Dockets: 2006-1385(IT)G
2006-1386(IT)G

BETWEEN:

GENERAL ELECTRIC CAPITAL CANADA INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on common evidence from May 25 to June 5,
from June 9 to June 18 and on July 2 and 3, 2009, at Toronto, Ontario.

Before: The Honourable Justice Robert J. Hogan

Appearances:

Counsel for the Appellant:	Al Meghji Martha MacDonald Neil Paris Joseph Steiner
Counsel for the Respondent:	Naomi Goldstein Justine Malone Myra Yuzak

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JUDGMENT

The appeals from the assessments made under Parts I and XIII of the *Income Tax Act* for the 1996, 1997, 1998, 1999 and 2000 taxation years are allowed in accordance with the attached reasons for judgment, and the assessments are vacated.

The parties will have until December 18, 2009 to arrive at an agreement on costs, failing which they are directed to file their written submissions on costs no later than December 21, 2009. Such submissions are not to exceed five pages.

Signed at Montréal, Québec, this 4th day of December 2009.

"Robert J. Hogan"

Hogan J.

Citation: 2009 TCC 563
Date: 20091204
Dockets: 2006-1385(IT)G
2006-1386(IT)G

BETWEEN:

GENERAL ELECTRIC CAPITAL CANADA INC.,
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REASONS FOR JUDGMENT

Hogan J.

SUMMARY OF ISSUE

[1] GE Capital US ("GECUS") charged the Appellant a fee for guaranteeing its debts owing to third-party creditors. The Appellant deducted that fee in respect of its 1996 to 2000 taxation years. The Minister of National Revenue (the "Minister") reassessed the Appellant, denying the deduction of the fee and adding Part XIII withholding tax because he believed the Appellant received no economic benefit from the guarantee and, as a result, the "arm's length" price for the guarantee would be zero. Part XIII tax is charged on the basis that the payment of the fee is deemed to be a dividend. The issue to be determined by this Court is whether the "arm's length" price for the service is at least 100 basis points (the Appellant's position) or zero (the Minister's position).

FACTUAL BACKGROUND

[2] At the commencement of the trial, the Court received a response to a request to admit the truth of certain facts (hereinafter the "statement of agreed facts") as well as the authenticity of certain supporting documents contained in a joint book of documents. I shall reproduce in part hereunder the statement of agreed facts before

summarizing the witnesses' testimony and reviewing the relevant documentary evidence.

The Appellant and Its Position in the GE Corporate Group

1. The Appellant was originally incorporated as Genelco Finance Limited under the laws of Canada in 1963. The Appellant changed its name to Canadian General Electric Credit Limited in 1969 and to Genelcan Limited in 1973. The Appellant adopted the corporate name General Electric Capital Canada Inc. ("GE Capital Canada") [Appellant] in 1988.

2. The Appellant has been an indirect, wholly-owned subsidiary of General Electric Company ("GE Company") [GE], a United States company, since incorporation.

3. [GE] carried on industrial businesses and financial services businesses during the years under appeal through a large number of legal entities around the world. The corporate structure of [GE] had separate ownership groups for the industrial and financial services businesses.

4. The financial services ownership group was organized under General Electric Capital Services, Inc. ("GE Capital Services") [GECSUS], an [*sic*] United States corporation that was a wholly-owned, direct subsidiary of [GE].

5. A principal subsidiary of [GECSUS] was General Electric Capital Corporation ("GE Capital US") [GECUS], a United States corporation that was wholly-owned, direct subsidiary of [GECSUS] during the years under appeal.

6. During the years under appeal, the Appellant was a wholly-owned, indirect subsidiary [of GECUS].

7. At all material times, the Appellant and [GECUS] did not deal with each other at arm's length within the meaning of the *Income Tax Act* (the "Act").

Business of [GECUS]

8. [GECUS] was a financial services company during the years under appeal and carried on a number of financial services businesses, as described as below.

9. In essence, [the GECUS] business model was to borrow funds from the capital markets at the lowest possible cost and then use the borrowed funds to lend or lease to other parties on profitable terms.

10. The business of [GECUS] originally related to financing the distribution and sale of consumer and other products of [GE]. By the mid-1990s, however, the types and brands of products financed by [GECUS] and the financial services offered by [GECUS] had become significantly more diversified, and very little

of the financing provided by [GECUS] involved products manufactured by [GE].

11. During the years under appeal, [GECUS] provided a wide variety of financing, asset management, and insurance products and services in the following five industry segments, directly or through its subsidiaries around the world . . . :

    (i) Consumer Services — private-label and bank credit card loans, personal loans, time sales and revolving credit and inventory financing for retail merchants, auto leasing and inventory financing, mortgage servicing, and consumer savings and insurance services;
    (ii) Equipment Management — leases, loans and asset management services, including sales, for portfolios of commercial and transportation equipment, including aircraft, trailers, auto fleets, modular space units, railroad rolling stock, data processing equipment, containers used on ocean-going vessels, and satellites;
    (iii) Specialized Financing — loans and financing leases for major capital assets including industrial facilities and equipment and energy-related facilities; commercial and residential real estate loans and investments; and loans to and investments in management buy-outs, including those with high leverage, and corporate recapitalizations;
    (iv) Mid-Market Financing — loans and financing and operating leases for middle-market customers, including manufacturers, distributors and end users, for a variety of equipment that includes data processing equipment, medical and diagnostic equipment, and equipment used in construction, manufacturing, office applications and telecommunications activities;
    (v) Specialty Insurance — financial guaranty insurance (municipal bonds and structured finance issues); private mortgage insurance; and creditor insurance covering international customer loan repayments.

Business of the Appellant

12. The Appellant was a financial services company during the years under appeal. It carried on in Canada some of the lines of financial services businesses that [GECUS] carried on in the United States and other jurisdictions outside of Canada, as described below.

13. In essence, the Appellant's business model was to borrow funds from the capital markets at the lowest possible cost and then use the borrowed funds to lend or lease to other parties on profitable terms.

14. The Appellant was initially formed to assist in the financing of products manufactured or distributed by General Electric Canada Inc. ("GE Canada"). By the mid-1990s, however, substantially all of the products financed by the Appellant and its subsidiaries were products manufactured by companies other than GE Canada and or its affiliates, and the Appellant also provided a range of other financial services.

15. At all material times, the Appellant and its Canadian subsidiaries carried on a number of businesses in Canada. Four of the larger businesses were:

    (i) a **commercial and transportation equipment financing business** serving manufacturers, distributors and end users with a broad range of financial products for equipment acquisitions. This business had locations across Canada and worked with the transportation, construction, printing, telecommunications, manufacturing, aeronautics and wholesale/resale distribution industries;
    (ii) a **fleet vehicle leasing and management business** involved in the leasing and financing of automobiles, light trucks, vans, buses and medium and heavy duty trucks and trailers to business users. The Appellant and its subsidiaries also provided specialised transportation management programmes to clients relating to maintenance management, national account purchasing, fuel purchasing and insurance;
    (iii) a **real estate financing business** for a wide range of income-producing properties, including office buildings, shopping centres, apartment complexes, condominiums, industrial buildings and warehouses;
    (iv) a **technology management services business**, which distributed computer products and offered financial arrangements ranging from sales to day rentals, operating leases and finance type leases. The scope of products and services included personal computers, mini-computers and test and measurement equipment supported by field technicians, networking consultants and other technology management services.

16. Other businesses carried on by the Appellant and its subsidiaries during the years under appeal included:

    (i) a **private label credit card business**, whereby the Appellant or its subsidiary entered into and administered credit accounts with customers of participating retailers in return for programme marketing support;
    (ii) an **auto leasing business** providing retail leasing programmes to dealers of new motor vehicles. The Appellant or its subsidiary purchased the vehicles and leases from the dealers on a non-recourse basis;
    (iii) short and long term renting and leasing of over-the-road commercial semi-trailers, chassis and storage containers and mobile modular office buildings, as well as the sale and financing of such equipment;
    (iv) a **full service railcar leasing business** offered to industrial shippers and Canadian railways. The Appellant or its subsidiary offered a range of management services to lessees including tracking mileage, arranging for leases, insurance, inspections, maintenance and repair work, as well as billing, collecting and remitting rents.

17. The Appellant's business grew rapidly during the period under appeal . . . .

. . .

19. The Appellant (consolidated) represented between 2 to 2.3 percent of the consolidated assets of [GECUS] and between 3 and 4.4 percent of the consolidated revenues of [GECUS] during the period under review . . . .

Debt Securities

20. The Appellant's business strategy required substantial amounts of capital, which the Appellant obtained by issuing debt in the form of commercial paper and unsecured debentures (the "Debt Securities").

21. The Appellant's Debt Securities were purchased exclusively by third parties unrelated to [GE] or [GECUS].

Description of Commercial Paper

22. The Appellant and its predecessor corporations issued short term promissory notes (also known as "commercial paper") on Canadian markets from the 1970s until early 1999.

23. During the years under appeal, the Appellant issued commercial paper on almost a daily basis. [The Appellant]'s Commercial Paper Program represented at least ten percent of the Canadian corporate commercial paper market.

24. During the years under appeal, the Appellant issued commercial paper under short term promissory note programs established in 1989 and 1996 (the "Commercial Paper Program") . . . .

25. The Commercial Paper Program prescribed a maximum aggregate principal amount outstanding of $7 billion. The actual aggregate principal amount of promissory notes outstanding during the Appellant's 1996 to 1998 taxation years varied from a low of approximately $1.7 billion to a high of approximately $3 billion . . . .

26. The Commercial Paper Program prescribed a maximum term of 270 days for the Appellant's promissory notes.

27. The Appellant issued commercial paper on a regular basis for a variety of principal amounts, maturities, interest rates and discounts . . . .

28. The Appellant's commercial paper was issued in Canadian and United States dollars and traded on the Canadian commercial paper market.

29. The Appellant's issuances of commercial paper were generally administered by financial institutions in Canada (the "Dealers").

30. The Appellant made its final issuance of commercial paper on February 4, 1999.

Description of Unsecured Debentures

31. The Appellant issued unsecured debentures on European markets from at least 1988 until 1997 (the "Unsecured Debentures").

32. The Unsecured Debentures typically were issued for a term of five to ten years and provided for the periodic payment of interest. The Unsecured Debentures were denominated in a variety of currencies, including Australian dollars, Canadian dollars, Luxemburg francs, Swiss francs and United States dollars . . . .

33. The Appellant issued the Unsecured Debentures under individual offerings and as part of the multi-issuer Euro Medium Term Note Program (a simpler and less costly mechanism for issuing Unsecured Debentures relative to individual offerings). In general, the Unsecured Debentures were listed for trading on the Luxemburg stock exchange. . . .

34. The Appellant's issuances of Unsecured Debentures were fully underwritten by a syndicate of financial institutions (the "Managers" or "Underwriters").

35. In respect of each issuance of Unsecured Debentures, the Managers agreed jointly and severally to procure subscriptions and payment for the Unsecured Debentures, or failing that, to subscribe and pay for the Unsecured Debentures on their own account. The Managers, the Appellant and [GECUS] formalised their agreement in a written Subscription Agreement . . . .

36. Subject to the Subscription Agreement, each Manager was allotted a specific amount of the Unsecured Debentures as the extent of its underwriting commitment . . . .

37. One Manager or a small group of Managers was allotted a significant amount of each issuance as its underwriting commitment (the "Lead Manager" or "co-Lead Managers").

. . .

Management of the Debt Securities

39. The Treasury Department of [GECUS] managed the Appellant's issuances of Debt Securities. On a daily basis, this department collected data from the Appellant's business units and determined the Appellant's net cash position for the day.

40. If the Appellant were short on cash for the day, the Treasury Department approached the commercial paper market through the Dealers. If the Appellant

were long on cash for the day, the Treasury Department decided how much debt to repay based upon debts that were maturing.

41. The Appellant also funded its acquisitions of asset portfolios, receivable portfolios and shares in other companies with commercial paper.

42. In respect of Unsecured Debentures, the Treasury Department performed an analysis of the Canadian debt position in total, including maturity levels and the proportions of commercial paper and Unsecured Debentures. On the basis of this analysis, the Treasury Department looked for opportunities with Managers to extend the maturity of the Appellant's debt from commercial paper into longer-term debt.

Implementation of the Guarantee

43. Prior to a corporate reorganisation in 1988, the Appellant's issuances of commercial paper and unsecured debentures had been guaranteed by GE Canada, a Canadian company that was an indirect subsidiary of [GE] and that carried on industrial businesses in Canada at the time.

44. [GECUS] began guaranteeing the Appellant's issuances of commercial paper and unsecured debentures after the corporate reorganisation in 1988.

45. Since 1988, including the years under appeal, [GECUS] unconditionally guaranteed payments due under the Debt Securities issued by the Appellant.

46. The full text of the [GECUS] guarantee was printed on the promissory notes issued under the Appellant's Commercial Paper Program . . . .

47. Similarly, the full text of [GECUS]'s guarantee was printed on the notes representing the Unsecured Debentures . . . .

Credit Ratings

48. In general, a credit rating is a credit rating agency's opinion of the general creditworthiness of an obligor, or the creditworthiness of an obligor with respect to a particular debt security or other financial obligation, based on relevant risk factors.

49. An "issue rating" is a credit rating agency's current opinion of the creditworthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program (including ratings on medium term note programs and commercial paper programs).

50. An "issuer rating" is a credit rating agency's opinion of an obligor's overall capacity to meet its financial obligations and focuses on the capacity and willingness of an issuer to meet all of its obligations as they become due.

Credit Rating Agencies

51. S&P [Standard and Poor's] is a credit rating agency based in the United States.

52. Moody's Investors Service ("Moody's") is a credit rating agency based in the United States.

53. The Dominion Bond Rating Service ("DBRS") is a credit rating agency based in Canada.

54. The Canadian Bond Rating Service ("CBRS") was a credit rating agency based in Canada during the years under appeal. CBRS was acquired by S&P on or around October 31, 2000.

Credit Ratings in Respect of [GECUS]

55. During the years under appeal, S&P assigned an issuer rating of AAA to [GECUS], the highest issuer rating assigned by S&P.

56. During the years under appeal, Moody's assigned an issuer rating of AAA in respect of [GECUS], the highest rating on Moody's credit rating scale.

Credit Ratings in Respect of the Appellant

57. During the years under appeal DBRS assigned to the Appellant's Commercial Paper Program a public credit rating of "R-1 high". According to the DBRS credit rating scale, commercial paper rated R-1 (high) is of the highest credit quality, indicating an entity possessing unquestioned ability to repay current liabilities as they fall due . . . .

58. In 1999, CBRS assigned to the Appellant's Commercial Paper Program a public credit rating of "A-1 (High)". The rating of A-1 (High) was the highest rating on the CBRS credit rating scale for commercial paper . . . .

59. S&P and Moody's assigned credit ratings to the Appellant's Unsecured Debentures and Commercial Paper Program during the years under appeal as part of detailed credit research and ratings reports on [GECUS] . . . .

60. No credit rating agency assigned a public issuer rating to the Appellant during the years in issue.

The Guarantee Fee

Implementation of the Guarantee Fee

61. Prior to 1995, [GECUS] did not charge the Appellant for the guarantees of the Appellant's Debt Securities.

62. In 1995, the Appellant's Board of Directors resolved to pay a fee for [GECUS]'s guarantees of the Appellant's Debt Securities . . . .

63. The Appellant and [GECUS] entered into written agreements concerning the guarantee fees ("Guarantee Fee Agreements") . . . .

64. Pursuant to the Guarantee Fee Agreements, [GECUS] agreed to guarantee the Appellant's Debt Securities and the Appellant, in turn, agreed to pay a fee to [GECUS] equal to 1% (or 100 basis points) per annum of the principal amount of the Debt Securities outstanding from time to time during a year.

65. Guarantee fees were payable in respect of unsecured debentures issued on or after April 13, 1995.

66. In respect of commercial paper, guarantee fees were payable in respect of issuances on or after October 31, 1995 . . . .

Calculation and Payment of the Guarantee Fees

67. During the years under appeal, the guarantee fees were calculated on a quarterly basis by the Treasury Department at [GECUS].

68. The Appellant typically paid the annual guarantee fee to [GECUS] in the year following accrual.

Tax Treatment of the Guarantee Fees by the Appellant

69. In computing its income for the years in question, the Appellant deducted the guarantee fees that had accrued in each year, in the following amounts:

Taxation Year	Guarantee Fees
1996	$30,974,070
1997	$37,149,390
1998	$36,339,640
1999	$17,586,207
2000	$14,378,876

70. The Appellant withheld and remitted to the Receiver General for Canada withholding tax at the rate of 10% from the guarantee fees paid to [GECUS] in respect of the 1996 to 2000 taxation years, pursuant to paragraph 212(1)(b) and subsection 214(15) of the Act and Article XI of the Canada-United States Income Tax Convention.

The Minister's Assessments and Reassessments

71. In reassessing the Part I tax payable by the Appellant, the Minister disallowed the full amount of guarantee fees claimed as deductions by the Appellant, as follows:

Taxation year	**Guarantee Fees Disallowed as Deductions in Computing Income**
1996	$30,974,070
1997	$37,149,390
1998	$36,339,640
1999	$17,586,207
2000	$14,378,876

72. The Minister made the following assessments of the Appellant's tax payable under Part XIII of the Act (collectively, the "Part XIII Assessments"):

Notice of Assessment Number	**Notice of Assessment Date**	**Taxation Year-End**	**Adjustment to Part XIII Tax**
6240554	March 11, 2004	December 31, 1996	$1,548,704
6240555	March 11, 2004	December 31, 1997	$1,857,470
6240556	March 11, 2004	December 31, 1998	$1,816,982
6240557	March 11, 2004	December 31, 1999	$879,310
6240558	March 11, 2004	December 31, 2000	$718,944

. . .

[3] The Appellant called 13 witnesses, seven of whom were qualified as expert witnesses. The Respondent called seven witnesses, five of whom were qualified as expert witnesses.

SUMMARY OF APPELLANT'S WITNESSES' TESTIMONY

Testimony of Roman Oryschuk

[4] Mr. Oryschuk testified that he was the president and CEO of GE Capital Solutions ("GECS"), a Canadian subsidiary of the Appellant, during the taxation years under review. Previously, he had run the equipment leasing business for the National Bank of Canada, and he became a GE employee when that business was sold to the Appellant.

[5] He was responsible for the Canadian business operations of the entity. He led a very dynamic sales team which was able to expand the mid-market equipment leasing business of the Appellant over the taxation years in question. He was not

responsible for meeting the financing needs of the business. That function was performed by GECUS, the guarantor of the Appellant's debt.

[6] The operations of the Appellant expanded rapidly over the period in question. The total assets of the business grew from $1.3 billion as Mr. Oryschuk's arrival to approximately $5 billion when he left to take on his new duties in Europe for a GE affiliate.

[7] Mr. Oryschuk testified that, similar to the situation in all of the GE enterprises, he had operational autonomy provided his operations could meet the financial benchmarks all GE entities were expected to meet. In the GE culture, an annual review was performed to determine growth prospects for the business, new markets, etc. If the Canadian operations failed to meet their financial targets, it was clear in the witness's mind that the businesses could be sold or wound down. According to the witness, this could be done through a sale of the assets backing a particular loan or leasing portfolio, or of the entire business if the problem was more general in nature.

[8] Mr. Oryschuk further testified the AAA rating obtained by the Appellant had an impact on his company in that it allowed funds to be obtained at competitive rates.

Testimony of Jeffrey Werner

[9] Mr. Werner testified that GE, headquartered in Fairfield Connecticut, was the parent of 12 separate lines of business, which ran independently of each other. Of these lines of business, 11 were considered part of the industrial businesses, e.g. aircraft engines, major appliances, plastics, etc. The remaining business line was the financial services business.

[10] Within the financial services business, GE held all the shares of GECSUS, a holding company for the entities in this particular business line. GECSUS, in turn, held shares in GECUS, GE Global Insurance Holding Corp. and Employer's Reinsurance Corp.

[11] The main purpose of GECUS was to fund the operations of affiliated companies by issuing commercial paper and unsecured debt instruments. After raising the funds needed, GECUS would provide those funds to the affiliates through intercompany transfers.[1] To avoid liquidity problems, GECUS maintained backup lines of credit in an amount equal to 50% of its outstanding commercial paper.

[1] Trial transcript, page 136, lines 1-4.

GECUS handled all the treasury functions for all of the businesses within the GE Capital group, including the Appellant.[2]

[12] After the reorganization in 1988, the Appellant became an affiliate of GECUS. The guarantees that were provided by the Appellant's former Canadian parent (GE Canadian Holdings Ltd.) remained with the Canadian parent[3] and GECUS began to provide guarantees to secure the Appellant's debt around April 1989.[4] There were no guarantee fees charged by GECUS from 1988 until 1996, the first taxation year under appeal.

[13] Although no fee was charged initially, as part of a transfer pricing review Mr. Werner was asked to make a recommendation to Mr. Jim Parke, CFO of GECUS, as to what guarantee fee the Appellant should be charged. Mr. Werner ultimately recommended a guarantee fee of 100 basis points (1%) of all new debt issued.

