GE verdict will set international precedent

The judge's approach to pricing in the GE guarantee fee case in Canada could have implications for discussions about similar issues in the UK, believes Murray Clayson of Freshfields Bruckhaus Deringer

The decision of the Tax Court of Canada in *General Electric Capital Canada Inc* released in early December will be of wide international interest for those concerned with the application of transfer pricing and thin-capitalisation concepts to debt financing.

The case concerned the deductibility of guarantee fees paid by the appellant (GEC Canada) to its triple-A rated US indirect parent company General Electric Capital Corporation (GECUS). From 1988 onwards GECUS guaranteed GEC Canada's commercial paper (CP) and debenture programmes. The tax years in dispute were 1996 to 2000. GEC Canada had from 1996 paid guarantee fees to GECUS calculated as 1% of the principal debt guaranteed.

Justice Hogan decided that the guarantee fees were not more than those which would have been paid in a transaction between parties at arm's length. He allowed the deductions, ruling that no additional dividend withholding tax had to be paid in Canada.

The Canadian tax authority challenged the deductibility of the fees on the basis that the benefit of the guarantee was of no value to GEC Canada. The argument was that GEC Canada could have raised its debt without the benefit of the guarantee, because of the "implicit support" that the market would assume would be available from GECUS. Because it followed that the fees were a gratuitous distribution of value, the tax authority moreover sought additional withholding tax on the basis that (to some extent relying on notions of recharacterisation) the fees should be regarded as dividends.

The key provision at issue from 1997 (the previous rule being agreed to have essentially the same effect) was section 247(2)(a) of the Income Tax Act (Canada), which so far as relevant provides:

(2) Where a taxpayer ... and a non-resident person with whom the taxpayer ... does not deal at arm's length ... are participants in a transaction or a series of transactions and (*a*) the terms or conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm's length ... any amounts that, but for this section and section 245, would be determined for the purposes of this Act in respect of the taxpayer ... for a taxation year or fiscal period shall be adjusted ... to the quantum or nature of the amounts that would have been determined if ... the terms and conditions made or imposed, in respect of the transaction or series, between the participants in the transaction or series had been those that would have been made between persons dealing at arm's length.

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UK transfer pricing law

This is not really so very different from the principal transfer pricing rule in the UK tax code, paragraph 1 Schedule 28AA Income and Corporation Taxes Act 1988:

(1) This Schedule applies where-

(a) provision ('the actual provision') has been made or imposed as between any two persons ('the affected persons') by means of a transaction or series of transactions, and

(b) at the time of the making or imposition of the actual provision-

(i) one of the affected persons was directly or indirectly participating in the management, control or capital of the other [which would have been the case as between GEC Canada and GECUS] ...

(2) ... [If] the actual provision-

(a) differs from the provision ('the arm's length provision') which would have been made as between independent enterprises, and

(b) confers a potential advantage in relation to United Kingdom taxation [for example,. a deduction for a fee] on one of the affected persons, ...

the profits and losses of the potentially advantaged person [the person obtaining the deduction] ... shall be computed for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision.

It is quite easy to imagine that, on identical facts concerning a UK borrower which had benefited from a non-UK parent's guarantee, a UK court could have delivered a judgement in pretty much identical terms to that handed down by Justice Hogan in Canada. Indeed, the structure of the judgement is somewhat reminiscent of that of the Special Commissioners in the UK's first major transfer pricing case in the spring of 2009 (*DSG Retail v Revenue & Customs Commissioners*, see *International Tax Review*, June 2009).

In fact the UK transfer pricing regime includes a special rule addressing loan guarantees and guarantee fees in particular. Paragraph 1B of Schedule 28AA applies where debt is issued by one of the "affected persons" and the series of transactions also includes the provision of a guarantee by the other of those persons.

In determining whether the actual provision differs from the arm's-length provision, regard must be had to "all factors" but including specifically the question whether the guarantee would have been provided at all in the absence of the special relationship, the amount that would have been guaranteed in the absence of the special relationship and the consideration for the guarantee and other terms which would have been agreed in the absence of the special relationship.

The UK transfer pricing/thin-capitalisation rules apply to all components of the cost of debt finance including guarantee fees. HM Revenue & Customs' practice is that paragraph 1B requires guarantee fees to be disallowed if they

lead to an increase in the cost of debt finance for a borrower compared with what it would have paid as an independent entity. Therefore if a guarantee provided by a group member increases the amount of debt that can be raised and thus the amount of interest payable, the guarantee will be disregarded: there would then be no deductible guarantee fee.

