



Recharacterizations under 247(2)(b)

Rob O'Connor, Deloitte

Legislation

- Subsection 247 (2) of the ITA:

Where a taxpayer...and a non-resident person with whom the taxpayer...does not deal at arm's length...are participants in a transaction...and...

(b) the transaction...

- (i) **would not have been entered into between persons dealing at arm's length, AND**
- (ii) **can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit,**

any amounts...shall be adjusted (in this section referred to as an "adjustment") to the quantum or nature of the amounts that would have been determined if...

(d) where paragraph (b) applies, the transaction...entered into between the participants had been the transaction...that would have been entered into between persons dealing at arm's length, under terms and conditions that would have been made between persons dealing at arm's length.

OECD

- Paragraphs 1.63 to 1.68 of Revised Transfer Pricing Guidelines (Sept 2009)
 - Generally, tax administrations should respect transactions as structured
 - Only in exceptional cases, disregard or substitute
 - Examples...
 - Recognize that related parties can and do enter into transactions that arm's length parties would not or would rarely
 - Fact that related party transactions not structured exactly the same as arm's length transaction may be reason for examination but not, in and of itself, determinative

3

TPRC Experience⁽¹⁾

247(2)(b) Referrals to TPRC		
Rejected	17	46%
Assessed	9	24%
Being Evaluated	<u>11</u>	<u>30%</u>
Total Referrals	<u>37</u>	<u>100%</u>

- Three broad categories
 - Patronage dividends
 - Offshoring of intangibles
 - Structure of loans/debts

⁽¹⁾ "Restructurations d'entreprises et prix de transfert", Presentation at APFF, Montreal, May 2010

4

Experiences with CRA

- Specific 247(2)(b) issues
 - Complicated by focus on “business restructuring” by OECD, CRA and others
 - To date, mostly associated with offshoring of intangibles
 - “Crown Jewels” argument

5

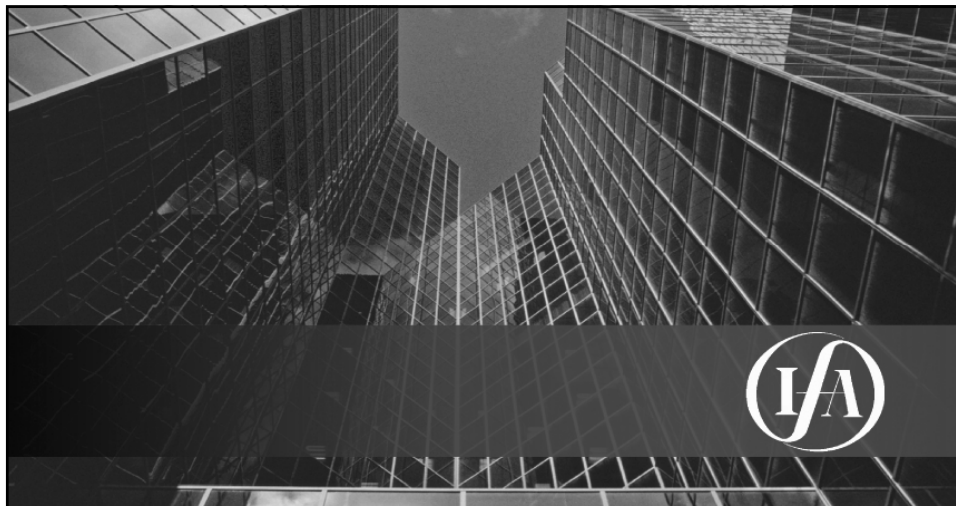
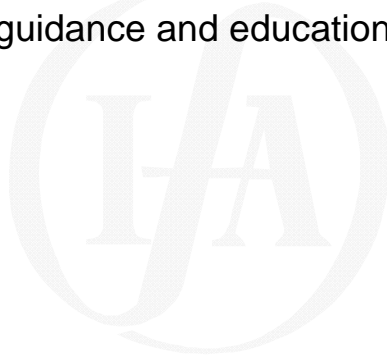
Quasi-Recharacterizations

- Often see transfer pricing adjustments that are made under 247(2)(a) but where the extent of the changes to the transaction are very significant
 - Is the adjustment really a “recharacterization”?
 - Can adjustment actually be made under 247(2)(a)?
 - Have both 247(2)(b)(i) and (ii) been considered and addressed?

