# An Economics Perspective on the GE Canada Decision

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## Introduction

The *General Electric Capital Canada*[2] case concerns the payment of a guarantee fee by a Canadian subsidiary ("General Electric Capital Canada Inc." or "GE Canada") to its U.S. parent. The Minister of National Revenue disallowed the deduction of the fee in each of the 1996 to 2000 taxation years on the grounds that the fee was not warranted due to the creditworthiness of GE Canada. In the Crown's view, GE Canada had the same credit rating as its parent (the guarantor). On December 4, 2009, in a landmark decision, the Tax Court of Canada allowed GE Canada's appeal, and ordered the reassessments vacated.

This article provides a summary of the case, the Court's decision, and some observations regarding the Court's interpretation of the arm's length principle.

## Facts

GE Canada obtained the substantial capital it required to carry out its business by issuing third-party debt in the form of commercial paper and unsecured debentures. GE Canada's parent company, General Electric Capital Corporation ("GE U.S."), began guaranteeing the debt after a corporate reorganization in 1988. The guarantee was unconditional and was printed on the debt instruments. In 1995, GE U.S. began charging a guarantee fee equal to one per cent of the principal amount of the outstanding debt.

As noted above, the Crown disallowed the deduction of the guarantee fee by GE Canada for its 1996 through 2000 taxation years, and reassessed GE Canada accordingly. The reassessment, which increased GE Canada's income by $136 million, was based on the view that GE Canada, as a core subsidiary of GE U.S., was entitled to the implicit support of GE U.S. and, therefore, the guarantee provided no benefit to GE Canada.[3]

## The Issue Before the Court

The Crown argued that, in the absence of a guarantee arrangement, the credit rating of GE Canada should be equalized with that of GE U.S. due to the parent–subsidiary relationship. The position was allegedly based upon paragraph 7.13 of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the "OECD Guidelines") which states that:

> Similarly, an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed. For example, no service would be received where an associated enterprise by reason of its affiliation alone has a credit rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member, or where the enterprise benefited from the group's reputation deriving from global marketing and public relations campaigns. In this respect, passive association should be distinguished from active promotion of the MNE group's attributes that positively enhances the profit-making potential of particular members of the group. Each case must be determined according to its own facts and circumstances.

The Crown maintained that GE Canada could have borrowed the same quantum of funds at the same interest rate with or without the explicit guarantee of GE U.S. and that the guarantee arrangement was simply a clearer indication of the implicit support[4] that already existed for the benefit of GE Canada.

The core economic issue before the Court can be simplified to the issue of the credit rating of GE Canada in the absence of the guarantee. The Crown maintained that GE Canada would have a credit rating of AAA and, therefore, no benefit was received from the guarantee of its parent. GE Canada maintained that its credit rating would have been well below its parent's AAA rating such that the benefit to GE Canada of the guarantee was at least one per cent of the outstanding loan balances.

## The Decision

The Court noted that market participants will seek out all relevant information, including information that helps them to understand their counterpart's motivation to enter into the transaction.[5] The Court concluded that it is necessary to identify the economically relevant characteristics of the transaction that may influence the arm's length parties in their negotiations. Essentially, the dispute between GE Canada and the Crown became a disagreement over the economically relevant characteristics of the guarantee arrangement that should be considered in determining an arm's length price for a guarantee.[6]

Paragraph 1.15 of the OECD Guidelines states:

> Application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable.

While the case specifically addresses guarantee fees, the interpretation of the economically relevant characteristics of the transaction is fundamental to all transfer pricing transactions.

The Court concluded that the starting point of the analysis is a stand-alone rating of the subsidiary, as this approach allows the analyst to gauge the ratings gap between the parent and the subsidiary before considering any notching to improve the rating. This is an important outcome as this is the common approach taken by tax-

payers and transfer pricing professionals. Many transfer pricing analyses start with the stand-alone credit rating, determine the corresponding interest rate, and compare that rate to the guaranteed rate. Therefore, the Court's approach validates this stand-alone credit rating approach.

In assessing if any rating uplift should exist due to the implicit support of the parent, the Court concluded that GE Canada's credit rating would be two or three notches higher. While the Court gave some rating uplift for the implicit support of the parent, the Court determined that GE Canada would not get a rating uplift of the 12 or 13 notches required to get to the AAA rating of GE U.S.

