



TRANSFER PRICING

**REPORT**

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Pricing Canada-U.S. Guarantees After GE Capital: Still Evolving

Drawing on decades of case law and regulations as well as recent commentary from practitioners and U.S. officials, the author thoroughly explores a notion that arose in the GE Capital Canada litigation—the impact of a parent company’s implicit support for its subsidiary in pricing a guarantee fee.

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In the past 13 months, two Canadian courts¹ and senior members of the U.S. Treasury and the Internal Revenue Service² expressed support for the notion that implicit support (or the benefits of passive associa-

tion) should be taken into account in pricing intercompany financial guarantees. This article examines the issues (and certain apparent deficiencies) with the notion and, separately, its potential impact on U.S.-Canada intercompany guarantees in light of several factors:

- comparative corporate tax rates between the two countries;
- a proposed Canadian statutory safe harbour against the necessity to charge fees for certain outbound guarantees;³
- the current, incomplete state of U.S. statutory or regulatory law on point, and
- other relevant U.S. tax factors.

¹ See *General Electric Capital Canada Inc. v. The Queen*, 2009 TCC 563 (Tax Court of Canada), and *The Queen v. General Electric Capital Canada Inc.* (2010) F.C.A. 344 (Federal Court of Appeal).

It is not yet known whether the government will seek leave from the Supreme Court to appeal the FCA’s Dec. 15, 2010, decision, which upheld the Tax Court’s December 2009 ruling in favour of the taxpayer.

² For coverage of comments by IRS Associate Chief Counsel (International) Steven Musher and Treasury Associate International Tax Counsel David Ernick, see Molly Moses, “ABA Panelists Debate Consideration of Implicit Support in Pricing Guarantees,” 19 *Transfer Pricing Report* 58, 5/20/10, and

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David D. Stewart, “U.S. Officials Engage Practitioners on Pricing of Guarantee Fees,” *Tax Analysts*, 5/10/10.

³ See generally Section 247 of the Canadian *Income Tax Act* (ITA), R.S.C. 1985, c.1 (5th Supp.), as amended, which mandates arm’s-length pricing for cross-border intercompany transactions. For an overview, see Boidman, note 10, below.

As widely reported,⁴ the Canadian court approval of the notion in the *GE* case arose in the context of upholding the fees paid by GE Capital Canada to its U.S. parent as not exceeding an arm's-length amount. The courts concluded that the value of implicit support to GE Canada that the U.S. parent provided through passive association should be taken into account as an offset or reduction in determining an arm's-length fee for any specific (explicit) support or guarantee provided by the U.S. parent.

However, the courts rejected the government's basic position that the U.S. parent's specific guarantee did not serve *at all* to increase GE Canada's credit rating (stemming from the implicit support) and therefore improve the terms on which it could borrow, with the result that there was no value to the subsidiary of the guarantee so that it should not have paid anything for it. Instead, it was held that even with implicit support accounted for, the fee paid by GE Canada, equal to 1 percent of its debt guaranteed, did not exceed (and was just a little over half of) the value (1.83 percent of its debt) to the subsidiary of the guarantee.

Implicit support, stemming from passive association (and the government's associated notion that an explicit guarantee provides no additional—or reduced—economic benefit) is seen as arising from an assumption that a parent would not permit its subsidiary (particularly if it is a “core” subsidiary) to become insolvent and, with or without the guarantee, the parent would be expected to take actions to protect the subsidiary's creditworthiness in order to, among other things, protect the parent's investment and its own good name and reputation.⁵ The Federal Court of Appeal agreed with the Tax Court that implicit support derived from the related group was a relevant factor that it should consider as part of the circumstances surrounding the transaction, but that in the circumstances under consideration, the benefit received by the Canadian subsidiary from the guarantee (1.83 basis points) exceeded the amount it paid for the same (100 basis points) and as such the fee met the arm's-length standard.

