

Debt Guarantee Fees and the Arm's-Length Standard

by Thomas Horst

Reprinted from *Tax Notes Int'l*, February 13, 2012, p. 537

Debt Guarantee Fees and the Arm's-Length Standard

by Thomas Horst

Thomas Horst is a managing director of Horst Frisch Inc. in Washington.

A draft of this article was prepared for and presented in a panel discussion of debt guarantee fees sponsored by the National Association for Business Economics on July 26, 2011, in Arlington, Virginia. The author is grateful to Scott Newlon, Bill Morgan, David Rosenbloom, Matthew Frank, and John Magee for their comments on earlier drafts. The views expressed are the author's own, not those of his commentators.

Copyright © 2012 Thomas Horst.

My original purpose in writing this article was to explain more fully why I concluded that the Canadian Tax Court and the Federal Court of Appeals had reached the right result in applying the arm's-length standard to loan guarantee fees in *General Electric Capital Canada, Inc.*¹ In the process of developing my analysis and discussing the issues with many others, I formulated a new framework, which I refer to as the "minority interest" framework, for considering whether a transfer price meets the arm's-length standard. Accordingly, the article describes that new framework and uses it to assess whether an intercompany debt guarantee fee charged to a finance subsidiary is at an arm's-length rate.

Section I of this article summarizes the key points of the Canadian courts' opinions in *General Electric Capital Canada, Inc.* Their ultimate conclusion was that the arm's-length guarantee fee was substantially lower than the reduction in the cost of debt for General Electric Capital Canada, Inc. (GECCAN) resulting from the guarantee.

Section II describes two alternative frameworks (which I refer to as the "separate entity" framework

and the "separate MNE group" framework) for determining an arm's-length guarantee fee that were advanced in *General Electric Capital Canada, Inc.* Section II also explains my third alternative, the "minority interest" framework, which hypothesizes that the subsidiary has a minority shareholder (for example, Berkshire Hathaway) and is fully mindful of its fiduciary duties to its minority shareholder in its business dealings with its parent company.

Section III provides a hypothetical example that illustrates the interaction between the subsidiary's business plan and its total cost of debt, including guarantee fees paid to its parent company. In my view, an arm's-length rate generally requires that both the parent and the subsidiary be no worse off than they would have been if they hadn't undertaken the intercompany transaction at issue (in this case, the debt guarantee). If the subsidiary adopts a business plan that maximizes the consolidated companies' "economic" profit, the arm's-length rate may be a fraction of what the subsidiary would have had to pay an independent financial institution to guarantee its debt. The independent-companies rate is not an arm's-length rate because it yields a profit result that would be unacceptable to a minority shareholder of the subsidiary.

Section IV draws an analogy between the product price a sales and marketing subsidiary (for example, Ford Canada) pays to its parent company (Ford U.S.) for a particular product (the Ford Taurus) and the fee a financial subsidiary (for example, GE Capital Canada)

¹*General Electric Capital Canada, Inc. v. The Queen*, 2009 TCC 563 and 2010 FCA 344. For a fuller analysis of the Canadian courts' opinions, see Thomas Horst, "How to Determine Tax-Deductible, Debt-Related Costs for a Subsidiary," *Tax Notes Int'l*, May 16, 2011, p. 589, *Doc 2011-8026*, or *2011 WTD 94-8*.

pays to its parent company (GE Capital U.S.) to guarantee its debt. Both of these intercompany transactions are at a different level of the market from the transactions those companies have with their unrelated customers.

