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Federal Court of Appeal

Cour d'appel fédérale

Date: 20101215
Docket: A-1-10
Citation: 2010 FCA 344

CORAM: NOËL J.A.
PELLETIER J.A.
MAINVILLE J.A.

BETWEEN:

HER MAJESTY THE QUEEN

Appellant

and

GENERAL ELECTRIC CAPITAL CANADA INC.

Respondent

Heard at Toronto, Ontario, on November 16, 2010.
Judgment delivered at Ottawa, Ontario, on December 15, 2010.

REASONS FOR JUDGMENT BY: NOËL J.A.
CONCURRED IN BY: PELLETIER J.A.
MAINVILLE J.A.

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REASONS FOR JUDGMENT

NOËL J.A.

[1] This is an appeal from a decision by Hogan J. of the Tax Court of Canada (the Tax Court Judge), vacating assessments issued by the Minister of National Revenue (the Minister) against General Electric Capital Canada Inc. (the respondent) pursuant to Parts I and XIII of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp) (the Act) with respect to its 1996 to 2000 taxation years.

[2] The Part I assessments denied the full amount of the deductions claimed by the respondent in computing its income with respect to fees paid to General Electric Capital US (GECUS), its parent company, for guaranteeing its capital market borrowings on the basis that such fees would not have been paid by an arm's length party for the guarantee provided. The Part XIII assessments reflect consequential adjustments which result from the fees being deemed to be dividends in the hands of GECUS for purposes of Part XIII in such circumstances.

[3] This case concerns the application of the now repealed subsection 69(2) and paragraphs 247(2)(*a*) and (*c*) which replace it. These provide the Minister with the authority to make transfer pricing adjustments where, *inter alia*, a taxpayer has paid to a non-resident person with whom it is not dealing at arm's length as payment for property or services an amount greater than the amount which a person dealing with an arm's length purchaser would have paid.

[4] The Tax Court Judge found as a fact that the guarantee fees paid by the respondent to GECUS did not exceed the amount which a person dealing at arm's length person would have paid in similar circumstances. He therefore vacated the assessments.

[5] The Crown contends that in so holding the Tax Court Judge committed a number of legal and factual errors. It asks this Court to allow the appeal on the basis that an arm's length party would not have paid the guarantee fee since it provided no value. Alternatively, it contends that the behaviour of the Tax Court Judge at trial was such as to give rise to a reasonable apprehension of bias against it. It asks that the matter be remitted for a new trial before a different judge.

[6] For the reasons which follow, I am of the view that the appeal should be dismissed.

BACKGROUND

[7] During the years in issue, the respondent was wholly-owned by GECUS, a United States corporation, which in turn was wholly-owned by General Electric Company (GE), also a United States corporation. Throughout this period, the respondent was in the business of providing financial services and financed a substantial portion of its operations with debt in the form of commercial paper and unsecured debentures (debt issuances).

[8] Between 1988 and 1995, GECUS provided to the respondent, at no cost, an explicit guarantee for its debt issuances. Starting with the 1996 taxation year, GECUS began charging a fee equal to 1% of the face amount of the respondent's debt issuances for that same guarantee.

[9] Applying this percentage, fees totalling $135.4 million were paid and deducted by the respondent in computing its income under Part I of the Act in respect of its 1996 through 2000 taxation years (Reasons at para. 2). The respondent also withheld and remitted non-resident tax at the rate of 10% of the fee under Part XIII of the Act, being the reduced rate applicable pursuant to article XI of the Canada-United States Income Tax Convention (the

Convention) to the interest deemed to have been paid to GECUS by reason of the payment of the guarantee fee (see subsection 214(15) of the Act).

[10] The Minister disallowed the deduction claimed by the respondent in computing income under Part I. The Part I assessments insofar as they relate to the 1996 and 1997 taxation years are based on subsection 69(2) of the Act:

69. (2) Where a taxpayer has paid or agreed to pay to a non-resident person with whom the taxpayer was not dealing at arm's length as price, rental, royalty or other payment for or for the use or reproduction of any property, or as consideration for the carriage of goods or passengers or for other services, an amount greater than the amount (in this subsection referred to as "the reasonable amount") that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, the reasonable amount shall, for the purpose of computing the taxpayer's income under this Part, be deemed to have been the amount that was paid or is payable therefore.

69. (2) Lorsqu'un contribuable exploitant une entreprise au Canada a versé ou convenu de verser à une personne non résidante, avec laquelle il avait un lien de dépendance, à titre de prix, loyer, redevance ou autre paiement pour un bien ou pour l'usage ou la reproduction d'un bien, ou en contrepartie du transport de marchandises ou de voyageurs ou d'autres services, une somme plus élevée que la somme (ci-après appelée "la somme raisonnable") qui aurait été raisonnable eu égard aux circonstances si la personne non résidante et le contribuable n'avaient eu aucun lien de dépendance, la somme raisonnable est réputée, aux fins du calcul du revenu du contribuable provenant de l'entreprise, avoir été la somme payée ou payable dans ce cas.