On the other hand, the effect of the guarantee in reducing the interest rate should be taken into account in determining the interest disallowance: the allowable deduction should be what the borrower would have paid without the guarantee. If a guarantee does not cause a company to exceed its stand-alone borrowing capacity, but decreases the interest expense (because of the lower credit risk assumed by the lender in reliance on the guarantee), an arm's-length guarantee fee should be deductible. Examples are given in HMRC's International Manual at INTM 563040.

Similar concepts

The Canadian Tax Court in *General Electric Capital Canada* applied essentially similar concepts (though without the express assistance of a rule like paragraph 1B) in testing whether the GECUS guarantee added any value for GEC Canada and thus merited remuneration and if so how much.

Given the discussion in the case of implicit parent company support (that is, in the absence of any formal legally binding guarantee) it is noteworthy that in the UK's paragraph 1B the notion of guarantee is extended to any:

> surety and to any other relationship, arrangements, connection or understanding (whether formal or informal) such that the person making the loan to the issuing company has a reasonable expectation that in the event of a default by the issuing company he will be paid by, or out of the assets of, one or more companies.

So, to restate the question in *General Electric Capital Canada*: "Were the guarantee fees of 1% paid by GEC Canada to GECUS in excess of that which would been paid between parties at arm's length?"

The conclusion of Justice Hogan was "No": so the guarantee fees were allowable and did not attract additional dividend withholding tax.

Expert witnesses

Expert evidence from economists, former rating agency senior personnel and bankers was a key feature of the proceedings. This also echoes the experience in the *DSG Retail* case, and indeed other major transfer pricing litigation being prepared now for trial in the UK.

There is an important reminder here for those looking to rely on expert witnesses in tax litigation – the requirement for impartiality on the part of the experts. Justice Hogan observed that an expert should not assume the role of advocate, and should not omit material facts which weaken his or her position; the expert should express an unbiased opinion on a technical subject. This represents the position before an English court too: see, for example, the *Ikarian Reefer* case [1993] 2 Lloyds Rep 68 and rule 35 of the Civil Procedure Rules. It is all too easy for litigants to proceed on the basis that experts are "their" witnesses.

Equally those invited to provide expert opinion must be careful not to fall into the trap of supporting their paymaster in a biased manner; their evidence is liable to be disregarded by the court. In *General Electric Capital Canada* Justice Hogan complimented certain of the experts who "answered my searching questions in a manner which was not always helpful to the Respondent's position" (those witnesses having been called by the respondent, that is, the Crown).

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Transactional analysis

Although the guarantee arrangement was in a sense extremely simple, drawing an appropriate comparison with a hypothetical arm's-length transaction proved to be more controversial. The court observed that ordinarily a third-party guarantor would support defined obligations for a fixed duration, but would then have little control over the timing of the borrower's debt issuance. GECUS's guarantee was provided *ad hoc* upon the issuance of debt by GEC Canada, an event which, in practice at least, GECUS's treasury department substantially controlled.

Thus an arm's-length guarantor would

Murray Clayson: Case concerned an arm's-length price for an explicit guarantee

assume more risk than GECUS did. Justice Hogan held that it was inappropriate to disregard these factors – as features of the controlled relationship – because in fact the relevant company law did not confer such control rights upon GECUS; although GECUS did in practice appropriate control of GEC Canada's money management function, this was not something attributable to its [indirect] ownership of shares in GEC Canada.

Another fact which the court found relevant was the long history of the GECUS guarantee. In testing what a third-party guarantor would charge GEC Canada, it would be relevant to take into account the history of the group guarantee – something to which investors would have become accustomed. Thus a prospective independent guarantor

> would anticipate that it would be difficult for the debtor to convince its investors to accept unguaranteed debt on the same terms and conditions as debt guaranteed by its parent... the cost of borrowing money would likely be higher that it would be if the appellant's debt had never been guaranteed by GECUS. The arm's length guarantor could use this knowledge as leverage in negotiating with the debtor... This history of the guarantee places the appellant in a more vulnerable position.

Here we see an allusion to the importance of relative bargaining power, an aspect emphasised in the *DSG Retail* case. "An accurate determination of the appellant's credit rating cannot be made by ignoring the fact that a guarantee was provided for all of its prior public indebtedness."