[14] In determining the guarantee fee to be charged, Mr. Werner testified, he understood the fee had to be an arm's length price.[5] Mr. Werner compared the rates that the Appellant would be able to obtain if it could borrow with the guarantee (investment grade rating) with the rate at which it could borrow without the guarantee (a non-investment grade rating).[6] This method is referred to as the yield curve approach and it reflects the costs of borrowing money given various maturities and different credit ratings. The differential or spread was determined to be between 100 and 300 basis points (1% to 3%).[7]

[15] The guarantee fee of 100 basis points (1%) was ultimately recommended by Mr. Werner since he believed it accurately represented the benefit the Appellant had been enjoying. Moreover, had there been arm's length negotiations, the Appellant would have kept some of the benefit for itself.[8]

[16] Mr. Werner testified that he did not believe the Appellant would have been rated AAA without the guarantee.[9] He denied GECUS would necessarily have

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[2] GE had its own treasury group to raise funds for the 11 industrial businesses, although this was rarely done since GE was asset heavy and had positive cash flow of $10 billion per year, leaving it with sufficient resources to provide funding to the industrial businesses.
[3] Trial transcript, page 293, lines 8-16.
[4] *Ibid.*, page 297, lines 20-25.
[5] *Ibid.*, page 224, lines 9-13.
[6] *Ibid.*, page 227, lines 2-5.
[7] *Ibid.*, page 228, lines 13-18.
[8] *Ibid.*, page 229, line 1, to page 230, line 6.
[9] *Ibid.*, page 214, lines 10-16.

supported the Appellant's operations; more precisely, he claimed that GECUS could have just walked away if there was no explicit guarantee in place.[10]

[17] During cross-examination, Mr. Werner conceded that its AAA rating was very important to GECUS.[11] GECUS, as an unregulated financial services company, did not have access to low-cost borrowings made available through deposits, to which banks do have access. Accordingly, GECUS and the Appellant were principally reliant on credit markets.[12] In the commercial paper market, they had to constantly roll over commercial paper.

[18] Mr. Werner admitted that GE valued its reputation, as stated in its public filings. He also admitted the Appellant used some of the same dealers and underwriters as those that are used by GE subsidiaries throughout the world to issue its commercial paper and bonds.[13]

Testimony of Laurence Booth, Ph.D.

[19] Dr. Booth has a bachelor's degree in science and economics from the London School of Economics, an M.A., an M.B.A. and a Ph.D. in business administration from Indiana University.[14] He is a professor of finance at the University of Toronto, holds the CIT Chair at the Rotman School of Management, and is in charge of the investment banking track in the MBA program at the University of Toronto.[15] His experience includes acting as an expert witness in financial and capital market matters, mainly with regard to regulated industries.[16] Specifically, in the case at bar, Dr. Booth was asked to give an opinion on:

(a) whether it was prudent and reasonable for the Appellant to obtain a guarantee from GECUS; and
(b) what the market value of that guarantee was.[17]

[20] Dr. Booth acknowledged that he is not an expert in establishing credit ratings and stated that he was not asked to do so. In fact, he noted that most U.S. or multinational parents guarantee the debt obligations of their Canadian subsidiaries.[18]

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[10] *Ibid.*, page 232, line 13, to page 233, line 15.
[11] *Ibid.*, page 382, lines 1-19.
[12] *Ibid.*, page 367, lines 3-9.
[13] *Ibid.*, page 359, lines 2-15; page 371, line 24, to page 372, line 1.
[14] *Ibid.*, page 512, lines 3-8.
[15] *Ibid.*, page 511, lines 1-22.
[16] *Ibid.*, page 513, lines 3-5.
[17] *Ibid.*, page 519, line 23, to page 520, line 4.
[18] *Ibid.*, page 542, lines 6-9.

[21] Unregulated financial services companies usually operate without a captive retail deposit base. Conversely, regulated banking institutions have extensive retail networks and generate a significant amount of their funds from customers' deposits which, in turn, are covered by the Canada Deposit Insurance Corporation. This allows banks to have a large source of low-cost and stable funds.[19] Without a guarantee, financial services companies such as the Appellant would be competing at a significant disadvantage. According to Dr. Booth, the Appellant would not, in the absence of the guarantee, have been able to raise capital as it did.

[22] Dr. Booth maintained that the guarantee also offered other advantages to the Appellant; for instance, it did not have to pay placement fees when issuing commercial paper through the dealer network. In addition, the Appellant avoided the need for backup lines of credit, which would have been required if the debt was not guaranteed. Typically, 100% of an issuer's commercial paper must be supported by backup lines of credit to guard against the refinancing risk that arises during periods of financial instability where investors look to government-issued treasury bills and the like. The Appellant did not have to negotiate backup lines of credit because GECUS was viewed as the ultimate creditor and had arranged for the availability of such credit facilities. That arrangement coupled with the explicit guarantee allowed the Appellant to piggyback on the sterling credit rating of GECUS.

[23] Dr. Booth testified that he was of the opinion that the Appellant could not have received a AAA rating or an R-1 high commercial paper rating without an explicit guarantee from GECUS.[20] The guarantee and the rating allowed the Appellant's commercial paper to be virtually risk free, similar to treasury bills.[21] The guarantee meant the Appellant could raise significant sums of money several times a day, over the telephone, from a variety of investors.[22] Dr. Booth admitted that the GE name alone would "notch up" the credit rating; however, he believed it extremely unlikely that this would have got the Appellant a credit rating sufficient to permit access to the commercial paper and swap markets in the volumes the Appellant needed to finance its Canadian operations.

[24] Dr. Booth acknowledged the capital markets would be shocked if GECUS allowed its Canadian subsidiary to default, assuming it had not guaranteed the Appellant's indebtedness. However, Dr. Booth advanced two circumstances in which the parent could allow a subsidiary to default: a single episodic shock that causes a huge loss of money or a gradual deterioration of the business.[23] Dr. Booth pointed out

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[19] *Ibid.*, page 543, lines 2-18.
[20] *Ibid.*, page 554, lines 3-12.
[21] *Ibid.*, page 585, lines 19-22.
[22] *Ibid.*, page 584, lines 20-25.
[23] *Ibid.*, page 590, lines 19-25.

that it was the economic value of the subsidiary that was important, not whether it had the same name as, or was considered a "core" or "strategically important" subsidiary of, GECUS. Dr. Booth asserted that if the parent's economic incentive is to walk away, then the parent will walk away, thereby changing any classification, e.g. core or strategically important, that the subsidiary may have.[24]

Testimony of Brian Neysmith

[25] Mr. Neysmith, now retired, was one of the co-founders of CBRS in 1973. After the company was sold to S&P in 2000, he remained with S&P until January 2003.[25] His main responsibility, after CBRS was sold, was to "merge the two companies together to harmonize the rating criteria [and] the rating methodology".[26] Mr. Neysmith was the person who "signed off" on, and authorized the issuance of, new ratings.[27]

[26] During the relevant period, CBRS's share of long-term debt and commercial paper rating in the Canadian medium-term market was significant; for example, in the commercial paper market CBRS held between 50% and 60% of the rating business.

[27] Mr. Neysmith stated that both CBRS and DBRS approached credit analysis from the same fundamental basis: looking at the ongoing financial condition of the company and its history.[28] Even though the ratings were similar in about 75% of the cases, the companies and issuers would usually request both: CBRS and DBRS.[29]

[28] Mr. Neysmith testified that CBRS would not have given the Appellant a AAA rating without GECUS' guarantee. According to the witness, CBRS would have rated the Appellant lower than A+ or A-1 high.

Testimony of Mark Fidelman

[29] Mr. Fidelman is an economist currently employed as a tax director at Deloitte Tax LLP in the U.S. His expertise pertains to transfer pricing and insurance industry pricing.[30]

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[24] *Ibid.*, page 644, line 19, to page 645, line 3.
[25] *Ibid.*, page 683, lines 2-16.
[26] *Ibid.*, page 683, lines 17-22.
[27] *Ibid.*, pages 686, lines 10-18.
[28] *Ibid.*, page 700, lines 19-24.
[29] *Ibid.*, page 701, line 8.
[30] *Ibid.*, pages 961-962.

[30] Mr. Fidelman used a model designed for pricing insurance products for the purpose of determining an arm's length price for the guarantee.

[31] According to the witness, a debt guarantee can be viewed as a form of credit insurance. Financial guarantees are sold as insurance products to improve creditworthiness with respect to both public-sector and private-sector debt. Examples of public entities in the U.S. availing themselves of financial guarantee insurance on debt issuances are municipalities with regard to economic development and general revenue bonds.[31]

[32] According to Mr. Fidelman, the stand-alone credit rating of the Appellant during the valuation period was in the range of BB to BB+ under an insurance pricing model.[32]

[33] According to the witness, an insurer would not take into account the benefit of an "implicit guarantee" from a subsidiary's parent when pricing insurance. As an insurer would expect to be asked to pay out under credit default insurance if the debtor defaulted, the insurer would not expect the debtor's parent to pay out on the basis of implicit support and, as a result, would take no account of an implicit guarantee when establishing an appropriate premium for the product.

[34] Asked to comment on a Respondent's expert, Dr. Saunders, Mr. Fidelman asserted that the expected loss cost is just one component of the total guarantee fee charged that would meet the requirements of the arm's length principle, and that the other major component is a return on risk capital.[33] Mr. Fidelman disagreed with the calculation by Dr. Saunders that was based on the Basel II regulatory regime. In the first place, Basel II was not in place during the years under study; rather, Basel I was applicable during that period.[34]

[35] Basing his opinion on the insurance pricing methodology, Mr. Fidelman concluded that the 1% fee charged the Appellant by GECUS does not generate the return on capital an insurer would demand for an insurance-based guarantee. On this basis, the fee paid by the Appellant does not exceed what would be charged in an arm's length relationship.

<u>Testimony of John Frederick Coombs</u>

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[31] *Ibid.*, pages 990-992.
[32] *Ibid.*, page 1048, lines 11-14.
[33] *Ibid.*, page 3358, lines 18-22.
[34] *Ibid.*, page 3359, lines 8-25.

[36] Mr. Coombs is a banker holding the office of vice-chairman of TD Securities and senior vice-president of TD Bank Financial Group, head of Europe and Asia Pacific.[35] This witness was qualified as an expert in banking and credit matters.[36] He was not qualified as a transfer pricing or credit rating expert.

[37] Mr. Coombs concluded the Appellant would not have been able to borrow the amount of funds it did in the Canadian commercial paper market without GECUS' guarantee.[37]

[38] Mr. Coombs testified the Appellant's debt-to-equity ratio was higher than that of other independent companies in the market. The Appellant's ratio was between 10 to 1 and 12 to 1 whereas other unregulated financial institutions had ratios between 5 to 1 and 8 to 1. On the basis of this factor alone, Mr. Coombs believed the Appellant would not have been rated investment grade.[38]

[39] Without a formal guarantee from the parent company, Mr. Coombs asserted, Canadian banks would have extended only limited credit facilities to the Appellant. Those facilities would have been short-dated (in the 3- to 12-month range) foreign exchange, derivative and operating credit facilities in amounts ranging up to perhaps $100 million in total.[39] The inference made by Mr. Coombs was that the Appellant would not have been able to negotiate large enough backup lines of credit to support its commercial paper program without the guarantee by its parent and, as a result, the Appellant would not have been rated investment grade.

[40] Mr. Coombs maintained that his opinion would not be influenced by the fact that a credit rating agency may have been willing to give the issuer an investment grade rating. Banks generally use the public debt ratings as a guideline or ceiling, but assign internal ratings based on their own fundamental analysis. TD Securities frequently assigns internal risk ratings below those determined by rating agencies. Banks would provide some accommodation, but Mr. Coombs did not believe the kind of accommodation given would have been sufficient for the Appellant to operate its business during the relevant period.[40]

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[35] *Ibid.*, page 1120, line 22 and page 1121, lines 5-9.
[36] *Ibid.*, page 1131, lines 17-23.
[37] *Ibid.*, page 1140, lines 20-25.
[38] *Ibid.*, page 1155, lines 1-19.
[39] *Ibid.*, page 1158, line 20, to page 1159, line 14.
[40] *Ibid.*, page 1169, line 23, to page 1170, line 4.

[41] In his opinion, without the guarantee, the Appellant would not have been able to obtain from banks the backup lines of credit required in order to get a DBRS or, at the time, CBRS, investment grade rating.[41]

[42] Mr. Coombs dismissed the implicit guarantee argument, reasoning that if the parent would never let the Appellant fail, Canadian banks would expect the commitment to be backed up by a formal guarantee.[42]

Testimony of William John Chambers, Ph.D.

[43] Dr. Chambers has been a professor at Boston University since 2005. He received a B.A. from College of Wooster in 1968 and an M.A., an M.Phil. and a Ph.D. in economics at Columbia University, the latter degree having been conferred in 1975.[43] He began his career with S&P in 1983 and held a number of senior positions with the company until he left in 2005.

[44] Dr. Chambers was asked to opine on the credit rating of the Appellant for the taxation years under review, assuming its indebtedness was not guaranteed by GECUS. He was instructed to use for this purpose the S&P rating criteria and methodology applicable in the years in question.[44]

[45] Dr. Chambers explained that in preparing a credit rating for a company that is a subsidiary of another, S&P first determines the stand-alone creditworthiness of the parent and the subsidiary. At this stage, Dr. Chambers asserted, the rating agencies take into account the relationship between the parent and the subsidiary in terms of the management services and expertise provided by the former, and their common name.[45] However, neither S&P nor Moody's would take into account the possibility that the parent might inject funds into the subsidiary or provide financial support through a different means.[46]

[46] Dr. Chambers concluded that the stand-alone creditworthiness of the Appellant, using the S&P rating criteria, would have been a single B+ or a BB- during the relevant period.[47]

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[41] *Ibid.*, page 1173, lines 2-9.
[42] *Ibid.*, page 1174, lines 13-15.
[43] *Ibid.*, page 1303, lines 14-20.
[44] *Ibid.*, page 1332, line 25, to page 1333, line 3; page 1333, lines 9-14.
[45] *Ibid.*, page 1794, lines 9-17.
[46] *Ibid.*, pages 1792-1794.
[47] *Ibid.*, page 1333, lines 9-14.

[47] There was much confusion during the trial regarding the distinction between a stand-alone and status quo rating. My understanding was that both of these ratings look at the subsidiary as a separate business as opposed to part of an integrated group. However, the distinction between the two is that the status quo rating takes into account the benefits of the common name, the parent's management team and existing business arrangements, such as intercompany loans. The stand-alone rating abstracts from these conditions. Because Dr. Chambers takes these elements into account, his first step results in a status quo rather than stand-alone rating.

First Step: Analysis of the Appellant on a Stand-Alone/Status Quo Basis

[48] Dr. Chambers assigned a B+ to BB- rating to the Appellant for various reasons. The Appellant was a profitable entity, growing rapidly in a very stable marketplace. Yet, rapid growth can be a red flag for financial institutions. The Appellant was thinly capitalized and its degree of leverage was quite high. Further, its profitability was also decreasing during the period. Although the Appellant had reduced its leverage and was growing rapidly, it did not seem able to continually generate profits or increasing profits. Dr. Chambers noted the Appellant's return on equity rose during 1995 and 1996, and then started to deteriorate.[48]

[49] Dr. Chambers looked at the competitive environment which was and continues to be very intense. The market share of large banking institutions declined, but overall the sector was growing rapidly: about 10% per year during the relevant period.[49]

[50] In that competitive market, the Appellant was a new entrant. The GE group had a clear mandate to grow, which translated into numerous acquisitions.[50] Overall, their growth was about 20% per year compounded.

[51] Dr. Chambers believed the Appellant's rating would have been stronger if the Appellant had maintained a debt-to-equity ratio of 7 to 1 or 8 to 1, similar to GECUS'.[51]

[52] This element was weighted heavily by Dr. Chambers in establishing the stand-alone/status quo rating. While the company was profitable, its fast-paced growth could lead to management problems. Further, the increase in loan loss provisions and the degree of leverage made the company susceptible to additional risks.[52]

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[48] *Ibid.*, page 1356, line 5, to page 1357, line 6.
[49] *Ibid.*, page 1359, lines 3-20.
[50] *Ibid.*, page 1360, line 19, to page 1361, line 7.
[51] *Ibid.*, page 1366, line 16, to page 1367, line 2; page 1367, lines 14-17.
[52] *Ibid.*, page 1385, lines 2-19.

Second Step: Factoring the Parent-Subsidiary Relationship into the Stand-Alone/Status Quo Rating

[53] Dr. Chambers testified that once all of the relevant factors are properly weighed by the rating analyst, the analyst will seek to rank the subsidiary in a spectrum that ranges from entities considered "core" on one end to "independent" on the other. "Core", in rating agency nomenclature, generally describes a subsidiary that would be supported by the parent in virtually all circumstances. "Core" tends to connote that the subsidiary constitutes a critical part of the group's business, represents a large proportion of existing business, and enjoys a large market share in terms of the central products or markets of the group. A subsidiary is more likely to be deemed "core" if its financial performance and growth exceed that of the aggregate business; thus, support is very unlikely to be required in this circumstance. In other words, the subsidiary is a key part of the organization; essentially, the organization could not function in its present form without that entity being present.[53] Not surprisingly, subsidiaries considered "independent" are not expected to benefit from parental support as they can be sold or closed down without any impact on the financial well-being of the group as a whole.

[54] In situations where the parent is deemed to be financially stronger and more creditworthy than its subsidiary, Dr. Chambers acknowledged, two approaches are applied to determine the subsidiary's final credit ratings. These methodologies are referred to as the top-down and the bottom-up approaches.[54]

[55] Under the top-down approach, the starting point is the parent's superior credit rating. Dr. Chambers believed one of the problems with the top-down approach is that the parent and subsidiary come to the marketplace when they both are generally doing well.[55] However, ratings are also about looking at what can happen during periods of financial stress. According to the witness, the bottom-up approach is more sound because it starts from the stand-alone or status quo rating and is adjusted to take into account the amount of support that can reasonably be anticipated in the circumstances.[56]

[56] Dr. Chambers asserted that a weak entity owned by a strong parent usually, although not always, will enjoy a stronger rating than it would on a stand-alone basis. Assuming the parent has the ability to support its subsidiary during a period of

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[53] *Ibid.*, page 1449, lines 18-22.
[54] *Ibid.*, page 1427, lines 15-25.
[55] *Ibid.*, page 1428, lines 9-14.
[56] *Ibid.*, page 1429, lines 7-13.

financial stress, the spectrum of possibilities still ranges from ratings equalization at one extreme to very little or no help from the parent's credit strength at the other. Where there is a large gap, rating agencies will demand more evidence of likely support.[57]

[57] In his report, Dr. Chambers canvassed the factors used by S&P to bridge the rating gap, which include strategic importance, percentage ownership, management control, shared name, domicile in the same country, common source of capital, financial capacity for providing support, significance of amount of investment, investment relative to amount of debt, the nature of other owners, management's stated posture, the track record of the parent company in similar circumstances and the nature of potential risks.[58]

[58] According to the witness, factors are not equally weighted in the evaluation. In general, economic incentive is the most important factor on which to base judgments about the degree of linkage that exists between a parent and a subsidiary.[59]

[59] Dr. Chambers looked at the factors one by one in light of the GE organization as a whole. For example, operating in Canada was strategically important for GECUS, as it was part of their overall plan for international expansion. At the same time, Dr. Chambers noted that the Appellant's assets represented a very small amount of GECUS' consolidated assets. For that reason, Dr. Chambers could not infer that the Appellant had a lot of strategic importance in the overall scheme of things in the GE organization.[60]

[60] Dr. Chambers recognized the Appellant was a wholly-owned subsidiary[61] and that a parent will be more inclined to support a wholly-owned subsidiary than one in which it has a minority's stake.[62]

[61] The witness noted that while there was overall management control from the top-down, on a day-to-day basis there was a lot of operating discretion left to the local operation.[63] The Appellant did not perform any essential or key services for its parent company.

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[57] *Ibid.*, pages 1432-1433.
[58] *Ibid.*, page 1443, lines 5-14. See also Exhibit A-85, expert report of Dr. William Chambers, page 18.
[59] *Ibid.*, page 1443, lines 20-25.
[60] *Ibid.*, page 1454, line 16, to page 1455, line 5.
[61] *Ibid.*, page 1456, lines 14-19.
[62] *Ibid.*, page 1706, line 23, to page 1707, line 2.
[63] *Ibid.*, page 1457, lines 3-17.

[62] The witness observed that the Appellant and GECUS did not have the same source of capital. Both companies were tapping the wholesale capital markets for their funding, but the specific instruments used were different. The Appellant focused primarily on the Canadian market and the European markets, whereas GECUS and the other subsidiaries borrow on the U.S. and international markets.[64]

[63] Midway through the spectrum, the "strategically important" category runs the gamut between the two extremes ("core" and "independent"). Some aspects of the business, i.e. a particular product or geographical location, are important as a growth engine for the organization or to stabilize the group.[65]

[64] Dr. Chambers concluded this part of his analysis by determining that the Appellant would be ranked as an "independent" subsidiary of GECUS by the rating agencies, meaning GECUS would be expected to provide little financial support to the Appellant in times of financial stress, if one assumes, that is, that its debt obligations were not guaranteed by GECUS.[66]

Credit Rating of the Appellant Without the Guarantee

[65] Concerning the final rating of the Appellant, Dr. Chambers stated that, without an explicit guarantee, the stand-alone rating might be raised one or two notches on the basis of its being within the GE Capital group of companies. Thus, if the Appellant's stand-alone rating was determined to be B+, its final rating would reasonably have been BB- or BB. If the stand-alone rating was determined to be BB-, the final assigned rating to the non-guaranteed obligations would be BB or BB+.[67]

[66] Dr. Chambers' opinion was influenced by the fact that all of the Appellant's indebtedness was guaranteed from 1988 to 1995. Assuming all new debt issues, beginning in 1996, would not have been guaranteed, Dr. Chambers believes the rating agencies would have demanded a clear articulation of the support that could be expected from the parent.[68] In practice, the rating agency would probably get the company on the phone and ask for a clear statement concerning the issue.[69] In Dr. Chambers' opinion, it would have been difficult for GECUS to convince a ratings committee that nothing had changed after removing the explicit guarantee.[70]

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[64] *Ibid.*, page 1465, lines 15-25.
[65] *Ibid.*, page 1450, line 22, to page 1451, line 14.
[66] *Ibid.*, pages 1640-1641.
[67] *Ibid.*, page 1334, lines 9-17.
[68] *Ibid.*, page 1523, lines 10-16.
[69] *Ibid.*, page 1524, line 18, to page 1525, line 4.
[70] *Ibid.*, page 1526, lines 14-19.