[My emphasis]

[11] Subsection 247(2) replaced subsection 69(2) effective for taxation years that begin after 1997. Of relevance are paragraphs 247(2)(*a*) and (*c*):

247. (2) Where a taxpayer or a partnership and a non-resident person with whom the taxpayer or the partnership, or a member of the partnership, does not deal at arm's length (or a partnership of which the non-resident person is a member) 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, or

(*b*) the transaction or series

(i) would not have been entered into between persons dealing at arm's length, and

(ii) can reasonably be considered not to have been entered into primarily for *bona fide* purposes other than to obtain a tax benefit,

247. (2) Lorsqu'un contribuable ou une société de personnes et une personne non-résidente avec laquelle le contribuable ou la société de personnes, ou un associé de cette dernière, a un lien de dépendance, ou une société de personnes dont la personne non-résidente est un associé, prennent part à une opération ou à une série d'opérations et que, selon le cas :

a) les modalités conclues ou imposées, relativement à l'opération ou à la série, entre des participants à l'opération ou à la série diffèrent de celles qui auraient été conclues entre personnes sans lien de dépendance,

b) les faits suivants se vérifient relativement à l'opération ou à la série :

(i) elle n'aurait pas été conclue entre personnes sans lien de dépendance,

(ii) il est raisonnable de considérer qu'elle n'a pas été principalement conclue pour des

any amounts that, but for this section and section 245, would be determined for the purposes of thi s Act in respect of the taxpayer or the partnershi p for a taxation year or fiscal period shall be adj usted (in this section referred to as an “adjustme nt”) to the quantum or nature of the amounts tha t would have been determined if,

(*c*) where only paragraph 247(2)(*a*) applies, the t erms and conditions made or imposed, in respec t of the transaction or series, between the partici pants in the transaction or series had been those t hat would have been made between persons deal ing at arm’s length, or

(*d*) where paragraph 247(2)(*b*) applies, the trans action or series entered into between the particip ants had been the transaction or series that woul d have been entered into between persons dealin g at arm’s length, under terms and conditions tha t would have been made between persons dealin g at arm’s length.

objets véritables, si ce n’est l’obtention d’un avantage fiscal,

les montants qui, si ce n’était le présent article et l’article 245, seraient déterminés pour l’applicati on de la présente loi quant au contribuable ou la société de personnes pour une année d’impositio n ou un exercice font l’objet d’un redressement de façon qu’ils correspondent à la valeur ou à la nature des montants qui auraient été déterminés si :

c) dans le cas où seul l’alinéa *a*) s’applique, les modalités conclues ou imposées, relativement à l’opération ou à la série, entre les participants av aient été celles qui auraient été conclues entre pe rsonnes sans lien de dépendance;

d) dans le cas où l’alinéa *b*) s’applique, l’opérati on ou la série conclue entre les participants avait été celle qui aurait été conclue entre personnes s ans lien de dépendance, selon des modalités qui auraient été conclues entre de telles personnes.

[My emphasis]

[12] The parties agreed and the Tax Court Judge accepted that, for present purposes, there is no meaningful difference between paragraphs 247(2)(*a*) and (*c*) and subsection 69(2) of the Act (Reasons at para. 179).

[13] The guiding assumption made by the Minister in disallowing the deduction of the guarantee fee is that in the event of a default by the respondent, GECUS would have supported the respondent regardless of the guarantee (Amended Reply to the Notice of Appeal at paras. 18hh), ii), jj) and 20a) and b), Appeal Book, Vol. I at p. 131). As such, the guarantee was superfluous.

[14] Given the Minister’s assumption that amounts were paid by the respondent to GECUS without anything being received in return, further assessments were issued under Part XIII on the basis that a benefit equal to the fee had been paid to GECUS. Such a payment gives rise to a deemed dividend subject to withholding tax at the reduced rate of 5% pursuant to article X of the Convention (because GECUS held more than 10% of the voting stock of the respondent).

[15] The respondent objected to both series of assessments alleging, *inter alia*, that the guarantee fee was at least commensurate with an arm’s length price and that it had properly computed and remitted the exigible Part XIII tax.
[16] The assessments were subsequently confirmed and the appeal to the Tax Court of Canada ensued.

DECISION OF THE TAX COURT

[17] The Tax Court Judge in describing the position of the parties, first identified the theory of the Crown (Reasons at para. 168):

> The [Crown] submits that the [respondent]’s credit rating would be equalized with that of GECUS by reason of affiliation in the absence of a guarantee arrangement. On this theory, the [Crown] claims that the [respondent] could have borrowed the same amount of money at the same interest rate without an explicit guarantee as it did with such a guarantee. As a result, the [respondent] did not receive an economic benefit from the guarantee. In this case, the arm’s

> length price for the guarantee is nil. The guarantee arrangement was simply a clearer indication of the implicit support that already existed in favour of the [respondent].

[18] He then referred to the method proposed by the Crown in order to establish that the explicit guarantee would have been of no value to the respondent in an arm's length context (Reasons at para. 169):

> Counsel invites me to consider the credit rating methodology developed and applied by [Standard & Poor's (S&P)] in the taxation years under review in assessing whether or not the [respondent]'s credit rating would be equalized with that of its parent in the absence of an explicit guarantee. Under S&P's credit rating system, the [Crown] claims, the [respondent] would be considered a "core subsidiary". According to the [Crown], the crucial point is that the [respondent's] credit rating would be notched up to the AAA rating of its parent, GECUS, on the grounds that both S&P and the [respondent]'s debt holders would recognize that GECUS had a strong economic incentive to provide financial support to the [respondent] in times of financial stress, even if it was not contractually obliged to do so.

