Discussion Draft on Financial Transactions released July 3, 2018 Executive Summary

Executive Summary

1. We are writing in response to the request of the Centre for Tax Policy and Administration of the OECD for comments on the July 3, 2018 Discussion Draft on Transfer Pricing Aspects of Financial Transactions (the "2018 Financial Transactions Discussion Draft"). Our comments are principally directed to the OECD's recommendations relating to recharacterizing functions, assets and risks under the guise of "accurately delineating" the transaction(s). Our comments are not limited to the specific questions asked in the discussion draft.

2. There is a real need for practical, workable guidance in this area. The number of global transfer pricing disputes relating to financial transactions and the obvious difficulty courts and taxpayers have encountered in dealing with transfer pricing issues in this context demonstrate the urgency of the need. The issues that arise in ascribing implicit support within a MNE group while treating the relevant entities as independent enterprises for "transfer pricing purposes" have been particularly troublesome and this calls for a clear, well-defined paradigm.

3. The 2015 BEPS revisions and the 2017 Transfer Pricing Guidelines reflect a shift away from respecting legal form and substance under the rubric of "accurate delineation". The OECD should recognize that accurate delineation is a new concept that would require legislative change in jurisdictions such as Canada where legal substance governs, barring the application of explicit recharacterization rules in the domestic legislation. This new concept also exacerbates the potential for conflict between jurisdictions where legal form and substance is respected and those where economic realities or substance are controlling.

4. The 2018 Financial Transactions Discussion Draft contains problematic proposals that reflect a continued shift away from respecting legal form and substance and from focusing on the simple question of whether prices charged between non arm's length ("NAL") parties are the same as those charged in a comparable uncontrolled transaction. More particularly, the 2018 Financial Transactions Discussion Draft prescribes "accurate delineation" before considering pricing. We believe that non-recognition of transactions as structured should continue to be reserved for exceptional circumstances.

5. The approach recommended by the OECD envisages that tax authorities may recharacterize transactions even if they can be reliably priced. Recharacterizing transactions that can be reliably priced serves no arm's length ("AL") pricing purpose and will lead to a lack of certainty, predictability and fairness. The OECD's recommendations appear solely designed to achieve certain anti-avoidance objectives rather than a desire to produce AL pricing. In our view, any policy decisions to avoid the recognition of income in lower or no-tax jurisdictions could best be achieved through targeted anti-avoidance rules (such as CFC rules, earnings stripping or thin capitalization rules, etc. rather than through distortions of the AL principle in the transfer pricing context). Recharacterizing functions, assets and risks under the guise of accurately delineating the transaction(s) for such anti-avoidance reasons will produce results that are not the same as those produced by the simple application of the AL principle. In our view, this will undermine the authoritative value of the OECD Transfer Pricing Guidelines and will lead to an increase in international tax disputes.

6. We are also providing comments on the recommendations in the 2018 Financial Transactions Discussion Draft regarding the recharacterization of debt as equity (or vice versa) and the suggestion that "accurate delineation" should exist in parallel with domestic thin capitalization rules. In addition, we offer specific comments on the draft guidance related to value creation, and determining the arm's length conditions for treasury activities, including intra-group loans and hedging, guarantees, and captive insurance.

Value Creation

7. The 2018 Financial Transactions Discussion Draft was prepared under the mandate of the Report on Actions 8-10 of the BEPS Action Plan Aligning Transfer Pricing Outcomes with Value Creation ("2015 BEPS revisions"). We submit that the new "value creation" criterion, introduced in the 2015 BEPS revisions and incorporated in the 2017 Transfer Pricing Guidelines, is novel and vague, does not necessarily yield the same terms and conditions as those produced under the AL principle embodied in Article 9 of the OECD Model Tax Convention, and reflects a shift away from the simple premise that prices charged between NAL parties should be priced the same as they would in a comparable transaction between two arm's length parties.

8. Despite implicit or explicit assumptions by the OECD that the concept of "value creation" accords with or is congruent with the AL principle, "value creation" is a new test and it has no foundation in Article 9 of the OECD Model or the Commentary on Article 9. Nor was this purportedly now self-evident objective of transfer pricing rules mentioned in the 1995 or 2010 Transfer Pricing Guidelines. Yet it is now simply assumed to be the primary objective of transfer pricing. At a conference for the National Association for Business Economics Transfer Pricing Symposium, in response to comments that the 2015 BEPS revisions fail to uphold the arm's length principle, Andrew Hickman, the then head of the OECD transfer pricing unit, acknowledged that the 2015 Revisions may not accord with the arm's length principle, stating:

   Perhaps [critics] will say we fudged it, but I would say that's a pragmatic fudge [...] It may be that we haven't got a pure version of the arm's-length principle, but perhaps we're looking for something that is just and equitable and might work.

9. In addition, "value creation" has no jurisprudential or doctrinal history, at least in Canada. The adoption of such a novel concept without any legal foundation or well-defined meaning can only lead to more disputes and the potential for double taxation. To many observers, the introduction of this concept was simply a device to make the authorized OECD approach ("AOA"), now prescribed for the attribution of income to a permanent establishment under Article 7 of the OECD Model Convention, applicable for Article 9 purposes by focusing on significant people functions (i.e., decision making) and significantly diminishing the importance of the provision of capital, without regard to whether it is consistent with the AL principle.