Testimony of John Campbell Hull, Ph.D.

[67] Dr. Hull is the Maple Financial Group Professor of Derivatives and Risk Management at the Rotman School of Management at the University of Toronto.[71] He holds a B.A. and an M.A. in mathematics from Cambridge University in England, an M.A. in operational research from Lancaster University in England and a Ph.D. in finance from Cranfield University in England.[72]

[68] Dr. Hull was asked to provide an opinion on the value of the guarantee in issue by analogy to the price of a credit default swap ("CDS"). He valued the guarantee by using the yield approach, which consisted of analyzing the spread between AAA-rated bonds and bonds that are an average of single B and BB, the credit rating Dr. Hull was asked to assume for the Appellant in the absence of an explicit guarantee.[73]

[69] In Dr. Hull's opinion, a CDS is a form of financial guarantee. In a CDS, there are two parties to the transaction, the provider of the protection, which often is an insurance company or financial institution, and the buyer. Typically the buyer of protection holds debt securities in a reference entity and seeks protection from credit defaults. In the event of a default by the reference entity, the provider of protection makes the buyer whole by paying up to the face value of the bond.[74]

[70] For purposes of his analysis, Dr. Hull assumed the guarantee would be in place for as long as the Appellant stayed in business in Canada, because if the guarantee was removed, the Appellant would be unable to issue new commercial paper to obtain the funds needed to pay the maturing commercial paper.[75]

[71] Nonetheless, in his calculation of the spread between the credit rating of the Appellant with a guarantee and its rating without a guarantee, Dr. Hull uses the yields on bonds with maturities of five and 10 years.[76]

[72] The witness concluded that the overall spread was about 352 basis points between a AAA rating and the B+ to BB- rating assumed for the Appellant in the absence of an explicit guarantee. As a result, the value of the explicit guarantee is approximately 1.83% based on a BB+ to BBB- credit rating range.[77]

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[71] *Ibid.*, page 1808, lines 9-13.
[72] *Ibid.*, page 1810, lines 4-12.
[73] *Ibid.*, page 1815, lines 4-21.
[74] *Ibid.*, page 1835, lines 11-22.
[75] *Ibid.*, page 1845, line 16, to page 1846, line 8.
[76] *Ibid.*, page 1846, lines 12-17.
[77] *Ibid.*, page 1859, lines 5-25.

Testimony of Stephen Cole

[73] Mr. Cole is an accountant and senior partner at the firm Cole & Partners. He is a fellow of the Institute of Chartered Accountants of Ontario, a fellow of the Canadian Institute of Chartered Business Valuators and a member of the ADR Institute of Canada Inc.[78]

[74] Mr. Cole was asked to explain the conceptual issue of valuation in the context of determining an arm's length price for the guarantee. He commented on whether the relationship between the Appellant and GECUS would influence the price at which a third-party guarantor would be willing to get involved.[79]

[75] According to Mr. Cole, the guarantor would start with the concept of arm's length price. The arm's length price is the amount determined in accordance with the arm's length principle that would have been reasonable in the circumstances if the parties to the transaction had been dealing at arm's length.[80]

[76] Mr. Cole described a notional negotiation in his report. The market dynamic, including a buyer and a seller, is integral to the definitions of fair market value and arm's length price. Mr. Cole portrayed the buyer's and the debtor's perspectives and then the perspectives of the arm's length providers of the guarantee.[81] The essence of any negotiation is that the parties can find a middle ground that is mutually satisfactory. The objective of the buyer, here the Appellant, is to find insurance or a guarantee at the lowest possible price. Conversely, the provider would like the highest possible price.[82] The market needs to be composed of many providers and there were numerous parties around the world with similar characteristics, such as deep-pockets, substantial size and sophistication in the financial sphere, who could all have provided the guarantee.[83]

[77] Mr. Cole reached the conclusion that the range of arm's length and fair market value prices for the guarantee is clearly above 1%.[84] Mr. Cole arrived at a 0.85% fee only with respect to a situation where the guarantor perceived the Appellant as being a AAA credit risk and there was no explicit guarantee. Yet, Mr. Cole does not believe

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[78] *Ibid.*, page 1904, lines 1-14.
[79] *Ibid.*, page 1912, lines 11-14.
[80] *Ibid.*, page 1934, lines 5-16.
[81] *Ibid.*, page 1977, lines 2-6.
[82] *Ibid.*, page 1977, lines 14-20.
[83] *Ibid.*, page 1978, lines 5-12.
[84] *Ibid.*, page 1986, lines 3-4.

that it was realistically possible for the Appellant to have obtained a AAA rating on its own.[85]

[78] Mr. Cole noted there was no benefit to GECUS in taking a dividend from the Canadian subsidiary; had they taken a dividend, they would simply have been increasing debt in the Canadian company and paying down debt in the U.S. company, but its aggregate access to capital would have been identical on a consolidated basis.[86] There would have been no benefit to the parent either if the Appellant had been capitalized differently because GECUS' debt-to-equity ratio is determined on a consolidated basis and because its access to capital is also determined on a consolidated basis.[87] In summary, GECUS' borrowing capacity was linked, *inter alia*, to its consolidated debt-to-equity ratio.

[79] Mr. Cole justified the reasonableness of both his guarantee fee and the guarantee fee charged by GECUS by looking at the proportion of the guarantee fee to the profits earned by the Appellant in each of the taxation years at issue. According to the witness, a 1% guarantee fee was in the range of 33 to 40% of the aggregate pre-tax and pre-guarantee fee profits of the Appellant. Mr. Cole believed GECUS would have been entitled to a return of between 15% and 20% if it had invested roughly $275 million of additional capital in the Appellant to improve the Appellant's creditworthiness. This percentage equates to roughly $69 million of profit, which is very close to the average guarantee fee that was in fact received.[88]

[80] In cross-examination, Mr. Cole confirmed his opinion that the Appellant could not have obtained a AAA rating without the guarantee. The witness believed an explicit guarantee was necessary in order to enable the Appellant to execute its business plan, which was based on achieving the lowest cost of capital.[89]

Testimony of Rowland Alexander Lewis

[81] Mr. Lewis was called upon by the Appellant to provide evidence on how the treasury departments of large corporate multinationals would view the concept of implicit support when pricing Canadian-denominated commercial paper used to invest short-term Canadian-denominated funds. From 1980 to 2000, Mr. Lewis worked in the treasury department of Texaco Canada and Heddington Insurance, a captive insurer of Texaco.[90]

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[85] *Ibid.*, page 1986, lines 11-21.
[86] *Ibid.*, page 2000, lines 2-10.
[87] *Ibid.*, page 2000, lines 16-23.
[88] *Ibid.*, pages 2000-2002.
[89] *Ibid.*, page 2014, line 20, to page 2015, line 3.
[90] *Ibid.*, page 2089, lines 12-20.

[82] Mr. Lewis testified that in his role of assistant treasurer he would invest in commercial paper based on investment guidelines, which included safety of principal, liquidity and foreseeable profit.[91] Mr. Lewis defined implicit support as an assumption by third parties that, in the event of an issuer's default, the parent company of the issuer would step in and keep everybody whole.[92] Texaco would not have assigned any value to implicit support during the relevant period because all its investments in short-term paper had to be made in such a way as to ensure safety of principal.[93] Given a choice between an unguaranteed debt issuance of the Appellant and a debt issuance of GECUS or GE, Texaco would buy the latter.

Testimony of David Victor Daubaras

[83] Mr. Daubaras has held the position of vice-president, tax, with the Appellant since 1995.[94]

[84] Mr. Daubaras did not believe the Appellant was simply an extension of GECUS. According to the witness, the U.S. would provide the Appellant with a financial target and it would be up to the Canadian management of the Appellant to achieve that target.[95]

Testimony of Bruce Bennett

[85] Mr. Bennett was the associate general counsel in the treasury division of GECUS between 1992 and 1998.[96] The witness was responsible for overseeing a small group of lawyers who supervised and implemented GECUS' debt issuance, insurance and derivative transactions.

[86] Mr. Bennett testified that the commercial objectives of GECUS' treasury department were to fund GECUS' consolidated business activities at the lowest possible cost while at the same time adhering to the risk management guidelines established by senior management.[97] These guidelines required that liabilities match the income stream of the assets they funded. For example, an asset that generated a short-term income stream would be supported by short-term borrowing.[98]

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[91] *Ibid.*, page 2096, lines 7-10.
[92] *Ibid.*, page 2103, lines 4-8.
[93] *Ibid.*, page 2103, lines 17-20.
[94] *Ibid.*, page 2108, lines 10-20.
[95] *Ibid.*, pages 2116-2118.
[96] *Ibid.*, page 2974, lines 16-20.
[97] *Ibid.*, page 2981, lines 1-9.
[98] *Ibid.*, page 2982, lines 9-25.

[87] Mr. Bennett acknowledged that GECUS valued its AAA rating because none of its competitors were able to borrow at the same low rate. The witness's understanding was that GECUS' guarantee allowed the Appellant to borrow at the lowest interest rate. From a tax standpoint, the guarantee enabled the Appellant to borrow without having to bear the cost of the Canadian withholding tax. If GECUS borrowed the funds directly and then loaned them to the Appellant, withholding tax would have been due on the interest payments. The guarantee also provided ease of execution. From the investor's standpoint it was as if GECUS was borrowing the funds directly. Fungibility, from a credit risk standpoint, was achieved between the commercial paper issued by GECUS and that issued by the Appellant because of the explicit guarantee. In summary, the explicit guarantee meant that the Appellant's debt holders benefited from GECUS' lower credit risk much in the same way that they would have if the funds had been loaned to GECUS in the first instance and then loaned by GECUS to the Appellant.[99]

SUMMARY OF RESPONDENT'S WITNESSES' TESTIMONY

Testimony of Stephen Allan Mitchell

[88] Mr. Mitchell is currently employed as an investment banker by RBC Capital Markets, a wholly-owned subsidiary of the Royal Bank of Canada ("RBC"). In 1995, he was senior manager of corporate banking at RBC.[100]

[89] From 1995 to 2000, RBC had business dealings with the Appellant. The nature of these dealings encompassed cash management services and credit facilities.[101] His current employer, RBC Capital Markets, has an ongoing relationship with the Appellant.[102]

[90] Mr. Mitchell is the signatory of a November 7, 1995 letter apparently written in response to an October 10, 1995 letter, both marked as Exhibit R-9A.[103] The October 10 letter sought information regarding the pricing of loans to be made to Canadian subsidiaries of GE and GECUS. Specifically, this letter involved an inquiry by the Appellant concerning GECUS' borrowing capacity on a stand-alone basis and concerning the pricing of a $2 billion credit facility without an express guarantee from the parent.[104]

[99] *Ibid.*, page 3005.
[100] *Ibid.*, page 2250, line 8, to page 2251, line 8.
[101] *Ibid.*, page 2252, lines 5-14.
[102] *Ibid.*, lines 15-18.
[103] *Ibid.*, page 2253, line 6, to page 2254, line 19.
[104] *Ibid.*, page 2258, lines 4-13.

[91] Under cross-examination, Mr. Mitchell testified that, as written in the third paragraph of the November 7, 1995 letter, considering the structure of the Canadian balance sheet at that time and the inherent leverage and debt coverage ratios, the Canadian company would come in below the BB level. However, the caveat to this is that the letter dated November 7, 1995 did not involve any transaction between RBC and the Appellant; rather, it provided market feedback only and, accordingly, one would not have sought credit approval or credit adjudication within RBC for the purpose of issuing this type of letter.[105]

[92] In the same letter, various GE Canadian subsidiaries were identified as requiring the parent company's guarantee before a commitment of bank credit facilities could be envisaged. Mr. Mitchell testified to the effect that the fact that they were GE subsidiaries was insufficient in and of itself to warrant a credit facility in the absence of a formal guarantee.[106] He went on to testify that the suggestion in the said letter was that at the B rating level the fully drawn cost would be 250 basis points, plus LIBOR.[107] Mr. Mitchell also agreed that the Appellant could not be considered a AAA-rated company.[108]

Testimony of Kevin Charles Clark

[93] Mr. Clark was, in 1995, a credit officer in 1995 at Scotiabank who was responsible for covering the Connecticut territory. His objectives involved building relationships with the bank's borrower clients. GECUS and GE were part of his portfolio and were clients of Scotiabank.[109]

[94] Mr. Clark was unclear as to the purpose underlying the inquiry from GECUS; generally, as in the letter of July 24, 1995 for example, he was asked about the cost of borrowing funds in Canada both with and without support from the parent company.[110] He believed at the time that the letter would lead to a lending relationship and also that the request for credit was for general corporate purposes.[111]

[95] Corporations like GECUS or the Appellant, whose businesses are large and diversified, frequently borrow for what Mr. Clark called general corporate purposes, which provides them with flexibility in their use of the funds.[112]

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[105] *Ibid.*, pages 2267-2270.
[106] *Ibid.*, page 2272, lines 10-17.
[107] *Ibid.*, page 2275, lines 1-6.
[108] *Ibid.*, pages 2276, line 19, to page 2277, line 4.
[109] *Ibid.*, page 2279, lines 2-11.
[110] *Ibid.*, page 2283, lines 15-24.
[111] *Ibid.*, page 2284, lines 9-22.
[112] *Ibid.*, page 2285, lines 6-10.

[96] The Bank of Nova Scotia would have been prepared, in 1995, to take on the responsibility of putting together a $2 billion unguaranteed commitment to the Appellant. This would have been achieved through syndication, that is, the bank would have been prepared to try to arrange such financing for the Appellant.[113]

[97] In the circles of syndicated lending, having the responsibility of arranging a facility for a well-respected name in the marketplace would have been viewed as an attractive opportunity, even though the facility was not for GECUS specifically. It would have given the Bank of Nova Scotia so-called "bragging rights" in the syndicated debt league circuit.[114]

[98] In the evaluation of the request for an unguaranteed loan, the attractiveness of the GE name and of the affiliation with GE was relevant to Mr. Clark's analysis, in light of the fact that GECUS was among the largest users of commercial paper in the U.S.[115]

[99] In paragraph 3 of his letter (Exhibit R-9B), Mr. Clark referred to "ownership". According to the witness, the term "ownership" referred to borrowing with a guarantee. He would give different rates depending on whether there was or was not ownership. Thus, the Appellant would have been able to borrow at a preferential rate if there was a guarantee from GECUS.[116]

Testimony of Anthony Saunders, Ph.D.

[100] Dr. Saunders received a B.S. in economics, an M.S. in economics and a Ph.D. in economics, all from the London School of Economics.[117] Dr. Saunders, a professor of finance at the Stern School of Business, New York University, was qualified as an economist specializing in credit risk measurement and in analysis and valuations relating to debt guarantees based on creditworthiness.[118]

[101] In his report, Dr. Saunders did not address the credit rating of the Appellant as a stand-alone entity; he considered that it was obvious the Appellant was a core or strategically important company in relation to its parent, GECUS.[119]

[113] *Ibid.*, page 2289, lines 2-14.
[114] *Ibid.*, page 2291, lines 1-13.
[115] *Ibid.*, page 2293, line 13, to page 2294, line 7.
[116] *Ibid.*, page 2294, line 8, to page 2295, line 3.
[117] *Ibid.*, page 2329, lines 15-18.
[118] *Ibid.*, page 2339, lines 16-25.
[119] *Ibid.*, pages 2353-2354.

[102] As a preliminary procedural matter dealing with the admissibility of Dr. Saunders' rebuttal report, the Appellant asserted that this report was not rebuttal per se, but served rather to fill in gaps in Dr. Saunders' initial report. I mentioned that my decision on this would be reserved until my final judgment. The Appellant did not succeed in convincing me that, on a balance of probabilities, the rebuttal aspects of Dr. Saunders' rebuttal report were not within the confines of rebuttal evidence. As I see it, Dr. Saunders addressed the stand-alone approach in his rebuttal report in order to counter the approach adopted by the Appellant, an approach with which he did not agree in the circumstances. While it stands as true that he recognized that a stand-alone analysis is part of the methodology employed by Moody's and S&P,[120] it is also clear that Dr. Saunders did his analysis without employing that methodology because he considered this step redundant. In short, Dr. Saunders believed it was unnecessary to perform a stand-alone analysis because the conclusion was obvious in the circumstances. Therefore, I do not agree with the Appellant's contention that such an analysis was in fact part and parcel of the methodology that Dr. Saunders purported to apply. In this light, I view the rebuttal report authored by Dr. Saunders as legitimate and viable rebuttal per se.

[103] Dr. Saunders used three steps to evaluate the reasonableness of the 1% fee. First, he identified how the rating agencies would rate the Appellant's debt. Second, having established that rating, he calculated an appropriate fee that would be charged by a third-party guarantor. Third, he looked at the issue of whether the 1% fee was excessive in terms of the risk-adjusted return on capital ("RAROC").[121]

[104] Dr. Saunders identified three approaches to creditworthiness measurement: (i) expert systems, (ii) traditional rating systems, and (iii) quantitative model approaches.[122]

[105] The expert system is purely qualitative and is based on characteristics of the borrower, namely: character, capital and capacity to repay, *inter alia*. The problem with expert systems is that they are purely subjective. Where the expert systems differ from quantitative systems is not so much in identifying the factors, but in weighing the factors in a consistent fashion.[123]

[106] As for traditional credit rating models, they use both qualitative expert systems and quantitative systems. These models focus on longer-term default risk.[124]

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[120] *Ibid.*, pages 2367-2368.
[121] *Ibid.*, page 2375, lines 6-25.
[122] *Ibid.*, page 2376, lines 14-21.
[123] *Ibid.*, page 2376, line 22, to page 2377, line 25.
[124] *Ibid.*, page 2378, lines 2-19.

[107] The third model, the quantitative model, is generally based on financial market data, such as stock prices, bond prices and CDS spread, *inter alia*.[125] Dr. Saunders testified that, during the period under assessment, investors, whether institutional or retail, relied most heavily on the traditional rating models. This method was employed by Dr. Saunders in his report.[126]

[108] In summary, Dr. Saunders concluded that the Appellant was a core subsidiary of GECUS at the relevant time and would have been rated AAA. Alternatively, he concluded the Appellant could be classified as having been strategically important, rather than of core importance, to GECUS, in which case it would have been rated AA. He determined what the fee would have been for a third-party guarantee given a AA rating, as opposed to a AAA rating. On this basis, his conclusion was that the fee would have been between 15 and 24 basis points over the relevant period. When looking at the risk-adjusted return on capital, Dr. Saunders concluded the 1% fee produced a very high risk-adjusted return on capital, much higher than what is called the "hurdle rate". In RAROC modeling, the "hurdle rate" is the return on equity required by stockholders before committing to an investment.[127]

[109] Dr. Saunders contended that Dr. Chambers did not notch up enough in taking into account implicit support by the parent company. He further stated that the importance of reputation is greater for unregulated financial institutions than for regulated ones, as the latter have the luxury of relying on regulators to come in to clean things up and constrain their lending activities. In his view, unregulated financial institutions only have their reputation to enable them to preserve and enhance the market's confidence in them, and the notching up should reflect this.[128]

[110] Dr. Saunders believed there would have been an enormous cost to GECUS if it had let the Appellant fail:

> I mean, as an economist, as I said, at the end of the day, it is a simple cost-benefit question. The cost is enormous. You have a company, GEC Capital Corporation [GECUS], issuing $2-trillion or more commercial paper and billions of dollars of bonds. If it could even possibly lead to a one- or two-notch downgrade, that would be an enormous increase in its cost of debt.[129]

[111] Five factors led Dr. Saunders to conclude that the rating agencies would likely have viewed the Appellant as a core subsidiary of GECUS: (i) the specialness, significance and value attaching to the AAA rating; (ii) the branding aspect of having

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[125] *Ibid.*, page 2378, line 20, to page 2379, line 18.
[126] *Ibid.*, page 2380, lines 11-23.
[127] *Ibid.*, page 2380, line 14, to page 2381, line 12.
[128] *Ibid.*, pages 2282-2283.
[129] *Ibid.*, page 2384, line 24, to page 2385, line 6.

the same name: investors are more likely to run from a parent that has the same name as a subsidiary that fails; (iii) the high degree of financial and managerial integration; (iv) the longevity of the subsidiary: the Appellant has been in Canada close to 40 years; and (v) the size of the subsidiary (the Appellant) in relation to the Canadian capital market.[130]

[112] Dr. Saunders did not place much weight on the fact that the Appellant is domiciled in Canada and is independent of GECUS. He remarked that with NAFTA, in a free-trading association between Canada and the U.S., there are strong economic links that reduce the significance of the separate domiciles of the Appellant and GECUS. Moreover, he also thought that the Appellant, with a 12 to 1 debt-to-equity ratio, was well-capitalized relative to chartered banks, for which an 18 to 1 debt-to-equity ratio is considered adequate — bearing in mind that we are dealing with core tier-one equity.[131]

[113] To calculate the difference between what a AA subsidiary and a AAA company might pay, Dr. Saunders reviewed the yield spread between a AAA and a AA company, relying on Canadian data. There were no real AAA Canadian corporate bonds for him to use, just Canadian government bonds, which means that the spread would actually be bigger given that AAA corporate bonds tend to yield slightly higher than AAA government bonds.[132] While the spread has a built-in premium for liquidity, because it does not measure default risk only, Dr. Saunders believes he proceeded conservatively as he assumed the liquidity spread to be zero, thereby leaving the whole spread for default risk.[133]

