

# WNTS Insight



## Canadian Federal Court of Appeal dismisses government's appeal of lower court decision that guarantee fees paid to U.S. parent were deductible

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In an important decision that could affect U.S. corporations with Canadian subsidiaries, the Canadian Federal Court of Appeal recently dismissed the Canadian government's appeal of the decision of the Tax Court of Canada in *General Electric Capital Canada Inc. v. The Queen*, holding that fees for financial guarantees paid by a Canadian company to its U.S. parent were not more than an arm's-length amount and are therefore deductible by the Canadian subsidiary.

In ruling for the taxpayer, the appeals court agreed with the Tax Court's rejection of the position of the Minister of National Revenue, who argued that "implicit support" from the parent made unnecessary the explicit guarantee for which the fees were paid. The appellate court found no errors of law or fact in the Tax Court decision.

### Background

During its 1996 to 2000 tax years, the Canadian subsidiary (GECC) deducted \$136 million in guarantee fees paid to its U.S. parent (GECUS) for explicitly providing financial guarantees. The Minister disallowed the deductions on the basis that the fees provided no value to the taxpayer. The Tax Court held for GECC and ordered that the Minister's reassessments be vacated, finding that the one-percent guarantee fee paid was equal to or below an arm's-length price.

While the 2009 Tax Court decision was a victory for GECC, in many ways it was a compromise between the position of the Minister and that of the taxpayer. The Minister argued that GECC did not benefit from the explicit guarantee because of the "implicit" guarantee that existed by virtue of the parent-subsidiary relationship and therefore, no payment was required for the explicit guarantee. The taxpayer argued that although such implicit support is recognized in the market, it is a factor inherent in a non-arm's-length relationship and as such cannot be considered under the arm's-length principle.

The Tax Court rejected both positions, finding that the implicit support derived from GECC being a member of the GE family was a relevant

factor that should be considered as part of the circumstances surrounding the transaction. However, even after considering the implicit support, the Tax Court found, using the "yield" approach, that there was significant benefit from the explicit guarantee. Because the benefit exceeded the price charged for the guarantee, the Tax Court found in favor of the taxpayer.

For discussion of the Tax Court decision, see WNTS Insight, "[Tax Court of Canada: Guarantee fees paid to U.S. parent were arm's-length and therefore deductible](#)," January 6, 2010.

### **The Parties' Positions on Appeal**

The Minister argued that the Tax Court judge committed four "errors of law" and also contended that the judge's behavior during the trial gave rise to a reasonable apprehension of bias against the Minister. The appellate court found no errors of law and rejected the bias argument on the grounds that the behavior in question -- the Tax Court judge's "excessive pursuit" of an analysis of the possible impact of a removal of the guarantee -- related to an issue that had "no substantial connection with the outcome" of the trial.

GECC argued that the Tax Court judge misapplied the relevant transfer pricing law in reducing the arm's-length price of the guarantee on account of implicit support. According to GECC, implicit support cannot arise if the parties are assumed to be truly arm's length; it arises only as a result of the non-arm's-length relationship that must be ignored under the arm's-length principle.

GECC also argued that the Tax Court judge erred by adopting the yield approach or "benefit to the borrower" approach instead of focusing on a market price for the guarantee. Because market participants would have charged up to 300 basis points to guarantee the debt, the yield approach undervalued the guarantee.

The appeals court rejected both of the taxpayer's arguments, stating that the concept underlying the applicable statutory provisions is "simple" -- "to ascertain the price that would have been paid in the same circumstances if the parties had been dealing at arm's length." This

determination involves "taking into account all the circumstances which bear on the price, whether they arise from the relationship or otherwise."

The appellate court also discussed the statutory objective, "which is to prevent the avoidance of tax resulting from price distortions which arise in the context of non arm's length relationships." The court concluded that "elimination of these distortions by reference to objective benchmarks is all that is required to achieve the statutory objective." In this case, because implicit support is a factor that an arm's-length person would find relevant in pricing a guarantee, the appeals court'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 appeals court judge also cited that court's recent conclusion in *GlaxoSmithKline Inc. v. Canada (GSK)* that all relevant circumstances must be taken into account when determining an arm's-length price. The price in question in *GSK* was for the active ingredient in a brand-name drug. The Tax Court judge held that the only transactions relevant to the price determination were bulk purchases of similar active ingredients. The appeals court rejected that position and recognized the existence of a parallel licensing agreement between GSK Canada and another entity within the group, which helped justify a much higher price. (The Minister has sought leave to appeal this decision to the Supreme Court of Canada.) Applying the same test, the appellate court in *GECC* decided that "there is no doubt that the existence of the implicit guarantee is relevant to the inquiry and must be considered in identifying the arm's length price."

On the matter of whether the yield/benefit approach is appropriate, the appeals court took the view that if the explicit guarantee provided no benefit, "an arm's length party standing in the shoes of [GECC] would not have paid anything towards it." It further found that "assessment of the benefit is but a means to ascertain whether a guarantee fee would have been paid by an arm's length party." **Observation:** The appeals court here responded to only one question -- whether an amount should be paid at all. It did not address whether the yield approach should, on its own, be used to establish the arm's-length price.

In conclusion, the appeals court rejected all the issues raised by both the Minister and GECC and dismissed the government's appeal, leaving the lower court decision in favor of the taxpayer in effect.

## Observations

The key aspect of this decision for taxpayers is the appellate court's confirmation of the Tax Court's conclusion that all relevant facts, including those related to the non-arm's-length relationship, must be considered. This guidance, based on *GSK*, provides a Canadian case law interpretation of the arm's-length principle as the price that would have been paid in the same circumstances if the parties had been dealing at arm's length, taking into account all relevant circumstances, whether or not they emanate from the non-arm's-length relationship.

In other words, this decision failed to confirm the view of many taxpayers that the arm's-length price needs to be established under the premise that the parties are totally unrelated "stand-alone" entities.

Although the decision represents a win for GECC based on its specific facts, the impact of the decision on other guarantee fee positions taken by taxpayers is uncertain. It appears that guarantee fees will need to be justified by the incremental benefits to the borrower receiving an explicit guarantee, above and beyond the benefit of any implicit support provided by the non-arm's-length relationship.

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