⁴ See David A. Ward, “Commentary, *General Electric Capital Canada Inc. v. Her Majesty The Queen*” (2010), 12 *ITLR* 509; Murray Clayson, “GE Verdict Will Set International Precedent,” *International Tax Review*, February 2010 at p. 34; Erik Kamphuis, “How to Deal with Affiliations in Interpreting the Arm's Length Principle: The GE Case Reviewed,” *International Transfer Pricing Journal*, July/August 2010, p. 292; Peter Menyasz, “Tax Court Ruling Favors GE Capital in Landmark Transfer Pricing Case” and “Consideration of ‘Implicit Support’ Worrisome in GE Capital Ruling, Practitioners Say,” 18 *Transfer Pricing Report* 845, 847, 12/17/09; François Vincent, “GE Capital Canada After GlaxoSmithKline,” 19 *Transfer Pricing Report* 607, 9/9/10; Peter Menyasz, “Canada's Federal Court of Appeal Upholds Landmark Ruling in GE Capital,” 19 *Transfer Pricing Report* 906, 1/13/11; and Peter H. Blessing, “Divergence of Third Party Pricing from Arm's Length Results,” *Tax Polymath: A Life in International Taxation: Essays in Honour of John F. Avery Jones*, IBFD, 2011, p. 153. See also a 16-country (including Canada and the United States) study on whether deductibility of loan guarantees entails taxability, *BNA Tax Management International Forum*, Vol. 31, No. 3, September 2010.

⁵ See paragraph 199 of the TCC judgement reproduced in note 6.

The Case For and Against Accounting for Implicit Support

Position of the Parties in GE

The following excerpts from the judgement by the Federal Court of Appeal provide an overview of the positions of the taxpayer, the government, and the Federal Court of Appeal on the relevance of implicit support.

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

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

[...]

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

[...]

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

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

[...]

... Do all of the economically relevant factors have to be considered in the determination of an arm's length price for the transaction in order to arrive at a meaningful comparison, as suggested

by the Crown? Does the scheme of paragraphs 247(2)(a) and (c) suggest that all factors which are particular to the non arm's length relationship must be discarded, as suggested by counsel for the [respondent]? . . .

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

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

At the onset it may be noted that there is not a consensus that the Tax Court did, in fact, conclude that implicit support should, as a matter of principle, be accounted for even though that is what the FCA thought and supported with its decision. The issue is elusive, and uncertainty was expressed by one observer about whether the Tax Court in *GE* came to a firm conclusion or deliberately avoided doing so. That theme was developed by reference to paragraph 199 of the judgement, which sets out the basic position on implicit support and reads (in part) as follows:⁶

[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.

One practitioner set out this theme in the following comment:

When reading paragraph 199 of the ruling in isolation, one may conclude from the second and following sentences that Justice Hogan felt that the implicit support had nothing to do with the ownership of shares (which defines the—applicable in

the *GE* case—*de jure* control). Instead, he seems to rule that the implicit support was rooted in the reputational pressure that is exerted by the debt holders of the *GECUS*. If one would read the ruling in this nuanced way, Justice Hogan smartly avoided the fundamental transfer pricing question he said he was going to address. [para. 187 *GE*] By rooting the implicit support in the reputational pressure and not in the indirect shareholding between *GECUS* and *GECAN* [*GE Canada*], the principal question of how to interpret the arm's length principle regarding affiliation benefits remains unanswered.⁷

The Basic Issue and Factors

Support for this notion has come from senior members of the IRS regarding considerations that likely would be taken into account in developing rules under Internal Revenue Code Section 482 to deal with intercompany financial guarantees.⁸ The 1968 Section 482 regulations generally did not require that fees be charged for such guarantees,⁹ and the 2006 temporary and in the 2009 final Section 482 services regulations¹⁰ the IRS punted—not only deferring rules on the matter but questioning whether financial guarantees are services for purposes of regulations dealing with their pricing.¹¹

There are two concerns with the FCA's agreement with the government (and the TCC) that passive association (and implicit support) is relevant and may be taken into account in determining the pricing of intercompany guarantees. First, it can have a distorting effect on the arm's-length principle¹² and confuse the manner in which it is viewed. Second, it may not stand up to certain analytical probing.

Does distortion arise by reason of a seductive context that makes the notion superficially appealing? Does the manner in which its proponents suggest that implicit support operates to price a residual guarantee transform a benefit (enhanced credit rating by reason of group affiliation) for which a parent company generally

⁷ See Kamphius, note 4, at p. 295.

⁸ See *id.*

⁹ See note 27 and text following note 46.

¹⁰ For a detailed discussion of these regulations from a Canadian perspective, see Nathan Boidman, "The Implications in and for Canada of the IRS's Final Section 482 Services Regulations," *The Tax Executive*, Vol. 61, No. 6, November-December 2009, p. 445.