Justice Hogan seemingly approves the proposition of one of the expert economists that, in evaluating the hypothetical arm's-length provision, a hypothetical guarantor should be taken to have characteristics similar to GECUS (AAA-rated subsidiary of AAA-rated parent, conducting an international unregulated financial services business that borrows large sums in the international CP markets); and a

hypothetical debtor should have similar characteristics to GEC Canada, that is, a subsidiary of an AAA-rated multinational. What some see as controversial is the extent to which regard may be had to the control relationship.

Pricing methodology

Interestingly, both GEC Canada and the government acknowledged that there were no comparable uncontrolled transactions from which a price could be derived. Resale price and cost plus methods were also rather obviously inapplicable. So each party tendered other methods. The taxpayer promoted two approaches, one based upon insurance theory and the other based upon credit default swaps (CDS). The government offered a credit ratings method leading to a "yield approach".

The insurance-based methodology was found to be "unreliable" given the difficulty of adjusting for risks and the control of risks and the absence of a reference market for insurance-backed corporate bonds.

The CDS approach was in fact considered by the judge to be analogous to the yield approach proposed by the government, but was found wanting because it assumed a credit rating for GEC Canada (to compare with a triple-A CDS spread); that credit rating was itself the crux of the matter in the case. But the credit rating methodology did appeal to the court as a logical way forward.

The Crown asserted that GEC Canada would have been AAA-rated because of the "implicit support" of GECUS; GECUS would have suffered "catastrophic damage to its reputation" if GEC Canada had been allowed to default on its unguaranteed debt. Compare the UK extended notion of "guarantee" described above. But Justice Hogan was unimpressed by the significance in this context of these commercial pressures on GECUS. It was irrelevant that GECUS could have injected equity into GEC Canada to improve its debt-equity ratio: this contradicted the principle of separate corporate personality:

> Implicit support is nothing more than one's expectation as to how someone will behave in the future because economic reasons will cause the person to act in a certain manner ... A guarantee is a much more effective form of protection.

(Different considerations might apply to certain unlimited liability corporations where a shareholder could be liable without limit to contribute to a company's liabilities.) Thus it was an "unwarranted leap of faith to conclude that the appellant's credit rating would be equalized with that of its parent if there were no guarantee in place". Similarly, it could not be assumed that GEC Canada would have access to GECUS's standby credit arrangements: GECUS as a separate legal entity was not obliged to give GEC Canada access to its facilities.

This approach to implicit support seems consistent with OECD thinking. Paragraph 7.13 of the OECD's Transfer Pricing Guidelines observes that no service is received where an associated enterprise by reason of its affiliation alone has a credit rating higher than it would if it were unaffiliated, whereas an intra-group service would usually exist where a higher credit rating were due to a guarantee from another group member.

UK tax law (paragraph 2 of Schedule 28AA) specifically requires that the transfer pricing code is to be construed in such manner as best secures consistency with the OECD Transfer Pricing Guidelines. It is questionable whether paragraph 1B, to the extent it bites upon non-legally binding arrangements or understandings which create a mere expectation of performance, can be comfortably reconciled with paragraph 7.13 of the guidelines.

In the UK, HMRC has argued that risk has not been effectively transferred to a subsidiary because the parent would bail out the subsidiary (for example, by capital injection) if the latter fell into financial distress. The separate legal personality aspect of Justice's Hogan judgment in *GE Capital Canada* may provide a useful counter-argument.

A stand-alone analysis for GEC Canada, using Standard & Poor's criteria, produced a credit rating of B+ to BB- (12-13 notches below AAA: see table). Despite the softness of "implicit support" discussed above, Justice Hogan was prepared to accept a ratings uplift of three notches to take account of this on the basis of expert evidence of typical market behaviour. Thus GEC Canada's final credit rating without explicit support would be taken to

Standard & Poor's credit ratings		
Long Term	**Short Term**	
AAA	A – 1+	Prime
AA+		High grade
AA		
AA –		
A+	A – 1	Upper medium grade
A		
A –	A – 2	
BBB+		Lower medium grade
BBB	A – 3	
BBB –		
BB+	B	Non-investment grade speculative
BB		
BB –		
B+		Highly Speculative
B		
B –		
CCC+	C	Substantial risks
CCC		Extremely speculative
CCC–		In default with little prospect for recovery
CC		
D	/	In default

be in the range of BBB- to BB+.