Finally, Section V concludes that in many transfer pricing cases, the best evidence of an arm's-length price will be based on a comparable transaction with a third party. But in some cases, the facts and circumstances of transactions between unrelated parties differ from those of the transactions between related parties, so the prices paid by the unrelated parties do *not* provide reliable evidence of what the related parties would have done had they been dealing at arm's length. In my view, the guarantee fees at issue in *General Electric Capital Canada, Inc.* fall into this latter category, as do the reimbursements for stock option costs that were at issue in the *Xilinx* case.²

I. *General Electric Capital Canada, Inc.*

To summarize the key points in *General Electric Capital Canada, Inc.*, the two Canadian courts concluded:

- GECCAN would have had a B+/BB- credit rating on a stand-alone basis — that is, if GECCAN were an independent company, rather than a subsidiary of its U.S. parent company, GE Capital Corp. (GECUS).
- Absent any written guarantees of its debt, but taking account of its ownership by GECUS, GECCAN's credit rating would have been "notched up" from B+/BB- to BB+/BBB- to reflect creditors' expectation that GECUS would take steps to prevent GECCAN from defaulting on its debt (sometimes referred to as the "implicit guarantee").
- Because GECUS provided explicit written guarantees to GECCAN's creditors, GECCAN's debt enjoyed the AAA credit rating that the rating agencies assigned to GECUS's own debt.
- In the absence of GECUS's guarantee, GECCAN would have been unable to execute its business plan because the Canadian commercial paper market was geared to the highest investment-grade borrowers.
- The benefit to GECCAN of GECUS's explicit guarantee was equal to the 1.83 percentage point differential between the average interest rates on BB+/BBB- rated debt and AAA rated debt, respectively.
- The arm's-length guarantee fee was less than GECCAN's 1.83 percent point interest rate saving because in arm's-length dealings, GECCAN

would have expected to keep some of the 1.83 percentage point benefit for itself. Because the guarantee fee actually charged by GECUS, 1 percent per annum, was notably less than GECCAN's 1.83 percentage point benefit, the Canadian Tax Court accepted that the arm's-length charge was no less than the 1 percentage point guarantee fee actually charged.

II. Alternative Frameworks

Were the Canadian courts correct in concluding that under GECCAN's facts and circumstances the arm's-length guarantee fee was substantially below what GECCAN would have paid a third-party guarantor for the same guarantee? The debate over the answer to this question is ultimately a debate over what is meant when a transfer price is said to be at an arm's-length rate. An arm's length price generally means the price that would have been paid by unrelated parties in the same transaction under the same circumstances.³ But what does it mean that unrelated parties are dealing with each other under the "same circumstances" as related parties do?

In *General Electric Capital Canada, Inc.*, two alternative frameworks were presented:

- The taxpayer (GECCAN) argued that the correct framework was to consider the subsidiary as a separate (stand-alone) entity that was independent of not only its own parent company, but also any other parent company (separate entity framework).
- The Canadian Tax Court rejected the taxpayer's separate entity framework in favor of the Crown's framework of a subsidiary of one multinational firm dealing at arm's length with the parent company of a second (but otherwise identical) multinational firm. Relying on this alternative "separate multinational enterprise group" (separate MNE group) framework, the Canadian Tax Court concluded that it was appropriate to "notch up" GECCAN's estimated credit rating to reflect GECUS's "implicit support" for any GECCAN debt not covered by a written guarantee.

In this article, I would like to advance a third framework for evaluating what is an arm's-length price, which I will refer to as the "minority interest" framework. Suppose that a parent company owns more than 50 percent, but less than 100 percent, of the shares of a subsidiary. Because the parent company owns more than 50 percent of the equity, the subsidiary's financial results are included in the consolidated financial statements of its parent company (the equity interest of the subsidiary's minority shareholders are reflected on the

²See Thomas Horst, "Employee Stock Options and the *Xilinx* Case," *Tax Notes Int'l*, Sept. 7, 2009, p. 849, *Doc 2009-18204*, or 2009 *WTD 171-9*.