[19] According to the Crown, this type of "implicit support" would be recognized by S&P in the case of the respondent with the result that its credit rating would be the same as that of GECUS (*i.e.* AAA) whether GECUS' explicit guarantee was in place or not. If the respondent's credit rating was unaffected, the costs of its debt issuances would be equally unaffected. In effect, the argument was that an arm's length party in the respondent's shoes would not pay anything for something which provided it with no benefit.

[20] The Tax Court Judge then turned to the position of the respondent. In particular, he noted the respondent's submission that (Reasons at para. 180):

> … The concept of "implicit support" relied on by the Crown to convince me that the [respondent]'s credit rating would be equalized with that of GECUS requires that one preserve the very non arm's length relationship which subsection 69(2) and paragraph 247(2)(*a*) invite me to ignore. Stated differently, the reputational pressures that may cause GECUS to support the [respondent] in times of financial stress exist because the [respondent] is allegedly a core subsidiary. This type of pressure does not exist in an arm's length relationship. All factors of influence flowing from the non arm's length relationship must be ignored to ensure an arm's length result. …

[21] After a lengthy analysis, he rejected the respondent's contention on this point. He concluded that, as proposed by the Crown, GECUS' implicit support, which derives from the respondent being a member of the GE family, was a relevant factor (Reasons at paras. 199-201). He later identified as another relevant factor the impact which the removal of the guarantee would have had if GECUS had made the decision to remove it, a finding that is central to the Crown's appeal (Reasons at para. 247).

[22] The Tax Court Judge then proceeded to the determination of the arm's length price of the guarantee transaction. He noted that the first step is to properly identify the transaction at issue. In the case at bar, that entailed "identifying the parties to the controlled transaction, the functions performed by each party and the risk assumed as part of the transaction" (Reasons at para. 232).

[23] The Tax Court Judge then considered the method for determining the arm's length price. He rejected the insurance-based model as unreliable. He explained that this method would result in pricing the guarantee at an amount which would tend to be too high given the manner in which insurers price the risk (Reasons at para. 254). In addition, this method involved the use of a credit rating product called "RiskCale" which did not take into account implied support (Reasons at para. 256).

[24] The Tax Court Judge also rejected the credit swap method proposed by the respondent. He found that the opinion of the expert witness who proposed this method was based "on assumed credit rating … provided to him by

counsel for the [r]espondent" and "the accuracy of his conclusion is entirely dependent on the accuracy of the assumed credit rating" (Reasons at para. 258).

[25] In the end, he accepted the Crown's position that what should be measured is the value of the benefit provided by the explicit guarantee and that the yield approach should be used for this purpose (Reasons at para. 259):

> … This should be done using the yield approach. The benefit is equal to the interest cost savings for the [respondent] determined by comparing the interest cost of unguaranteed debt to that of guaranteed debt. To determine the interest savings for the [respondent], one must arrive at a factual finding of the [respondent]'s credit rating without the explicit support of its parent. …

[26] Earlier in his reasons, the Tax Court Judge introduced the various witnesses who appeared before him including thirteen experts, five for the Crown and eight for the respondent (Reasons at paras. 4-166). The lead experts with respect to the yield approach were William John Chambers, who holds a Ph.D. in economics from Columbia University and appeared for the respondent, and Edward Emmer who appeared on behalf of the Crown. Both were employed by S&P during most of their career, Mr. Emmer having spent the better part of that time with the ratings division. They were asked to assess the credit rating which the respondent would attract with and without the guarantee provided by GECUS using the credit rating criteria used by S&P.

[27] The opinion expressed by Mr. Emmer was that the respondent would maintain its AAA rating without GECUS' explicit guarantee by reason of the implicit support which results from the respondent's relationship with GECUS and GE. Dr. Chambers for his part opined, using the same criteria, that the respondent's credit rating would have been in a significantly lower range without GECUS' explicit guarantee. He expressed the view that the rating would be between B+ to BB- at the lowest and BB+ to BBB- at the highest (Reasons at para. 72).

[28] Preferring the testimony of Dr. Chambers, the Tax Court Judge found that the respondent's credit rating without GECUS' explicit guarantee would have been in the range of BB+ to BBB-. He later reiterated relying on the testimony of Mr. Werner, a former executive of GECUS, that the explicit guarantee was necessary (Reasons at paras. 284-301).

[29] The Tax Court Judge concluded (Reasons at para. 305):

> … under the yield approach, the interest cost savings based on the rating differential between [BBB-/BB+]and AAA, the latter being the rate achieved with the GECUS guarantee in place, work out to approximately 183 basis points or 1.83%. I am of the view that a 1% guarantee fee is equal to or below an arm's length price in the circumstances, as [the respondent] received a significant net economic benefit from the transaction. The net economic benefit exceeds the 1.83% calculated under the yield approach. … [The parties confirmed at the hearing that the above quote in the original reasons erroneously identifies the low end of the rating as BBB-/BBB+ as a result of a clerical error.]

[30] Given this conclusion, the Tax Court Judge rejected the Crown's contention that for purposes of the Part XIII non-resident tax, the guarantee fees were to be treated as deemed dividends rather than deemed interest (Reasons at paras. 306 and 307).

POSITION OF THE CROWN

[31] In support of its appeal, the Crown identified what it describes as four errors of law. The Crown also contends that the Tax Court Judge made a number of palpable and overriding errors and that, in any event, his judgment cannot stand because his behaviour during the trial gave rise to a reasonable apprehension of bias against it.