6

Conclusion

- Significant activity on audit and at TPRC
- Additional guidance and education would be helpful

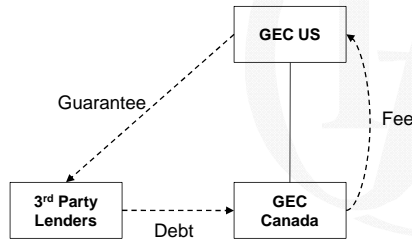


Arm's Length Standard and GE Capital

Rob O'Connor, Deloitte

General Electric Capital Canada Tax Court Decision

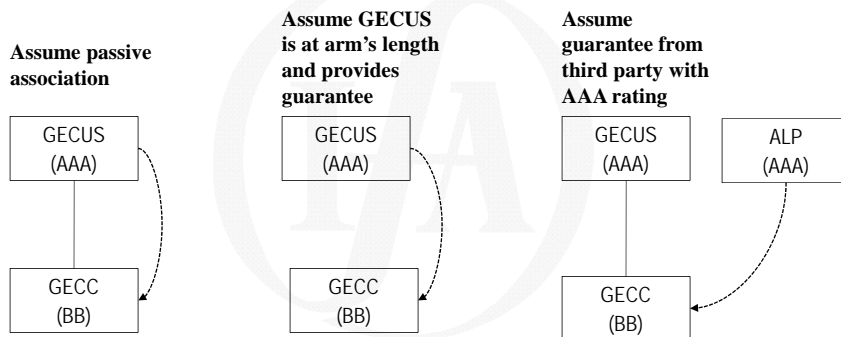
- Issue – Guarantee fee paid by GE Capital Canada to GE Capital US
- GECUS provided lenders unconditional guarantee of GECC borrowing
- GECUS (and GECC debt) rated AAA
- GECC “stand-alone” rating?
- GECC paid 100 basis point guarantee fee to GECUS
- CRA denied fee in entirety
 - Support implicit, guarantee not required
 - OECD 7.13 “passive association”



9

General Electric Capital Canada Tax Court Decision

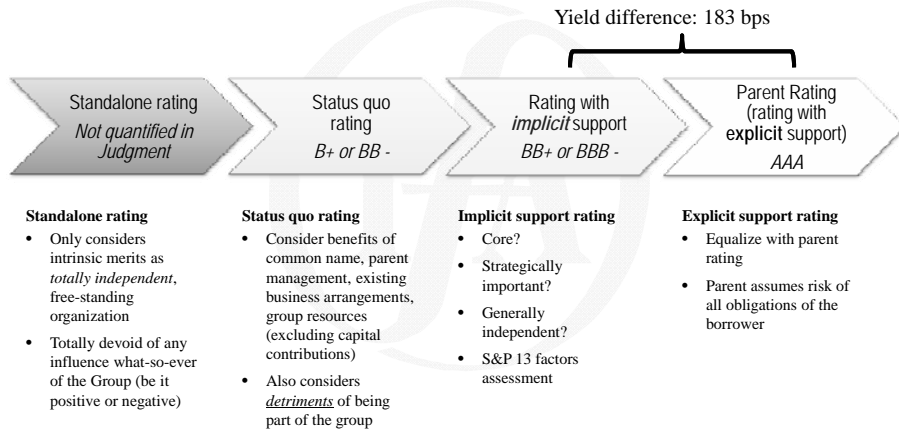
Possible approaches – Differing “Arm’s Length Standards”?