³This is a restatement of the second sentence in IRC reg. section 1.482-1(b)(1), which defines an arm's-length "result."

consolidated balance sheet separately from the equity of the parent company's own shareholders). But even though the subsidiary is "controlled" by its parent company, the subsidiary's board of directors still has a fiduciary duty to protect the interests of its minority shareholders by assuring that the terms of its dealings with its parent company meet the arm's-length standard.⁴

In actual practice, minority shareholders may have difficulty in assuring that the subsidiary's board of directors has fully discharged its fiduciary duties. But since we are considering at this point what an appropriate framework is, I will assume that the subsidiary's minority shareholder is Berkshire Hathaway, and through its representation on the subsidiary's board of directors, the minority shareholder is well informed about the subsidiary's business and the scope and terms of its dealings with its parent company. Accordingly, the framework I would apply to evaluate an arm's-length guarantee fee is that of a subsidiary that faithfully and effectively discharges its fiduciary duty to its minority shareholders. In discharging those duties, the subsidiary agrees to a transaction with the parent company if, and only if, taking account of the transfer price, the subsidiary expects an economic gain from the transaction.

Conversely, the parent company agrees to a transaction with its subsidiary if and only if, taking account of the transfer price, the parent company expects an economic gain from the transaction. I would assume that the multinational company taken as a whole undertakes an intercompany transaction if the company expects an economic gain from the transaction before income taxes.⁵ The amount of the company's overall gain does not depend on what transfer price is applied. Rather, the transfer price determines how the overall gain is divided between the parent and the subsidiary. Because the parent's own gain equals the overall (consolidated company) gain from the transaction minus the gain allocated to the subsidiary, an arm's-length price is one that allocates some gain to each of the parties.

I think the minority interest framework is helpful because it clarifies how arm's-length dealings between two affiliates of the same MNE group could actually

occur, rather than requiring one to imagine hypothetical situations that bear little resemblance to any real-world dealings.

III. A Hypothetical Example

To determine whether a guarantee fee meets the arm's-length standard under my "minority interest" test, consider a hypothetical example described in detail in the table that appears at the end of this article. Four scenarios are presented:

- In Scenario 1, a parent guarantees the subsidiary's debt and does not charge a guarantee fee. The subsidiary funds 90 percent of loans to its customers with parent-guaranteed debt and 10 percent with equity, some fraction of which is obtained from minority shareholders. Equity capital is required by a finance company to cushion the risk that some customers may default on their loans. The cost of equity capital is an imputed cost equal to the rate of return that the subsidiary's shareholders, including its minority investors, could obtain on other equity investments of comparable risk. The cost of equity is higher than the cost of debt because it includes a premium to compensate equity investors for the additional risk they take by investing in equity, not debt. The subsidiary's overall cost of funding its loans is a weighted average of its low cost of debt and its high cost of equity; the weighting of the two costs is based on the subsidiary's 90-10 capital structure. The interest rate the subsidiary charges its third-party customers is sufficient to recover not only its overall cost of funding those loans, but also a residual amount referred to as its "economic" profit. This residual economic profit represents the maximum guarantee fee the subsidiary could pay its parent company and still earn the rate of return required by its equity investors.
- Scenario 2 is the same as Scenario 1 except the guarantee fee is at the rate (1.83 percent per annum) the parent would have charged an unrelated customer having the same credit rating as the subsidiary's unguaranteed debt, which is also assumed to be the rate an unrelated financial institution would have charged the subsidiary absent the parent's guarantee. For convenience, I will refer to this rate as the "independent-companies" rate. Under Scenario 2, the subsidiary continues to follow the same business plan and charge the same interest rate to its customers as it charged under Scenario 1. However, a guarantee fee is charged at the independent-companies rate. Under the assumptions of my example, the dollar amount of the guarantee fee under Scenario 2 exceeds not only the subsidiary's economic profit under Scenario 1, but also the subsidiary's net interest income under that scenario. That is, the subsidiary has a net interest loss. The result under Scenario 2

⁴See *In the Matter of Ford Motor Company of Canada, Limited*, Superior Court of Justice (Ontario, Canada), Commercial List Court File No. 98-3075, Jan. 22, 2004.