Errors of law

[32] The Crown first argues that the Tax Court Judge failed to identify the relevant transaction because he took into account a fact which did not exist, namely the removal of the explicit guarantee (Crown's memorandum at para. 39). It follows that the Tax Court Judge analyzed and valued a transaction different from the one that took place (*ibidem*). According to the Crown, the lack of an explicit guarantee should only be considered for the purpose of the valuation exercise, an analysis conducted after the identification of the relevant transaction (Crown's memorandum at paras. 40-44).

[33] The Crown further argues that the Tax Court Judge erred in preferring the evidence of the respondent's expert Dr. Chambers insofar as it failed to address four significant characteristics which were relevant in assessing the value of the explicit guarantee. The characteristics were (i) the control or management assumed by both GECUS and the respondent; (ii) the risk that the respondent would default and the impact it would have on GECUS; (iii) the fact that GECUS and the respondent had common sources of capital and customers; and (iv) GE's public position, its impeccable track record, and the stated importance of maintaining its AAA rating. The Tax Court Judge accepted that these four characteristics were significant in the identification of the correct transfer price. However, by relying on Dr. Chambers' analysis, the Tax Court Judge, in effect, gave no consideration to those factors (Crown's memorandum at paras. 53 and 54).

[34] The Crown further contends that the Tax Court Judge committed a legal error in failing to conduct a "reasonableness" check. In so saying, the Crown recognizes that a "reasonableness" check is not essential in every case. However, it argues that the Tax Court Judge, having recognized the need to conduct such a check, dismissed or ignored "all methods offered by the parties save for one which he had already concluded was unreliable" (Crown's memorandum at para. 55).

[35] Finally, the Crown alleges that the Tax Court Judge committed another legal error by relying on the business judgment of Mr. Werner in reaching his conclusion on the pricing issue. In particular, the Tax Court Judge erred in relying on Mr. Werner's subjective evidence despite the fact that the arm's length principle requires that the evidence adduced be of an objective character. Moreover, the Crown argues that the Tax Court Judge failed to recognize that what was in issue was Mr. Werner's decision to implement the explicit guarantee back in 1988 and to begin charging for it in 1995.

<u>Palpable and overriding errors</u>

[36] The Crown argues that the Tax Court Judge's conclusion that the respondent's credit rating would not have been close to AAA without the explicit guarantee was based on three erroneous findings of fact: the rejection of Mr. Emmer's evidence as well as that of two other experts produced by the Crown; the adoption of the evidence of Dr. Chambers; and the finding that the respondent would be unable to obtain back-up lines of credit in the absence of GECUS' explicit guarantee (Crown's memorandum at paras. 66-88). In making these arguments, the Crown does not dispute the Tax Court Judge's prerogative to prefer the evidence of one witness over the other. It submits that the Tax Court Judge's reasons for preferring the respondent's evidence were "unreasonable, improper or not based on the evidence" (Crown's memorandum at para. 67).

<u>Principles of natural justice and procedural fairness</u>

[37] The Crown's submissions on this issue are two-fold. First, it argues that during the conduct of the trial, the Tax Court Judge's "interventions … were of a nature and extent that transgressed permissible interventions and destroyed the image of judicial impartiality" and that, as a result, the trial "was procedurally unfair, giving rise to a reasonable apprehension of bias" (Crown's memorandum at para. 112). Second, the Crown argues that the reasons for judgment are inadequate as they "do not address outstanding evidentiary objections, rely on cases not raised at the hearing, treat evidence inconsistently, ignore significant evidence of many witnesses and fail to provide adequate analysis on pivotal issues, preventing meaningful appellate review" (Crown's memorandum at para. 113).

[38] At the hearing, the submission of the Crown became much more focussed. Relying on the recent decision of this Court in *Heron Bay Investments Ltd. v. Canada*, 2010 FCA 203 (CanLII) [*Heron Bay*], which was released after the respective memoranda were filed, the Crown took the position that the Tax Court Judge committed the same breach of procedural fairness as that identified in that case, *i.e.* he introduced his own theory of the case which became the linchpin for his conclusion.

POSITION OF THE RESPONDENT

[39] Responding to this last allegation, the respondent took the position during the hearing that *Heron Bay* has no application on the facts of this case. Dealing with the bias argument as originally framed by the Crown in its memorandum, the respondent submits that it is at best an attempt to nullify what turned out to be a bad result from the Crown's perspective. In this respect, the respondent points to the absolute failure on the part of the Crown to raise any sort of objection over the course of the 20-day trial.

[40] Turning to the first alleged error of law, the respondent maintains that the Crown should not be allowed to argue that the Tax Court Judge erred in taking into account the impact of the removal of the guarantee since the valuation methodology that it proposed required the Tax Court Judge to do exactly that (Respondent's memorandum at paras. 40 and 41).

[41] With respect to the allegation that the Tax Court Judge failed to consider relevant economic factors, the respondent points out that the factors in question are not mandatory. As to the alleged misapplication of the business judgment rule, the respondent contends that, contrary to the Crown's assertion, the Tax Court Judge did not rely on this rule in determining the arm's length price (Respondent's memorandum at paras. 42 and 43-46 respectively).

[42] Finally, the respondent takes the position that no palpable and overriding errors of fact have been demonstrated. Specifically, there was a basis in the evidence for the conclusion that its debt issuances would not have been rated close to AAA without the guarantee, that the guarantee was therefore a necessary part of its business plan and that no back-up lines of credit could have been obtained without it (Respondent's memorandum at paras. 47 and 48).