[114] Dr. Saunders also performed a mortality analysis; his conclusions are set out at panel A of Exhibit 13 appended to his report.[134]

[115] The RAROC analysis carried out by Dr. Saunders calculated how much capital a third party would require to support capital at risk of the Appellant, viewing the Appellant as either AAA or AA. He used three models to calculate this.[135] The average of the three models after tax (assuming a tax rate of 40%) is 113% which is high compared to the hurdle rate of 22%-23%,[136] that is, the RAROC is more than four times greater than the return on equity of the stockholder, which suggests that

[130] *Ibid.*, pages 2388-2395.
[131] *Ibid.*, pages 2398-2399.
[132] *Ibid.*, pages 2405-2406.
[133] *Ibid.*, page 2408, lines 8-13.
[134] *Ibid.*, page 2410, line 19, to page 2411, line 5.
[135] *Ibid.*, pages 2415-2416. The results are summarized at Tab 18 of Exhibit R-24.
[136] *Ibid.*, page 2424, line 18, to page 2425, line 23.

the fee charged by GECUS was too high.[137] He testified that a reasonable guarantee fee in the circumstances would have been 20 basis points.[138]

[116] Using Dr. Altman's Z-score double prime model, which he claimed is very relevant for determining the creditworthiness of financial institutions, Dr. Saunders determined that the Appellant's creditworthiness improved during the years 1998-2000. The Appellant's creditworthiness improved on the basis that its ability to pay debt improved with the conversion of short-term debt to long-term debt from a related funding company in 1999 and 2000.[139] This result flows from the notion that investors are worried about ability to pay debt, which he says is calculated by measuring current assets relative to current liabilities. In his rebuttal report, Mr. Fidelman recalculated the X1 variable in the Altman Z-score double prime model to take into account the misclassification of receivables as long term.[140] Dr. Saunders believed cutting down on commercial paper (i.e., short-term debt) correlatively reduces current liabilities. He added that Mr. Fidelman used the RiskCalc model that is built around manufacturing firms.[141] In his view, the three benefits to using the Z-score double prime model are that it was calibrated just prior to the period relevant to this appeal, it is a private sector model, and it focuses on non-manufacturing firms.[142]

[117] Dr. Saunders testified to the effect that the only impact of GECUS dropping its explicit guarantee with respect to the Appellant's debt offerings would be a lowering of the latter's rating from AAA to AA. In his opinion, the U.S. parent would still have incentive to support the Appellant in order to maintain its own AAA status, in the absence of an explicit guarantee. According to Dr. Saunders, economic incentive is the most important factor in finance.[143]

[118] Dr. Saunders contended that the explicit written guarantee was a costly and unnecessary mechanism given the strength of the economic incentive for the parent to provide the Appellant with implicit support, but he agreed that the explicit guarantee achieved the goal of securing a AAA rating for the Appellant.[144] The institutional investor, seeing the Appellant's unguaranteed debt offerings, but knowing they are issued out of Connecticut, by the same treasurer, by the same

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[137] *Ibid.*, page 2425, line 18, to page 2426, line 10.
[138] *Ibid.*, page 2430, lines 19-25.
[139] *Ibid.*, pages 2433-2438.
[140] *Ibid.*, pages 3378, 3393.
[141] *Ibid.*, page 2434, line 23, to page 2435, line 1.
[142] *Ibid.*, page 2435, lines 10-17.
[143] *Ibid.*, pages 2439-2441.
[144] *Ibid.*, page 2447, lines 1-22.

company, and with the same liability structure would reason that it is not a separate company issuing the debt.[145]

[119] In Dr. Saunders' view, GECUS decided what capitalization level to impose on the Appellant. This cannot be viewed as independent capitalization. Therefore, the actual capitalization level of the Appellant should be ignored for the purposes of determining its stand-alone credit rating. From the witness's standpoint, what determines whether the Appellant constitutes a core subsidiary under the S&P criteria is the consolidated capital ratio, as opposed to the independent capital ratio of the Appellant, since the Appellant did not choose its own capital ratio. Further, given that the parent is AAA, it could inject capital into the subsidiary at any time.[146]

[120] In relation to the S&P criteria for classification as a core subsidiary, one of which is the inconceivability that the unit could be sold when its "dependence upon the rest of the group make[s] it impossible to sever the entity from the rest of the parent group",[147] Dr. Saunders was of the view that, given the hub-and-spoke system and the push to maximize geographic diversification, it is inconceivable that the Appellant would be sold.

[121] Dr. Saunders recognized that GE Financial Assurance Holdings Inc. was rated A+, despite being a 100%-owned subsidiary carrying the GE name and accounting for 20% of the assets of the consolidated GECUS.[148]

<u>Testimony of Harold J. Meyerman</u>

[122] Mr. Meyerman was qualified as an expert in banking, not in rating matters.[149] He worked most of his professional career in the U.S., where he held very senior banking positions prior to his retirement. At the initial stage of his career, for a very brief period, Mr. Meyerman was the manager of a Canadian bank branch located in British Columbia.[150]

[123] The witness testified that banks do their own credit risk analysis, typically using a bottom-up approach, analyzing the various entities and then arrive at a consolidated statement.[151] Banks use credit rating agency analyses as a check on their own internal ratings.[152]

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[145] *Ibid.*, page 2486, line 16, to page 2487, line 16.
[146] *Ibid.*, page 2525, lines 16-25.
[147] *Ibid.*, page 2532, lines 8-17.
[148] *Ibid.*, page 2564, line 1, to page 2565, line 18.
[149] *Ibid.*, page 2651, lines 6-12.
[150] *Ibid.*, pages 2624-2638.
[151] *Ibid.*, page 2653, line 20, to page 2654, line 4.
[152] *Ibid.*, page 2655, line 18, to page 2656, line 8.

[124] Between 1995 and 1998, stated Mr. Meyerman, North America was an integrated commercial paper market. Canadian investors would invest in the commercial paper of U.S. issuers and vice versa.[153]

[125] According to the witness, GE's reputation was second to none. Even among AAAs, it was in a league of its own. GE, during that period, was the most admired company in the world. Major investors wanted to acquire GE or GECUS debt offerings.[154] In that era, GE or GECUS could dictate their own terms in respect of covenants.[155]

[126] Discussions between Mr. Meyerman's bank and GECUS about the Appellant issuing commercial paper in its own name without an explicit guarantee would necessarily involve the rating agency people coming on board to equalize the ratings, or at least get close to doing so. Investors would require this.[156]

[127] The witness appeared to be acutely aware of the fact that the removal of GECUS' guarantee would not be treated as welcome news by the credit rating agencies called upon to rate the Appellant's unguaranteed debt. In cross-examination, the witness left me with the impression that a high investment grade AAA credit rating for the Appellant would have been more feasible had its debt been unguaranteed from the outset. The witness asserted he would want to have a very good understanding of the reasoning underlying Mr. Werner's hypothetical decision to stop guaranteeing the Appellant's debt. While the witness insisted it would still be possible to issue AAA paper if GECUS showed signs of support, he acknowledged there would be a cost differential between two AAA note issues, one guaranteed and the other unguaranteed.[157]

[128] While Mr. Meyerman did not agree that the explicit guarantee was the most efficient or cost-effective way of enabling the Appellant to enter the capital markets on the financial strength of its parent, GECUS, he did view the explicit guarantee as a more certain means to encourage investors. However, even where there is an explicit guarantee, investors will still ask questions concerning credit quality, but to a lesser extent.[158]

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[153] *Ibid.*, page 2659, line 18, to page 2660, line 13.
[154] *Ibid.*, page 2661, lines 7-25, and page 2662.
[155] *Ibid.*, page 2664, lines 19-25.
[156] *Ibid.*, pages 2681-2684.
[157] *Ibid.*, page 2692, line 17, to page 2693, line 15.
[158] *Ibid.*, page 2722, line 1, to page 2723, line 15.

[129] Mr. Meyerman suggested that, in a hypothetical world, one possible reason for dropping the parent company guarantee would be to reduce the cost of funding the Canadian company, thereby enabling it to compete more effectively. He did not accept the proposition that dropping the guarantee leads to an inescapable inference that GECUS has decided it wants to keep its options open in terms of whether or not it will come to the rescue of the Appellant.[159]

Testimony of Edward Emmer

[130] Mr. Emmer was called as an expert in credit rating analysis. He spent virtually his entire career with S&P, starting there in 1969 and retiring in 2008. The majority of that time was spent with the ratings division where, between 1992 and 2005, he was head of global corporate and government ratings at S&P.[160] The witness was qualified as an expert in credit risk analysis relating to a broad cross-section of multinational entities, including industrial and global financial institutions.[161]

[131] During his period at S&P, it was common for Mr. Emmer to meet with GE executives. For example, he attended, with fellow S&P employees, GE's annual reviews, at which GE executives were in attendance.[162]

[132] While his direct involvement with GE executives decreased as his management responsibilities grew in scope, they still met once a year. He was also kept informed by his analysts. Additionally, if something major was transpiring which could have an impact on GECUS' AAA rating, he would participate in the discussions.[163]

[133] His assignment for the purposes of the present case was to determine how S&P would rate the unguaranteed debt of the Appellant. His conclusion was that the unguaranteed debt of the Appellant would be rated the same as its parent company, GECUS.[164]

[134] He conceded having made a computational error in relation to the size of the Appellant relative to GECUS, as pointed out by Dr. Chambers. This error occurred from failing to take into account the differences in currency values. Mr. Emmer added that this computational error did not alter his overall opinion with respect to

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[159] *Ibid.*, pages 2755-2757.
[160] *Ibid.*, pages 2782-2783, 2793.
[161] *Ibid.*, page 2811, lines 15-22.
[162] *Ibid.*, page 2798, line 1, to page 2799, line 20.
[163] *Ibid.*, page 2806, lines 7-24.
[164] *Ibid.*, page 2812, lines 15-25.

the amount of support the parent would provide to its Canadian subsidiary:[165] GECUS would support the Appellant even if it withdrew its guarantee. The Appellant was essentially an extension of the global business units.[166]

[135] Mr. Emmer referred to two different approaches to determining ratings: the model-driven and analysis-driven approaches. The model-driven approach works by analyzing financial ratios and then putting them through a model, which in turn determines the rating. Institutions with high amounts of loans outstanding tended to use this approach. The analysis-driven approach looks at many of the same factors that are used as inputs into the model, but, in addition, this approach considers certain qualitative, forward-looking factors, for example: what management's intentions and strategy were for their company.[167]

[136] S&P prefers the analysis-driven approach, depending upon the situation, because the qualitative factors can far outweigh the quantitative. In the present case, for example, numbers express one thing, but on considering the ownership structure, namely the fact that the Appellant is owned by GECUS, one may reach a far different conclusion.[168]

[137] Mr. Emmer conducted a credit rating pyramid analysis in connection with the Appellant. At the relevant time, he found, the Appellant, because of its ownership by GECUS, would be rated higher than the Canadian government's external obligations.[169] The quality of GE management was excellent, which had a downstream effect on the management decisions of the Appellant.[170] GE had a strong credit culture, which encompassed several characteristics: a commitment to excellence, a sound value system, awareness of every transaction's impact on the bank, balancing the short and the long term, respect for credit basics and no tolerance for surprises.[171] These characteristics would be overriding factors in determining how one would expect a company to act in the marketplace with respect to its obligations.[172]

[138] In his appraisal of the Appellant's profile, as opposed to its credit rating, Mr. Emmer concluded the profile would not suggest a AAA rating on a stand-alone basis.[173]

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[165] *Ibid.*, page 2813, line 11, to page 2814, line 22.
[166] *Ibid.*, page 2816, lines 9-21.
[167] *Ibid.*, page 2825, line 19, to page 2827, line 21.
[168] *Ibid.*, page 2827, line 22, to page 2828, line 13.
[169] *Ibid.*, page 2837, lines 10-13.
[170] *Ibid.*, page 2839, lines 11-19; page 2840, line 18, to page 2841, line 4.
[171] *Ibid.*, page 2841, line 6, to page 2842, line 3.
[172] *Ibid.*, page 2843, lines 5-20.
[173] *Ibid.*, page 2843, line 21, to page 2844, line 9.

[139] The fact that GECUS guaranteed debt of the Appellant would be viewed by S&P as indicating that the Appellant was an important subsidiary because otherwise GECUS would not have guaranteed the debt. In Mr. Emmer's view, GECUS would only guarantee something they firmly stood behind and viewed as a long-term, important part of the company.[174] However, I noted during his testimony that he had difficulty explaining how the Appellant and GECUS could portray a decision by GECUS to stop guaranteeing the Appellant's debt. If guaranteeing the debt meant GECUS would stand behind the Appellant, did removing the guarantee signify the opposite? Mr. Emmer left me with the impression that GECUS would not contemplate such a move because it would disrupt the Appellant's ability to raise capital quickly and cheaply.

[140] This being said, the witness maintained that S&P would view the Appellant as strategically important to its parent despite its relatively low proportion of assets on a consolidated basis. The Appellant has been doing business in Canada since 1963. Canada is neighbour to the U.S. and global expansion was an important strategic objective of both GE and GECUS. For those reasons, the Appellant was an important strategic asset that its parent would not walk away from.[175]

[141] In relation to parent-subsidiary rating links, Mr. Emmer believed that parent companies are going to do what is in their best interest. In the present case, it is appropriate to equalize the ratings of the subsidiary and the parent. In the case of entities that are dependent on financing in the capital markets, the parent is less likely to let the subsidiary go.[176]

[142] Mr. Emmer advocated a top-down approach to arrive at the Appellant's rating. He viewed this as most appropriate in this situation because he felt that the ownership of the Appellant by GECUS was the most important factor. The unguaranteed debt of the Appellant would have to be approved by its board of directors, which is composed of senior executives from GECUS. The debt must also be approved by GECUS to ensure compliance with its internal policies. The witness believed that if the Appellant's board and GE's vice-president of finance authorized the issuance of unguaranteed debt of the Appellant, they would stand behind that debt, particularly considering that the letters GE are attached to the debt. According to the witness, there is no way GECUS could walk away from the Appellant's debt in the capital markets, as opposed to debt of the Appellant resulting from a private transaction, given that GECUS was dependent on the capital markets for financing — it had to

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[174] *Ibid.*, page 2846, line 22, to page 2847, line 10.
[175] *Ibid.*, page 2847, line 21, to page 2848, line 6.
[176] *Ibid.*, page 2867, line 10, to page 2868, line 13.

roll over $2 to $3 billion of debt each day and it issued tens of billions of dollars of debt every year.[177]

[143] Mr. Emmer believed Dr. Chambers placed too much emphasis on the as-reported financial statements of the Appellant and that he did not give enough weight to the fact that the Appellant was owned by GECUS and ultimately by GE. Dr. Chambers also underestimated the impact that a default of the Appellant would have, not only on the Appellant, but on GECUS.[178]

[144] Mr. Emmer believed the Appellant's financial statements do not tell the whole story. He pointed out that more time had probably been spent looking at the financial statements of the Appellant in the past month than GE probably did in a whole five-year period. In his view, the Appellant's financial statements were merely an accounting consolidation.[179]

[145] Mr. Emmer could not reconcile his opinion with that produced by Dr. Chambers (AAA vs. BB), nor did he believe a ratings committee would have accepted Dr. Chambers' recommendation during the period in question.[180] Dr. Chambers' view was, in Mr. Emmer's opinion, not within the realm of what could be considered reasonable, given that Mr. Emmer was not aware of any situation where a AAA-rated financial institution had a subsidiary carrying its name that was rated BB.[181]

[146] According to Mr. Emmer, the stand-alone analysis emphasized by Dr. Chambers is circular and is an exercise in futility given that GECUS can make the Appellant look, financially speaking, any way it wishes with no impact upon GECUS' consolidated financial statements.[182] Therefore, he believed Dr. Chambers placed too much emphasis on the Appellant's capitalization ratio in his analysis.

[147] In the absence of an explicit guarantee, Mr. Emmer was not sure whether the parent company would have to do something (beyond its implicit support) to enhance the balance sheet of the subsidiary in order to make it match what the capital markets required under a stand-alone analysis. In this sense, according to Mr. Emmer, the support is explicit as opposed to implicit.[183] However, assuming intact ownership,

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[177] *Ibid.*, page 2872, lines 14-17; page 2873, line 15, to page 2875, line 16.
[178] *Ibid.*, page 2817, lines 2-20.
[179] *Ibid.*, page 2818, lines 4-18.
[180] *Ibid.*, page 2818, line 19, to page 2819, line 6.
[181] *Ibid.*, page 2819, lines 7-16.
[182] *Ibid.*, page 2885, lines 3-25.
[183] *Ibid.*, page 2886, line 11, to page 2887, line 8.

and everything else being equal, he believed this would result in the rating recommendation he said he would make to the ratings committee.[184]

[148] In a worst case, yet reasonable, scenario in which the Appellant was allowed to default, GECUS would face difficulty in rolling over, or become unable to roll over, its maturing debt obligations. Therefore, if the market began to lose confidence in GECUS as a result of the Appellant's default, it would have about one week to improve market sentiment because even if it completely drew down its bank lines it would not have sufficient liquidity to repay the commercial paper.[185] As a result, Mr. Emmer affirmed, GECUS would do anything to prevent a loss of market confidence in it.[186]

[149] Finally, he agreed that there was clearly a business reason for the guarantee: it provided a straightforward mechanism for ratings equalization. However, according to the witness, this does not mean that the Appellant would not have been AAA without the guarantee.[187]

Testimony of Brian Becker, Ph.D.

[150] Dr. Becker holds a Ph.D. in applied economics from the Wharton School of the University of Pennsylvania.[188] Dr. Becker was qualified as an economist specializing in transfer pricing.[189]

[151] The witness testified that an arm's length valuation involves a two-step approach. The first is to define what it is you are valuing, otherwise, it is difficult to ascertain what evidence to look for in trying to arrive at the value. In this case, determining how different strategic factors and characteristics would fit into an arm's length valuation is not simple. The second step is to look for evidence of what the price might be in the marketplace directly, through prices, profit margins, ratings and anything that may be of value. Then, one must sort through all of this information to find that which is more useful, making any adjustments that may be necessary here and there.[190]

[152] In step one, Dr. Becker described the characteristics of the relevant transaction. He then proceeded to determine what the transaction would look like if the parties

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[184] *Ibid.*, page 2887, lines 12-18.
[185] *Ibid.*, page 2929, line 25, to page 2931, line 4.
[186] *Ibid.*, page 2932, lines 14-17.
[187] *Ibid.*, page 3139, lines 9-19.
[188] *Ibid.*, page 3146, lines 1-4.
[189] *Ibid.*, page 3163, lines 6-8. Dr. Becker's expert report is Exhibit R-31 and his rebuttal report is Exhibit R-32.
[190] *Ibid.*, page 3178, line 7, to page 3179, line 7.

were at arm's length.[191] According to the witness, one of the important characteristics in this case is the organizational structure of the parties.[192]

[153] In defining the transaction, regard should be given not only to the terms of the transaction, but also to the behaviour of the parties. The risks of the parties in the hypothetical debtor and hypothetical guarantor transaction should match that of the parties in the actual transaction.[193]

[154] In his rebuttal report, Dr. Becker discussed the imprecision of the construct adopted by Mr. Cole who, in his report, maintained the guarantor in the same structure/position, but recast the position of the party receiving the guarantee as a stand-alone company. By making a downward adjustment for only one of the parties to the transaction, Mr. Cole rendered his construct biased and imprecise.[194]

[155] Transfer pricing is to be approached from both sides, from the guarantor's side in terms of what its costs are and from the debtor/beneficiary's side in terms of the benefit to it. Both parties must be satisfied in order for them to agree to a transaction. Dr. Becker took issue with Mr. Fidelman's insurance-based model on the basis that its application considered the issue only from the standpoint of the guarantor. Looking only at the cost in some calculation on one side does not, unless the other side is willing to pay that cost, lead to the completion of a transaction.[195]

[156] Mr. Fidelman's model, by working from the point of view of costs to the guarantor, does not take into account what the debtor might be willing to pay given the existence of implicit support. In the witness's view, taking that aspect into account would in effect lead to the determination of a lower fee that the debtor would be willing to pay for the guarantee.[196]

[157] Counsel for the Respondent referred to Mr. Cole's testimony to the effect that account should not be taken of the parent-subsidiary relationship in an arm's length valuation. In response to this, Dr. Becker remarked that Mr. Cole actually was taking into account the parent-subsidiary relationship, at least with respect to the guarantor, by refusing to view the guarantor as a stand-alone entity. Further, the parent-subsidiary relationship and the entire organizational structure does potentially affect how one defines and characterizes the transaction, and in this regard, the transfer

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[191] *Ibid.*, pages 3179-3184.
[192] *Ibid.*, page 3188, lines 8-13.
[193] *Ibid.*, page 3188, line 14, to page 3191, line 10; page 3192, lines 6-13.
[194] *Ibid.*, page 3194, line 14, to page 3195, line 17.
[195] *Ibid.*, page 3197, lines 10-21.
[196] *Ibid.*, page 3200, lines 1-17.

pricing Dr. Becker was familiar with already incorporates the parent-subsidiary relationship (i.e., the organizational structure).[197]

Testimony of Deloris Wright, Ph.D.