⁵In some cases, a parent company may not want to guarantee the debt of its subsidiary even though the subsidiary's cost of debt would be reduced if it had the parent's guarantee. For example, in *GE Capital Canada, Inc.*, GE Financial Corp. was a regulated insurance company, also a subsidiary, but whose debt was not guaranteed by the U.S. parent company. GE Financial Corp's debt was rated A+, which is four notches below the parent company's AAA rating.

would be totally unacceptable to minority shareholders of the subsidiary, who require a rate of return that is no less than their cost of equity capital. In my view, this is *not* an arm's-length result.

- Under Scenario 3, the subsidiary revises its business plan and increases the average interest rate charged to customers to the rate required to recover its own cost of funds (including a guarantee fee at the 1.83 percent independent-companies rate). While the subsidiary pays the guarantee fee to its parent company, its cost of debt is the same as it would have been if it borrowed money from third parties without the parent company's guarantee. Under Scenario 3, most of the subsidiary's erstwhile customers switch their business and borrow from other financial institutions offering lower interest rates. Consequently, the subsidiary's volume of loans to its customers under Scenario 3 shrinks to one-tenth of the loan volume under Scenarios 1 and 2. But given the higher interest rates charged to customers, the subsidiary can now afford (1) to pay its parent company a guarantee fee at the 1.83 percent independent-companies rate and (2) to provide a rate of return to its shareholders that equals their 12 percent cost of capital. So unlike Scenario 2, Scenario 3 yields a guarantee fee for the parent company at the independent-companies rate and a rate of return on equity equal to the minority shareholders' cost of equity capital.
- While Scenario 3 yields a result that may be acceptable to both the parent and the minority shareholders of the subsidiary, the result is not optimal from the perspective of the consolidated company. From that perspective, the cost of debt to fund 90 percent of the subsidiary's loan portfolio reflects the parent company's low cost of debt, not the higher cost that the subsidiary incurs when it pays a guarantee fee to the parent company. That is, *the optimal result for the consolidated companies requires that the subsidiary adopt the business plan and charge its customers the interest rate it would have charged if paid no guarantee fee.* Given the larger loan volume at the lower interest rate, the subsidiary not only has an economic profit before payment of the guarantee fee, but that economic profit is high enough to allow the subsidiary to pay a guarantee fee higher than that under Scenario 3.

To demonstrate this point, Scenario 4 assumes that the subsidiary follows the optimal business plan, but pays a guarantee fee that is (1) less than its total economic profit under Scenario 1, but (2) greater than the dollar amount of the guarantee fee under Scenario 3. Consequently, both the subsidiary and the parent would be better off under Scenario 4 than under Scenario 3. But to achieve a superior result from both companies' perspectives requires:

- the parent company to charge a guarantee fee at a rate that is a fraction of the independent-companies rate; and
- the subsidiary to disregard the rate of the guarantee fee in setting the interest rates that it charges to customers and instead adopt the business plan that maximizes the consolidated companies' economic profit.

IV. Levels of the Market

Many commentators assert that the independent-companies rate is by definition the arm's-length rate. My contrary view is that the arm's-length fee for a parent's guarantee of a subsidiary's debt may be a fraction of the independent-companies rate because the facts and circumstances of the parent's dealings with its subsidiary are different from the facts and circumstances of either company's dealings with independent parties. The key difference results from the fact that the subsidiary pursues the business plan that maximizes the economic profit of the consolidated company, while an independent company pursues a business plan that maximizes its own separate-company economic profit. To understand this difference, it may also be useful to draw an analogy to the familiar distinction between different levels of the market for a product.