[43] In the event that any of these alleged errors were committed, the respondent submits that the appeal nevertheless cannot succeed. According to the respondent, the Tax Court Judge committed two fundamental errors in his application of the arm's length standard which, when corrected, can only lead to the dismissal of the appeal.

[44] First, the arm's length standard required the Tax Court Judge to situate the parties to the transaction (GECUS and the respondent) as persons unaffiliated with each other. In this context, implicit support would not arise, because "the concept of implicit support is rooted in the familial relationship between affiliated companies" (Respondent's memorandum at para. 55). The Tax Court Judge therefore misapplied the transfer pricing law by "reducing the arm's length price for the guarantee on account of implicit support" (Respondent's memorandum at para. 55).

[45] Second, the respondent argues that the Tax Court Judge erred in adopting the "yield approach" or "benefit to the borrower" approach. If the Tax Court Judge had correctly applied the arm's length standard, he "would have focused on the market price for the guarantee – the price that [the respondent] would have had to pay to acquire a guarantee from the market – rather than measuring its benefit to [the respondent]" (Respondent's memorandum at para. 56). The respondent contends that if the Tax Court Judge had applied the correct standard, there is no doubt that it would have prevailed, since the evidence was undisputed that an "unrelated bank or insurance company would have charged [the respondent] up to 300 basis points to guarantee $7 billion of debt" (Respondent's memorandum at para. 56).

[46] The respondent urges the Court to address these issues whether or not it is necessary to do so in order to dispose of the appeal. It submits that "it would be unfortunate if appellate silence were [sic] construed by the Minister, taxpayers or foreign tax administrations as implied endorsement of the trial judge's approach" (Respondent's memorandum at para. 61).

ANALYSIS AND DECISION

Scope and application of the relevant provisions

[47] There is a fundamental dispute between the parties as to the scope and application of subsection 69(2) and paragraphs 247(2)(*a*) and (*c*) of the Act on the facts of this case. Counsel for the respondent argued before the Tax Court that affiliation benefits enjoyed by the respondent as a result of its non arm's length relationship with GECUS cannot be considered for the purpose of assessing the reasonable arm's length price under these provisions. It follows that the concept of "implicit support", relied upon by the Crown for its proposition that the explicit

guarantee was of no value to the respondent, cannot be considered as it is a by-product of the non arm's length relationship.

[48] The Crown on the other hand maintained, and the Tax Court Judge agreed, that the arm's length principle requires a comparison of the transaction at issue between related parties and the same transaction between independent parties. Only a single fact is changed, namely the transaction is assumed to occur between arm's length parties. As such, affiliation benefits – as the implicit guarantee in this case – are relevant and must be considered in determining the arm's length price. The issue therefore is how much an arm's length party, benefiting from the implicit guarantee, would be willing to pay for the explicit guarantee.

[49] Strictly speaking, it is not necessary to address this issue because, for the reasons which follow, the appeal cannot succeed even if the view adopted by the Tax Court Judge was found to be incorrect. However the issue goes to the core of the decision and should be addressed.

[50] The Tax Court Judge identified the position of the parties as follows (Reasons at para. 187):

> … Do all of the economically relevant factors have to be considered in the determination of an arm's length price for the transaction in order to arrive at a meaningful comparison, as suggested by the Crown? Does the scheme of paragraphs 247(2)(*a*) and (*c*) suggest that all factors which are particular to the non arm's length relationship must be discarded, as suggested by counsel for the [respondent]? …

[51] The issue so framed gives rise to a pure question of statutory construction which must be assessed on a standard of correctness.

[52] It is important to note that the respondent does not contend that the method adopted by the Tax Court Judge has the effect of re-casting the transaction in an impermissible way. The method identifies the transaction as it took place between the respondent and GECUS and seeks to ascertain the benefit to the respondent by comparing, based on recognized rating criteria, the credit rating associated with the implicit support with that associated with the explicit support. The only question is whether implicit support is a factor that can be considered when applying subsection 69(2) and paragraphs 247(2)(*a*) and (*c*), given that it arises by reason of the non arm's length relationship.

[53] The Tax Court Judge answered this question in the affirmative. I can detect no error in this regard.

[54] The concept underlying subsection 69(2) and paragraphs 247(2)(*a*) and (*c*) is simple. The task in any given case is to ascertain the price that would have been paid in the same circumstances if the parties had been dealing at arm's length. This involves taking into account all the circumstances which bear on the price whether they arise from the relationship or otherwise.

[55] This interpretation flows from the normal use of the words as well as the statutory objective which is to prevent the avoidance of tax resulting from price distortions which can arise in the context of non arm's length relationships by reason of the community of interest shared by related parties. The elimination of these distortions by reference to objective benchmarks is all that is required to achieve the statutory objective. Otherwise all the factors which an arm's length person in the same circumstances as the respondent would consider relevant should be taken into account.

[56] In the present case, it is common ground that in the context of the yield method, implicit support is a factor which an arm's length person would find relevant in pricing the guarantee. It follows that it had to be considered. The suggestion that implicit support should be ignored would require the Court to turn a blind eye on a relevant fact and deprive the transfer pricing provisions of their intended effect.

[57] Paragraph 1.6 of the Organization for Economic Co-operation and Development's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* supports this view. It states that the concept of independent parties is used to adjust profits "by reference to the conditions which would have been obtained between independent enterprises in comparable transactions in comparable circumstances" (Reasons at para. 204). The Tax Court Judge properly notes that the concept of independent enterprises is similar to the arm's length concept in that both presuppose that neither party controls the other or is subject to common control (*ibidem*).