[158] Dr. Wright received a bachelor of science degree in business from Oklahoma State University and a Ph.D. in economics from Iowa State University.[198] She was qualified as an expert economist specializing in transfer pricing.[199] Dr. Wright was not asked to do a transfer pricing study. Rather she was asked to critique the Appellant's analysis.[200]

[159] According to the witness, the first step in the analytical approach to determining arm's length prices is to identify the transaction under review. In so doing, she assumed that the parties were unrelated but every other aspect of that relationship remained unchanged.[201] She would look at both sides of the transaction. In respect of both parties, the question to ask is: what are the functions performed and the risks incurred? The next step involves asking oneself the meaning of these facts and then considering whether there is a comparable market transaction in which unrelated parties deal with each other in the same way as the Appellant and GECUS.[202]

[160] Noting there were no perfect comparables, Dr. Wright stated that the next step is to evaluate the comparable transaction in relation to the relevant one and to ask: what are the differences between the comparable and the relevant transaction that have an impact on the price that unrelated parties would agree to? Adjustments are then made for these differences. At this point, the result will be a reliable arm's length price,[203] but the comparable may be rejected from the outset if it is too different.[204] The parties can resort to a different method in that case.

[161] Two additional facts came to Dr. Wright's attention when reading the trial transcripts. First, nobody from the Appellant's side participated in the transaction. Second, because there were 50-60 players in the commercial paper market, GECUS was issuing its debt to a small, integrated global capital market. Thus, reputational issues become very important.[205]

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[197] *Ibid.*, page 3202, line 10, to page 3203, line 24.
[198] *Ibid.*, page 3208, line 20, to page 3209, line 2.
[199] *Ibid.*, page 3224, lines 1-2. Dr. Wright's rebuttal report is filed as Exhibit R-33.
[200] *Ibid.*, page 3239, line 22, to page 3240, line 4.
[201] *Ibid.*, page 3240, lines 5-24.
[202] *Ibid.*, page 3241, lines 3-23.
[203] *Ibid.*, page 3242, lines 3-18.
[204] *Ibid.*, page 3242, lines 19-25.
[205] *Ibid.*, pages 3243-3247.

[162] The witness asserted there is no comparable transaction here because a third-party guarantor would never manage the risk as GECUS does in the present case. Without a comparable, the manner in which the witness analyzed the relevant transaction is as follows: all the decisions are made in the U.S., so what price would the U.S. parent charge and what price would the Canadian subsidiary be willing to pay? The Appellant would say that the U.S. parent is making all of the decisions and controlling all the risk. This ensures that the Canadian subsidiary (the Appellant) will not default on the loan.[206]

[163] The witness did, however, acknowledge that GECUS takes on risk as a result of the guarantee (e.g., the risk of a flight to quality government paper only), even though it has supervisory control over the subsidiary.[207] There is also a benefit to the Appellant in that GECUS cannot abandon it in the event of a liquidity crisis or a flight to quality that renders it prohibitively expensive or impossible to refinance the debt.[208]

[164] Dr. Wright stated that a number of factors must be considered in determining an arm's length price for the guarantee. First, account should be taken of the parent's reputation (i.e. implicit support). To the extent that the analysis has already taken this into account, no further adjustment should be made. Additionally, no covenant was required from the Appellant as a result of the guarantee, which is a benefit to the Appellant. This should be reflected in the amount of the fee. It has the impact of increasing the fee. Next, there were no reserves for loss contingencies in GECUS, but Mr. Fidelman computed his fee by assuming the insurer would have a loss contingency reserve and there would need to be a return on that. This would need to come out of the fee. Lastly, regard should be given to what the witness referred to as the substance of the transaction, the question being in an unrelated-party situation, would the debtor pay a fee to the guarantor where the guarantor has complete control over the default risk?[209] I note that the witness also agreed with the Court's observation that if the guarantee is withdrawn, value should also be attributed to the negative impact that would have on the market's perception of the parent's willingness to support the Appellant.[210] Dr. Wright also agreed with the position that benefits accruing to GECUS qua shareholder should not be taken into account in the determination of a market price for the transaction.[211]

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[206] *Ibid.*, page 3255, lines 2-22.
[207] *Ibid.*, page 3257, lines 1-12.
[208] *Ibid.*, page 3257, lines 13-22.
[209] *Ibid.*, page 3276, line 9, to page 3278, line 8.
[210] *Ibid.*, page 3269, lines 8-19.
[211] *Ibid.*, page 3260, line 21, to page 3261, line 16.

[165] According to the witness, Mr. Cole's analysis did not make a comparison between the intercompany facts and the third-party facts. Dr. Wright believed that Mr. Cole's results were unreliable because he failed to consider adjustments in his analysis.[212]

[166] Dr. Wright believed GECUS would have been willing to charge the Appellant a low guarantee fee because the potential cost to GECUS of a default by the Appellant would have been much greater than the potential benefit that it would have got from an arm's length guarantee fee.[213]

POSITION OF THE PARTIES

Respondent's Position

[167] Counsel for the Respondent posits that former subsection 69(2) and current paragraph 247(2)(*a*), which are the relevant provisions of the *Income Tax Act*[214] (the "*ITA*") applicable to the issue herein, conform with the principles enunciated in the Organisation for Economic Co-operation and Development guidelines (the "OECD Guidelines") on transfer pricing.[215] In this regard, chapter 7 of the OECD Guidelines provides specific commentary on intra-group services. This chapter informs us on two key issues: whether an intra-group service has, in fact, been provided and, if so, what the proper arm's length price is for the service. One of the key principles relied on by the Respondent in this case is enunciated at paragraph 7.13, which reads as follows:

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

[212] *Ibid.*, page 3280, lines 10-19.
[213] *Ibid.*, page 3302, lines 9-14.
[214] R.S.C. 1985, c. 1 (5th Supp.).
[215] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* (Paris: OECD Publishing, 1995), as supplemented through 2001.

[168] The Respondent submits that the Appellant'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 Respondent claims that the Appellant 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 Appellant 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 Appellant.

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

[170] This economic incentive originates from GECUS' AAA credit rating, which allows it to borrow large amounts of money at very low interest rates. This highest investment grade rating is a significant comparative advantage as few enterprises active in the unregulated financial sector are rated AAA. The Respondent argues that GECUS would suffer a significant credit rating downgrade if a like-named affiliate, such as the Appellant, was allowed to default on its debt. In such a case, the additional borrowing costs to GECUS would exceed the cost of financial support to the Appellant, thus prompting GECUS to intervene. Therefore, GECUS would not sacrifice its AAA rating by allowing the Appellant to default on unguaranteed debt.

[171] Counsel for the Respondent points out that Mr. Emmer, who was qualified as an expert on credit rating methodologies, testified that this type of "implicit support" would be recognized by S&P in the case of the Appellant and that its credit rating would be equalized with that of GECUS even in the absence of an explicit guarantee.

[172] As an alternative position, the Respondent invites me to adopt a two-step approach in the event that I find the Appellant's credit would not be equalized with that of GECUS. As a first step, I should identify the interest rate spread based on my conclusions regarding the difference between the Appellant's and GECUS' credit rating (the "yield approach"). As a second step, appropriate adjustments should be

made to the interest rate differential to take into account the benefits flowing to GECUS under the guarantee arrangement. The Respondent claims these benefits would be taken into account in arm's length bargaining.

Appellant's Position

[173] The Appellant advances two legal arguments in opposition to the Crown's approach to this case. Mr. Meghji, counsel for the Appellant, points out that the Crown's approach presupposes that the benefits that flow from the parties' relationship should be taken into account in determining whether the 100-basis point annual fee paid by the Appellant for the guarantee exceeds an arm's length price. Counsel argues the affiliation benefit, if any, enjoyed by the Appellant from its place in the GECUS organizational structure cannot be considered under subsection 69(2) and paragraph 247(2)(*a*) of the *ITA*. The scheme laid out by these provisions requires that one situate the parties opposite each other to determine how they would have arranged their transaction if they had been dealing at arm's length. All distortions that arise from the parties' relationship must be eliminated to arrive at an arm's length result.

[174] If an affiliation benefit exists, as alleged by the Crown, it exists because GECUS indirectly owns all of the shares of, and controls, the Appellant. This factor is not present in an arm's length relationship and must be discarded to determine an arm's length price for the transaction. It follows from this premise that the Appellant's credit rating prior to the implementation of the explicit guarantee must be determined solely on a stand-alone basis without factoring in any credit rating for the implicit support of GECUS. On a stand-alone basis, counsel contends, the evidence shows the Appellant's credit rating to be, at best, BB in the years in question. As a result, under the yield approach proposed by the Crown, the economic benefit enjoyed by the Appellant under the guarantee arrangement far exceeds the fee paid to GECUS.

[175] Counsel also argues that the factors which the Crown invites me to consider and adjust for under its alternative two-step approach are benefits that accrue to GECUS qua shareholder. For example, the prospect of higher dividends due to enhanced profits derived from interest cost savings accrue to GECUS because of share ownership and not by virtue of the guarantee arrangement. This benefit is attributable to the fact that GECUS assumed the risk of investing capital in the business of the Appellant. All benefits that are attributable to share ownership should be ignored.

[176] Finally, the Appellant submits that the Crown's approach in this case is flawed because it is based on the proposition that the explicit guarantee was not needed by the Appellant in the circumstances. Counsel posits that this is why the Crown led evidence to convince me that the Appellant would be rated AAA even without an explicit guarantee from its parent. According to the Appellant, subsection 69(2) and paragraph 247(2)(*a*) of the *ITA* require that the transaction arranged by the parties be priced by the Minister. The parties entered into a guarantee transaction, and the yield approach put forward by the Minister merely determines the cost at which the Appellant can borrow money, it does not seek to address the question of what a guarantee would cost in similar circumstances. The Minister did not bother to ask himself whether an arm's length party would have provided a guarantee to the Appellant because the Minister had decided that the guarantee was simply not required in the circumstances. For the Respondent to succeed, the reassessments would have had to have been based on paragraph 18(1)(*a*) of the *ITA*.

[177] As a final point, the Appellant submits that the Crown's theory in this case is not supported by the evidence adduced at trial. In brief, the Appellant argues that the evidence demonstrates the following:

(a) The explicit guarantee was implemented to satisfy bona fide business needs of the Appellant. This is confirmed by the fact than an explicit guarantee has been in place from 1988 to the present day. It was only in 1995 that a guarantee fee was charged. The Respondent now accepts this fact as it has dropped its reliance on paragraph 247(2)(*b*) of the *ITA*.
(b) The explicit guarantee benefited the Appellant's lenders, who obtained the right, in the event of the Appellant's default, to demand payment from GECUS, which became legally bound to discharge the Appellant's obligations as a result of the explicit guarantee.
(c) Even if one were to accept the Crown's theory regarding the case, the Appellant would not have obtained a AAA rating from S&P, or any other rating agency for that matter, if implied support was taken into account in the analysis. The Appellant's credit rating would have been between BB and BB- without an explicit guarantee.
(d) The rating agencies and investment dealers would demand that the Appellant maintain standby letters of credit in the amount of $3 billion if it tried to gain access to the Canadian commercial paper markets without an explicit guarantee. The Appellant could not negotiate standby credit facilities without the explicit support of its parent.

ANALYSIS

Legal Framework

[178] I will examine the competing legal positions presented by the parties before turning my attention to the evidence in this case.

Is a Stand-Alone Credit Rating the Proper Analytical Approach?

[179] The parties argue that the wording differences between subsection 69(2) and paragraph 247(2)(*a*) of the *ITA* are not meaningful for the purpose of this appeal. In addition, both parties agree that it is the transaction arranged by the parties that is the object of the transfer pricing analysis. The parties disagree on which of the economically relevant characteristics of the guarantee arrangement should be considered by me in determining an arm's length price for the guarantee transaction.

[180] The Appellant maintains that the Respondent's approach is flawed because subsection 69(2) and paragraph 247(2)(*a*) require me to situate the Appellant and GECUS opposite each other as arm's length parties in order to ascertain whether the price agreed to meets an arm's length standard. According to the Respondent, the words of subsection 69(2) require that I ascertain whether the amount paid was ". . . greater than the 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 concept of "implicit support" relied on by the Crown to convince me that the Appellant'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 Appellant in times of financial stress exist because the Appellant 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. The risk assumed by one party to a transaction has no bearing on the default risk of the other party prior to the implementation of the guarantee arrangement. In the present case, the failure of the Appellant to meet its financial obligations would taint its parent's reputation because AAA issuers are expected not to allow their core subsidiaries to default.

[181] I believe a careful analysis of the scheme of the transfer pricing rules is required to dispose of this issue. Because the parties agree there is no meaningful distinction between the scope of subsection 69(2) and paragraph 247(2)(*a*) of the

ITA, I will deal with the text of the latter provision for the reasons that it is more complete and that it represents Parliament's last word on the matter.

[182] Paragraph 247(2)(*a*) of the *ITA* provides that the Canadian transfer pricing rules apply to parties that do not deal with each other at arm's length. For the purposes of the *ITA*, related persons are deemed not to deal with each other at arm's length.[216] In a corporate context, paragraph 251(2)(*b*) of the *ITA* states that corporations are related to:

> (i) a person who controls the corporation, if it is controlled by one person,
>
> (ii) a person who is a member of a related group that controls the corporation, or
>
> (iii) any person related to a person described in subparagraph 251(2)(*b*)(i) or 251(2)(*b*)(ii) . . . .

[183] Similarly, paragraph 251(2)(*c*) provides that two corporations will be considered related:

> (i) if they are controlled by the same person or group of persons,
>
> (ii) if each of the corporations is controlled by one person and the person who controls one of the corporations is related to the person who controls the other corporation,
>
> (iii) if one of the corporations is controlled by one person and that person is related to any member of a related group that controls the other corporation,
>
> (iv) if one of the corporations is controlled by one person and that person is related to each member of an unrelated group that controls the other corporation,
>
> (v) if any member of a related group that controls one of the corporations is related to each member of an unrelated group that controls the other corporation, or
>
> (vi) if each member of an unrelated group that controls one of the corporations is related to at least one member of an unrelated group that controls the other corporation.

[184] The common thread in each of the above cases is *de jure* control. *De jure* control means the right of control residing in the ownership of the shares which carry the majority of the voting rights that can be exercised to elect the majority of directors to a corporation's board.

[185] Paragraph 251(1)(*c*) provides that it is a question of fact whether unrelated parties are dealing with each other at arm's length. The courts have developed the following criteria to determine this factual question:

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[216] See paragraph 251(1)(*a*) of the *ITA*.

(a) Was there a common mind directing the bargaining of both parties to the transaction?
(b) Were the parties to the transaction acting in concert, without any separate interest?
(c) Was there *de facto* control?

The common thread here is *de facto* control.

[186] The parties do not dispute that GECUS and the Appellant are related and not dealing at "arm's length" by virtue of the *de jure* control that the former entity has over the latter.

[187] Paragraph 247(2)(*a*) also indicates that the "arm's length" principle must be applied by the trier of fact in determining whether an adjustment of an amount otherwise determined for the purposes of the *ITA* is required to match the "quantum or nature" of the amounts that would have been determined if the terms and conditions of the transaction had been made by arm's length parties. In this case, the crux of the dispute is whether the guarantee fee paid by the Appellant to GECUS exceeds an arm's length price. There are two opposing positions that I must choose between in determining this question. 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 Appellant? What do the relevant transfer pricing provisions say on this point? Before answering this question, it is important to recall the applicable principles of statutory interpretation.

[188] The words of a statute cannot be altered by a textual, contextual, and purposive analysis when they are clear and plain. One would simply interpret the words or expression according to their ordinary meaning, which is often referred to as the plain meaning rule. However, the expressions "arm's length" and "non-arm's length" are creations of law. They are not words of ordinary language from which a plain meaning can be easily distilled. In this case, the parties debated how the expression "arm's length" should be interpreted in a hypothetical world, thereby inevitably making the legal and practical effect of the transaction somewhat uncertain. Starting from the premise that the meaning of the expression is not clear and plain, one must turn to the textual, contextual and purposive analysis to clarify the expression in the context of transfer pricing.

[189] The modern approach to statutory interpretation was stated by the Supreme Court of Canada in *Canada Trustco Mortgage Co. v. Canada*:[217]

> 10 It has been long established as a matter of statutory interpretation that "the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament": see *65302 British Columbia Ltd. v. Canada*, [1999] 3 S.C.R. 804, at para. 50. The interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole. . . .
>
> [Emphasis added.]

[190] The origin of the modern rule is often attributed to E.A. Driedger, he who wrote that "the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament".[218]

[191] As noted in *Minister of National Revenue v. Sheldon's Engineering Ltd.*,[219] when considering the phrase "dealing at arm's length":

> . . . the *Income Tax Act* . . . does not purport to define the meaning of the expression generally: it merely states certain circumstances in which persons are deemed not to deal with each other at arm's length.

[192] While a number of cases, including many in a taxation context, have attempted to define the phrase "non-arm's length", few have discussed the converse, namely the meaning of the phrase "arm's length".

[193] The meaning of arm's length was considered extensively in *Crawford & Co. v. Canada*[220] by Porter J. The provision being considered, subsection 5(2) of the *Employment Insurance Act*,[221] defers to paragraph 251(1)(*b*) of the *ITA* for guidance on the arm's length issue. As noted by Porter J., the majority of cases considering the phrase "arm's length" in Canada have "tended to involve one person (either legal or natural) controlling the minds of both parties to the particular transaction". More specifically, he stated:

> 29 However, simply because these leading cases involved such factual situations, does not mean that people who might ordinarily be in a non arm's length relationship cannot in fact "deal with each other at a particular time in an 'arm's

[217] 2005 SCC 54, [2005] 2 S.C.R. 601.
[218] E.A. Driedger, *Construction of Statutes*, 2nd ed. (Toronto: Butterworths, 1983) at page 87 ("Driedger").
[219] [1955] S.C.R. 637.
[220] [1999] T.C.J. No. 850 (QL).
[221] S.C., 1996, c. 23.

> length' manner", any more than it means that people who are ordinarily at arm's length might not from time to time deal with each other in a non arm's length manner. These cases are quite simply examples of what is not an arm's length relationship rather than amounting to a definition in positive terms as to what is an arm's length transaction. Thus at the end of the day all of the facts must be considered and all of the relevant criteria or tests enunciated in the case law must be applied.

[194] The meaning of arm's length was considered outside a tax context by the British Columbia Court of Appeal in *Re Galaxy Sports Inc.*,[222] and that court defined the term as meaning "no bonds of dependence, control or influence, between the corporation and the person in question", in the sense that the latter has no moral or psychological leverage sufficient to diminish or possibly influence the free decision making of the former.

[195] More consistent with economic theory, is the definition adopted by the Court of Queen's Bench of Alberta in *Pocklington Foods Inc. v. Alberta (Provincial Treasurer)*:[223]

> 197 . . . In assuming that the parties are acting at arm's length, the negotiation is contemplated to be between parties with opposing interests, each having an economic stake in the outcome.

[196] With this background in mind, the concept of "dealing at arm's length" used in the context of the transfer pricing rules to determine a market price for a transaction refers to how independent parties negotiating with each other in the marketplace would behave — the vendor or service provider, for the purpose of achieving the highest price or best terms for his goods or services, and the other party, the purchaser, for the purpose of acquiring the goods or services at the lowest price.

[197] In the final analysis, the "arm's length" principle in the transfer pricing context is tied to modern economic theory, which is based on observations of how parties act in the marketplace. Economic theory assumes that individuals in the marketplace will employ a cost benefit analysis in choosing among the alternatives available for achieving their commercial objectives. The arm's length principle also embodies other features of general human behaviour. Market actors will seek out all relevant information, including information that helps them to understand their counterpart's motivation for entering into a transaction with them. Dr. Becker advanced these concepts in his report and during his testimony at trial.

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[222] 2004 BCCA 284.
[223] (1998), 159 D.L.R. (4th) 81.

[198] The question becomes one of fact or, more precisely, one of identifying the economically relevant characteristics of the transaction that may influence the arm's length parties in their negotiations.

[199] In my opinion, counsel for the Appellant misapplied the arm's length principle when he suggested to me that the concept of "implicit support" should be ignored because it is rooted in the non-arm's length relationship. That concept has nothing to do with the exercise of *de facto* or *de jure* control which defines a non-arm's length relationship. The reputational pressure is exerted by GECUS' debt holders. It is GECUS' debt holders that would react negatively if the Appellant was allowed to default on its debt. The fact that both GE and GECUS prize their AAA rating is commonly known in the marketplace. In many instances, it was GE and GECUS that advertised the materiality of their AAA credit rating in their public press releases and annual returns.[224]

[200] I can easily imagine how, in the present day context, the iconic investor, Warren Buffet, would have known that GE valued its AAA credit rating and that the loss of this status would entail significant additional financial charges for all of its operations. This factor would undoubtedly have been taken into account in designing the terms and conditions of, and determining the dividend rate and the conversion premium for, the GE preferred shares for which Berkshire Hathaway ultimately subscribed.[225] Undoubtedly GE would have weighed the pros and cons of agreeing to a private placement rather than issuing a public offering or lobbying the U.S. government for credit enhancement or support. Successful investors and investees are undoubtedly always attempting to use all information and current circumstances to their advantage.

[201] The evidence which is discussed later in this judgment shows that anyone contracting with GE or GECUS would be aware of the fact that GE or GECUS would want to preserve its high rating. Dr. Chambers, who appeared for the Appellant, accepts the fact that implicit support could lead to a double notch increase in the Appellant's credit rating for unguaranteed debt over a stand-alone rating. The question of fact then becomes how successful this negotiating approach would be, having regard to all of the other relevant facts and circumstances, some obviously countervailing, that would be taken into account in arm's length negotiations.

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[224] General Electric Company, 1999 Annual Report, Management's Discussion of Financial Resources and Liquidity, page 53:

> Based on past performance and current expectations, in combination with the financial flexibility that comes with a strong balance sheet and the highest credit ratings, management believes that GE is in a sound position to complete the share purchase program, to grow dividends in line with earnings, and to continue making selective investments for long-term growth.

