Tax & Regulatory Services

News Alert

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Court of Appeals in Canada confirms Tax Court decision, treating the guarantee fee paid by GE Canada to be at arm's length

In brief

Recently, the Federal Court of Appeal ("FCA") dismissed the Crown's appeal in case of General Electric Capital Canada (the "taxpayer")[1]. Earlier, in 2009 the Tax Court of Canada ("TCC") had decided on the matter in favour of the taxpayer[2].

The case before the TCC was that during the years in issue, the taxpayer, an indirectly wholly-owned Canadian subsidiary of General Electric Capital Corporation Inc. ("GE US"), a US organisation, carrying on the businesses of financing, leasing, real estate financing and technology management financed its operations by borrowing funds from capital markets in the form of commercial paper and unsecured debentures under a guarantee from GE US since 1988, wherein GE US started charging guarantee fees from 1995 at a rate of 1% per annum on the principal amount of debt outstanding. The Canada Revenue Agency ("CRA") denied the deduction of the guarantee fees fully on the basis that GE US would have supported the taxpayer regardless of the explicit guarantee. The TCC allowed the taxpayer appeal and vacated the CRA's assessments. (Please refer to our News Alerts dated 12 March 2010, for a detailed explanation on the ruling)[3].

The TCC ruling was based on the following key points, being:

- the "implicit support" of the parent company was a relevant factor and could not be ignored; and
- the "yield approach" was the most appropriate method to determine the arm's-length guarantee fee. The cost savings to the taxpayer on account of the guarantee based on the credit rating differential was determined to be approximately 1.83% (based on one of the expert reports). Therefore, the 1% guarantee fee charged to the taxpayer was found to be at arm's length.

[1] Her Majesty the Queen *v.* General Electric Capital Canada Inc. [2010] FCA 344

[2] General Electric Capital Canada Inc. *v.* Her Majesty the Queen [2009] TCC 563

[3] Link: www.pwc.com/in/en/services/Tax/News_Alert/2010/PwC-NewsAlert-2010

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In conclusion, the earlier ruling position was upheld, with further comments at this level on the aspect of yield approach and the relevance of implicit support, described in subsequent sections.

Crown's and GE Canada's position on appeal

The Crown identified in its appeal what it described as four errors of law, the most significant one being that the Judge failed to identify the relevant transaction because he took into account the fact that did not exist, namely, removal of the explicit guarantee and its impact on the taxpayer cost of borrowing.

Further, the taxpayer argued that the TCC judge made two principal errors in his application of the arm's-length standard. Firstly, under the true arm's-length standard an implicit support would not have arisen, and secondly, the TCC judge was wrong in applying the "yield approach" or "benefit to borrower approach" and not focussing on the "market price" for the guarantee.

FCA Ruling

The FCA rejected both the arguments of the taxpayer, stating that the concept underlying the transfer pricing law is to ascertain the price that would have been paid in the same circumstances if the parties had been dealing at arm's length and which involves taking into account all of the circumstances which bear on the price, **whether they arise from the relationship or otherwise**. The FCA highlighted that in this case, because implicit support is a factor that an arm's length person would find relevant in pricing a guarantee, the FCA's view was that it had to be considered, and ignoring it would be turning **"a blind eye on a relevant fact and deprive the transfer pricing provisions of their intended effect."**

The FCA also rejected the taxpayer's second argument that the yield method was incorrect, pointing out that the **assessment of benefit is but a means to ascertain whether a guarantee fee would have been paid by an arm's length party.**

The FCA then turned to the Crown's arguments. On the first ground, the FCA agreed with the Crown that the TCC judge did make a mistake in law by considering withdrawal/removal of the explicit guarantee for the purposes of identifying the relevant transaction. However, on this point the FCA concluded that this was only one of the factors considered by the TCC judge and it would have "…no impact on his finding that a gap existed between the credit rating which the respondent would have obtained with or without the explicit guarantee, and that the 1% guarantee fee was within this gap".

All the other arguments being technical issues were discussed and dismissed. In short, the ruling of the TCC was upheld.

Conclusion

The taxpayer appeal decision by the FCA confirms to most of the tenets proposed in the ruling by the TCC; however, it opens the platform for deliberating on an improved method than the yield approach. The ruling is of aid in clarifying the following:

- The FCA in its order has acknowledged that the yield method seeks to identify the benefit which the explicit guarantee provides, where the assessment of benefit is but a means to ascertain whether a guarantee fee would have been paid by an arm's length party. Therefore, the yield method operates like a benefit test and simply provides a cap to the guarantee fee, but not the market price *per se*. However, the FCA did not provide any guideline on the suggested approach to determine the market price. This means taxpayers should not limit their study simply to the yield approach (sufficient for a benefit test) and continue probing additional methods to find an arm's length market price. Therefore, to a limited extent it has differed with the TCC ruling on this issue.

- The principle of factoring 'implicit support' ruled by the TCC has been confirmed by the FCA. Therefore, the final credit rating of the guaranteed entity would be seen as somewhat between its own "stand-alone rating without implicit support" and the "parent company rating".

Key take- aways

Although most of the approaches followed by the TCC have been assented to by the FCA, the decision does leave some loose ends while pricing financial transactions by stating that the yield approach is appropriate for a benefit test and not concluding on the appropriate approach for arm's length pricing. The FCA's reiteration of implicit support, which has also found mention in another Canadian tax decision, in the case of GlaxoSmithKline[4], is perhaps the most important element arising from this case.

From an Indian standpoint, provision of guarantee and pricing such facilities is an emerging area in the transfer pricing arena, for which taxpayers would be advised to consider international practices. Applying the ratio of this ruling, the implicit differential of a guarantee between related parties would have to be reckoned. Further, taxpayers in India should not restrict themselves to the yield approach (as it is primarily a 'benefit test') and look to additional comparative benchmarks which may be available, depending upon the facts of each case.

[4] GlaxoSmithKline *v*. The Queen [2008] TCC 324

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