[58] This view is consistent with the recent decision of this Court in *Glaxosmithkline Inc. v. Canada*, 2010 FCA 201 (CanLII) [*Glaxo*] (leave to appeal pending before the Supreme Court). The assessments in that case were based on the assumption that Glaxo (a Canadian resident corporation) had paid more than an arm's length price for bulk active ingredients purchased from its foreign non arm's length supplier. The Tax Court Judge held that the only transactions that were relevant for purposes of subsection 69(2) were the bulk purchase transactions.

[59] On appeal before this Court, Glaxo argued successfully that all relevant circumstances were to be taken into account, including the existence of a parallel licensing agreement between Glaxo and another entity within the Glaxo group. In the words of Nadon J.A., the relevant circumstances are those which "an arm's length purchaser, standing in the shoes of [Glaxo], would consider relevant in deciding whether it should pay the price paid by [Glaxo] for the [active ingredient]" (my emphasis) (*Glaxo* at para. 73). Applying this test, 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.

[60] There is equally no merit to the respondent's argument that the method used by the Tax Court Judge is flawed because it identifies the benefit which the explicit guarantee procured rather than the arm's length price which the respondent would have to pay for this guarantee. No doubt, the method seeks to identify the benefit which the explicit guarantee provides. However, it necessarily follows that if the explicit guarantee provides no benefit, an arm's length person, standing in the shoes of the respondent, would not have paid anything towards it. The assessment of the benefit is but a means to ascertain whether a guarantee fee would have been paid by an arm's length party.

[61] The respondent made the further argument that, with respect to the 1998 and subsequent taxation years, only the invocation of paragraphs 247(2)(*b*) and (*d*) would have allowed the Minister to disallow the full amount of the claimed deduction. According to the respondent, disallowing the claimed amount in full is akin to saying that the transaction would not have been entered into between persons dealing at arm's length. The respondent submits that only paragraphs 247(2)(*b*) and (*d*) can be used in these circumstances (Respondent's memorandum at paras. 57-60).

[62] It is not necessary to address this issue. Nowhere in his reasons does the Tax Court Judge discuss or allude to paragraphs 247(2)(*b*) and (*d*). There is therefore no basis for the respondent's concern that appellate silence could be viewed as sanctioning either one of the positions which it now says are in issue (Respondent's memorandum at para. 61).

The Crown's appeal

[63] I now turn to the arguments raised by the Crown in support of the appeal in the order in which they were raised. The Crown alleges the commission of four errors of law. The first is that the Tax Court Judge erred by removing the explicit guarantee for purposes of identifying the relevant transaction. The submission is that he could only do so in conducting the valuation exercise.

[64] As noted earlier, the yield method was based on a comparison between the credit rating which an arm's length party, in the same circumstances as the respondent, would have obtained and the credit rating which would have been obtained without the explicit guarantee (Reasons at para. 259). No one takes issue with the fact that the explicit guarantee had to be notionally removed in order to conduct this exercise. This is what the Tax Court Judge did.

[65] However, the Tax Court Judge went on to consider the impact which the removal of the guarantee would have had if it had been removed (Reasons at para. 247):

> I also note that due consideration must be given as well to the fact that the [respondent]'s debt had been guaranteed by GECUS since 1998. The [respondent]'s investors had grown accustomed to the fact that its debt had been guaranteed by its much larger U.S. parent long before GECUS decided to charge the [respondent] a fee for the guarantee arrangement. In arm's length negotiations, this fact would not go unnoticed. **A prospective guarantor**, when approaching negotiations, 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. Investors would attribute less value to the parent's implicit support in this scenario; most likely, they would wonder why unguaranteed debt was now being issued. The cost of borrowing money would likely be higher than it would be if the [respondent]'s debt had never been guaranteed by GECUS. **The arm's length guarantor** could use this knowledge as leverage in negotiating with the debtor. GECUS and the [respondent] are supposed to bargain as arm's length parties. This history of the guarantee places the [respondent] in a more vulnerable position, as is shown by the evidence considered later on in these reasons.
>
> [My emphasis]

He later criticizes Mr. Emmer for having failed to consider the impact which a decision to drop the guarantee would have had on the respondent's credit rating (Reasons at paras. 282 and 283).

[66] In so saying, the Tax Court Judge lost sight of the fact that the purpose of the yield approach which he adopted was to measure the benefit which the explicit guarantee brought to the respondent in comparison with implicit support. He could not re-cast the transaction on the basis that the explicit guarantee had, in fact, been removed and assess the impact of the removal.

[67] That being said, I do not believe that this error would have altered the conclusion which the Tax Court Judge reached. This conclusion essentially rests on the adoption of the report of Dr. Chambers. As counsel for the Crown submitted herself during the hearing – with an obvious eye towards her bias argument – the impact of the removal of the guarantee was not an important factor in the reasoning adopted by Dr. Chambers. He referred to it as one of twelve considerations that were relevant according to the S&P credit rating criteria and it played a minor role in the conclusion that he reached (Appeal Book, Vol. 13, pp 3725 and 3727 respectively). Significantly, Dr. Chambers' rebuttal report does not criticize Mr. Emmer for his failure to mention this factor (Rebuttal Report, Appeal Book, Vol. 13, pp. 3740-3772), and none of the other six experts who testified on behalf of the respondent relied on this factor.