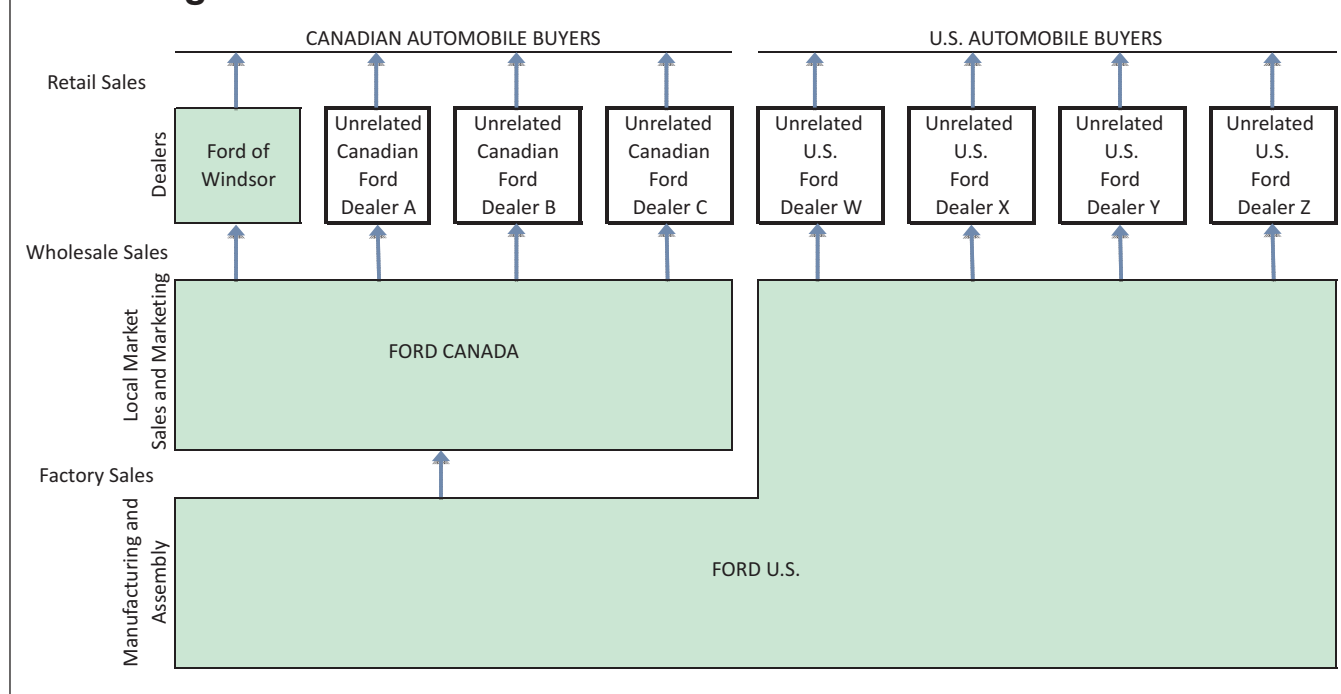
A. Levels of a Product Market

Consider the familiar transfer-pricing situation of a U.S. manufacturing company (for example, Ford Motor Co.) that markets its products (here, automobiles) in both the United States and Canada. Assume that within the United States, the parent company (Ford U.S.) sells a particular model (for example, a Ford Taurus) to its franchised U.S. Ford dealers at a wholesale price of \$25,000, and the U.S. Ford dealers resell that model at a weighted average retail price of \$27,000. So there are two "market" prices — \$25,000 and \$27,000 — for the same Ford Taurus, corresponding to the two levels of the market — wholesale and retail.

Ford also sells the Taurus to franchised Canadian dealers, which resell the Taurus to Canadian customers. For simplicity, assume that the wholesale and average retail prices in Canada translate to the same U.S. dollar amounts — \$25,000 and \$27,000 — as the U.S. wholesale and retail prices. Ford has a separately incorporated Canadian subsidiary (Ford Canada) that markets Ford automobiles in Canada and supports its Canadian Ford dealers. To fund Ford Canada's sales and marketing activities, Ford U.S. sells the Ford Taurus to Ford Canada at an assumed "factory" price, \$24,500, a \$500 discount from the \$25,000 Canadian wholesale price. Figure 1 summarizes this example.