10. Richard Tremblay and Al-Nawaz Nanji of our firm previously commented on BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterization and Special Measures) released December 19, 2014 ("2014 Discussion Draft") prior to the 2015 Revisions. In a letter dated February 4, 2015, they commented that the 2014 Discussion Draft introduced a new test based on "value creation" that affords revenue authorities too much discretion. We are once again submitting comments on this important topic.

11. There is also no broad international consensus on what value creation means from a transfer pricing perspective. Jonathan Schwarz, for example, has pointed out that value creation frequently appears in policy documents and new legal instruments as the justification for new international tax rules, but is nowhere explained. Professor Herzfeld pointed out the following flaw in that regard:

    In its July report to the G-20 on BEPS implementation, the OECD continued to emphasize value creation, noting that "a key component of ensuring that taxation is aligned with value creation is the ability to tax administrators to understand where Multinational Enterprises have their activities and where the revenues are generated." But the report on actions 8-10 and the subsequent revisions to the transfer pricing guidelines all suffer from a major flaw: The OECD didn't say what creates value, nor did it provide guidance for determining where revenues should be considered generated.

    As a result, there is no generally accepted legal meaning available to courts and revenue authorities to resolve future disputes.

12. In short, the concept of "value creation" incorporated in the 2017 Transfer Pricing Guidelines prescribes ignoring legal form and substance to re-determine the terms and conditions of a NAL transaction based on subjective criteria which may, but will not necessarily, yield terms and conditions that are in accordance with the AL principle as established in Article 9 of the OECD Model Tax Convention or indeed in the 1995 or 2010 Transfer Pricing Guidelines.

13. Introducing and relying on a new test without a well-defined or commonly understood meaning, and which abandons reliance on legal form and substance, will lead to a lack of certainty, predictability and fairness and will result in more double taxation and more tax disputes.

14. The comments submitted by Richard Tremblay and Al-Nawaz Nanji on the 2014 Discussion Draft pointed out that value creation appeared to be akin to an economic substance determination. Canada, unlike the US, does not have an economic substance doctrine. There is support for this view. Professor Wolfgang Schön, for example, put the case that "value creation" is indeed new and has been conflated with "economic substance" which, in the BEPS context, has in turn been conflated with tax avoidance and artificial arrangements.

15. The adoption of a test that produces results that conflict with the AL principle for purely anti-avoidance purposes unrelated to pricing per se, can only serve to undermine reliance by courts and others on the OECD Transfer Pricing Guidelines.

Accurate Delineation

16. The 2014 Discussion Draft introduced a new six-step analysis for "accurately delineating transaction(s)": (1) Identify economically significant risks; (2) Determine how specific, economically significant risks are contractually allocated; (3) Determine through a functional analysis how the associated related parties assume and manage specific, economically significant risks; (4) Determine whether the contractual assumption of risk is consistent with the conduct of the related parties; (5) Apply the guidance on allocating risk if the related party assuming risk does not control the risk or does not have the financial capacity to assume the risk; and (6) Price the transaction, taking into account the financial and other consequences of risk assumption, as appropriately allocated, and appropriate compensate risk management functions.

17. Under accurate delineation, the OECD does not simply ask how much would be paid to the person who provides the control function (i.e., a service) under AL dealing. Rather, the OECD allocates the bulk of the return to that person without regard to the fact that it did not provide the relevant capital, and the service may be of little value. This is not how things work in the AL world.

18. Accurate delineation involves assessing how parties' arrangements (including risk allocation) compare to what revenue authorities assert arm's length parties would do. This allows revenue authorities to disregard the legal form and substance of a transaction or series of transactions to effectively create a transfer pricing fiction that attributes the bearing of risks to entities that provide significant people functions away from the entities that legally and economically bear the risks.

19. This reflects a departure from both the AL principle and prior guidance from the OECD that non-recognition of legal form and substance should only be used in exceptional circumstances – and not where a transaction can be reliably priced. From a Canadian perspective, "accurate delineation" and recharacterization are one and the same.

20. Non-recognition is a serious undertaking which should be restricted to appropriately rare situations and remain exceptional. As discussed in more detail below, the OECD itself has said that non-recognition should be reserved for exceptional circumstances because recharacterization could produce arbitrary results.

21. The 2015 BEPS revisions mandated specific follow-up work on transfer pricing aspects of financial transactions. The 2018 Financial Transactions Discussion Draft represents the first OECD document on this topic, aiming to clarify the principles in Chapter I of the 2017 OECD Transfer Pricing Guidelines. Instead of clarifying the 2017 Transfer Pricing Guidelines, the 2018 Financial Transactions Discussion Draft instead highlights a number of areas where the OECD seems unsure as to what the approach or right answer should be.

22. Chapter I of the 1995 Guidelines was dedicated to providing guidance on the AL principle, which OECD member countries said should be the international standard used for pricing transactions between NAL parties.

23. The 1995 Guidelines provide that the compensation that each party receives should reflect the functions that it performs, while also taking into account the assets used and the risks assumed by each party. The 1995 Guidelines provided that the allocation of functions, assets and risk in AL transactions should be determined based on the contractual terms between the parties.