Under the yield approach the interest cost saving based on the rating differential between BBB-/B+ and AAA was found to be about 183 basis points (1.83%). Justice Hogan agreed that GEC Canada would not be expected to pay over all of its interest savings to obtain the benefit of the guarantee.

Thus he arrived at the conclusion that a 1% fee was equal to or below an arm's-length price. In fact GEC Canada received a "significant net economic benefit from the transaction" of more than the 1.83%, as it could not itself have procured the standby facilities required to support its CP programme and did not reimburse GECUS for the latter's costs on its standby arrangements. So the guarantee fee was not excessive and the transfer pricing adjustment proposed by the government was rejected.

There is a rather unsettling leap from the 1.83% to the upholding of the 1% fee. It is a convention in transfer pricing to use what Justice Hogan calls the "yield" approach to determine the ceiling for the fee, representing as it does the full value of the guarantee to the borrower.

The floor is then determined by reference to the minimum fee which the guarantor would require, as measured by the guarantor's expected exposure together with his required return for bearing that exposure – an insurance model approach which the judge refers to as the "capital at risk" method. The relative bargaining power of the parties would then be reviewed to determine a reasonable split of the remaining unallocated benefit of the guarantee.

The insurance model

Justice Hogan dismissed the insurance model as a reliable basis for determining an arm's-length fee in this case but apparently only because he disagreed with the way in which it had been applied. He actually finds corroboration for the results of the yield model by noting that when the insurance approach is applied correctly, the 1% guarantee fee would produce for the guarantor an expected return on its required capital of 7.5%, which (by implication) he finds not to be excessive.

Having dismissed the insurance model, Justice Hogan must then make his judgment solely on the basis of a relative bargaining power split of the full value of the guarantee fee to the borrower. At this point his otherwise thorough analysis reduced to the statement that he is "of the view" (paragraph 305) that the split of the 1.83% (plus) benefit of the guarantee should be at least 1% in favour of the guarantor – but without stating why, other than that without the guarantee the borrower would not have been able to execute its business plan.

Canadian court decision may have implications for the UK. *Source: www.ge.com*

This begs the question of whether it could have secured a guarantee from another party. It did not attempt to do so; and Justice Hogan noted that guarantee insurance has not been used for the type of debt in question, but the insurance model could still be a guide to what GEC Canada would have had to pay to a hypothetical third party for such a guarantee. The range of arm's-length returns upon capital employed in the North American insurance industry could have been benchmarked, and when applied to the required capital calculation could have been expressed as a range of minimum guarantee fees.

(Thus Justice Hogan has already calculated that a return on capital employed of 7.5%, which we could quite easily imagine to lie in the arm's-length range, would imply that an insurer would require a guarantee fee of at least 1%.) It is suggested that the insurance model should continue to be referred to if we are to avoid essentially subjective decisions as to the split of wide ranges of benefits created by related-party guarantees.

Further reading on
www.tpweek.com

The future of comparables in transfer pricing
(November 17 2009)

UK companies on edge after HMRC wins large settlement *(June 10 2009)*

IRS produces cost sharing and contract manufacturing rules
(January 7 2009)

What it means

Some commentators have suggested that *General Electric Capital Canada Inc* is another symptom of the arm's-length principle being undermined. Particular concern has been expressed about the recognition of implicit support as being relevant in determining an arm's-length price. But one can perhaps rationalise the decision on the basis that it analyses the outcome that would have arisen between hypothetical parties, dealing independently of one another, but where, having regard to the characteristics of the parties, the borrower was a subsidiary of a triple-A rated parent from whom some measure of implicit support could be assumed.

This need not be regarded as an erosion of the arm's-length principle or abandoning respect for separate legal personality: it is just part of the factual matrix. Indeed, the tax authority's case for a form of "consolidated" or "equalized" credit rating has been firmly rebuffed by the court. What was being assessed was an arm's-length price for an explicit guarantee; not the transfer pricing treatment of implicit support.

As indicated above, it is quite possible that an English court would be attracted to an approach along the lines of that adopted by Justice Hogan. Certainly we might expect to see the case influencing thin capitalisation and guarantee discussions with HMRC.

In any event, we can all be brought down to earth by Justice Hogan's observation (at paragraph 273 of the judgment) that "In the final analysis, transfer pricing is largely a question of facts and circumstances coupled with a high dose of common sense."

With that message ringing in its ears, the Crown has now filed its appeal.

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