[68] This is not a close case where a single factor can be said to tilt the balance. The report produced by Dr. Chambers starts from the premise that, with an explicit guarantee in place, the respondent would have benefited from a AAA credit rating. He explains that an explicit guarantee provides for unconditional and legally enforceable support limited only by the guarantor's capacity to pay. This is why such a guarantee will usually result in the subsidiary's credit rating being equalized with that of the parent (Appeal Book, Vol. 13, p. 3718). In contrast, implicit support is based on an expectation of behaviour that is dependent on future economic circumstances, a distinction which the Tax Court Judge found significant after emphasizing the difficulty in predicting economic trends (Reasons at para. 281).

[69] Dr. Chambers explained in his report that it is conceivable that a subsidiary could attract the same credit rating as its parent without an explicit guarantee, but this would require particular circumstances – in essence where the relative economic importance of the subsidiary or its role within the group make abandonment by the parent virtually impossible – which are simply not present in this case (Appeal Book, Vol. 13, p. 3721 and 3722). The Tax Court Judge accepted this view. He found, after confronting the salient aspects of Mr. Emmer's opinion (Reasons at paras. 263-283), that "… it would be an unwarranted leap of faith to conclude that the [respondent]'s credit rating would be equalized with that of its parent if there were no guarantee in place. …" (Reasons at para. 290).

[70] The opinion of Dr. Chambers both as to the existence and extent of a gap is corroborated by independent evidence in the form of two quotes obtained by the respondent from the Royal Bank of Canada (the Royal Bank) and the Bank of Nova Scotia. The quotes were given in response to a strategic query made by the respondent and GECUS in order to test the reasonableness of the proposed fee back in 1995. The query sought to identify the credit rating which these banks would attribute to the respondent on a "stand alone basis", *i.e.* without the explicit guarantee, in pricing the supply of comparable credit ($2 billion or more) over an ongoing period of time (2, 3, 5 or more years). Both quotes confirm that implicit support would attract a lower credit rating level (Reasons at para. 88-99) and the Royal Bank goes so far as to suggest a B rating with a fully drawn cost of borrowing of 250 basis point (Reasons at para. 92).

[71] While these quotes were exploratory in nature and not binding in any way, they nevertheless evidence a spontaneous assessment of the credit risk which professional lenders would have been willing to ascribe to the respondent on a stand alone basis back in 1995.

[72] The Crown insisted on the fact that the Tax Court Judge rejected two of its experts because they had failed to consider the impact of the removal of the guarantee. That is so. The Tax Court Judge referred to this on a number of occasions in discussing the testimony of Mr. Emmer (Reasons at paras. 139 and 279). He even went so far as to observe in a strange twist that Mr. Emmer was uncomfortable in answering questions on this point (Reasons at para. 283). He also mentioned this in rejecting the evidence of Dr. Saunders, another expert called by the Crown (Reasons at para. 298).

[73] However, it remains that this is but one factor amongst others referred to by the Tax Court Judge in rejecting the testimony of Mr. Emmer and Dr. Saunders (as to Mr. Emmer, see Reasons at paras. 265-268 and 274-278; and as to Dr. Saunders, see Reasons at paras. 298-300). When regard is had to these other factors, it is clear that their testimony would have suffered the same fate whether the Tax Court Judge had placed reliance on the impact of the withdrawal of the guarantee or not.

[74] I therefore conclude that the error committed by the Tax Court Judge had no impact on his finding that a gap existed between the credit rating which the respondent would have obtained with and without the explicit guarantee, and that the 1% guarantee fee was within this gap.

[75] Turning to the other alleged legal errors, the Crown argues that the Tax Court Judge erred in law in failing to consider four relevant characteristics in assessing the value of the explicit guarantee. A similar error is said to arise from his failure to conduct a "reasonableness" check.

[76] As to the former, the sole contention is that the Tax Court Judge preferred the evidence of the respondent's expert (Dr. Chambers) who did not rely on these four characteristics (Crown's memorandum at paras. 46-54). With respect, this does not establish that the Tax Court Judge did not have these four characteristics in mind. This is particularly so when regard is had to the fact that the Tax Court Judge highlighted the importance of at least three of these four factors in the course of his reasons (Reasons at paras. 231-305). The Crown's real complaint appears to be that the Tax Court Judge should have preferred the evidence of Mr. Emmer over that of Dr. Chamber's because his report did not reflect these characteristics. This goes to the weighing of the evidence, and as demonstrated earlier, the evidence amply justifies the decision of the Tax Court Judge to prefer the evidence of Dr. Chambers.

[77] As to the "reasonableness" check, the Crown itself recognizes that there is no legal principle that requires such a check to be conducted in every case. The Crown nevertheless maintains that the Tax Court Judge, having found that such a check was required in this case, erred in conducting this check on the basis of a method which he had rejected, *i.e.* the insurance-based method.

[78] With respect, the Tax Court Judge did not hold that a reasonableness test was necessary in this case and he did not purport to conduct such a check. He simply said, in rejecting the insurance-based method, that it was unreliable for the reasons that he identified "… save perhaps … as one method among others to be considered at the stage of the 'sanity check …'" (Reason at para. 257).

[79] In any event, the reasonableness test proposed by the Crown seeks to demonstrate that a 2% guarantee fee would be unreasonable because it represents an excessive portion (*i.e.* 60%) of the respondent's profits when computed without taking into account the cost of the guarantee (Crown's memorandum at paras. 57-59). With respect, I do not see how this can assist the Crown given that the fee actually charged and claimed as a deduction was 1%.