24. The 1995 Guidelines do indicate that, in some circumstances, it may be appropriate to determine whether a purported allocation of risk is consistent with the economic substance of the transaction by examining the actual conduct of the parties. According to the 1995 Guidelines, these situations are limited to instances where the parties are essentially engaged in window dressing or a sham (e.g., they do not act in accordance with the terms of the underlying agreements).

25. The 2010 Transfer Pricing Guidelines reiterated that the starting point for any transfer pricing analysis is to examine the actual contract between the parties and that the economic substance of the transaction is only relevant where the contract amounts to window dressing or a sham.

26. Paragraph 9.168 of the 2010 Transfer Pricing Guidelines states:

Paragraph 1.64-1.69 explicitly limit the non-recognition of the actual transactions or arrangement to exceptional cases. This indicates that the non-recognition of a transaction is not the norm but an exception to the general principle that a tax administration's examination of a controlled transaction should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them. The word "exception" in the context is similar to the meaning to "rare" or "unusual". It reflects that in most cases it is expected that the arm's length principle under Article 9 can be satisfied by determining arm's length pricing for the arrangement as actually undertaken and structured.

27. The 1995 and 2010 Transfer Pricing Guidelines were clear – taxpayers and revenue authorities should try to price the actual transaction, except in rare and exceptional circumstances. Paragraph 1.121 of the 2017 Transfer Pricing Guidelines professes to maintain this approach:

Every effort should be made to determine pricing for the actual transaction as accurately delineated under the arm's length principle. The various tools and methods available to tax administrators and taxpayers to do so are set out in the following chapters of these Guidelines. A tax administration should not disregard the actual transaction or substitute other transactions for it unless the exceptional circumstances described in the following paragraphs 1.122 -1.125 apply.

28. In contrast, the 2017 Transfer Pricing Guidelines appear to have abandoned this "pricing first" approach in favour of a potential "recharacterization first" approach under the guise of accurately delineating the transaction. Paragraph 9.180 of the 2010 Transfer Pricing Guidelines states:

[...] If an appropriate transfer price (i.e. an arm's length price that takes into account the comparability – including functional – analysis of both parties to the transaction or arrangement) can be arrived at in the circumstances of the case, irrespective of the fact that the transaction or arrangement may not be found between independent enterprises and that the tax administration might have doubts as to the commercial rationality of the taxpayer entering into the transaction or arrangement, the transaction or arrangement would not be disregarded under the second circumstance in paragraph 1.65.

29. Although the "pricing first" approach (e.g., paragraph 9.180 of the 2010 Transfer Pricing Guidelines) makes sense, it appears to have been discarded in the 2017 Transfer Pricing Guidelines and is not evidenced in the 2018 Financial Transactions Discussion Draft. The reason again appears to be a primary mission shift away from determining the AL pricing of the transaction at issue, and instead to countering perceived tax avoidance.

30. With respect to circumstances where non-recognition is appropriate, paragraph 1.122 of the 2017 Transfer Pricing Guidelines states:

> Because non-recognition can be contentious and a source of double taxation, every effort should be made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and to ensure that non-recognition is not used simply because determining an arm's length price is difficult.

31. We submit that the reference to the transaction as "accurately delineated" in the 2017 Transfer Pricing Guidelines allows for the recharacterization of what the OECD describes as economically relevant characteristics before taxpayers and revenue authorities get to the stage of determining whether legal form and substance should be disregarded as that question was previously understood.

32. The first step advocated throughout the 2018 Financial Transactions Discussion Draft is accurately delineating the transaction(s). The OECD prescribes that accurate delineation be done before trying to price the transaction. This is inconsistent with prior guidance and with the objective of the AL principle for transactions that can be reliably priced.

33. The concept of accurate delineation, introduced in the 2015 BEPS revisions, changes the focus away from determining an AL price to recharacterizing perceived avoidance transactions into what are deemed to be acceptable transactions between AL parties. This determination is subjectively made by viewing the MNE's transactions through an anti-avoidance prism that shifts risk bearing away from entities which actually provide capital and bear risks to ones that employ certain "decision-makers", regardless of the market value of the functions performed by such persons. This is not what has been commonly understood as the focus of transfer pricing generally, or Article 9 of the OECD Model Convention in particular, and represents a clear departure from the approach of prior Transfer Pricing Guidelines. We submit that it would make more sense to continue with a pure pricing (terms and conditions) focus, in the absence of exceptional recharacterization conditions that countries such as Canada have incorporated into their domestic tax legislation.

34. The new approach is not in sync with the laws of jurisdictions like Canada, where taxpayers are assessed on legal form and substance, not on economic realities or similar non-legal parameters unless the doctrine of sham or a recharacterization rule such as paragraphs 247(2)(b) and (d) of the Canadian Income Tax Act applies.

35. As a general matter, deeming things to be something they are not in fact or law "for transfer pricing purposes" can only make things more complicated for non-transfer pricing income tax and non-tax purposes. The OECD should, for example, give some consideration to the possibility of minority shareholdings and how groups are to deal with the incidence of tax liability arising in entities that do not actually earn the related income.

36. It would be far better if the OECD explicitly stated in the Transfer Pricing Guidelines recharacterization commentary all circumstances where it felt recharacterization should be permitted. That would at least afford countries the opportunity to incorporate in their legislation the same tests if they agree with the circumstances described or to express their disagreement and put other countries on notice of the issue in their treaty negotiations. The current approach suggested by the OECD is rife with uncertainty – and effectively masks the disagreement that is likely inherent in the manner in which different countries will interpret the guidelines.