[225] http://www.genewscenter.com/content/detail.aspx?ReleaseID=4220&NewsAreaID=2, press release "GE Announces Common Stock Offering; Warren Buffett Announces Investment In GE", October 1, 2008.

[202] My interpretation of the "arm's length" principle used in the context of subsection 247(2) is consistent with the decision of my colleague, Rip A.C.J. (as he then was), in *GlaxoSmithKline Inc. v. The Queen*.[226] In that case, he recognized that the arm's length principle enunciated in the OECD Guidelines inform us as to the proper interpretation and application of former subsection 69(2), as follows:

> 59 Subsection 69(2) of the Act is analogous to Article 9(1) of the *OECD Model Double Taxation Convention on Income and Capital*. The OECD issued a commentary on transfer pricing analysis in 1979. The Canada Revenue Agency ("CRA") relies on OECD Commentaries in assessing: Information Circular 87-2, *International Transfer Pricing and Other International Transactions*, dated February 2, 1987. Information Circular 87-2 was replaced by IC 87-2R, *International Transfer Planning* on September 27, 1999. The Federal Court of Appeal has said that it is "common ground that the [OECD Commentary] inform or should inform the interpretation and application of subsection 69(2)".
>
> 60 The OECD Commentary on Article 9(1) relies on the arm's length principle to determine the prices that multinational enterprises ("MNEs") would charge for goods and services sold from one jurisdiction to another. The arm's length principle recognizes that independent enterprises would charge prices according to market forces when dealing with each other. The Commentary recognizes that transfers between MNEs do not necessarily represent the result of free market forces, but may instead have been adopted for the convenience of the MNE. Consequently, prices set by an MNE may differ significantly from the prices agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions.

[203] Rip A.C.J. was applying principles accepted by the Federal Court of Appeal in *SmithKline Beecham Animal Health Inc. v. Canada*.[227]

[204] Paragraph 1.6 of the OECD Guidelines 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".[228] Paragraph 1.15 of the OECD Guidelines reinforces this principle by providing as follows:

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

[226] 2008 TCC 324, 2008 DTC 3957.
[227] 2002 FCA 229, [2002] F.C.J. No. 837 (QL).
[228] The concept of independent enterprise is very similar to the concept of arm's length as both concepts presuppose that neither party controls the other or is subject to common control.

> sufficiently comparable. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (eg. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences . . . . This point is relevant to the question of comparability, since independent enterprises would generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk or other comparability factors discussed below) when valuing those options.
>
> [Emphasis added.]

[205] This is a clear articulation of the importance of maintaining the relevant economic characteristics of the controlled transaction in order to ensure the reliability of the comparisons with uncontrolled transactions.

Is Reliance on Paragraph 18(1)(a) Required in Order to Uphold the Reassessments?

[206] Counsel for the Appellant also takes issue with the Respondent's approach in this case on the basis that the Minister failed to ask a critical question required under subsection 69(2) and paragraph 247(2)(*a*) of the *ITA*. In the Appellant's view, the Crown has built its entire case on the grounds that the explicit guarantee was not required in the circumstances because the Appellant's credit rating would have been equalized with that of its parent in any event. According to the Appellant, subsection 69(2) and paragraph 247(2)(*a*) of the *ITA* require the Minister to inquire how non-arm's length parties would have priced the transaction in similar circumstances. This was not done. The Crown failed to adduce pricing evidence at trial as required by the relevant provisions.

[207] I believe counsel has oversimplified the Crown's approach to this case. In fact, the Respondent did not argue that the guarantee fee was not incurred for the purpose of earning income, which is the test prescribed by paragraph 18(1)(*a*). The starting point for the Crown's approach is the creditworthiness of the Appellant before the explicit guarantee was implemented. The Respondent argues that the object of a guarantee is credit enhancement. To determine whether or not, in fact, the explicit guarantee mitigated the default risk of the Appellant's debt offerings, one must first determine the Appellant's credit rating without the explicit guarantee.

[208] According to the Respondent, because the guarantee does not enhance the Appellant's credit, the Appellant would not have entered into the guarantee contract with GECUS if the parties had been unrelated. The Respondent contends that a AAA-rated issuer would not enter into a guarantee contract in similar circumstances.

[209] Stated differently, because of implicit support there would be a ratings equalization between the Appellant and its stronger parent, GECUS. In that case, the Appellant would have no reason to seek out a third-party guarantor in the marketplace. There could be someone willing to provide the guarantee for a price higher than zero, but the Appellant would be unwilling to buy the guarantee if it provided no economic benefit. Therefore, it is not surprising that no market data can be found that can be used to price the transaction.

[210] I share this point of view. I believe an arm's length person would not contract for a service if that person feels the service would provide no benefit in the circumstances. I find the above argument to be persuasive on this point, provided that the evidence considered later on in this judgment demonstrates that the Appellant received no benefit, or little benefit, from the guarantee arrangement.

[211] I note that the case law on a provision which is similar to subsection 69(2) and paragraph 247(2)(*a*) does not support the Appellant's contention that neither of these provisions can be used to eliminate the expense in its entirety. The case law has held that section 67 of the *ITA* can be relied on by the Minister to disallow an expense, in whole or in part, if it can be shown that the expense was unreasonable in the circumstances. Section 67 operates much in the same way as subsection 69(2). The latter provision focuses on the reasonableness of an expense incurred by a taxpayer in a cross-border related-party transaction.

[212] This point was considered by the Federal Court of Appeal in *Hammill v. Canada*,[229] a case in which that court dismissed the appellant's argument that section 67 could not be used to reduce an expense to zero, as follows:

> 52 In devising the "recommended approach", the Supreme Court identified section 67 as the statutory means of controlling excessive or unwarranted expenditures once a source of income is found to exist. It said at paragraph 57:
>
> > ... If the deductibility of a particular expense is in question, then it is not the existence of a source of income which ought to be questioned, but the relationship between that expense and the source to which it is purported to relate. The fact that an expense is found to be a personal or living expense does not affect the characterization of the source of income to which the taxpayer attempts to allocate the expense, it simply means that the expense cannot be attributed to the source of income in question. As well, if, in the circumstances, the expense is unreasonable in relation to the source of income, then s. 67 of the Act provides a mechanism <u>to reduce or eliminate the amount of the expense</u>. Again, however,

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[229] 2005 FCA 252, [2005] F.C.J. No. 1197 (QL).

> excessive or unreasonable expenses have no bearing on the characterization of a particular activity as a source of income. [emphasis added]
>
> 53 The choice of words (reduce or eliminate) is not accidental. The Supreme Court was setting-up section 67 as the proper means of testing the reasonableness of an expense once a business has been found to exist. It was doing so after having explained that at the first level of inquiry (i.e. the existence of a source of income and the relationship between an expense and that source) courts ought not to second guess the business judgment of the taxpayer (*Stewart, supra,* paragraphs 55, 56 and 57). Section 67 was identified as the statutory authority pursuant to which an inquiry could be made as to the reasonableness of an expense. In my view, the Supreme Court in *Stewart* acknowledged that there is no inherent limit to the application of section 67, and that in the appropriate circumstances, it can be used to deny the whole of an expense, if it is shown to be unreasonable.

[213] There is no reason why I should depart from this principle in the instant case. During argument, I asked counsel for the Appellant whether he agreed with me that his approach meant that the Minister could not challenge a stewardship service or a duplicative service under the transfer pricing rules relied on in the instant case. Counsel for the Appellant agreed with this observation. I believe the principles enunciated in the *Hammill* case prove that this argument is flawed. A transfer pricing charge can be eliminated under the transfer pricing rules without resorting to a claim made under paragraph 18(1)(*a*), provided that it is established that the value of the benefit received from the service is nil.

The Role of Expert Witnesses

[214] Before embarking on a detailed analysis of the evidence and the technical opinions presented by the experts at trial, I believe it would be useful to remind ourselves of the role an expert is called upon to play and the approach a trial judge should take in hearing opinion evidence.

[215] First and foremost, with regard to expert evidence, I believe it is essential that the person deciding the case fully understand the witness's opinion before deciding to accept it in whole or in part or to reject it. I surmise that counsel on both sides spent a considerable amount of time coming to an understanding of the opinions the experts were called upon to articulate at trial. Counsel for both sides demonstrated they were extremely well prepared for the trial and had acquired a mastery of highly technical financial information and theories. I complimented both sides at the end of the trial for their thoroughness at the hearing. Nonetheless, there were a number of technical points covered by the experts on each side that required considerable clarification.

For example, the Altman Z-score double prime model used by Dr. Saunders in his report is highly technical and is difficult for a lay person to understand at first glance.

[216] Bryant, Lederman and Fuerst write in *The Law of Evidence in Canada*:

> The expert witness should provide independent assistance to the court and should not assume the role of an advocate. An expert should state the facts or assumptions upon which his or her opinion is based and should not omit to consider material facts which weaken his or her position.[230]

[217] Similarly, Jean-Claude Royer in *La preuve civile* describes the expert's responsibility as follows: "L'expert doit être impartial. Son rôle est d'éclairer le tribunal et non d'être l'avocat d'une partie."[231]

[218] Secondly, I observed, after listening to the experts, that it is easy for them in the heat of the moment to forget counsel's often repeated advice. An expert's role is to express an unbiased opinion on a technical subject that the Court considers useful to hear and that is relevant to the subject matter of the case, no more no less.

[219] I appreciate the precarious position in which our legal system places opinion witnesses, and because they find themselves in such a position, expert evidence can, I believe, be at times biased. Further, I would add, this consequence is not necessarily the expert's fault but is a product of the pressure imposed by the system. Experts know that it is easier to obtain mandates when their opinions are often accepted by the courts.

[220] For example, Glenn R. Anderson suggests, in his treatise titled *Expert Evidence*, that not all expert bias is dishonest or an intentional attempt to mislead or confuse the court.

> Attitudes and expectations inherent in the adversarial system foster certain beliefs about the role of the expert witness. Some expert witnesses genuinely view it as their proper role to assist persons employing them by whatever means is enabled by their specialized knowledge. These experts are biased, but not necessarily dishonest. They do, however, overlook their primary duty to assist judges and juries.[232]

[221] Master Sandler of the Ontario Superior Court of Justice also discusses this difficulty in *Peter Lombardi Construction Inc. v. Colonnade Investments Inc.*,[233] a

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[230] Alan W. Bryant, Sidney N. Lederman & Michelle K. Fuerst, *The Law of Evidence in Canada*, 3rd ed. (Markham, Ont.: LexisNexis, 2009) at paragraph 12.134.
[231] Jean-Claude Royer, *La preuve civile*, 4th ed. (Cowansville, Qc. : Éditions Yvon Blais, 2008) at paragraph 468.
[232] Glenn R. Anderson, *Expert Evidence*, 2nd ed. (Markham, Ont.: LexisNexis, 2009) at page 341.
[233] [1999] O.J. No. 3752 (QL) (Ont. S.C.J.).

decision in which he gave little weight to the evidence of two expert witnesses whose objectivity and independence were compromised due in part to the "exigencies of litigation".

> 420 . . . in coming to a decision on any particular issue where I had conflicting opinions and values from Mr. Doherty and Mr. Hand, I sometimes accepted Doherty's views, and sometimes accepted Hand's views, and sometimes I accepted neither, and came up with my own assessment based on the probabilities and reasonableness that surrounded any particular issue. . . .

[222] Master Sandler concluded that the opinion witnesses became advocates for a particular position on some issues and "let their obligations to their respective clients over-ride their duty to assist the court in arriving at the correct result".[234]

[223] In another case, Master Sandler gave little weight to the evidence of an advocating expert. He commented that the expert had gone "too far" in his opinions and took pains to emphasize that none of the opinion witnesses testifying in that trial were free of credibility problems such as bias and lack of objectivity.[235] Master Sandler then cited observations of Feldman J. in *Interamerican Transport Systems Inc. v. Canadian Pacific Express and Transport Ltd.*:[236]

> 61 . . . An expert witness is called to provide assistance to the court in understanding matters which are beyond the expertise of the trier of fact. Such a witness is not to be an advocate of one party, but an independent expert. Expert witnesses are of course paid a fee by the party calling them which in itself may be considered to affect their independence. The court will examine the demeanour of an expert in the way the evidence is given, in particular whether the expert takes on the role of an advocate for one side, or remains objective, in weighing the evidence and attributing value to the opinion. If the expert does adopt the attitude of a neutral, then the fact that he is being paid or that the defendant is his client will cause little or no concern, but that will not be the case if he appears to lose his neutrality. In that case the value of his evidence can diminish significantly.[237]

[224] In *Fenwick v. Parklane Nurseries Limited*,[238] MacFarland J. concluded that the expert witness of the appellant was partisan and gave little weight to his testimony.

> 35 Courts traditionally afford expert witnesses a great deal of respect. This is so because these persons possess an expertise in a particular area of endeavour where

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[234] *Ibid.*, at paragraph 419.

[235] *Rudberg (c.o.b. Urban Design & Renovation) v. Ishaky*, [2000] O.J. No. 376 (QL) (Ont. S.C.J.), at paragraph 232 (*Rudberg*).

[236] [1995] O.J. No. 3644 (QL) (Ont. C.J. - Gen. Div.).

[237] *Rudberg*, note 235 above.

[238] [1996] O.J. No. 3656 (QL) (Ont. C.J. - Gen. Div.).

> lay persons require assistance. The hallmark of an expert witness is that he or she exercises an independent professional judgment in their assessment of the facts of a given case. Where there is any suggestion that a witness who is proffered as an expert has not that professional independence but has rather simply taken on the cause of the client who pays the bills, a court will be most reluctant to place great weight on the opinions of that expert.

[225] Again, in *Shearsmith v. Houdek*, Romilly J. gave little weight to the evidence of an expert who was more an advocate for a party than an objective opinion witness.[239]

[226] All in all, judges must ensure experts are acting in conformity with their role of *amicus curiae*; they must decide whether an expert has overstepped and whether the expert's testimony is prejudicial to the interest of justice.[240] As the above examples illustrate, in some cases Canadian courts have simply disqualified opinion witnesses for playing the role of advocates, and in others, judges have given little weight to the expert evidence. However, all courts have held that a lack of objectivity, neutrality and independence has, at the very least, a significant impact on the weight to be accorded to expert evidence, if that evidence is not simply declared inadmissible at the outset.

[227] I believe it is the duty of a trial judge to be sure that the expert appearing before him has not advertently or inadvertently put on a counsel's robe in pressing his opinion upon the court. Often such improper conduct can only be uncovered through direct questions from the bench to the expert. Opposing counsel's cross-examination will also often expose such conduct, but not always. In any event, comparing a judge to a sphinx has been outdated for some time now. Judicial silence is no longer considered to guarantee impartiality and neutrality in the decision-making process. In 1985, Lamer J. (as he then was) observed in *Brouillard also known as Chatel v. The Queen*:[241]

> 17 . . . it is clear that judges are no longer required to be as passive as they once were; to be what I call sphinx judges. We now not only accept that a judge may intervene in the adversarial debate, but also believe that it is sometimes essential for him to do so for justice in fact to be done. Thus a judge may and sometimes must ask witnesses questions, interrupt them in their testimony and if necessary call them to order.

[Emphasis added.]

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[239] 2008 BCSC 997, at paragraph 11.
[240] Gordon D. Cudmore, *Civil Evidence Handbook*, Vol. 2, looseleaf (Toronto: Carswell, 1987), at paragraph 14.
[241] [1985] 1 S.C.R. 39 (LexUM) (*Brouillard*).

[228] This modern trend is based on the understanding that the principal role of a judge is to discern the truth. Not all litigants can afford to hire the best counsel or, for that matter, afford any representation. Accessibility to the courts has been restricted by costs which have increased substantially. Rinfret J. of the Québec Court of Queen's Bench, now the Québec Court of Appeal, described the two opposing theories as follows:

> [UNOFFICIAL TRANSLATION]
>
> The question to be posed is indeed the following: What does "justice" consist of?
>
> Must a judge, without a word, listen to testimony, hear arguments, and limit himself to reaching a decision solely based on the evidence and arguments the parties are willing to submit?
>
> Must a judge, realizing that counsel inadvertently, through lack of inability, or ignorance, has forgotten to produce evidence or to present an argument, deliver a judgment he knows to be inequitable to the parties?
>
> Must the client suffer the consequences of the clumsiness of his counsel?
>
> Some would answer in the affirmative; they believe the judge must rely strictly and rigorously on what was presented and that counsel, not the judge, is master of the hearing.
>
> Conversely, the alternate theory demands that the only master of the hearing be the judge, leaving him to direct the proceedings in the best interests of justice. To achieve this, the judge must inquire about all facts, even those which, for one reason or another, a party might have omitted to submit to the court. He must raise questions of law, even if these have not been submitted to him, provided that, in each case, he gives the parties or their counsel the chance to be heard on these issues.
>
> The law or justice is not a matter of surprises or technicalities.
>
> It is a judge's duty to shed as much light as possible on the question, to correct the situation, and to make up for the clumsiness or the ignorance of counsel, should this be required. This is how I understand "justice".
>
> However, a judge must not act in such a way as to cause the parties to lose their vested rights, and the judge, by the exercise of his discretion, will ensure the protection of those rights.[242]

[229] The judge has liberty to intervene in the proceedings in the interest of truth, provided he gives both parties full latitude to address the points raised by his questions. More recently, the Federal Court of Appeal in *NCJ Educational Services*

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[242] *Poulin c. Laliberté*, [1953] B.R. 8, at pages 9 and 10.

Limited v. Canada (National Revenue)[243] tempered the more traditional view of the role of a judge expressed in *James v. The Queen*[244] by declaring that it does not stand for the principle that a judge should refrain from intervening, but rather, that a judge should refrain from excessive intervention. Desjardins J.A. quotes the following passage from the manual *A Book for Judges*[245] by the Honourable J.O. Wilson in support of this more modern view of justice:

> . . . the rule is not against any intervention; it is against excessive intervention. Edmund Burke said: “a judge is not placed in that high position to be the mere arbiter of parties. He has a further duty, independent of that, and that duty is to ascertain the truth.
>
> [Emphasis added.]

[230] I believe that not only questions for the purpose of clarification are permissible when dealing with experts, but also questions designed to ensure that the attitude of the expert witnesses has not become that of an advocate. This broad statement is tempered by the right that must be fully afforded to counsel to complete the examination or cross-examination of the witnesses and to answer the questions raised by the judge.

Framework for the Determination of an Arm’s Length Price

Defining the Hypothetical Transaction

[231] The Respondent called two transfer pricing economists, Dr. Wright and Dr. Becker, as expert witnesses to opine on the analytical framework for conducting a transfer pricing analysis. I found each of these witnesses to be unbiased experts. At times they answered my searching questions in a manner which was not always helpful to the Respondent’s position. They acted as unbiased experts and not as advocates, thus avoiding an often critical mistake made by expert witnesses. Both of these witnesses had in-depth practical experience in the transfer pricing field and numerous publications to their credit. I found their opinions to be very helpful and in conformity with the OECD Guidelines on which the Canadian transfer pricing rules are based.

[232] Both of these professionals agreed that the first step in a transfer pricing dispute is to properly identify the transactions at issue. In the present case, this step

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[243] 2009 FCA 131.
[244] 2001 DTC 5075 (FCA).
[245] J.O. Wilson, *A Book for Judges*, written at the request of the Canadian Judicial Council (Ottawa: Minister of Supply and Services Canada, 1980) at page 44.

involves identifying the parties to the controlled transaction, the functions performed by each party and the risk assumed as part of the transaction.

[233] Dr. Becker wrote in his report that "... it is necessary to define the terms/characteristics of a transaction by creating a hypothetical (arm's length) transaction. This hypothetical serves as a proxy for the intercompany transaction under arm's length circumstances."[246]

[234] Dr. Becker emphasized the importance of matching the risks of the transaction in the hypothetical construct. Credit risk has a significant bearing on the guarantor's potential loss and, as a result, should affect the price charged. This is different from many other types of related-party transactions where risk may play a much lesser role. In the instant case, features of the borrowing transaction, to which the guarantee is accessory, also have a bearing on the assumed risk.

[235] Therefore, one of the first steps of the analysis is the determination of the Appellant's debt rating with and without the guarantee. It is expected that the price for the guarantee would vary with the default risk assumed by the guarantor. The higher the initial credit rating of the issuer without the guarantee, the lower the price and vice versa.

[236] As noted above, the Appellant did not have a treasury department. GECUS centralized all of the Appellant's treasury functions at the head office. Strict instructions were given by GECUS that only Mr. Werner's treasury group could raise credit and deal with outside investors, underwriters and bankers. I infer from the evidence that this was done because GECUS had to reassure its investors that it had implemented conservative financial practices throughout its organization. This behaviour was consistent with GECUS' AAA credit rating.

[237] Mr. Werner's treasury group determined the timing and negotiated the terms of the Appellant's debt issues. As a result, GECUS, the guarantor, exerted control over the Appellant's default risk. A third-party guarantor would not control the financial function of its debtor. It would not determine how and when the debtor would issue debt. It would not manage the debtor's cash flow and control debt payments.

[238] A third-party guarantor would not control the timing with respect to its guarantee. The credit enhancement arrangement would be negotiated in advance for a fixed term and agreed to by both parties, and the debtor would determine the timing

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[246] Exhibit R-31, expert report of Dr. Brian Becker, Economic Analysis of the Guarantees Made by General Electric Capital Corporation to General Electric Canada Inc. 1996-2000, pages 12-13.

of its debt issuance. Therefore, a third-party guarantor would assume more risk than GECUS did in the instant case. For example, commercial paper must be refinanced every 30, 60 or 90 days, depending on the maturity date of the debt. To provide assurance to the marketplace that the debt can be repaid, investors would need to know that subsequent debt issues are also covered by the same third-party guarantee, otherwise the third party could refuse to guarantee new debt issued to replace maturing debt, or charge a higher premium for the guarantee. As a standby credit facility would be required to achieve a AAA credit rating, one can easily imagine that the banking syndicate would require the third-party credit enhancement to be in place for the full term of the standby facility. Otherwise, the banking syndicate would be taking on a much greater risk.

