



Lessons from the GE Capital Canada case

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With increased audit activity and recent tax litigation in Canada, determining the arm's-length pricing of guarantees continues to be a difficult transfer pricing issue and risk for multinationals. Gordon Hands of CUFTanalytics discusses the issues raised in the GE Capital Canada's guarantee fee transaction litigation.

In December 2009, the Tax Court of Canada gave its decision on the GE Capital Canada case based on expert witness testimony and final closing arguments from legal counsel for the Canada Revenue Agency (CRA) and from GE Capital Canada. The decision has important implications and has led to a prolonged discussion about the major issues facing taxpayers in determining an arm's-length guarantee fee.

Key decisions

In the GE Capital Canada case, the intra-group guarantee was a financial guarantee provided by the parent entity (GE Capital) in support of its Canadian subsidiary's third-party public debt.

Although the guarantee arrangement dates back to 1988, the guarantee fee was not put in place until 1995. The debt securities that were guaranteed were not bank loans, but commercial paper issued in the Canadian money market and unsecured debentures issued under its medium term note facility in the Euro-markets.

These debt securities had the highest quality credit ratings from the credit rating agencies and, therefore the lowest cost of borrowing in the Canadian debt market for GE Capital Canada.

The economic benefit of this type of intra-group financial guarantee is that it enhances the creditworthiness of the borrower or the borrower's debt issue. As a result, the borrower can access debt funding at a lower cost of borrowing or potentially obtain other benefits related to the amount of financing or other non-interest rate or fee related benefits in the terms of the debt offering.



The Judge ruled in favour of GE Capital Canada's position that the 1% guarantee fee it paid to its related-party guarantor (GE Capital) did not exceed an arm's-length price.

Main transfer pricing issues the court heard

Was the intra-group guarantee necessary?

The question was whether or not debt market participants would have purchased GE Capital Canada's unguaranteed debt securities, in sufficient amounts required by GE Capital Canada to fund its business plan and at low enough rates for them to be profitable, even if the parent-subsidary affiliation or implicit financial support would have resulted in GE Capital Canada being considered an AAA-rated issuer, in other words, equivalent to the parent GE Capital.

On this issue, the judge ruled that GE Capital Canada could not have raised the necessary funds at the low interest rates it benefitted from without the explicit guarantee from GE Capital and therefore the guarantee was in fact necessary in order for the subsidiary to execute on its business plan.

What is the most appropriate transfer pricing method and methodology?

Taxpayers and tax authorities commonly disagree on the creditworthiness or credit risk related to the intra-group guarantee transaction. The GE Capital Canada case was no exception.

The judge concluded that the correct methodology for the facts and circumstances of this case was to use the yield approach by first applying a two-step. The yield approach is meant to estimate the total potential interest rate savings (in other words, the total economic value) achieved by the borrowing entity as a result of the explicit guarantee.

This two-step approach consisted of 1) estimating the stand-alone or status-quo credit rating and then notching that credit rating for the affect of the parent-subsidary relationship, and 2) looking at the spread in corporate bond yields between the parents credit rating of AAA and the estimated credit rating of GE Capital Canada (inclusive of the implicit support provided through the parent-subsidary relationship).

Should the credit risk be assessed with consideration of the parent-subsidary affiliation or relationship?

The judge concluded that the parent-subsidary relationship must be considered in determining the credit rating of the subsidiary, but that it is not reasonable to expect that implicit support would equalise the subsidiary's credit rating to that of its parent. The judge decided that the uplift in GE Capital Canada's stand-alone credit rating would be



three credit rating notches taking the credit rating of GE Capital Canada from B+/BB- to BB+/BBB-.

Lessons learned

Three transfer pricing-related issues in this case provided taxpayers with the following lessons to be learned;

- whether implicit support from the parent-subsidiary affiliation would reduce the net economic benefit to the subsidiary of an explicit financial guarantee,
- whether consideration of implicit support in determining the credit risk of the subsidiary is consistent with the concept of the arm's length principle, and
- provided the most appropriate transfer pricing methodology to determine an arm's-length guarantee fee for a financial (or loan) guarantee.

Parent-subsidiary affiliation

It is clear from this case that, in the assessment of the credit risk of the subsidiary, the parent-subsidiary affiliation must be considered. This does not mean that this assessment will conclude that the parent-subsidiary affiliation will always result in the subsidiary's credit risk being improved or that its credit risk could be equalised with that of its parent's external credit rating.

The assessment of implicit support is whether or not the debt market participants would, by reason of the parent-subsidiary affiliation, charge the subsidiary a lower rate of interest (or some other net economic benefit) without an explicit financial guarantee. It is not whether or not the credit rating agencies would notch the stand-alone credit rating.

This case offers a glimpse into the subjective criteria that credit rating agencies use for notching the stand-alone credit rating of the subsidiary for the parent-subsidiary affiliation. However, this subjective process may not be entirely representative of what lenders would consider in setting the interest rate.

Implicit support

The next lesson is that, in applying the arm's length principle, the ownership or shareholder relationship between the parent and subsidiary must be ignored so that the parties are transacting as if they were distinct and separate enterprises. So any benefit the guarantor-parent receives from providing the financial guarantee in its role as a shareholder of the subsidiary can not be considered in determining the arm's-length guarantee fee.

Conversely, any economic benefit the subsidiary receives as being a subsidiary of the parent must be ignored. Therefore, the subsidiary would not compensate the parent for any economic benefit it receives solely from the parent-subsidiary affiliation. This means that implicit support is consistent with the arm's length principle.