Control over Risk

37. There is no authority in general Canadian law for attributing income away from the party that legally earns income merely because another party decided that the party earning the income should either acquire the property that gave rise to it or legally assume the risk that gave rise to the income. Our transfer pricing recharacterization provision would require far more for its application in such a situation.

38. A group entity ("Sub") that actually makes a loan to another group company ("Borrower") engaged in a high-risk venture operating in another jurisdiction is bearing the risk of loss related to that loan in fact and in law. The fact that an employee in a sister subsidiary ("SisterCo") advised or recommended which group entity should make the loan (the making of which required approval by Sub's Board of Directors) does not legally or economically shift the risk of loss from the actual lender, Sub, to SisterCo. SisterCo's balance sheet will never reflect the loan as an asset, nor will its income statement show a bad debt loss if Borrower defaults on the loan.

39. In fact, the group's parent company senior executives will often have ultimate responsibility for important decisions such as which entity is to pursue certain activities. The OECD's approach to control over risk could lead to all group income being attributed back to the parent company within a MNE group since that is where ultimate decision-making often occurs. We suspect that is not what the OECD has in mind. Similarly, we doubt that the OECD expects countries to hasten to allocate all losses of a group to their jurisdiction based on the location of certain "decision makers."

40. The 2018 Financial Transactions Discussion Draft dictates that the material risk be "allocated" to SisterCo in such a transaction. The first question should instead be what compensation is paid to SisterCo for the services its employees provide to Sub. The 2017 Transfer Pricing Guidelines recharacterize the transaction under the accurate delineation rubric and attribute the majority of the income (or loss) to SisterCo. That does not follow logically from the text of Article 9 of the OECD Model Convention. In fact, the only relevant question from an Article 9 perspective is the AL amount of the fee payable to SisterCo for the services it rendered. If all, or almost all, of the related income is deemed to be earned by SisterCo regardless of the value of the services it provided, Article 9 of the OECD Model Convention has not been properly applied.

41. For anti-avoidance reasons, there has been an increasing focus on the location of decision-makers following the 2015 BEPS revisions. But the analysis provided by the OECD does not purport to consider whether the decision making is difficult or complex. There has been no discussion whatsoever as to considering what compensation makes sense in the circumstances. Rather, the discussion has solely been about how much to allocate to the capital provider/risk taker (e.g., risk-free rate of return), and the residual profit is "allocated" to the service provider without even broaching the subject of valuing the services provided. This is contrary to common sense, real world experience with AL dealing and the well established principle that one starts by compensating the least complex party and allocates residual profit to the most complex. This reflects a shift away from the Article 9 AL principle to a system based on the OECD's AOA approach to applying Article 7 of the OECD Model Convention regarding permanent establishments.

42. Further, as other commentators have indicated, modern MNE groups may have decision makers in multiple jurisdictions, and the approach advocated by the OECD in the 2018 Financial Transactions Discussion Draft could make compliance very difficult (if not impossible). This is especially relevant in the R&D context but might also be the case where financial decision-making is involved.

43. The anti-avoidance lens which is being inserted into the transfer pricing rules is a bridge too far. Taxpayers, revenue authorities and the courts are already having a difficult time resolving disputes. Reality should be addressed. The OECD initially admitted in the BEPS process that "Special Rules", which it recognized were not in accordance with the AL principle, were necessary to address BEPS concerns. The OECD eventually abandoned that approach by inventing new principles that it says were always embodied in the AL principle. Serious consideration should be given to reverting to a methodology that does not try to stretch the AL principle beyond its breaking point. If special rules are needed to address transfers of intellectual property into low-tax jurisdictions, and if CFC rules are considered inadequate, perhaps such rules could be added via the multilateral instrument. In any event, consideration should be given to introducing explicit, targeted rules dealing with anti-avoidance situations, rather than burdening all AL pricing determinations with this added complexity. This is especially so where the transactions can be reliably priced. In commercial terms, the value of the OECD transfer pricing franchise is seriously diminished by the current anti-avoidance approach.

Debt and Equity

44. Debt/equity issues and capitalization are addressed in Section B of the 2018 Financial Transactions Discussion Draft, which describes the application of the principles of Section D.1 of Chapter I of the 2017 Transfer Pricing Guidelines to financial transactions. Paragraph 3 of the 2018 Financial Transactions Discussion Draft states that the balance of debt and equity in an AL relationship will be the result of various commercial considerations and that, in contrast, a MNE group has the discretion to decide the amount of debt and equity that will be used to fund an entity within the group.

45. The 2018 Financial Transactions Discussion Draft was intended to clarify how accurate delineation may relate to the capital structure of an entity within a MNE group. Paragraph 10 of the 2018 Financial Transactions Discussion Draft recognizes that certain countries may have different views on the application of Article 9 to determine capitalization of an entity within a MNE group. More particularly, the discussion draft states: "this section is to provide guidance to those countries that use accurate delineation under Chapter I to determine whether a purported loan should be regarded as a loan for tax purposes (or should be regarded as some other kind of payment, in particular a contribution to equity capital)."

46. Since the OECD recognizes that acceptance of the accurate delineation approach in this area at least is not universal, we suggest that it would make more sense to stick with the current (pre-BEPS) exceptional circumstances recharacterization model, and minimize the situations where different competent authorities are unable to resolve double taxation situations arising due to debt/equity characterization issues.

