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Transfer pricing alert

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Intercompany contingent liability payments: staying well-armed

The Canada Revenue Agency (CRA) is increasingly focusing on intercompany financial transactions. The last two years saw three landmark transfer pricing court cases that dealt with financial transactions: *the Queen v. General Electric Capital Canada Inc*[1] (*GE Capital*), *the Queen v. McKesson Canada Corporation*, and *the Queen v. General Electric Canada Company* (*GE Company*).

In *GE Company*, currently in its earliest stage, the Crown challenges guarantee fees paid by General Electric Canada Company's (GE Company's) predecessors[2] to their U.S. parent in a manner very familiar to those who followed *GE Capital*. The significance of this dispute is that for the first time in Canadian transfer pricing litigation history the CRA questions the commercial purpose of a cross border transaction. In *GE Company*, the Crown argues that the guarantees were unnecessary and thus guarantee fees that the Canadian taxpayers paid to their U.S. parent should be disallowed. Referring to s.247 2(b) in the Income Tax Act, the Crown contends that "the transactions… would not have been entered into by arm's length parties because there would have been no economic incentive present" and that the guarantee fees were introduced "… for no bona fide purposes other than to obtain tax benefits."

In all preceding transfer pricing cases considered by Canadian courts on financial or non-financial transactions, the Crown only disputed the arm's length nature of the transfer prices, not the purpose of the transaction itself.

What makes financial transactions so dispute prone?

Many intercompany financial transactions are large and complex; they often involve some kind of contingent liability where a Canadian taxpayer makes regular payments to a related foreign entity that has assumed the contingent liability. Guarantees, insurance, reinsurance, and derivatives involve a contingent liability to a larger or smaller extent. In simple terms, a Canadian taxpayer purchases protection from a future uncertain event which has uncertain financial consequences. Due to an inherent uncertainty, such event, of course, may or may not happen. When it happens, a foreign related party that has assumed a risk must make significant payments to honour the contingent liability that materialized.

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[1] For more information on the case, please refer to our *Transfer Pricing Alerts* of **January 8, 2010**, **May 14, 2010**, and **December 20, 2010.**

[2] One of the predecessors is General Electric Capital Canada Inc., the appellant in *GE Capital* in the Tax Court of Canada.

However, if the event did not occur or contingent liability did not materialize, with hindsight it can be difficult to resist an impression that the payments to a related party were made "… for no bona fide purposes".

Armed for a contingency

In our experience, for intercompany transactions involving a contingent liability, such as a guarantee or reinsurance, it is crucial to analyze and document *expected* pre-and-post transaction risk profiles of participating entities at the time an intercompany transaction is entered into. Such *ex ante* analysis and documentation are very important since transactions are usually structured based on the probability distribution *expected* at the time when the transaction is entered into. Several years later, it can be prohibitively difficult to recreate this information and, if audited, to build arguments stronger than those of tax authorities, which often resort to hindsight.

A contemporaneous transfer pricing planning or documentation study that addresses both the commercial reason and the pricing of intercompany transactions involving a contingent liability is a good shield against the perfect vision of hindsight.

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