[239] The guarantee arrangement provided by GECUS to the Appellant was not established in advance for a fixed duration. The guarantee was given on a one-off basis and only upon the issuance of the commercial paper, an event that GECUS' treasury department controlled to some degree through its performance of the cash management function for the Appellant. Undoubtedly because the parties were not dealing at arm's length, there was no need to agree in advance to a term for the guarantee. However, this situation could not exist, for the reasons noted above, if a third-party arrangement was entered into. Therefore, an arm's length guarantor would assume more risk than GECUS, and this would require either an adjustment in the pricing or the use of an alternative methodology to determine the arm's length price. I believe that all of the above factors would be different for a third-party insurer or guarantor; they would undoubtedly magnify the risk for the insurer or guarantor, thus resulting in a higher premium.

[240] Mr. Meghji, counsel for the Appellant, objected that these factors should not be taken into account in the determination of an arm's length price on the grounds that GECUS enjoys control over these factors because of its indirect share ownership of the Appellant. Simply put, what we have here is a benefit accruing to GECUS qua shareholder. I believe that Mr. Meghji's argument is based on an oversimplification of the corporate law applicable to the Appellant.

[241] In theory, or in corporate law, directors manage, or supervise the management of, the business and affairs of a corporation,[247] while officers run the daily operations within the framework of the policies and directions set by the elected board of directors. Yet, in practice, where economic forces come into play, officers of large

[247] *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 , subsection 102(1) [*CBCA*]: "102(1) Subject to any unanimous shareholder agreement, the directors shall manage, or supervise the management of, the business and affairs of a corporation".

corporations determine the corporate destiny; they have the vision; they hold the reins of the corporation; and they often select their own successors.[248]

[242] Shareholders have some rights; for example, they elect the board of directors. These legal rules can be altered in a unanimous shareholder agreement and the shareholders can appropriate the powers of the board of directors "to manage, or supervise the management of, the business and affairs of the corporation".[249]

[243] As for the day-to-day operations of a business, the *Canada Business Corporations Act* (the "*CBCA*") does not specifically allow for shareholders to appropriate powers of officers. According to Bruce Welling, this reality is "formalistically consistent with the traditional corporate law notion that officers are limited functionaries appointed by the board of directors".[250]

[244] In *Duha Printers (Western) Ltd. v. Canada*,[251] Iacobucci J. explained:

> 61 ... Directors generally owe a duty not to the shareholders but to the corporation, and shareholders could not, therefore, control the day-to-day business decisions made by the directors and their appointed officers. In other words, although the shareholders could elect the individuals who would make up the board, the board members, once elected, wielded virtually all the decision-making power, subject to the ability of the shareholders to remove or fail to re-elect unsatisfactory directors.
>
> [Emphasis added.]

[245] All in all, the fundamental distinction remains that shareholders can appropriate the powers to appoint the officers, but not the powers of the officers to in fact manage the business. This is the result of a close reading of subsection 146(1) of the *CBCA*.[252]

[246] As the above shows, GECUS could not appropriate the money management functions of the Appellant by virtue of the exercise of the voting rights it indirectly held with respect to the Appellant. Practically speaking, it did appropriate the

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[248] Bruce Welling, *Corporate Law in Canada: The Governing Principles*, 3rd ed. (London, Ont.: Scribblers Publishing, 2006) at pages 300, 469 (Welling).

[249] *CBCA*, note 247 above, subsection 146(1):

> 146(1) An otherwise lawful written agreement among all the shareholders of a corporation, or among all the shareholders and one or more persons who are not shareholders, that restricts, in whole or in part, the powers of the directors to manage, or supervise the management of, the business and affairs of the corporation is valid.

[250] Welling, note 248 above, at page 469.

[251] [1998] 1 S.C.R. 795.

[252] *CBCA*, note 247 above.

function, but this was not something that was attributable to ownership of its shares in the Appellant.

[247] I also note that due consideration must be given as well to the fact that the Appellant's debt had been guaranteed by GECUS since 1998. The Appellant'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 Appellant 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 Appellant'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 Appellant are supposed to bargain as arm's length parties. This history of the guarantee places the Appellant in a more vulnerable position, as is shown by the evidence considered later on in these reasons.[253]

[248] The Crown argues that the issue herein does not warrant an investigation of the impact of the removal of the guarantee. According to the Respondent, the trial has to do with the pricing of the guarantee remaining in place.

[249] I find this argument ironic in light of the case presented by the Respondent at trial. It was the Respondent that insisted that an arm's length price for the guarantee must be determined using the yield approach. The Respondent was thereby calling for the determination of the Appellant's credit rating both with and without an explicit guarantee. An accurate determination of the Appellant's credit rating cannot be made by ignoring the fact that a guarantee was provided for all of its prior public indebtedness.[254] The Crown cannot pick and choose among the economically relevant characteristics of the transactions and use only those facts that are favourable to its position. Witnesses for both the Appellant and the Respondent acknowledged that the prior guarantee is a relevant fact which cannot easily be explained away in the determination of a credit rating for the Appellant without an explicit guarantee.

[250] This brings us to the next step, which concerns the proper description of the analysis of the parties to the hypothetical transaction. Dr. Becker suggests the hypothetical guarantor should have characteristics similar to GECUS, namely, it

[253] See paragraphs 280 and 281 below.
[254] Trial transcript, page 3094, lines 15-18.

should be a AAA-rated multinational subsidiary of a AAA-rated multinational parent. Similarly, the hypothetical debtor should be a subsidiary of a AAA-rated multinational corporation. The hypothetical parent of the debtor should be a corporation conducting an international unregulated financial services business that borrows large amounts of money in the international commercial paper markets.

[251] Dr. Wright emphasized the importance of evaluating the comparability of the transactions, or the importance of the methodology used to justify the transfer price, as follows:

> A careful transfer pricing study would spend considerable effort to determine whether GECUS should be compared to a bank or insurance company guarantor because that affects the guarantee fee computation. The potential increase in GECUS' interest expense attributable to default by [the Appellant] is significantly larger than the guarantee fee that a third party bank or insurance company would require . . . .[255]

The Correct Methodology

[252] Both parties acknowledge there are no comparable uncontrolled transactions. The parties also agree that the resale price and cost plus methods are inapplicable. Having eliminated the preferred transaction-based methodologies, each party presented competing pricing methodologies for my consideration.

[253] The Appellant introduced an insurance-based model and a CDS methodology as alternative methods. The Respondent offered the S&P credit rating methodology for consideration under the yield approach to establishing the Appellant's credit rating without a guarantee, on the theory that the guarantee fee cannot exceed the value of the benefit resulting from the service provided.

Insurance-Based Methodology

[254] At trial, following the examination-in-chief and cross-examination of Mr. Fidelman, I mentioned that I had considerable reservations about his proposed methodology. First, Mr. Fidelman admitted that guarantee insurance has been used as a credit enhancement arrangement only for municipal bonds and asset-backed securities. Such an arrangement has not been used to mitigate default risk with respect to corporate bonds or commercial paper. I suspect the market has not developed because insurers price the risk higher than the benefit perceived by corporate issuers that have parent corporations able to provide credit enhancement in

[255] Exhibit R-33, rebuttal report of Dr. Deloris Wright, 3rd page.

the form of a guarantee or other types of explicit support. In the present case, I believe the risk assumed would not be the same for an insurer as it was for GECUS, as the insurer would be unable to control the timing, terms and payment of the Appellant's debt offering. It would be asked to guarantee GECUS in advance of its issuance and for a specific term. This was not the case for the arrangement negotiated between GECUS and the Appellant. In short, the guarantor would have no control over the debtor's default risk. This is a situation very different than that enjoyed by GECUS.

[255] I do agree with Mr. Fidelman that, logically, a third-party insurer would attach very little worth to the "implicit support" of GECUS because if it was called upon to execute its guarantee of the Appellant's debt it would be expected to pay up. Nonetheless, a default by the Appellant on its debt would not be welcomed by GE and GECUS as it would signify to the marketplace that parts of the consolidated enterprise were not as reliable as expected. In the end analysis, GE's and GECUS' creditors are lenders on the strength of those corporations' consolidated balance sheet. This was confirmed by the Appellant's experts, Mr. Cole and Mr. Coombs.

[256] In addition, Mr. Fidelman relied upon a credit rating product called "RiskCalc" to obtain a stand-alone rating. The stand-alone credit rating did not take into account the implied support of GECUS as it was not designed to deal with debtors in the financial industry that had AAA-rated parents. Mr. Fidelman was required to do an arbitrary "notching up" to match the public ratings of independent companies, which calls into question the reliability of this methodology. Finally, Mr. Fidelman concluded that the guarantee fee under the insurance approach would still be 0.85% even if the Appellant was viewed as a AAA-rated issuer without an explicit guarantee. This stands in contradiction to the position adopted by Mr. Werner, who believed an arm's length guarantee fee could not exceed the value of the benefit received by the Appellant.

[257] It is impossible for me to determine with any degree of certainty whether the above factors, some of which support the insurance methodology and others of which clearly do not, are perfect counterweights to each other. Mr. Fidelman did not address how the additional risk that would be assumed by the insurer would affect price. I surmise that if he did not address the fact that a third-party insurer would assume greater risk under a properly structured arm's length guarantee arrangement, it was on the advice of counsel, given the legal argument that I had rejected earlier. Therefore, I consider the insurance-based methodology to be unreliable in the circumstances, save perhaps for its use as one method among others to be considered at the stage of the "sanity check" recommended by Dr. Wright as a final step to be performed in ascertaining the arm's length price for the transaction.

CDS Methodology

[258] Dr. Hull uses a CDS methodology to come up with a price range for the guarantee transaction. A careful review of Dr. Hull's testimony reveals that the CDS approach is analogous to the yield approach proposed by the Respondent. This witness admitted that he was asked to use for the purpose of his analysis an assumed credit rating which was provided to him by counsel for the Respondent. On the basis of the assumed rating, he concludes that the premium under a CDS would be equal to the yield difference between the Appellant's assumed rating and the AAA rating attributed to the Appellant's debt as a result of GECUS' guarantee. In the end, Dr. Hull's analysis does little to clarify the issue herein. The accuracy of his conclusion is entirely dependent on the accuracy of the assumed credit rating that he uses in his report. That is the crux of the matter in this case.

Yield Approach

[259] The Respondent asserts that the first step in the transfer pricing inquiry is to calculate the value of the benefit enjoyed by the Appellant as a result of GECUS' guarantee. This should be done using the yield approach. The benefit is equal to the interest cost savings for the Appellant determined by comparing the interest cost of unguaranteed debt to that for guaranteed debt. To determine the interest savings for the Appellant, one must arrive at a factual finding of the Appellant's credit rating without the explicit support of its parent. Could the Appellant be a AAA-rated issuer without the guarantee?

[260] Counsel for the Appellant takes issue with this approach on the grounds that it does not entail a search for an arm's length price. The Appellant argues that this method leads to the determination of a value to the owner. In addition, counsel argues that the Crown has priced the wrong transaction. According to counsel, for the purpose of the appeal the Minister is required to price the actual transaction, which is a guarantee, and not a loan as suggested by the Respondent.

[261] This latter argument is contradicted by the testimony of the Appellant's principal lay witness, Mr. Werner, who testified that he determined the guarantee fee on the basis of his estimate of the benefit received by the Appellant:[256]

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[256] Trial transcript, page 224, line 6, to page 225, line 24.

MR. MEGHJI: Now, Mr. Werner, what did you understand your objective to be in determining the guarantee fee?

MR. WERNER: I understood my objective to be to develop and support a guarantee fee which was arm's-length, which was a market rate, which was supportable by data, objective data, in the marketplace.

MR. MEGHJI: Now, in seeking to arrive at this, you have used the words market price. I will use the words market price.

In arriving at this market price of the guarantee, the guarantee fee amount -- sir, I want you to go in bite-sized pieces carefully -- what exactly did you do, you and your staff?

MR. WERNER: <u>We started with -- we started by determining what the benefit to the borrower, that is GE Capital Canada, of the guarantee would be</u>.

MR. MEGHJI: Okay. And in the process of starting with that, did you have to make any -- did you have to make any analysis of whether GE Capital Canada was an investment grade company?

MR. WERNER: We talked about this at the end of -- the answer is yes. We talked about it at the end of the day yesterday that we had determined in 1988, 1989 that GE Capital Canada was, at best, right on the edge between investment grade and non-investment grade, and that our opinion as to that creditworthiness had not changed.

MR. MEGHJI: So you started with that, with that this was not an investment grade company?

MR. WERNER: Yes.

MR. MEGHJI: Then you said you started by -- the question was asked: What was the benefit to GE Capital Canada?

MR. WERNER: Yes.

MR. MEGHJI: Now, how is it that you went about determining the benefit to GE Capital Canada of the guarantees?

MR. WERNER: Well, <u>they certainly could not -- would not, in a commercial setting, pay more the guarantee fee</u> than the <u>benefit of that guarantee fee</u>.

. . .

[Emphasis added.]

[262] In his testimony, Mr. Werner has admitted that the yield approach proposed by the Crown is in fact an acceptable methodology for determining an arm's length price. As his own words show, that is what he used himself.

Application of Credit Rating Methodology

[263] The Crown posits that the Appellant did not benefit form GECUS' guarantee of its indebtedness because its debt would have been rated AAA solely on the basis of the implicit support of GECUS. The Respondent had Mr. Emmer qualified as an expert on credit rating methodology and the Appellant had Dr. Chambers similarly qualified. Both of these experts held senior positions with S&P over the course of their long careers with that credit rating agency.

[264] Both of the experts relied to various degrees on the rating criteria published by S&P and Moody's to demystify the rating process. The contrary opinions expressed by the experts are largely based on two factors. Dr. Chambers prefers the relevant quantitative factors over the applicable qualitative factors. Dr. Chambers, who appeared for the Appellant, places greater weight on factors such as the small size of the Appellant's balance sheet compared to that of its parent and its high debt-to-equity ratio of 12 to 1 in concluding that the Appellant did not possess the characteristics to be rated AAA. It was on the cusp of an investment-grade rating once account was taken of a certain degree of implicit support from its parent, GECUS.

[265] Mr. Emmer arrives at the contrary view because he favours qualitative over quantitative factors in his analysis. In the present case, Mr. Emmer suggests that GECUS would have suffered catastrophic damage to its reputation had the Appellant been allowed to default on unguaranteed debt it issued to the public. According to this expert, GECUS would have taken whatever steps were necessary to ensure that no default would occur because, if it failed to do so, its own prized AAA rating would have been jeopardized. The cost to it of a credit rating downgrade would far exceed the cost of preventing the Appellant's default. GECUS gave its guarantee out of convenience, for itself alone. The guarantee facilitated the task of its treasury department with respect to debt issuances by the Appellant.

[266] I have difficulty with Mr. Emmer's opinion on this matter. I do not believe the quantitative factors identified by Dr. Chambers in his report can be summarily dismissed on the theory of reputational pressure. The evidence shows that S&P, the rating agency where Mr. Emmer spent his career, demanded that GE execute a keep-well agreement under which it committed to maintaining GECUS' debt-to-equity ratio at 8 to 1. GE and GECUS both enjoyed AAA ratings in the taxation years under

review. I understand that the rationale for the keep-well agreement was tied to the level of preferred share capital that GECUS had issued to outside investors. Preferred shares have debt-like characteristics. They are not considered to offer the same type of permanent capital as common shares. Events can trigger the redemption of the shares unless they have been made to be perpetual. To protect against an erosion of capital, the keep-well agreement required GE to, *inter alia*, add capital if preferred shares were retracted and not replaced.[257] I imagine that, if GECUS' debt-to-equity ratio was unimportant, S&P would not have seen the need to demand the execution of the keep-well agreement.

[267] Mr. Emmer and the Crown dismiss the debt-to-equity ratio on the basis that it is circular in its application. In other words, GECUS can make the Appellant's balance sheet look more or less attractive by providing it with more or less capital. GECUS did not provide more capital to the Appellant because the guarantee saved it from doing so. Whether this is true or not does not matter. I believe creditors and rating agencies are concerned about the debt-to-equity ratio of debtors. Common share capital, in my opinion, provides a more robust means of weathering either a storm of financial difficulty that affects the industry or a generalized recession than does implied support. Creditors have no recourse against the parent if they rely on the expectation that the parent will come to the rescue of its subsidiary and it fails to do so. I infer that S&P acknowledged this fact when it demanded that GE execute a keep-well agreement with respect to its direct subsidiary, GECUS.[258]

[268] I also take issue with the suggestion that GECUS could have injected capital into the Appellant to improve the latter's debt-to-equity ratio; I do so on the grounds that this contradicts the well-accepted principle that a corporation is a separate person whose very existence provides limited liability protection to its shareholders. The extent of a shareholder's exposure through the corporation is limited to the amount of capital the shareholder chooses to invest. In the absence of a guarantee from the shareholder, creditors can expect nothing more or less.

[269] This comment must be tempered with respect to other types of corporate entities that exist on the Canadian corporate landscape. For example, shareholders of an Alberta unlimited liability corporation ("ABULC") have unlimited joint and several liability for any liability, act or default of the ABULC. This type of entity is often used in cross-border financing with the U.S. to facilitate so-called "double dip" financing structures.[259]

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[257] *Ibid.*, page 1221, line 12, to page 1222, line 18.
[258] A keep-well agreement is a contractual undertaking that amounts to the provision of a service.
[259] *Business Corporations Act*, R.S.A. 2000, c. B-9, s. 15.2.

[270] Because the shareholder is jointly liable with the ABULC, a guarantee of the corporation's debt by the shareholder might not create a benefit for the corporation. Moreover, because the joint and several liability results from share ownership, there might be no service that the shareholder could charge for; it would be passive association as a shareholder. If the shareholder had a higher credit rating than the subsidiary, legal status alone may require a notching up in the credit rating of the subsidiary. This may also have implications for the interest rate that could be charged on intercompany loans. This latter comment must be qualified if the shareholder is simply an intermediary shell corporation whose only asset is shares of the ABULC. This might also be true if an indirect parent of an ABULC provides a guarantee for its indebtedness, assuming, for example, the direct shareholder is a non-resident corporation. The guarantee in these circumstances might benefit both the ABULC and its shareholder, which might necessitate allocating the liability equally.

[271] The immediately preceding comment must be further qualified with respect to a Nova Scotia unlimited liability company ("NSULC)", which is often used in a cross-border financing context for the purpose mentioned above. In this case, the liability of the shareholder is conditional.

[272] Briefly, the Nova Scotia *Companies Act* ("*NSCA*")[260] permits the incorporation of a company with no limit on the liability of its shareholders. Pursuant to section 135 of the *NSCA*, past and present shareholders of a NSULC are jointly and severally liable for all debts and liability when the NSULC is wound up or liquidated with insufficient assets to satisfy its obligations. For past shareholders, the liability is extinguished if the shareholder ceased being a shareholder one year before the winding-up or liquidation.

[273] An NSULC must be wound up or liquidated if it has insufficient assets to meet its obligations. There is no immediate liability for the shareholder. In this context, the

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> 15.2 – Liability (1) The liability of each of the shareholders of a corporation incorporated under this Act as an unlimited liability corporation for any liability, act or default of the unlimited liability corporation is unlimited in extent and joint and several in nature.
> (2) Notwithstanding subsection (1), but subject to any immunity from liability otherwise available on pleading the *Limitations Act* as a defence, a former shareholder of an unlimited liability corporation is not liable for any liability, act or default of the unlimited liability corporation unless an action to enforce a claim arising out of that liability, act or default is brought within 2 years from the date on which the former shareholder last ceased to be a shareholder of the unlimited liability corporation.
> (3) A former shareholder of an unlimited liability corporation is not liable for any liability, act or default of the unlimited liability corporation that did not exist on or prior to the date on which the former shareholder last ceased to be a shareholder of the unlimited liability corporation.
>
> [Emphasis added.]

[260] R.S. 1989, c. 81, s. 1.

guarantee might provide a greater benefit to the corporation and a more remote benefit to the shareholder. This would be particularly true if the shareholder was a shell corporation. Needless to say, the facts and circumstances of each case must be well understood. With this background in mind, one must be aware that it would be dangerous for taxpayers to draw general inferences from this particular case, as differences in facts or circumstances or in the economically relevant characteristics of a transaction can lead to a very different result. In the final analysis, transfer pricing is largely a question of facts and circumstances coupled with a high dose of common sense.

[274] Mr. Emmer also used the argument of reputational pressure to skip over an essential first step imposed under the rating methodology criteria used for rating subsidiaries of a public corporation. The rating literature submitted at trial provides that an analyst must start the rating process by completing a stand-alone rating of the subsidiary before proceeding to determine whether ratings uplift is required in order to take into account the benefit of implicit support by the parent. The literature explains the rationale for the stand-alone rating; its purpose is to allow the analyst to gauge the rating gap between the subsidiary's and its parent's ratings. More concrete signs of implicit support are required to bridge a large rating gap. An analyst cannot make a rating proposal to the ratings committee that oversees the final rating until this step is completed. Mr. Emmer knew this requirement, yet he does not fully comply with it in his main report. I find nothing in the literature that would require this step to be carried out only with respect to certain types of industries. Because he fails to conduct this critical first step, he has no reference point for opining on the rating gap and the signs of implicit support that must be recognized by the analyst to justify the notching up of the Appellant's rating. With this background in mind, his opinion on the subject appears to me to be speculative at best.