47. The broad discretion given to tax authorities in the 2018 Financial Transactions Discussion Draft to determine whether an instrument should be treated as debt or equity will inevitably invite more disputes than arise currently. For example, under Canadian law, an instrument labelled as debt can only be recharacterized in egregious circumstances (see below). The new OECD accurate delineation approach will encourage Canadian and other revenue authorities to reassess based on recharacterization more frequently under the umbrage of the 2017 Transfer Pricing Guidelines since the threshold to recharacterization under accurate delineation is much lower than recharacterization is under Canadian law and the prior OECD Transfer Pricing Guidelines. This will lead to more double taxation and more impediments to international trade.

48. Paragraph 16 of the 2018 Financial Transactions Discussion Draft provides economically relevant characteristics that may be useful indicators in accurately delineating a loan: the presence or absence of a fixed repayment date; the obligation to pay interest; the right to enforce payment of principal and interest; the status of the funder in comparison to regular corporate creditors; the existence of financial covenants and security; the source of interest payments; the ability of the recipient of the funds to obtain loans from unrelated lending institutions; the extent to which the loan is used to acquire capital assets; and the failure of the purported debtor to repay on the due date or to seek an extension to pay.

49. Under Canadian law, the nature of an instrument as debt or equity is determined by general legal principles – i.e., the form or label attached to an instrument can be overturned only if the legal substance of the arrangement is clearly different.

50. The Tax Court of Canada recently applied the leading Canadian case on debt/equity characterization, Canadian Deposit Insurance Corp. v. Canadian Commercial Bank, [1992] 3 SCR 558, in the context of a hybrid instrument in Barejo Holdings ULC v. The Queen, 2015 TCC 274, aff'd 2016 FCA 304. The question before the Tax Court was whether two non-interest bearing “Notes” that, upon maturity, would pay the value of a specified pool of investment assets, were debt or equity. The Tax Court noted that the Notes had both debt and equity-like features, including a specified interest rate (of zero) and the possibility of a nil return upon maturity and concluded that the Notes were closer to being debt based on their features and the parties’ intention (including the fact that the instruments were called “Notes”, refer to a “Principal Amount”, have a maturity date and ranked pari passu).

51. Assuming a debt is a debt as a matter of legal substance, and subject to the potential application of the recharacterization rule in paragraphs 247(2)(b) and (d) of the Income Tax Act, there is no support for the recharacterization of debt as equity in Canadian law. Per the Tax Court in the Barejo decision, if the instrument has the core essential characteristics of debt, it is debt for purposes of the Income Tax Act.

52. In Barejo, the Tax Court listed the following essential characteristics of a debt for purposes of the Income Tax Act: (i) an amount or credit is advanced by one party to another party; (ii) an amount is to be paid or repaid by that other party upon demand or at some other point in the future set out in the agreement in satisfaction of the other party’s obligation in respect of the advance; (iii) the amount described in (ii) is fixed or determinable or will be ascertainable when payment is due; and (iv) there is an implicit, stipulated, or calculable interest rate. There is no reference to several of the “economically relevant characteristics” that the OECD suggests may be useful indicators in accurately delineating a loan including, for example, the source of the interest payments and default of the debtor on the due date. In short, form largely governs.

53. It should not be forgotten that allowing the recharacterization of debt “for transfer pricing purposes” under the rubric of accurately delineating the transaction(s) can make things more complicated for non-transfer pricing purposes and for Mutual Agreement Procedure purposes. Allocating income (and related tax liability) to an entity that does not in fact make a loan and receive interest can make the payment of the related tax liability problematic – especially where there are minority shareholders in the entity that actually earns/receives the income.

Domestic Thin Capitalization

54. The 2018 Financial Transactions Discussion Draft states that the guidance is not intended to prevent countries from implementing approaches to address capital structure and interest deductibility under domestic legislation, nor does it mandate accurate delineation as the only approach for determining whether purported debt should be respected as debt.

    How will conflicts be resolved through the Mutual Agreement Procedure if such seemingly unprincipled latitude is permitted or indeed encouraged?

    In particular, countries such as Canada have taken the view that they are not limited by Article 9 or the AL principle in restricting interest expense. Is the OECD telling these countries that it is appropriate to ignore the AL principle in this situation and to limit interest expense on debt even if the relevant economic characteristics of the capital structure (e.g. debt equity ratio) are within the AL range?

    If that is the case, how can the OECD even purport to be applying the AL principle?

55. A recharacterization of debt as equity, or vice versa, should only be permitted in specifically targeted exceptional situations – i.e., where the "extraordinary" transfer pricing recharacterization rule applies. To do otherwise will simply multiply the opportunities for competent authorities to disagree and for double taxation to arise.

56. In the Canadian context, the thin capitalization rules in the Income Tax Act provide for a 1.5:1 maximum debt-to-equity ratio, with interest on any excess debt being disallowed as a deduction (and treated as a distribution for withholding tax purposes). The Canadian tax authority has indicated that this rule applies even if Article 9 of a relevant treaty would permit a greater debt-to-equity ratio. Surely, in this case, taxpayers should not be subject to both arbitrary thin capitalization limits and the AL principle limitations under Article 9 of the OECD Model Convention. Where countries such as Canada choose to ignore Article 9 when it benefits taxpayers, they should not be able to rely on it where it benefits the fisc. We understand that, unlike Canada, some countries apply the transfer pricing AL principle to determine how much related party debt of a foreign-owned subsidiary is appropriate. From a fairness perspective, such an approach should be applied consistently to either increase or decrease the amount of debt and applicable interest expenses (which we recognize may not be as easy to administer as the Canadian approach).