10

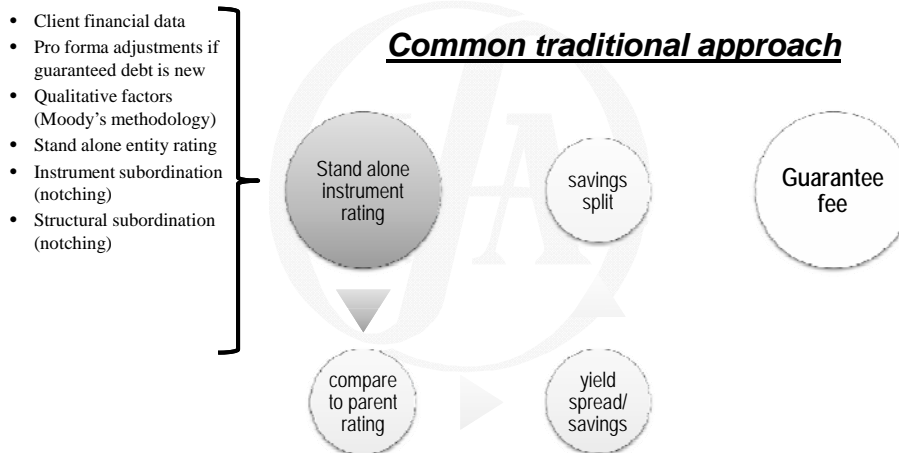
Case approach

General Electric Capital Canada Inc. vs. The Queen



Traditional approach

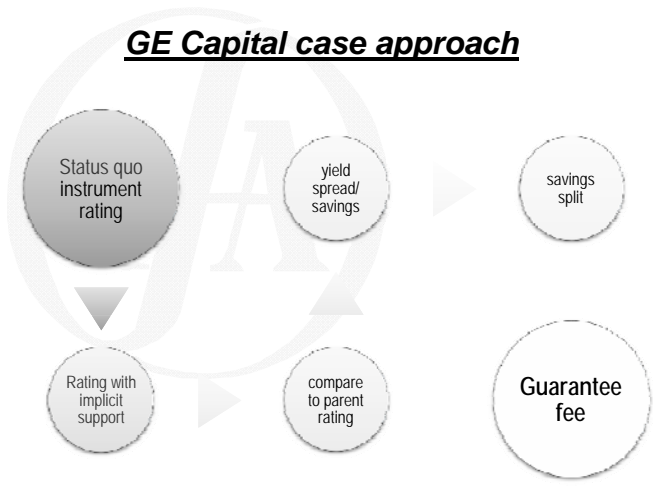
Considerations for interpreting the case



Approaches compared

Considerations for interpreting the case

- Client financial data
- Qualitative factors (Moody's methodology)
- Stand alone entity rating
- Instrument subordination (notching)
- Structural subordination (notching)
- Management access, shared name, other factors



The GE Capital Canada case decision

Pros:

- Guarantee transactions have a more-than-nominal value
- Need to be priced in accordance with the arm's length principle
- Yield approach is appropriate
- Implicit support has impact on pricing of guarantee but quantum is very fact-specific

Cons:

- Uncertainty with regard to the application of the arm's length principle, by considering parental support in the pricing model
- Distinguished difference between a stand-alone and a status quo rating, without guidance on how to move from one to the other
- Little guidance on how to set the arm's length range. 100 basis points guarantee fee was "equal to or less than an arm's length price".

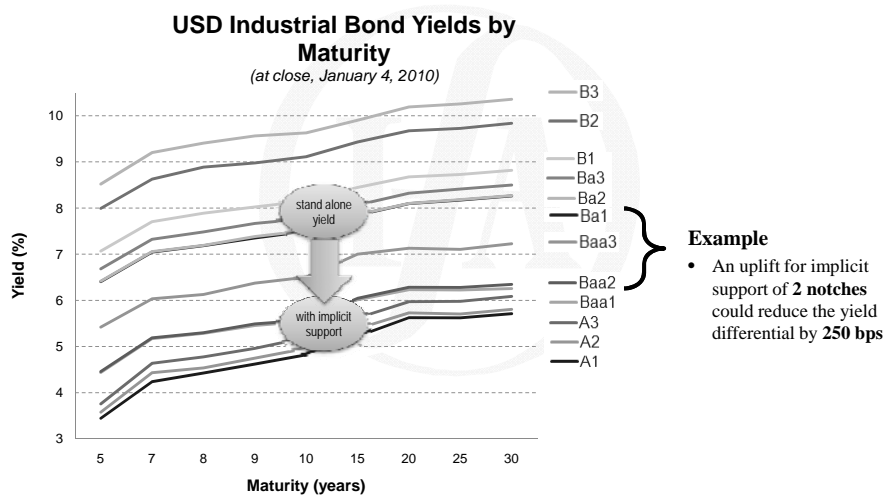
Crown Appeal

- Reasons for Appeal filed by Crown
 - Errors in law
 - Errors in fact
 - Procedural/process issues
- Brief summary, implicit support has more significant impact
- Reasonable guarantee fee is nil or, in the alternative, 0.15% to 0.24%

15

Implications and issues

Considerations for interpreting the case



16

Implications and issues (cont'd)

Areas Impacted by Decision

FIN48	<ul style="list-style-type: none">•Material exposures if case methodology applied?•Existing reserves alleviated with decision?
MAP	<ul style="list-style-type: none">•Competent Authority resolution, if available might be made more difficult if divergent views
CRA audits	<ul style="list-style-type: none">•Support to appeal total disallowance of a guarantee fee?
Compliance in other countries	<ul style="list-style-type: none">•Can this be reconciled with guarantor countries were income being recorded?•Risk of “undercharging” based on guarantor country rules
Loans	<ul style="list-style-type: none">•Is this case decision applicable to loan pricing as well?