In principal, the best way to determine whether the \$24,500 factory price is at an arm's-length rate would be to identify the price paid in a comparable sale by an automobile manufacturer and an unrelated Canadian marketer (CUP). Ford U.S. does sell identical automobiles to unrelated buyers (its U.S. Ford dealers) for

Figure 1. Levels of the Market for Sales of Ford Automobiles



\$25,000. But no one would maintain that an arm's-length factory price for the Ford Taurus was equal to either the \$25,000 wholesale market price or the \$26,000 retail market price. Even the lower price, \$25,000, is too high to allow Ford Canada to recover its sales and distribution costs, much less to make a profit. That is, the wholesale and retail prices do not set arm's-length prices for Ford U.S. sales to Ford Canada because they aren't at a comparable level of the market.

Assuming there were no arm's-length factory sales by automobile manufacturers to country or regional marketers, neither the CUP method nor any other transaction-based transfer pricing method could be applied. Rather, the factory prices for Ford automobiles would likely be determined by applying a profit-based method: the comparable profits method or the profit split method. Profit-based methods generally seek to determine whether a transfer price produces an acceptable result from the perspective of one or both parties. In short, even when market prices are available, they aren't applied if the facts and circumstances of the market sales (including the level of the market) are not comparable to the facts and circumstances of the related-party transaction.

B. Levels of the Debt Market

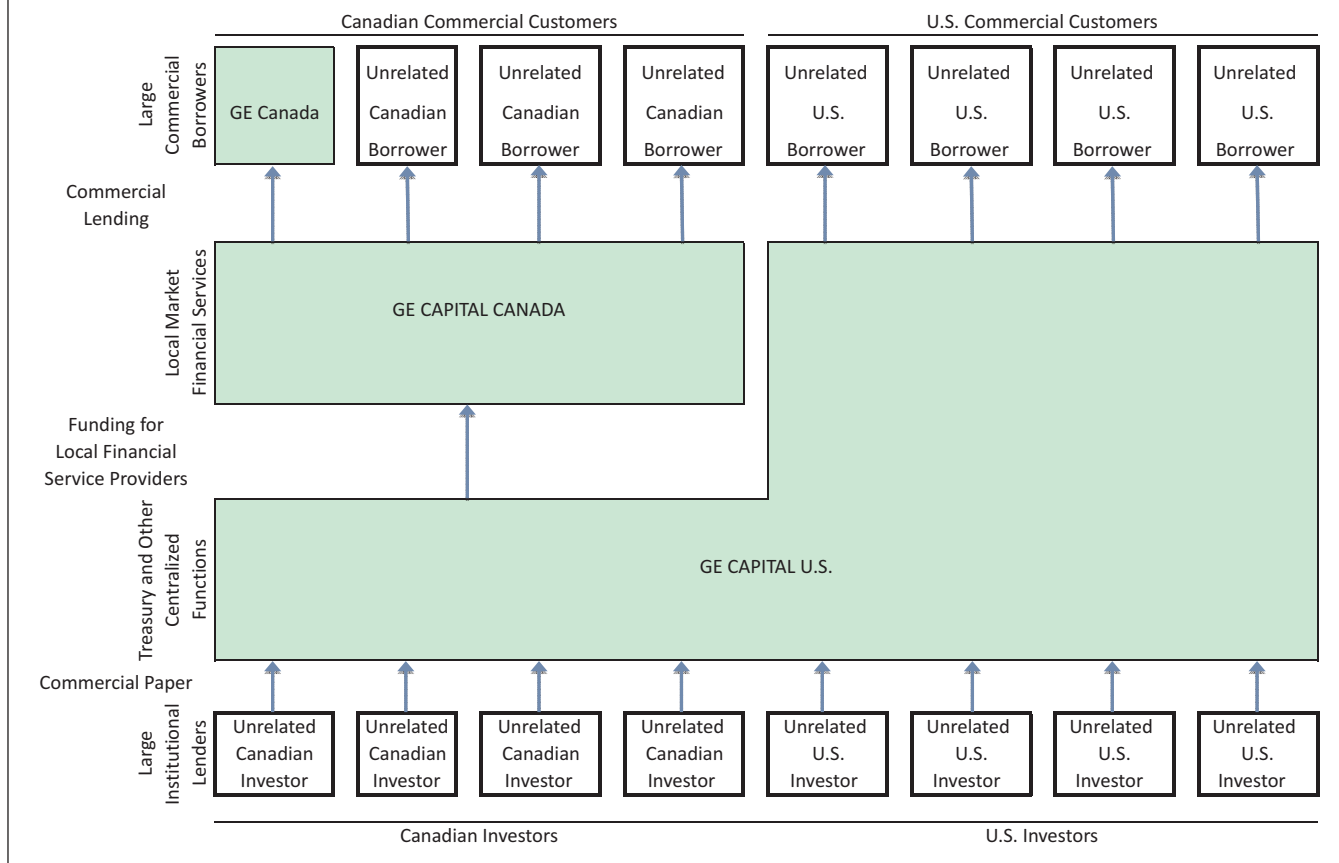
Just as there are different levels of the market for products, so too are there different levels of the market for debt. And just as the different levels of a product market have different market prices, the different levels