Based on the evidence provided, the Court concluded that the GE Canada rating was BBB/BB+. The Court concluded that the interest rate benefit was equal to 183 basis points.[7] Therefore, the Court concluded that the one per cent guarantee fee was equal to or below an arm's length price. It is interesting that the Court did not conclude the rate was in the range. In fact, it noted that "the net economic benefit exceeds the 183 basis points calculated under the yield approach" due to the significant net economic benefit from the transaction.[8]

## Observations

The Court arrived at the same conclusion as the great majority of commentators on the case:[9] conceptually, an explicit parental guarantee provided a benefit for which a fee was justifiably chargeable and deductible under the Act.

On the road to what we consider to be the appropriate result for GE Canada, the Court had to determine whether, in the circumstances, the arm's length price of the explicit guarantee had been exceeded. For that, the Court had to decide which relevant economic factors should be taken into account in the determination of an arm's length price for the guarantee. In particular, in determining the arm's length price for an explicit guarantee, the Court had to decide how much value, if any, should be attributed to implicit support that might exist (for which nothing could be charged), and how much value should be attributed to the explicit guarantee.

The answers provided by the Court in respect of these economic factors raise important issues. Notwithstanding its overall positive outcome, in that the Court upheld the deductibility of the entire fee as charged, it can be argued that the decision may contain some deviations from economic theory that could lead to problems for the application of the arm's length principle in transfer pricing in Canada.

### Explicit Parental Guarantee has Value

The Court's decision demonstrates that the Canada Revenue Agency's standing position to reassess based on the notion that an explicit parental guarantee provides no benefit to the related-party borrower is inappropriate. Parental guarantees on loans have value for at least two reasons: (1) the interest rate benefit received through a lower cost of borrowing; and (2) the negative impact of removing such a guarantee. This judgment is a significant win for GE Canada and other companies that use intercompany guarantees.

### Economically Relevant Characteristics of the Transaction and Implicit Support

On many occasions in the judgment, the Court indicated that implicit support cannot be enforced and third parties would not consider it. Yet the Court concluded that the credit rating would be notched up for the implicit support.

The reasons for any notching uplift are important. A credit rating summarizes a variety of information into one measure. The fundamental purpose of a credit rating is to provide a signal to the market about the probability of default. Factors that affect the probability of default have a direct effect on the credit rating. This credit rating signal helps address information asymmetries that exist between the borrower and the holders of the debt.

If there are specific activities that reduce the probability of default, the argument for the rating uplift would exist. If Canco were exceptional at managing its debt, it may be that the probability of default is lowered, and the credit rating may be increased. If Canco contracted this service out to another service provider – related or unrelated – and the debt management services were exceptional, then some ratings uplift may exist. Unlike the implicit support argument, in this case, the better credit rating is due to an explicit activity performed for which compensation is owed.

According to the Court, third-party guarantors assuming the default risk of GE Canada could, and should, ask for a higher guarantee fee because, unlike GE U.S., they would not assume the cash management function of GE Canada and would have less clear information on GE Canada. Basically, the Court concluded that the arm's length price for the guarantee has to take into account the fact that, on the one hand, GE U.S. takes charge of the cash management function of GE Canada and that, somewhat concurrently, GE U.S. has a level of information about GE Canada that any third party could not have. In other words, there is no asymmetry of information between GE U.S. and GE Canada in contrast to what would be the case between GE Canada and any third-party guarantor. For these two factors, the Court inferred that the guarantee fee that GE U.S. could charge to GE Canada was lower than what would be charged by any other third-party guarantor.

One might call into question the validity of that conclusion. To the extent the money management activities of GE U.S. provides it with better information and allows it to reduce a lender's estimation of GE Canada's default risk (and as a result augment the credit rating of GE Canada), these benefits result from GE U.S.'s activities. Accordingly, in the very logic of paragraph 7.13 of the OECD Guidelines, these benefits could attract a charge and are not appropriable by GE Canada as the Court's reasoning suggests. Rather, these benefits are appropriable by GE U.S. as the performer of the money management activities and unique possessor of superior information. Otherwise, it

might be seen as contradicting the economic principle of opportunity cost.

When it comes to implicit support (where it is clear that GE U.S. did not perform any specific functions), the linkages to a lower probability of default are less clear. For example, the Court took issue with the Crown's suggestion that GE U.S. could have injected capital into GE Canada to improve Canada's debt-to-equity ratio.[10] If additional capital was provided, the probability of default would decline, thus raising the credit rating. The Court noted that considering this possible capital injection would contradict the well-accepted principle that a corporation is a separate person whose very existence provides limited liability protection to its shareholders. Also, it was noted by the Court that "creditors have no recourse against the parent if they rely on the expectation that the parent will come to the rescue of its subsidiary and it fails to do so".[11] Again, there is doubt as to whether the market would consider the potential rescue by the parent as reducing the probability of default.