[80] Lastly, the Crown argues that the Tax Court Judge improperly relied on the business judgment of Mr. Werner in order to hold that the explicit guarantee was necessary (Reasons at paras. 290-294). The Crown emphasizes that the transfer pricing adjustment is based on the assumption that the explicit guarantee was superfluous from the perspective of the respondent because it added nothing to what it already had. As such, the question whether the explicit guarantee was necessary is at the core of the transfer price adjustment, and had to be assessed by reference to objective rather than subjective evidence.

[81] However, the reasons show that the Tax Court Judge was mindful of this distinction. At the beginning of the discussion regarding the necessity of the guarantee, he pointed out that there was no need to address this issue because he had already held– after applying the method proposed by the Crown – that the respondent's unguaranteed debt would not be rated close to AAA (Reasons at para. 284). It followed from this that the guarantee was necessary. He nevertheless chose to address it because of the novelty of the issue and the amounts at stake (*ibidem*).

[82] It can therefore be seen that the Tax Court Judge considered Mr. Werner's business judgment only after having found, based on objective evidence, that the explicit guarantee was necessary. I can see no error in this regard.

Palpable and overriding errors

[83] I have already expressed the view that the evidence allowed for the conclusion that Dr. Chambers' evidence was to be preferred over that of Mr. Emmer's and the other experts produced by the Crown who supported a similar view.

[84] The remaining allegation is that the Tax Court Judge committed a palpable and overriding error in finding that the respondent would be unable to obtain back-up lines of credit in the absence of an explicit guarantee (Crown's memorandum at paras. 85-88).

[85] Two experts provided evidence on this issue, Mr. Coombs for the respondent and Mr. Meyerman for the Crown. In the end, the Tax Court Judge accepted the opinion expressed by Mr. Coombs (Reasons at paras. 39 and 40). The Tax Court Judge also explained why GECUS' stand-by facilities could not support back-up lines of credit without GECUS' explicit support (Reasons at para. 297). The conclusion reached by the Tax Court Judge was open to him on the evidence.

[86] At the hearing, counsel for the Crown placed great emphasis on the two quotes obtained from the Royal Bank and the Bank of Nova Scotia (see para. 70 above). According to counsel, the Tax Court Judge could not reach the conclusion that he did when regard is had to this evidence.

[87] With respect, the quotes in question were exploratory in nature. They fall substantially short of establishing that the respondent had available to it the back-up facilities necessary for an unguaranteed debt issue for the required amounts in its sole name without explicit parental support. In any event, even if these quotes did establish a capacity to obtain the required credit facilities, the quoted rates were clearly beyond 1% with the result that any error on the part of the Tax Court Judge on this point would not have affected the outcome.

Procedural fairness

[88] At the hearing of the appeal, the Crown reconfigured its bias argument by reference to the recent decision of this Court in *Heron Bay*, which involved the same judge. In that case, this Court found that the judge had introduced

his own theory of the case, elicited the relevant evidence on this point from his own questioning of the witnesses and relied on this evidence for a conclusion that was critical to his decision, which in that case favoured the Crown.

[89] Similarly, the Crown alleges that the Tax Court Judge in this case developed his own theory of the case, *i.e.* that the removal of the guarantee was relevant and had negative impact on the respondent's credit rating, that he elicited the relevant evidence on this point from the witnesses, and that he relied on this evidence for a critical conclusion in favour of the respondent.

[90] With respect, two of these three factors are plainly missing in this case. First, the Tax Court Judge did not introduce the notion that the impact of the withdrawal of the guarantee was a relevant consideration for the assessment of the respondent's credit rating. It was introduced by Dr. Chambers in his report. Second, for the reasons already expressed, the Tax Court Judge's finding that the withdrawal of the guarantee was relevant did not play a critical role in the outcome.

[91] The record does show that the Tax Court Judge, by his questions, engaged in an excessive pursuit of this issue which made counsel from both sides at times uncomfortable (see for instance, Appeal Book, Vol. 23, pp. 6408, 6409, 6454 and 6455; Vol. 32, pp. 8333, 8334, 8388 and 8389; Vol. 33, p. 8409; Vol. 34, pp. 8644-8651; Vol. 36, pp. 9022-9031 and 9064-9070; Vol. 37, pp. 9240-9242). However, this line of questioning does not establish that bias could reasonably be apprehended against the Crown. What it shows is that the Tax Court Judge became overly concerned about an issue that had no substantial connection with the outcome.

[92] As to the alleged insufficiency of the reasons, it has not been shown that the elaborate reasons given by the Tax Court Judge in this case do not allow for the conduct a meaningful review (*R. v. Sheppard*, 2002 SCC 26 (CanLII), [2002] 1 S.C.R. 869 at para. 28).

[93] I would dismiss the appeal with costs.

"Marc Noël"

J.A.

"I agree
J.D. Denis Pelletier J.A."

"I agree
Robert M. Mainville J.A."

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKET: A-1-10

(APPEAL FROM A JUDGMENT OF THE HONOURABLE JUSTICE ROBERT J. HOGAN OF THE TAX COURT OF CANADA DATED DECEMBER 4, 2009, NO. 2006-1385(IT)G, 2006-1386(IT)G.)

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CONCURRED IN BY:	PELLETIER J.A. MAINVILLE J.A.
DATED:	December 15, 2010

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