of the market for debt are characterized by different interest rates. For example, the LIBOR is the average interest rate that large money-center financial institutions (for example, Citibank) offer to lend funds to other large money-center financial institutions. By contrast, the interest rates those banks *pay* investors for large deposits that are not subject to reserve requirements or other bank regulations (Eurodollar deposits) are slightly less than the contemporaneous LIBOR. Similarly, the interest rates those banks *charge* for loans to customers will be higher than the contemporaneous LIBOR and in many cases equal to LIBOR plus a fixed premium (for example, 80 basis points) that reflects the creditworthiness of the borrower, the term of the loan, or the type and amount of the loan collateral.

GE Capital was not a bank and could not fund its loans to commercial customers with inter-bank borrowings. But because of its AAA credit rating, GE Capital could issue commercial paper, which from an institutional lender's perspective is an alternative to making a Eurodollar bank deposit. Because the interest cost of GE Capital's commercial paper was comparable to the interest cost of a large bank's Eurodollar deposit, GE Capital could compete with large banks in making loans to commercial and industrial borrowers.

Just as the U.S. parent company, GE Capital U.S., lent to major commercial and industrial customers in the United States, its Canadian subsidiary, GE Capital Canada, lent to major commercial and industrial customers in Canada. To execute this business plan and be competitive with the leading Canadian banks, GE

Figure 2. Levels of the Market for Financial Services to Commercial Customers



Capital Canada needed to raise funds by issuing low-cost Canadian commercial paper. Given its lower creditworthiness, the only way GE Capital Canada could issue commercial paper was with the guarantee of its parent company, GE Capital U.S.

The way I view these relationships is depicted in Figure 2. The bottom of Figure 2 is drawn as if GE Capital U.S. were issuing commercial paper to Canadian investors and re-lending the proceeds to GE Capital Canada, which has the same economic substance as GE Capital's guaranteeing GE Capital Canada's commercial paper. GE Capital Canada uses the commercial paper proceeds (together with the equity capital invested by GE Capital U.S.) to fund its commercial loans to Canadian borrowers (including GE Canada, the Canadian sales and marketing subsidiary that sells GE products in Canada). GE Capital Canada's loans to commercial and industrial Canadian borrowers are at the same level of the debt market as are GE Capital U.S.'s loans to its own U.S. commercial and industrial borrowers.

Quite possibly, the commercial and industrial borrowers that are GE Capital customers in the United States and Canada include companies with the same

credit rating that GE Capital Canada would have if its debt were not guaranteed by its parent company. Presumably, the average interest rates those borrowers would have paid during the years at issue would have exceeded the commercial paper rate by 183 basis points. But in my view, those interest rates reflect a different level of the market from intercompany loans or loan guarantees by GE Capital U.S. to GE Capital Canada. GE Capital Canada would not pay the same (high) interest rates that GE Capital charges unrelated commercial and industrial borrowers, just as Ford Canada would not pay the same (high) prices of Ford automobiles that Ford U.S. charges is unrelated U.S. dealers. In the absence of any comparable transactions between unrelated parties that are at the same level of the market as the intercompany transactions, one must revert to transfer pricing methods based on the profitability of the intercompany transaction for one or both related parties.