The parent-guarantor relationship needs to be split. The guarantor would be hypothesised as being an entity outside of the multinational group and would only need to be characterised as having a credit rating of sufficient credit quality as to be able to provide credit enhancement to the subsidiary's third-party lender. The subsidiary remains a member of a multinational group but it is hypothesised that its parent is not the same entity as the guarantor.

In this hypothetical structure, the lender would, in an arm's-length lending transaction, consider the subsidiary's affiliation with its parent and as a member of the multinational group (including their overall strategic importance to the group) in assessing the subsidiary's credit risk. Therefore the interest rate would reflect the lender's expectations of financial support in the event of default. Again, this assessment may still lead to the conclusion that there is no interest rate savings for the implicit support provided by the parent-subsidiary affiliation.

Most appropriate transfer pricing methodology

The final lesson in this case is that the selection and application of the most appropriate transfer pricing method to determine an arm's-length guarantee fee for a financial or loan guarantee must consider the economic benefit to the subsidiary (in other words, its interest rate savings as a result of the explicit financial guarantee).

The interest rate savings method using corporate bond data in a yield spread analysis was used to test whether or not the guarantee fee was equal to, or less than, an arm's length guarantee fee.

This case reinforced the importance of, and the difficulty in, determining the credit risk rating of the subsidiary. This is a critical first step in determining the arm's-length guarantee fee. As part of the credit risk estimation process, it is not only necessary to determine the stand-alone credit risk of the subsidiary, but to also consider the impact of the parent-subsidiary affiliation (the implicit support) on the stand-alone credit risk.

There are credit risk estimation models available from the major credit rating agencies that can be used to estimate the stand-alone credit rating. But there are only general methodologies or frameworks provided in the literature published by the credit rating agencies to subjectively evaluate the ratings uplift from the implicit managerial and financial support arising from the parent-subsidiary affiliation.

A better assessment of credit risk is the credit risk measures of forward-looking probability of default (PD) and expected loss (EL). These are reliable credit risk measures publicly available from the credit rating agencies. In fact, the credit rating categories are actually created by the credit rating agencies mapping a level or range of EL to a credit rating.



For example, Moody's maintains and publishes these credit risk measures daily for public companies. Conversely, credit ratings are only updated when the company or issuer requests an updated rating review. This means that the observed credit rating for a particular company may no longer reflect the actual credit risk that the bond holders or investors have priced into the bond yield for that company or issuer.

This may lead to yield data of this bond issue being included in a yield spread analysis when it should not or conversely not being included in the analysis when it should. Additionally, the credit rating agencies track and maintain PD and EL data on many unrated public companies. Therefore, debt instruments, such as credit agreements, issued by these unrated public companies, can be considered in the search for and selection of potential comparables which offers taxpayers a larger set of comparable data.

The interest rate savings method should be applied in assessing the net economic benefit of the intra-group loan guarantee and determining the arm's-length guarantee fee. The court case relied on the yield spread analysis approach or yield approach to approximate the interest rate savings. This approach ignores the actual interest rate charged on the guaranteed debt. Also, it does not take into consideration publicly available data on corporate loans from third party lenders.

The yield approach relies on a differential in corporate bond yields observed in the secondary bond market. But is the observed differential in yield spread on corporate bonds a good proxy for the interest rate savings? And what, if any, comparability adjustments would be required for the corporate bond data to be reliable and comparable? In particular differences in liquidity risk and market (bonds have an investor/investor relationship versus loans which are lender/borrower). The court case did not address these questions, but they are at the heart of the continuing debate.

It is recommended that the first step in the guarantee fee analysis should be to determine what the related party borrower would have been charged as an interest rate if there was no explicit guarantee by looking at lending margins (which is the credit spread over the default-free interest rate for corporate loans,) in the primary loan market. At the same time, this step would consider the impact, if any, on the interest rate due to the parent-subsidary affiliation.

There are models available from the credit rating agencies to estimate the forward-looking probability of default and the loss given default that, when combined, provide an estimate of EL for the related party borrower. With this data, a search can be made to find comparable loan transactions with borrowers that have a similar level of EL or similar credit risk to the tested borrower. EL data is available on both rated and unrated public companies. Therefore, the taxpayer can determine comparability in credit risk profile for the comparable uncontrolled borrowers.



For illustrative purpose, the following table provides the unadjusted average lending margin range for BBB-rated borrowers in the financial services industry observed in the period six months prior to the start of each year. In any year the total potential interest savings applying this methodology would be equal to the lending margin for the BBB-rated borrower plus the appropriate reference rate (for example, 3-month CAD LIBOR) less the actual third party interest rate (such as 90-day CAD commercial paper). The guarantee fee would be some portion of this interest rate savings based on other qualitative factors that would reflect the negotiating position of the parties if they were dealing at arm’s length.

	Minimum	Maximum
1996	25 bps	150 bps
1997	20 bps	70 bps
1998	24 bps	75 bps
1999	20 bps	88 bps
2000	32 bps	150 bps

Source data for lending margins was gathered from the CUFTanalytics CUFT database

The final lesson! There is more controversy to come.

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CUFTanalytics is a transfer pricing consulting firm providing services to the global community of multinational corporations. CUFTanalytics specializes in transfer pricing solutions for determining the arm’s length charges for all types of intercompany financial transactions, including intercompany loans and intra-group loan guarantees. In addition to our CUFT Database, that contains comparable uncontrolled loan and guarantee fee pricing and related information on thousands of transactions, we have developed a robust methodology to make reliable and quantifiable comparability adjustments to the third-party transactions.