The reasoning of the Court in respect of the effects of the removal of the explicit guarantee opens the door to concluding that, following that removal, the value of the implicit support would be nil. Indeed, based on the idea at the heart of the Court's reasoning itself, in terms of the signal provided to the market, should the impact of the explicit guarantee removal on the information sets of the borrower and lenders not be such that, in their minds, the probability of GE U.S. providing implicit support would be nullified?

The Crown's position, as summarized in paragraph 168 of the decision, is very telling in this respect: "the guarantee arrangement was simply a clearer indication of the implicit support that already exists in favour of [GE Canada]". Would the removal of the guarantee not be a clear indication that no support would be provided following that removal – otherwise, why would a parent have put in place an explicit guarantee at all?

In that sense, one may question the Court's conclusion that, in addition to the explicit guarantee to be charged, there would remain at equilibrium some implicit support, the value of which could not be charged. Again based on the idea at the heart of the Court's reasoning, this result seems to contradict economic principles. Following the removal of an explicit guarantee, why would GE U.S. decide not to monetize and appropriate the totality of any apparently measurable economic benefit associated with its brand and reputation that is used by GE Canada?

If the parent company did not monetize the entire economic benefit and left some residual creditor's and debtor's moral hazard in the form of unpaid implicit support, suboptimal risk-taking decisions on the part of both the subsidiary and its creditors could exist. For example, a subsidiary, knowing there is implicit support upon which it can rely and not paying for the benefit received, could be less concerned about the impact its decisions could have on the probability of default, thus creating suboptimal behaviour that leads to disequilibrium. For the lenders, if they considered the implicit support to exist, they could be less concerned about the operations and financial performance of the borrower, again creating suboptimal behaviour and disequilibrium. The removal of the guarantee would lead us to conclude that implicit support no longer exists and the guarantor would monetize the entire economic benefit associated with an explicit guarantee.

We note that the same argument would hold in the case whereby implicit support was initially offered and it was subsequently converted to an explicit guarantee – the implicit support would have no value in the market. The Court's conclusion suggests that equilibrium in that situation would include a value for any implicit support and an explicit guarantee. This contradicts economic principles just as much as it means that the guarantor would decide not to monetize and appropriate all the measurable economic benefits it generates, knowingly and against its own self-interest leaving the subsidiary and its creditors with suboptimal risk-taking incentives.

**Other Potential Applications for Implicit Support**

Given the Court's acceptance of some level of implicit support notwithstanding the explicit guarantee, there are transactions in respect of which the arguments of implicit support could be used to eliminate or alter transfer prices on other transactions. The use by a foreign subsidiary of the trademark of its parent company is a case in point. Third parties will pay more for products because the third parties recognize and value the group's name and the underlying brand. Could one use implicit support arguments based on the *GE Canada* case and paragraph 7.13 of the OECD Guidelines to argue that no payment is required for the subsidiary's use of the trademark? Presumably the subsidiary could expect the implicit support of the parent in that the parent would not be expected to sue the subsidiary for trademark infringement and the parent would want to continue to distribute its products in the local market.

## Conclusion

The OECD Guidelines are based on the widely accepted "separate legal entity" approach. The Court found its way to the appropriate answer in determining that the fee charged for the explicit guarantee was reasonable. Although the Court somewhat recognizes the separate legal entity approach, it appears to have overextended the concept of implicit support and the ambit of the factors to take into account. It remains to be seen what impact the Court's reasoning and the related economic implications will have on the interpretation of transfer pricing in Canada.

**Notes:**

[1] The opinions expressed in this article are those of the authors and do not necessarily reflect the opinions of KPMG LLP (the Canadian member firms of KPMG International, a Swiss cooperative) and other member firms of KPMG International. The authors wish to thank François Vincent, Mary Furlin, Paul Hickey, and Clark Chandler for their comments and suggestions, along with all our colleagues who willingly had discussions with us while we sorted through the economic arguments in the case. Any errors and omissions are attributed solely to the authors. Comments may be addressed to the authors at stephanedupuis@kpmg.ca and mdhoffman@kpmg.ca.

[2] *General Electric Capital Canada Inc. v. The Queen*, 2010 DTC 1007 (TCC).

[3] We note that, in its Reply to the Notice of Appeal, the Crown also put forth a recharacterization argument, asserting that the guarantee arrangement was not entered into for *bona fide* purposes other than to obtain a tax benefit. During the trial, the Crown abandoned this argument and agreed that the guarantee was entered into for legitimate business reasons.