V. Conclusion

An arm's-length rate requires that both the parent and the subsidiary be no worse off than they would

have been if they had not undertaken the transaction at issue. The independent-companies rate is not an arm's-length rate because that rate yields a result that would be totally unacceptable to a minority shareholder. Under the facts and circumstances in my hypothetical example, when the subsidiary adopts a business plan that maximizes the consolidated company's economic profit, the arm's-length rate is a fraction of the independent companies' rate. The critical difference between the facts and circumstances of independent companies and those of a parent and a finance subsidiary is analogous to a difference in the level of a market.

In many instances, the best evidence of an arm's-length price *will be* based on a comparable transaction with a third party (for example, Ford Canada's sales of automobiles to Ford-owned dealers, or GE Capital Canada's loans to the GE Canada sales and marketing affiliate). But in other cases, the facts and circumstances of transactions between unrelated parties differ from those of the transactions between related parties, so the prices paid by the unrelated parties *do not* provide reliable evidence of what the related parties would have done if they had been dealing at arm's length. In my view, guarantee fees paid by local finance subsidiaries to their parent companies fall into this latter category. ♦

Impact of Debt Guarantee on Profits of Subsidiary, Parent, and Consolidated Company

	Scenario 1 — Parent Guarantee at No Charge	Scenario 2 — Parent Guarantee With 1.83% Fee #1	Scenario 3 — Parent Guarantee With 1.83% Fee #2	Scenario 4 — Parent Guarantee With 0.25% Fee
Subsidiary's Results				
1. Interest Expense	5.00%	5.00%	5.00%	5.00%
2. Guarantee Fee Paid to Parent	0.00%	1.83%	1.83%	0.25%
3. Total Cost of Debt (line 1 + line 2)	5.00%	6.83%	6.83%	5.25%
4. Cost of Equity	12.0%	12.0%	12.0%	12.0%
5. Debt/Total Capital Ratio	90%	90%	90%	90%
6. Total Cost of Capital ((line 5 x line 3) + (100% - line 5) x line 4)	5.70%	7.35%	7.35%	5.93%
7. Average Lending Rate	6.00%	6.00%	7.35%	6.00%
8. Total Loans to Customers	\$1,000.0	\$1,000.0	\$100.0	\$1,000.0
9. Total Debt (line 8 x line 5)	\$900.0	\$900.0	\$90.0	\$900.0
10. Total Equity (line 8 - line 9)	\$100.0	\$100.0	\$10.0	\$100.0
11. Interest Income (line 8 x line 7)	\$60.0	\$60.0	\$7.3	\$60.0
12. Interest Expense (line 1 x line 9)	\$45.0	\$45.0	\$4.5	\$45.0
13. Guarantee Fee Paid to Parent (line 2 x line 9)	\$0.0	\$16.5	\$1.6	\$2.3
14. Total Cost of Debt (line 12 + line 13)	\$45.0	\$61.5	\$6.1	\$47.3
15. Net Interest Income (line 11 - line 14)	\$15.0	-\$1.5	\$1.2	\$12.8
16. Rate of Return on Equity (line 15 ÷ line 10)	15.0%	-1.5%	12.0%	12.8%
17. Cost of Equity (line 4 x line 10)	\$12.0	\$12.0	\$1.2	\$12.0
18. Subsidiary's "Economic" Profit (line 15 - line 17)	\$3.0	-\$13.5	\$0.0	\$0.8
Parent Company and Consolidated				
19. Guarantee Fee Paid to Parent (line 13)	\$0.0	\$16.5	\$1.6	\$2.3
20. Consolidated "Economic" Profit (line 19 + line 18)	\$3.0	\$3.0	\$1.6	\$3.0