory rate applies differently depending on whether the lending shareholder controls the borrower (that is, it is a related party) or not (that is, it is a non-controlling direct shareholder, such as a minority shareholder). Regarding deductibility of interest paid by a company to a related-party lender, the statutory rate is only a presumption. If the applied interest rate exceeds the statutory rate, the interest expense may still be deductible if the borrower demonstrates that the applied rate does not exceed an arm's-length rate. Surprisingly, when a company pays interest to a non-controlling direct shareholder, interest expenses may be deducted only to the extent of the statutory rate — there is no fallback on the arm's-length principle. In other words, when applied to a loan from a non-controlling direct shareholder, the rate is not a presumption but a cap imposed by law. Obviously, there is no direct conflict between the general transfer pricing rule and the specific rule for related parties — the specific rule only sets a minimum rate and the applied rate can be higher. In contrast, however, the specific rule for interest paid by a company to its non-controlling shareholders is a specific override of the arm's-length principle.

C. Germany

Germany has adopted the arm's-length principle for cross-border transfer pricing purposes. However, new rules have been proposed that arguably are not in line with the arm's-length principle.

For inbound financing, the proposal states that the group rating must in principle be controlling for the interest rate to be charged unless the German borrower has a better rating in which case the interest rate needs to reflect this, that is, needs to be lower. In contrast, the group rating is not applied in outbound financing cases with the notable consequence that the absence of guarantees must be reflected in the interest rate. Also, under the proposed rules, financing services are considered in principle to be ancillary or supporting transactions. For our purposes, the notable consequence is that the interest rate needs to be equal to the riskless interest rates of government bonds of the highest credit rating, adjusted for the term of the loan.

In summary, the above proposed German rules are in marked deviation from what the OECD has proposed in this regard.

D. India

While the Indian ITA, 1961, does not specifically refer to the arm's-length principle, it provides for the computation of income arising from international transactions and specified domestic transactions based on an arm's-length price. The modalities of computation of the arm's-length price can be found in the Income Tax Rules, which contain specific instructions including the use of comparability analyses, prescribed methods, the range concept, the use of multiyear data, and penal consequences.

The determination of an arm's-length price under the legislation's general provisions is subject to safe harbor rules. If an eligible assessee undertakes a transaction that is covered by the safe harbor rules (eligible transactions) and the transaction value is within the limits prescribed thereunder or in line with the circumstances specified in the rules, then the assessee may opt to complete the necessary formalities and be governed by the safe harbor rules instead of the general arm's-length principle. Once exercised, the option is valid for three years unless the assessee opts out of it.

In line with the BEPS initiative, the most recent addition to the list of eligible transactions involves the receipt of low-value-adding intergroup services when the entire value of the international transaction (including a markup of 5 percent or less) does not exceed INR 100 million (about $1.31). This cost-plus 5 percent markup is in line with the arm's-length rate accepted for such transactions. Also, in accordance with various judicial precedents, payments within the limits prescribed by the Reserve Bank of India (RBI) under the foreign exchange regulations also qualify for safe harbor treatment for determining the arm's-length nature of a transaction. For example, interest on an Indian entity's external commercial borrowing from a foreign enterprise is subject to a total cost ceiling of the "benchmark rate plus 350 basis points" under the foreign exchange regulations. Likewise, if the interest that an Indian enterprise pays to a foreign associated enterprise is within the prescribed guidelines, then it is considered to be at arm's length. Similarly, under the erstwhile foreign exchange policy, commission or royalty payments to foreign entities were permitted to be made only if the commission or royalty rates were within prescribed RBI limits. The RBI's approval of commission or royalty payments could be considered sufficient justification for declaring the transaction to be at arm's length for transfer pricing purposes.

Broadly, if an eligible assessee enters into an eligible international transaction and exercises the option to be governed by safe harbor rules, then the income tax authorities must accept the transfer price that the assessee has set for the transaction if it is in accordance with the circumstances or limits specified in the rules — the authorities may not make any comparability adjustments based on the general arm's-length principle. However, provisions pertaining to maintenance of transfer pricing documentation and filing the transfer pricing audit report still apply even if the assessee exercises the safe harbor option. If the eligible assessee has not exercised an option for an eligible international transaction, the general arm's-length principle rule applies without reference to the rates specified in the safe harbor rules.

Also relevant to transfer pricing, section 94B of India's ITA includes an interest limitation rule, which applies when an Indian company incurs any interest expenditure (or an expense of a similar nature) exceeding INR 10 million on a debt issued by a nonresident associated enterprise. The rule denies the use of interest as deductible expense in computing the taxable income for the relevant assessment year — regardless of the arm's-length nature of the underlying transaction — if it exceeds 30 percent of earnings before interest, taxes, depreciation, and amortization. This is a more specific rule and therefore it overrides the general transfer pricing provisions. Although the assessee must benchmark the payment of interest using India's general arm's-length principles, if the amount of interest is more than INR 10 million, section 94B's limitation on interest deduction remains applicable. The excess interest disallowed can be carried forward.

E. Italy

Transfer pricing in Italy is governed by article 110, paragraph 7 of the Italian Tax Code. In accordance with Legislative Decree No. 50 of April 24, 2017, article 110, paragraph 7 of the Italian Tax Code now makes explicit reference to the arm's-length principle, with Italy's stated purpose being to align the domestic provision with article 9 of the OECD model tax convention. The Ministerial Decree of May 14, 2018, contains implementing regulations, with article 1 expressly referring to "international tax practices" in order to apply the arm's-length principle. Italian tax law does not contain specific overlapping or conflicting rules that affect cross-border transfer pricing.