[275] Dr. Chambers, on the other hand, did perform a stand-alone rating analysis as prescribed by the S&P criteria in effect during the years under review. He concludes, after applying all of the relevant criteria, that the Appellant would have been rated B+ to BB- on a stand-alone basis. As a result, he is in a position to determine that there is a large differential between the Appellant's stand-alone rating and that of its parent. The gap is between 12 and 13 notches. He testified that the typical ratings uplift is two to three notches.

[276] There are other difficulties with the influence that Mr. Emmer claims reputational pressure would have had on GECUS' behaviour. I view reputational pressure in this context as an offshoot of the buildup of social capital in the marketplace by GE and GECUS. All parties agree that AAA-rated issuers must demonstrate consistent behaviour to achieve the confidence of their debt holders that

all of their obligations will be promptly discharged. There is disagreement among the parties as to the extent to which this consistent behaviour must be displayed, the Respondent's position being that it must be extended to the Appellant because it is a core or strategically important subsidiary.

[277] On cross-examination, Mr. Emmer was confronted with the S&P rating report issued in 1999 for the GE group. GE Financial Corp., an indirect insurance subsidiary of two AAA-rated parents, GECUS and GE, was rated A+, that is, four notches below the AAA rating of its parent corporations.[261] I note that GE Financial Corp. had 10 times more assets than the Appellant; its assets represented approximately 21% of GECUS' consolidated assets. If reputation alone is a strong factor for ratings equalization, surely GE Financial Corp. would have been a much better candidate for the ratings uplift proposed by Mr. Emmer for the Appellant. A default by GE Financial Corp. would no doubt have had a much bigger impact on GECUS than a default by the Appellant. I recognize that GE Financial Corp. is a regulated insurance company and that the Appellant operates an unregulated financial services business. Nonetheless, I cannot imagine how GE Financial Corp.'s failure would be of lesser consequence to GECUS than a default by the Appellant. I share Dr. Chambers' view that the sheer size difference alone would account for a bigger impact.

[278] In addition, Mr. Emmer made a computational error in his application of a quantitative fact. Mr. Emmer admitted Dr. Chambers had correctly pointed out that he failed to take into account currency differences when comparing certain of the Appellant's financial ratios to those of its parent. When corrected for these errors, the Appellant's growth ratio and the size of its balance sheet compared to GECUS' consolidated balance sheet were revised downwards.

[279] I believe Mr. Emmer also failed to adequately consider the impact of the removal of GECUS' guarantee. This guarantee had been in place long before there was a hint of a guarantee fee. There is no longer any suggestion by the Crown that the guarantee was executed as an artifice for the siphoning off of the Appellant's profits in the form of a guarantee fee. It was executed solely for legitimate business reasons.

[280] Dr. Chambers believes that the investment community and the rating agencies would have reacted negatively to the removal of the guarantee. I agree that, if GECUS had removed its guarantee, that would have signified that its appetite for providing credit support for the Appellant had diminished. I imagine that it would have been difficult in those circumstances to convince investors that they did not have to worry about the removal of the guarantee because reputational pressures

[261] Trial transcript, page 3117, line 21, to page 3119.

would compel GECUS to avoid the Appellant's default in any event. Moreover, I believe the investment community would have reacted by quoting the well-known proverb "a bird in the hand is worth two in the bush".

[281] Implicit support is nothing more than one's expectation as to how someone will behave in the future because economic reasons will cause the person to act in a certain manner. Economic circumstances can change quickly, as evidenced by the recent credit market meltdown. A guarantee is a much more effective form of protection. It is something that investors in the present case would have been reluctant to give up in light of the fact that substantially all of the Appellant's debt had been guaranteed for a very long period of time.[262]

[282] Mr. Emmer, appearing for the Respondent, recognized that he had difficulty imagining how a decision to drop the guarantee could have been presented as a positive or neutral fact by the Appellant in attempting to secure commitments for unguaranteed commercial paper. For example, in response to my question on this point, he testified as follows:[263]

> JUSTICE HOGAN: The facts are a little different. I think counsel is putting the question to you that they come to you and you are wearing your cynical, sceptical hat, and they say: We have been guaranteeing our debt for eight years now and we want to remove the guarantee. Can we get there?
>
> Wouldn't your antennas go up a little bit, and say, why -- wouldn't you ask these very questions, Why won't you put pen to paper? Why are you sort of changing your attitude?
>
> THE WITNESS: . . . It would have to ask: Why would they -- other than for this particular instance, why would they want to stop guaranteeing the debt of their subsidiary?
>
> I understand why we're looking at it that way, and I think sort of my thought process was, and still would be, that if they allowed them to issue the debt, that they would stand behind it with a guarantee or without a guarantee.
>
> However, it is difficult to come up with a scenario where they would not -- where they would cease to guarantee the debt, other than for purposes of the discussions that we have been having for the past three or four weeks.
>
> So I have problems sort of making that leap, because I agree it is an unrealistic scenario. It is very hypothetical.

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[262] *Ibid.*, page 3094, lines 15-18. The exception is a small short-term loan ($75 million) linked with the Appellant's year-end.
[263] *Ibid.*, pages 3099-3102.

Why would they want to stop? You know, you look at the infrastructure that they have in place up in Stamford, Connecticut, the trading desk and all of the relationships that they have with commercial paper dealers, and so on. And why would they want to stop doing it?

So I think it is an unrealistic scenario that you are asking me to really opine on. So that is why I keep coming back to the same point, that if they let them do it, if they let -- sorry, if they let Canada issue without the guarantee, they would stand behind it.

The question is: Why would they want to do that? And it is very difficult for me to come up with a reason why -- it would be an irrational decision on their part to do that.

So that is the challenge that I guess we've all been having for the past couple of weeks. It becomes very, you know, hypothetical and, you know, a bit unrealistic to assume that.

I mean, everything -- as I understand it, everything that GECC does is -- you know, I think they have, I believe we discussed, Australia and New Zealand, and I forget how Japan was structured, but they guaranteed that.

My antenna would go up, also. Before mine would go up, I know that Mr. Werner's would be up well before mine, and he would say, Is this a reasonable thing for us to do? And I think he would conclude it is not a reasonable decision; therefore, he wouldn't --

JUSTICE HOGAN: He'd say, Why rock the boat; right?

THE WITNESS: Exactly, yes, yes. Why (a) rock the boat, and (b) I think, you know, even if we assigned an AAA rating to the debt, I still think that investors would want a premium.

JUSTICE HOGAN: They would want a premium?

THE WITNESS: They would want a premium without the guarantee, yes. I mean, we have been here for a month or three weeks -- it is seems like a month – like, three weeks discussing this, and we still haven't come to a definitive conclusion.

We could rate it AAA, but that doesn't mean that investors wouldn't want some kind of premium. The guarantee is clear. It is black and white. Here it is. You don't have to go through 15 criteria and sort of count angels on the head of a pin to see if it is core, strategic, non-strategic, or what have you.

[Emphasis added.]

[283] During this line of questioning, I noted from Mr. Emmer's demeanour that he was very uncomfortable answering the question. For example, he claims that the

removal of the guarantee is an unrealistic scenario. For the reasons that I noted earlier, this question lies at the very foundation of the Crown's case submitted at trial. It is an economically relevant fact that should have been considered by Mr. Emmer in preparing his opinion.

Was the Guarantee Necessary?

[284] The last point on this subject is whether market participants would have purchased the Appellant's unguaranteed debt even if it was rated AAA. Generally speaking, I could address this point simply by referring to my earlier conclusion that the evidence does not show on a balance of probabilities that the unguaranteed debt of the Appellant would be rated close to AAA. Nonetheless, I will deal with this specific matter because this case is the first of its kind to be presented to the Court for consideration and there is a substantial amount of money at stake.

[285] Mr. Coombs testified that the banks take third-party ratings into account. However, he did note that these ratings are only one of the many inputs considered in the banks' internal credit assessment process. He also emphasized that the banks' internal rating will often be lower than the ratings of the external rating agencies.

[286] I do not find it surprising that banks adopt a more cautious approach. They are committing capital while the rating agencies are being paid to provide a credit rating opinion by the debt issuer that they are asked to rate. This raises numerous issues of conflict of interest which are beyond the realm of this judgment. Suffice it to say that recent events such as the sudden meltdown of asset-backed financing structures have shown that these concerns are nonetheless very legitimate.

[287] Mr. Lewis noted in his testimony that sophisticated market participants such as Texaco would not assign weight to implicit support because they would be accepting a risk without a commensurate return. Security of principal repayment was paramount and implicit support was simply an extrapolation of someone's opinion that economic incentives would cause the parent company to act although not legally bound to do so. Implicit support is like a metaphorical "invincible wallet". It is something investors believe exists and may be available to provide financial support if the right circumstances are present, but few investors are foolish enough to believe that it is equivalent to a guarantee. Mr. Emmer recognizes this very fact in his testimony cited in paragraph 282 above. By its nature, implicit support does not afford to sophisticated investors the same degree of reassurance that the parent will act that a legally enforceable guarantee provides.

[288] I note that the commercial paper market is largely composed of sophisticated investors, whether they be corporations that have a need to invest excess short-term liquidities, large pension funds or conduit entities such as mutual fund trusts that employ experienced money managers. Retail investors often participate in this market by buying units of a mutual fund trust thereby benefiting from the market know-how of the funds' money managers. In light of this evidence, it appears implausible that the Appellant could have raised the same large sums of money at the low interest rates that it benefited from even if its debt had been rated AAA. Mr. Emmer confirmed this fact during his cross-examination.[264] Dr. Booth also confirmed that most of the Canadian subsidiaries of foreign public corporations borrow in the Canadian commercial paper market on the strength of a parent company guarantee. This fact was undisputed by the Crown. Therefore, it is hard to imagine there would be the same willingness for investors to accept AAA-rated debt pricing for unguaranteed debt of the Appellant.

[289] Dr. Saunders and Mr. Meyerman also testified, *inter alia*, that economic incentive was the most important factor in determining the likelihood of parental support. These witnesses confirmed the fact that GE and GECUS valued their AAA status. This rating was the key element of both companies' competitive strategies, but more so for GECUS than GE because the ability to offer low interest rates is an important competitive advantage for leasing and other forms of equipment financing.

[290] I have no doubt that GE and GECUS valued their AAA status. Mr. Werner confirmed this fact in his testimony. This being said, I believe, for the reasons noted above, that it would be an unwarranted leap of faith to conclude that the Appellant's credit rating would be equalized with that of its parent if there were no guarantee in place. I note that neither Dr. Saunders nor Mr. Meyerman is an expert in credit rating agency methodologies.

[291] As stated earlier, the Crown's theory that the guarantee was unnecessary contradicts Mr. Werner's business judgment that the guarantee was necessary, a position acknowledged to have merit by Mr. Emmer during his cross-examination. In other areas involving the application of the *ITA*, the courts have declared that they will exercise caution before adopting conclusions that contradict the properly exercised business judgment of taxpayers. This approach is preferred in order to avoid the proverbial "Monday-morning quarterback syndrome". In the present case, the experts were asked to provide an opinion after the fact based on incomplete information. They were not in the business trenches. It is hard to establish the exact dynamics of credit markets after the fact. They change quickly.

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[264] *Ibid.*, page 506, lines 8-25.

[292] In making these comments, I note that the wording of section 247 of the *ITA* appears problematic when attempting to apply the notion of business judgment. The problem arises from the fact that subsection 247(2) allows the Minister to scrutinize certain cross-border transactions and essentially substitute an arm's length price for the price used in the transaction. I make reference to the business judgment rule merely because it is a useful tool for evaluating the credibility of a witness. Other corroborating factors, such as Mr. Emmer's recognition of the legitimacy of the guarantee, assist me in according greater evidentiary weight to Mr. Werner's testimony. Finally, as a passing comment, I note that Mr. Werner has been retired from GE and GECUS for a number of years. The passage of time has freed him from the influence of his former employer and undoubtedly has contributed to his objectivity on the subject of the guarantee.

[293] Mr. Werner was busy raising billions of dollars of funds for the Appellant when the issue of the guarantee was being considered. He dealt with the major financial market intermediaries on a daily basis. Mr. Meyerman acknowledges that Mr. Werner was very good at his job and that GECUS treasury personnel was often more experienced and qualified in the workings of debt markets than the personnel working for the major banks.[265] Mr. Werner was being judged on the results he achieved in a corporate culture that punished failure quickly and rewarded long-term success. For this reason, greater weight must be accorded to the testimony of Mr. Werner on this point.

[294] Mr. Werner's view is supported by the testimony of Mr. Coombs. Mr. Coombs, given his Canadian banking experience, was much more familiar with the workings of the Canadian capital markets than Mr. Meyerman, who worked predominantly in the U.S. Recent events illustrate that there are differences in capital market practice in different countries. Canadian banks are more conservative in their lending practices than U.S. banks, as confirmed by Mr. Coombs in his testimony.

[295] Mr. Meyerman accepts this view although he qualified his opinion by saying it is only the TD Bank that is known to be conservative. There is no debate on the issue that standby bank facilities must be in place to support debt issued in the commercial paper markets. The facilities are required to guard against systemic market risk, including liquidity risk. Investors in commercial paper need reassurance that on the maturity of their paper the issuer will be able to repay. For example, if an issuer was unable to issue new commercial paper because of a flight to quality, the standby facilities must be available to be drawn upon to repay the maturing commercial paper. This reassures investors that there is security of principal repayment notwithstanding the possibility of short-term market disruptions.

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[265] *Ibid.*, pages 2762-2763.

[296] Mr. Coombs was adamant in his testimony that the Appellant could not arrange standby facilities of the size required to cover the large volume of debt that it needed to issue in order to execute its business plan. Mr. Meyerman acknowledges Canadian banks would have had to play a large role in this type of credit facility. I cannot imagine how a large banking syndicate could have been put together to support a facility sufficient to cover the commercial paper issued by the Appellant, in light of the fact that the Appellant's debt had been guaranteed by GECUS for many years. If the answer is that economic incentives would cause GECUS to support the Appellant in any event, I can easily imagine that, as suggested by Mr. Coombs, the banks would say "put your money where your mouth is".

[297] The Crown, in argument, attempted to minimize this point by asserting that GECUS had standby facilities in place that the Appellant could rely on. I cannot accept this point of view. GECUS, as a separate legal entity, is not required to give the Appellant access to its credit facilities. If it did so through contractual agreement, it would have had to negotiate this right with its banking syndicate. Undoubtedly, GECUS would have been expected to remain liable for amounts drawn by its subsidiary, the Appellant. This would have become a different form of explicit support that would have constituted a bona fide group service that GECUS would have been entitled to charge an arm's length fee for.

[298] Dr. Saunders was the only expert witness for the Respondent who provided evidence as to the market price of the guarantee. His opinion on the guarantee fee was premised on his finding that the Appellant's final credit rating would have been AA+ without an explicit guarantee. I do not accept his conclusions on the Appellant's final credit rating for many of the same reasons that I do not accept Mr. Emmer's view on this subject. Briefly, Dr. Saunders failed to consider the impact of the removal of the guarantee. He did not perform a stand-alone rating in his initial report. His conclusion is at odds with the business judgment of Mr. Werner. In the case of this witness I would add that he acknowledged he was not an expert in applying credit rating methodology. In short, I prefer Dr. Chambers' and Mr. Werner's evidence on this point.

[299] The methodology used by Dr. Saunders to value the guarantee fee also appears to be flawed. He used historical default data from rating agencies for a AA credit rating to arrive at the expected loss reserve. He argues that the Appellant's score would have been less than 100 basis points based on his opinion of its credit rating, which I have found to be flawed. Assuming nonetheless that he is right in his assumption, he fails to take into account a rate of return on the risk capital, which is required as compensation for expected loss. Because Dr. Saunders allows a charge only for expected loss, he has not made allowance for a return in the form of profit. This methodology allows the guarantor to recover only its cost. In the arm's length world, a service is generally provided for profit. A guarantor would not risk capital with the hope of only breaking even. If it did, it would be better off investing its capital in risk-free term deposits.

[300] Dr. Saunders' analysis also incorporates the wrong risk capital requirement. He uses the risk capital requirement of the Basel II regime and not that of the Basel I regime which was in force in the years in question. When the Basel I requirement is applied in conjunction with Dr. Saunders' opinion that the Appellant would be rated AA, which I have rejected for the reasons outlined earlier, GECUS' expected return on capital is lowered from 149.3% to 12.5%. When adjustments are made to Dr. Saunders' "capital at risk" model to take into account a BB+ final rating, the expected return on capital at risk is reduced to 7.5%.

[301] For all the reasons noted above, I conclude that the Appellant's final credit rating without explicit support would be in the range of BBB-/BB+. This means the ratings uplift from the stand-alone/status quo rating to take account of implicit support is three notches.

Are Further Adjustments Required to the Yield Approach?

[302] The Respondent argues that the determination of the yield spread is only the first step or starting point for the determination of the value of GECUS' explicit guarantee. According to the Respondent, further adjustments are required to take into account the benefits that the guarantee provides for GECUS. The Crown argues that the yield approach creates a "value to owner" benchmark. This is an inappropriate test for determining an arm's length fee. In its written submission filed at trial, the Respondent identifies the following points as potential benefits that can be raised by the Appellant, in its hypothetical arm's length negotiations with GECUS, for the purpose of lowering the guarantee fee that it should pay:

a. no management of the risk;[266]

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[266] Respondent's written submissions, at paragraph 70.

b. it is in [GECUS'] best interest to support the Appellant, even in the absence of an explicit guarantee, because of the potential costs involved in failing to support, including loss of AAA leading to higher interest costs, loss of clients and inability to roll over commercial paper;[267]
c. [GECUS'] easier access to, and freedom with respect to, the Appellant's capital since there are no restrictions arising as there might be with other forms of guarantee;[268]
d. the Appellant is part of the hub and spoke strategy favoured by [GE]; a weakening of a spoke would weaken the whole wheel;[269]
e. no cost to [GECUS];[270] and
f. if a third party provides a guarantee, [GECUS] will be relieved of its obligation and should therefore contribute to paying the cost of that third-party guarantee.[271]

[303] The second, third and fifth of the above points made by the Crown are all covered under the yield approach because the final rating reflects a three-notch ratings uplift. In short, the reputational pressures and economic incentives that motivate GECUS to provide financial support are already fully taken into account in the yield approach analysis. A second adjustment would be tantamount to double counting those factors.

[304] The first point has been dealt with in my analysis of the insurance methodology proposed by Mr. Fidelman. I believe a third-party insurer would be unwilling to evaluate the risk at the same price as GECUS did because it would be assuming greater risk. I also subscribe to the view that a third-party insurer would place less weight on implicit support because the fact that a third-party guarantee was obtained would be a strong indication that the parent would be unwilling to support its subsidiary in the event of failure or of default on the debt instruments covered by the third-party guarantee. The insurer would be expected to pay up in such a case because it received a premium for the service of having taken on the risk of the Appellant's default. The two factors commented on immediately above in this paragraph offset each other to some degree. This being said, it is too difficult to determine whether they are perfect counterweights to each other. As noted earlier in this judgment, that is why I chose the yield approach over the insurance methodology.

[305] I agree with Mr. Werner's view that the Appellant cannot be expected to pay 100% of its interest cost savings. Otherwise, it would have no economic incentive to enter into the transaction. With this in mind, I note that, under the yield approach, the

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[267] *Ibid.*, at paragraph 72.
[268] Trial transcript, page 218, lines 11-23; page 3005, lines 10-16.
[269] *Ibid.*, page 2392, line 8, to page 2393, line 11.
[270] *Ibid.*, page 2191, line 16, to page 2194.
[271] *Ibid.*, page 1872, line 17, to page 1876, line 13; page 3198, line 24, to page 3199, line 10.

interest cost savings based on the rating differential between BBB-/BBB+ and AAA, the latter being the rate achieved with the GECUS guarantee in place, work out to approximately 183 basis points or 1.83%.[272] 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 Appellant received a significant net economic benefit from the transaction. The net economic benefit exceeds the 1.83% calculated under the yield approach.[273] Without a guarantee, the Appellant would have been unable to procure standby letters of credit in an amount sufficient to cover its commercial paper program. It is undisputed that the Appellant did not reimburse GECUS for the costs incurred by the latter under its standby facility. The Appellant would have been unable, in the absence of the guarantee, to execute its business plan, as the Canadian commercial paper market was geared to the highest investment-grade issuers.

Part XIII Withholding Tax

[306] The Crown asserts that the Minister issued the Part XIII assessments on the grounds that the guarantee fees are benefits that the Appellant conferred on a shareholder. These amounts are deemed to be dividends for the purposes of Part XIII.

[307] This position is not sustainable in light of my conclusion that the guarantee fee paid by the Appellant did not exceed the amount of an arm's length price. It is undisputed that the Appellant paid the full amount of withholding tax due on the guarantee fee on the basis that the amounts were deemed to be a payment of interest for the purpose of Part XIII. Therefore, there are no grounds for upholding the Part XIII assessments.

CONCLUSION

[308] For all the reasons set out above, I allow the Appellant's appeals and I hereby order that the assessments under Parts I and XIII of the *ITA* covered by these appeals be vacated.

[309] The cases cited and considered by the Court are listed in the appendix hereto.

Signed at Montréal, Québec, this 4th day of December 2009.

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[272] Exhibit A-88, expert report of Stephen Cole, pages 38-39. Mr. Cole relied on the work of Dr. Hull and Dr. Booth to reach this result.
[273] Trial transcript, page 552, lines 20-25. According to Dr. Booth, the guarantee offered the Appellant other benefits: it did not have to pay the placement fees required in order to place commercial paper through the dealer network, and it did not have to pay for backup lines of credit in Canada.

"Robert J. Hogan"

Hogan J.

APPENDIX

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