57. We note that there is an apparent conflict between the commentary to Article 9 of the OECD Model Convention and the 2018 Financial Transactions Discussion Draft in this regard. Paragraph 3 of the commentary regarding Article 9 of the OECD Model Convention states:

As discussed in the Committee on Fiscal Affairs' Report on "Thin Capitalisation" there is an interplay between tax treaties and domestic rules on thin capitalisation relevant to the scope of the Article. The Committee considers that:

(a) the Article [Article 9] does not prevent the application of national rules on thin capitalisation insofar as their effect to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation [emphasis added].

58. The above paragraph reflects an understanding that Article 9 limits domestic thin capitalization rules – i.e., domestic thin capitalization rules apply only insofar as they fit the AL paradigm.

59. The 2018 Financial Transactions Discussion Draft appears to ignore the above paragraph in the Commentary to the OECD Model Convention by sanctioning the application of both domestic thin capitalization rules (without any limitations) and Article 9 – i.e., the "lesser of" approach.

60. In any event, one provision should be enough. Taxpayers that establish a capitalization structure which is respected as a matter of legal substance and that is in line with domestic thin capitalization provisions should not generally face this added Article 9 uncertainty – i.e., meeting the debt-to-equity ratio in the domestic thin capitalization rules and yet also facing potential exposure with respect to a transfer pricing adjustment under the rubric of accurate delineation.

61. The US history in this area should inform the discussion and any revisions to the 2018 Financial Transactions Discussion Draft. It is very difficult to prescribe the circumstances in which an instrument should be recharacterized from debt to equity or vice versa. The US tried to do this in the context of the IRS and Treasury's proposed section 385 Regulations. After receiving public comments, the IRS released regulations under Code Section 385 that drastically limited the scope of the proposed regulations on related party financing transactions.

All or Nothing

62. In the context of the example contained in paragraph 17 in the 2018 Financial Transactions Discussion Draft, Box B.2 asks for commentators' views on whether the entire amount of a debt that exceeds that which would be viewed as appropriate under the AL principle needs to be "accurately delineated" as equity, or just the excess amount.

63. As noted above, in Canada, there is no domestic Income Tax Act rule that provides for the recharacterization of debt as equity. We are not aware of a situation where an instrument has been parsed in the manner contemplated here. However, it would seem highly inappropriate to sanction the disallowance of 100% of the interest on a debt instrument because, for example, it is found to be 10% over the amount permitted under the accurate delineation threshold proposed by the OECD. To do so would be grossly unfair and punitive. It might be more acceptable to adopt such an approach if recharacterization were limited to egregious circumstances as we suggest.

Business Strategies Relevance

64. The 2018 Financial Transactions Discussion Draft provides factors specific to financial transactions that need to be considered as part of accurate delineation. These include: contractual terms; functional analysis; characteristics of financial products or services; economic circumstances; and business strategies.

65. With respect to business strategies, the discussion draft advocates taking a MNE's prior practices into consideration to determine the arm's length nature of a transaction with different terms and conditions.

66. We submit that the test should prima facie be whether the particular loan terms and conditions accord with the AL principle. Article 9 of the OECD Model Convention simply requires the terms and conditions to be consistent with what AL parties would agree to. It does not require consistent behaviour within a MNE group. If a MNE group typically provides a parental guarantee but chooses not to do so in a particular situation, it is not clear why the loan should prima facie be deemed to be entered into on NAL terms.

67. There are several bona fide business reasons for a MNE to depart from what it has done in the past in other situations – e.g., a MNE might not wish to provide a guarantee to a new subsidiary in a high risk venture. Under the OECD's proposed approach, however, any group member that loaned funds to a new high risk member would seemingly be forced to lend at a rate that assumes a parental guarantee. Unless the reasons for departing from past practice result in a transaction with terms and conditions that do not constitute AL dealing, it is not apparent why they should fail to satisfy the requirements of Article 9. Imputing other terms and conditions in such cases should only be based on specific anti-avoidance concerns/rules.

68. MNE group business strategies are of course relevant in specific situations, such as where a group is trying to gain a foothold in a market and prices its goods at a price that is clearly below the prevailing market price, i.e., a market penetration strategy. The prices charged in such a case are obviously not in accordance with those charged by other AL parties (at least initially), and yet because the strategy is one undertaken by independent enterprises in uncontrolled transactions, such prices may well accord with the AL principle. But where the terms and conditions of a financial arrangement are in accordance with AL terms and conditions, there is no apparent justification for deeming those terms and conditions to be NAL simply because they do not accord to those which the group normally has in its contracts.

69. It seems reasonable to afford recognition in some circumstances to the de facto effects that control affords in respect of one group entity vis-à-vis another – for example, it may obviate the need for a term or condition found in AL instruments – but we fail to see how departure from group business strategies should per se lead to a NAL dealing determination.