F. Japan

Japan has general transfer pricing legislation based on the arm's-length principle. Japan generally follows the OECD transfer pricing guidelines. It also has more specific rules that affect transfer pricing, referred to as the imputed income recognition and donation regime, that have existed for more than 50 years. For example, if a Japanese corporation makes an interest-free loan to a foreign subsidiary, the regime requires the Japanese corporation to recognize interest income at an FMV rate, and then deems the company to have donated the same amount to the foreign subsidiary. This would leave the Japanese corporation with only the imputed income because the deemed donation is nondeductible. This is generally similar to transfer pricing rules under which the Japanese corporation would be required to recognize interest income of an arm's-length rate. The Japanese government believes that when a Japanese corporation has in substance donated an amount to its foreign subsidiary, the imputed income recognition and donation regime takes precedence, while in other cases the transfer pricing rules apply.

However, the regime does not formally qualify as a safe harbor. Japanese practitioners generally contend that the government prefers to use the imputed income recognition and donation regime because it is a domestic tax regime, and thus, unlike in transfer pricing cases, disputes are not subject to the mutual agreement procedure and it is relatively easy for the authorities to write an assessment notice without performing any detailed transfer pricing analysis.

G. Mexico

Mexico introduced the arm's-length principle into its income tax law in 1996. Most of the specific transfer pricing rules appear in articles 76, 179, and 180 of the income tax law, which require taxpayers to produce and maintain documentation demonstrating that taxable income and deductions arising from intercompany transactions are consistent with the amounts that would have resulted between unrelated parties under similar conditions. Also, Mexico will apply the OECD transfer pricing guidelines to the extent they are consistent with the domestic law and any applicable treaty. Significantly, Mexico's transfer pricing provisions apply to transactions with foreign related parties and also those with domestic related parties. Mexico has not adopted any specific rules that conflict or overlap with the general transfer pricing rule.

Mexico's 2020 tax reform adopted interest deduction limitations based on the BEPS action 4 recommendations. The rule limits interest deductions to 30 percent of the adjusted tax profit. If interest is not deductible in a given year because of this limitation, the interest deduction can be carried forward for 10 years. Also, there are exceptions for specific debts that finance public infrastructure work projects, real estate construction, and productive governmental enterprises. However, this rule should not be seen as conflicting with the general principles of transfer pricing.

H. South Korea

South Korea has adopted the arm's-length principle in its tax legislation. It also has more specific rules that affect cross-border transfer pricing. For example, South Korea's tax law contains a rule that prescribes a rate of interest for related-party loans with nonresident persons. The prescribed rate — currently, 4.6 percent for loans to foreign affiliates and the 12-month LIBOR plus 1.5 percent for loans from foreign affiliates — approximates an arm's-length rate and acts as a safe harbor. If the prescribed rate is not used, then general transfer pricing rules apply.

I. United Kingdom

The United Kingdom has adopted transfer pricing rules, based on the arm's-length principle and the OECD guidelines. Generally, the United Kingdom has been an enthusiastic adopter of the OECD's BEPS initiatives, including the revised transfer pricing guidelines. Significantly, the United Kingdom has been a leader in introducing a higher-rate diverted profits tax as an added incentive to comply with transfer pricing rules. If both a diverted profits charge and a transfer pricing adjustment apply, the latter takes priority if the matter is resolved pre-litigation, but the diverted profits charge takes priority if the matter is litigated. Thus, this creates an added incentive to settle transfer pricing disputes rather than fight them in court.

J. United States

In 1968 the United States became the first country to enact transfer pricing rules based on the arm's-length principle in IRC section 482. Treas. reg. section 1.482-2 provides the framework for evaluating the appropriate rate of interest on an intercompany loan.[14] The general rule states that an arm's-length interest rate is the rate that would be charged in an independent transaction with or between unrelated parties at the same time and under similar circumstances as the debt arose and taking into consideration all relevant factors such as the principal amount, presence of security, and duration.

In addition to the general facts and circumstances test, reg. section 1.482-2(a)(2)(iii)(B) provides an applicable federal rate safe haven. The IRS publishes the applicable federal rate. For bona fide debt between members of a group of controlled entities, the safe haven is met if the loan is denominated in U.S. dollars, the lender is not engaged in a trade or business of making loans to unrelated parties, and the rate of interest on the loan ranges from 100 to 130 percent of the appropriate applicable federal rate (that is, the short-term, medium-term, or long-term rates, as applicable). If these criteria are satisfied, the rate of interest cannot be challenged under general transfer pricing rules.[15]

V. Conclusion

Since 1998 when Canada enacted the arm's-length principle in section 247 ITA, the inherent potential for transfer pricing controversies has been exacerbated by the question of how to resolve conflicts or overlaps that may arise between the general transfer pricing rule and more specific domestic anti-BEPS rules that may apply to the same transaction.

After years of uncertainty, the government recently adopted a policy to give overall priority to section 247 ITA, and it has released draft legislation to give effect to that policy. However, the draft appears to require further consideration and modifications — particularly in relation to the competing rules of section 17 ITA, which address outbound loans, and of section 69(1) ITA, which involve the competing FMV standard — to operate properly.

The foregoing also shows that most of the surveyed countries (Australia, France, Germany, India, and the United States) give priority to targeted rules when they conflict with the general arm's-length principle, with mixed results in Japan and the United Kingdom. But the survey also shows that in other countries these conflicts have not given rise to the degree of controversy seen in Canada, and in some countries (Italy, Mexico, and South Korea) the issue appears not to exist or not to have attracted any particular attention. ■

[14] The interest rate is also relevant to determining whether a loan is respected as debt for U.S. tax purposes under IRC section 385.

[15] There are other rules that can impute interest on loans, like the below-market loan rules of IRC section 7872 or seller-financed sales of property under IRC sections 1274 and 483 (each of which generally imputes interest at the applicable federal rate).