[4] The Court uses the term *implicit support* as an equivalent to *implicit guarantee*. In the context of the case, the two terms are interchangeable, but we will use in this article the term *implicit support* as the Court, except in rare instances, used that term when referring to the concept of implicit guarantee.

[5] *Supra* note 2, paragraph 197.

[6] The adjustments for 1996 and 1997 were based on subsection 69(2) of the *Income Tax Act* ( the "Act"), while the adjustments for 1998, 1999, and 2000 were based on subsection 247(2). Neither GE Canada nor the Crown agreed that the wording differences between these two subsections were not meaningful for the purposes of the appeal.

[7] The Court rejected the two pricing methods proposed by GE Canada and adopted the method proposed by the Crown, yet the Court used the Crown's method to support the position of GE Canada.

[8] *Supra* note 2, paragraph 305.

[9] See, for example, Hoffman, Michael, Stephane Dupuis, and Kirsty Rockall. "Is the CRA Abandoning the Arm's-length Principle? Potential Implications from *GE Canada v. The Queen*." *BNA Tax Management Transfer Pricing Report*. September 6, 2007.

[10] *Supra* note 2 paragraph 268.

[11] *Ibid.*, paragraph 267.

# Tax Aspects of Commencing and Ceasing To Use Property in a Canadian Branch

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## I. Introduction

There is a general proclivity of non-residents to use a Canadian subsidiary ("Canco") rather than a branch to carry on business in Canada. There may, however, be a number of tax-related reasons why a non-resident (a "NR") may decide to carry on a branch business in Canada rather than use a Canco. For example, using a branch may be more beneficial: i) if there are start-up losses arising in Canada that the NR can utilize for its domestic tax purposes and that would otherwise be trapped in a Canco, or ii) if the NR can make use of foreign tax credits if the NR pays the Canadian taxes itself. Moreover, potential transfer pricing issues that might arise in respect of transactions between a Canco and its NR shareholders may be avoided by using a branch. In addition, in view of changes to the *Canada–U.S. Tax Convention* (the "Convention"), there may be benefits under the Convention available to a U.S. resident carrying on business in Canada through a branch, such as a reduced rate of branch tax (5%). In contrast, if the U.S. resident instead used a fiscally transparent unlimited liability Canco to carry on business in Canada, benefits under the Convention such as a 5% rate of withholding tax on dividends would not be available on dividends paid from Canco to its U.S. parent.[2]

The *Income Act* (Canada) (the "Act") contains "fresh start" rules that apply when a Canadian branch starts to use property in Canada, and a deemed disposition and ensuing tax consequences when a Canadian branch ceases to use property in Canada. Subject to treaty protection, if any, the resulting income and gain from a deemed disposition on cessation of use of property by the branch would be subject to Part I tax and potentially branch tax in Canada.

This article begins with an overview of the general Canadian federal income tax treatment of a Canadian branch when it commences or ceases to use property in Canada, and a more specific explanation of how Canadian branches are treated in respect of commencing or ceasing to use the following types of property in Canada: capital property, depreciable property, inventory and eligible capital property. It then sets out Canadian branch tax implications. Finally, this article briefly comments on the application of treaty benefits in respect of Canadian tax liabilities arising on commencing or ceasing to use property in a Canadian branch.

## II. Canadian Income Tax Treatment

### A. General

As discussed below, immediately before a branch starts to use property in Canada, various provisions in Part I of the Act provide for a "fresh start" – a deemed disposition of capital property, depreciable property, eligible capital property and inventory, followed by a deemed acquisition at fair market value ("FMV") at the time of commencement of use of the property.

Similarly, when a branch ceases to use property in Canada (other than as a result of an actual disposition), there is a deemed disposition followed by a deemed acquisition of the property at FMV under the Act. This would arise not only on cessation of the branch itself, but also when the NR withdraws the property from use in Canada, such as by removing equipment and inventory from Canada.

In general, the "fresh start" rules for using property of the NR in a branch are expected to produce the same tax consequences as transferring the same property to a Canco. If a Canco were used, there would be an acquisition of the property by Canco at a cost equal to FMV if FMV consideration were paid by Canco. Conversely, if Canco was wound up and all of its property distributed to its NR parent, there would be a deemed disposition at FMV, and a deemed dividend. However, there are no symmetrical rules dealing with a Canco commencing to use property for the purposes of earning income from a business outside Canada, or if there is a proportionate change in business use between Canada and elsewhere.