70. If a MNE group chooses a 100% equity capital structure for most of its group and a 50%/50% debt/equity capital structure in one entity, the question under Article 9 should only be whether the terms and conditions of the actual capital structure are arm's length, not whether they are typical to that MNE group. Once again, if there are specific avoidance concerns, they should be dealt with by special rules rather than by a tortured interpretation of the AL principle.

Treasury Function (Section C of the 2018 Financial Transactions Discussion Draft)

71. Section C of the 2018 Financial Transactions Discussion Draft provides guidance for determining the arm's length conditions for treasury activities, including intra-group loans, cash pooling and hedging.

Intra-Group Loans

72. The 2018 Financial Transactions Discussion Draft assumes that the ultimate parent of a multi-national group "owns all the assets legally owned by subsidiaries". This is obviously not correct from a legal perspective and suggests that the OECD is moving away from the AL principle and a separate legal entity approach. We suggest that the guidance employ more appropriate language – and simply acknowledge situations where the OECD is suggesting a departure from the AL principle so that each country can clearly indicate whether they agree or disagree with such deviations.

73. The fact that the subsidiary's assets are not legally owned by the parent company or other group member should not be disregarded in carrying out the TP analysis, and certainly not without considering whether there are any priority claims or potential claims over the subsidiary's assets. For example, having a registered charge on a subsidiary's property may be far better than having legal control of the subsidiary where the subsidiary has other creditors or potential creditors (e.g., revenue authorities, product liability claimants, etc.)

Series of Short-Term Loans

74. The 2018 Financial Transactions Discussion Draft suggests that a series of short-term loans should be accurately delineated as a long-term loan where the parties intend to enter into a series of loans. However, if the short-term loans are all properly priced in accordance with the AL principle as short-term loans at the relevant times when they are entered into, there is no apparent transfer pricing reason to treat them as one long-term loan even if the parties' intent at the outset was clearly to renew the short-term loans. A long term loan would likely have had very different terms and conditions (e.g., interest rate).

75. The only issue being considered from a transfer pricing perspective should be whether the short-term loans were properly priced based on their structural features.

76. An investor may reasonably choose to invest in a series of one year GICs for ten-years rather than a ten-year GIC. If the investor in fact earns less than it would have earned on a ten-year GIC, it can hardly go to the AL issuer at the end of ten years and ask to be topped up to the amount it would have received if it had chosen the ten-year instrument.

77. How the market views the future is inherent in the different terms of short and long term loans that the market produces. The OECD cannot assume that taxpayers have special knowledge of future fluctuations in market rates or other factors and can arrange their affairs based on that special knowledge. If the OECD has an anti-avoidance agenda beyond determining AL prices, it should deal with that explicitly in the appropriate form.

Bank Opinion Letters

78. The 2018 Financial Transactions Discussion Draft rejects bank opinion letters (which state the interest rate a bank would apply if it were to make a comparable loan). According to the OECD, such an approach would represent a departure from an AL approach based on comparability since it is not based on a comparison with an actual transaction. However, this ignores the basic reality that when pricing a hypothetical AL transaction the attempt is always to price a transaction that did not actually happen. The profit split method is also not based on actual comparable transactions. In many cases, the best evidence available to taxpayers (and taxing authorities) will be to rely on opinions of experts (such as banks) regarding AL interest rates. It is imperative that the OECD recognize and respect a taxpayers' ability to rely upon the best information commercially available to them for determining AL rates.

Renegotiation of Loans

79. Another problematic statement in the 2018 Financial Transactions Discussion Draft is the statement that borrowers need to consider the possibility of renegotiating the interest rate on a loan when macroeconomic circumstances lead to a reduction of the financing costs in the market. This statement suggests that AL parties would replace existing loans with new ones when rates decline. This ignores commercial reality and the likely application of penalties. Typically in AL situations a borrower can not simply demand a reduction in interest rates to reflect changes in market conditions – much as a lender can not simply demand an increase if market conditions cause fluctuation in the opposite direction. Rather, the party seeking to terminate an existing contractual relationship will generally be required to pay a penalty to the other as compensation for the change in anticipated interest over the remaining term of the loan. The addition ab initio of an interest rate reset right at certain future dates would, of course, affect the interest rate applicable.

Hedging

80. Parent companies often hedge their subsidiaries' foreign exchange exposure vis-à-vis the parent's balance sheet. The parent may be the only rated entity in the MNE group and it may simply be more cost efficient for it to enter into one transaction rather than having subsidiaries enter into separate transactions. In any event, there seems to be no transfer pricing reason to deem a subsidiary to have carried out a hedge just because the hedge relates to it (as suggested in the example in Box C.11 of the 2018 Financial Transactions Discussion Draft).

81. It is the party who enters into the hedging transaction that subjects itself to the chance of profit and risk of loss. There is no NAL transaction or series of transactions to price in the example in Box C.11. Accordingly, deeming the subsidiary to have carried out the hedge is beyond the scope of Article 9 of the OECD Model Convention.

Guarantees (Section D of 2018 Financial Transactions Discussion Draft)

82. The 2018 Financial Transactions Discussion Draft suggests that there be could be applied a rebuttable presumption that every group member has the same credit rating as other group members (i.e. the effect of group membership). This may be a significant benefit to the revenue authorities where the debtor entity is resident (i.e., reduces the quantum of the guarantee fee).

83. The Tax Court of Canada decision in General Electric Capital Canada Inc. v The Queen, 2009 TCC 563 suggests that the presumption will often be wrong. More specifically, this case establishes that a subsidiary's credit rating does not automatically adjust to the parent's credit rating by virtue of implicit support – i.e., courts look at the surrounding facts and circumstances. It is therefore not clear that this presumption makes sense and it would appear to impose an extra hurdle on taxpayers that correctly price their transactions in accordance with the actual facts.

84. Moreover, from a fairness/consistency perspective, if tax authorities seek to rely on implicit support to reduce the amount of deductible expenses paid by residents in their jurisdiction, they should similarly reduce the amount of any income inclusions where similar payments are received by residents in their jurisdiction.

Maximum Interest Rate

85. The draft posits a maximum interest deduction based on the group's average external rate. There is no basis for assuming that this is in accordance with the AL principle on a separate entity basis. Again, if there are separate anti-avoidance concerns they should be dealt with by special targeted rules.

Paradigm Urgently Required

86. The OECD should outline in detail the paradigm to be employed as a general matter when applying the TP rules in respect of MNE groups. In particular, this paradigm is required to apply doctrines such as implicit support in revisions to the 2018 Financial Transactions Discussion Draft. The recognition that the debtor is "still a member of the group" raises issues relative to the hypothetical independent enterprise analysis that Article 9 mandates (we submit that it should be "a" group, not "the group"). The determination of the proper paradigm has led to considerable debate and uncertainty as is evidenced by the number of cases dealing with this issue and the length of the judicial decisions needed to deal with them.

87. In General Electric, the Canadian Courts had to deal with it in the context of a guarantee provided by a parent to its subsidiary. They viewed the subsidiary as a member not of the group but of another group with similar characteristics. In this regard, the OECD should outline its view on what characteristics should be preserved.

Guarantor with same Credit Rating

88. It may well be appropriate to pay a guarantee fee to a guarantor even if the guarantor has the same credit rating as the borrower. Lenders, for example, may provide a lower interest rate if they have access to more assets. The assumption seems to have been that a difference in credit ratings is required to justify a fee, which is simply not the case in an AL context.

Captive Insurance (Section E of 2018 Financial Transactions Discussion Draft)

89. The captive insurance proposals in the 2018 Financial Transactions Discussion Draft are out of step with Canadian insurance law. In addition, the 2018 Financial Transactions Discussion Draft departs from arm's length requirements in the following ways.

90. First, the OECD suggests that a captive does not need to have as much capital if dealing with related parties as it would if it were dealing with an AL party. This seems to be a direct contradiction of Article 9's mandate to treat internal transactions as if they were AL ones.

91. Further, the OECD is recommending rewarding the captive based solely on regulatory capital of their host jurisdictions. Regulatory capital in many jurisdictions commonly used by captives is not necessarily based on sound actuarial principles, especially where the captives insure only related party risks. In many cases sound business judgment requires a captive to retain a greater amount of capital than the bare minimum required from a regulatory perspective. Capital requirements should be based on market requirements (including relevant commercial considerations) if they are to comply with Article 9 of the OECD Model Convention.

92. Second, where multiple group entities insure their risks with a group captive, and the captive is then able to group the risks and get a more favourable price from reinsurers than the group members could have obtained singly, the OECD draft says that the benefit should not stay with the captive. The OECD's view is that the benefit should be re-distributed out to the participants.

93. Where the captive actually assumes the risks and reinsures them, it remains primarily obligated to the insured parties. The latter usually do not have recourse to the parties that the captive reinsured the risks with. It does not make sense for the captive to earn only the equivalent of a brokerage commission since a broker does not assume the relevant risks. This is not akin to obtaining a better price for pencils on a group basis.

94. The OECD has specifically requested comments on the example given in paragraphs 187 and 188 of the 2018 Financial Transactions Discussion Draft. The example given, which relates to insurance contracts sold by a technology retailer to its customers and insured by a NAL party, begins with the proposition that the AL sales of insurance to customers take place at above-market prices, and appears to assume a particular economic analysis with respect to the drivers of these apparently above-market AL prices – that is, that they arise from a "point of sale advantage" enjoyed by the retailer. This assumption appears to be premature in the absence of expert economic evidence in respect of the particular circumstances of the dealings. Moreover, and despite the comment in paragraph 186 that competition would usually work to limit the amount of profit that can be earned both on the part of the sales agent and the insurer, in the example at paragraphs 187 and 188, the OECD allocates all of the residual profit to the sales agent. This is inconsistent with the AL principle.

95. We also note that in many jurisdictions the compensation that can be received by a person who is not licensed as an insurance agent is limited by non-tax regulation. In these circumstances, there can be no adjustment to the compensation earned by such a person for transfer pricing purposes, as an arm's length distributor cannot earn more. See, for example, the 1972 decision in Commissioner of Internal Revenue v. First Security Bank of Utah, N.A., et al, wherein the United States Supreme Court held that the U.S. transfer pricing rule could not be applied to attribute income earned in respect of the reinsurance of credit insurance policies by a captive insurer to national banks operating in the same corporate group, on the basis that the banks "had been advised by counsel that they could not lawfully conduct the business of an insurance agency or receive income resulting from their customers' purchase of credit life insurance."

OSLER, HOSKIN & HARCOURT LLP

Per Richard G Tremblay