¹¹ As discussed further below, such doubt is consistent with the U.S. Tax Court's decision in February 2010, which found, in *Container Corp. (Vitro International Corporation) v. Comr.*, 134 T.C. No. 5, that financial guarantees do not, generically, comprise the provision of a service, although for the purposes of U.S. withholding taxes on outbound payments to foreign persons (not comprising income effectively connected with a U.S. trade or business) they are more akin to the provision of services than the provision of a financing.

¹² For useful background on the state of pricing guarantees in the United States, see John Breen, "Evaluating the Arm's-Length Price of Financial Guarantees: A Review of the OECD Framework," *Tax Notes International*, 9/13/10, p. 869. Also see the author's reaction (*Tax Notes International*, Vol. 59, No. 13, 9/27/10, at page 1049) to Breen's suggestion in note 37 of his article that the arm's-length standard requires that group affiliation be taken into account when pricing intercompany guarantees.

⁶ 2009 TCC 563.

and without compulsion *does not* charge a subsidiary into a benefit for which a parent (the argument goes) *should not* charge a subsidiary?¹³

The concern is that arm's-length profit allocations require that each unit of a multinational enterprise be rewarded commensurate with its contribution. That requires that each unit benefit from its resources and circumstances. To put that into context, consider the separate—but yet revealing—simple situation of a parent selling highly branded proprietary widgets to a distributor subsidiary. Should the subsidiary be able to argue that the transfer price for the widget be reduced, because once it owns the widget it should (as such owner) be richly rewarded upon the resale? That argument would, presumably, be dismissed out of hand. But is it different from contending that passive association be taken into account in pricing guarantees? In that respect, the FCA's support of the notion can be put into question through a dynamic that pulls away from the notion and pushes to the contrary conclusion, as discussed in the next section.

Associated with the issue is a related argument raised by GE that the arm's-length principle required a focus on what a third party would have charged for the guarantee, not the yield method (computing "benefits" in terms of an enhanced credit rating) approach adopted by the courts.

The latter actually raises a threshold question: Would a third party have provided the guarantee at all, or was a non-guaranteed lender or a third-party guarantor taking the risks—without the rewards—of an equity provider? If that is the case, there would have been no such player and no such transaction available, and therefore no comparable transactions available, and therefore no basis at all to test the fee under the arm's-length standard.

That thinking, in part, underlies arguments as to why a related party need not charge a guarantee fee under the arm's-length standard. It also can be seen as not inconsistent with the landmark U.S. decision (which has no counterpart in Canada), *Plantation Patterns*,¹⁴ which treated a loan to a corporation that was guaranteed by the shareholder as having been made to the shareholder, which then made an equity investment in the corporation.

Note that a proposed safe harbour from charging a guarantee fee in draft Section 247(7.1) of the Act—discussed below—could be seen as partially following *Plantation Patterns*, but without the critical recasting of the guaranteed loan (to the subsidiary) as having actually been made to the parent (which then made an equity contribution). Consistent with this is the thought that the guarantees effectively are just one way the parent could capitalize the subsidiary (in place of capital stock investment), and that as such (1) no third party would guarantee the loans because such party would be taking the risk of an equity investor (but without the upside) so that (2) there were no comparable guarantee transactions to look at and (3) that a parent does not charge a subsidiary a fee to invest in its capital stock.

¹³ Both the U.S. services provisions at Regs. § 1.482-9(l)(5), Example 19, and aspects of the 1995 OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* suggest there should not be a charge.

¹⁴ *Plantation Patterns Inc. v. Comr.*, T.C. Memo 1970-182, *aff'd* 462 F.2d 712 (5th Cir. 1972), *cert. denied* 409 U.S. 1076.

Separately, the matter is sufficiently difficult that extraneous elements can easily enter the debate. For example, in one report, the frame of reference to discussing the role of affiliation in interpreting the arm's-length principle included Article 9(1) of the OECD Model Income Tax Convention. This is presented as a cornerstone element, but intercompany guarantees can involve units of a multinational not based in a treaty country. In that case, the model treaty would provide no guidance.¹⁵

The FCA Position and a Push-Pull Dynamic

The FCA reasoned that implicit support is to be taken into account because it is a related relevant event or fact. In support of this reasoning, the court pointed to its recent decision in another high-profile transfer pricing case, involving GlaxoSmithKline, in which it said related relevant events or facts must be taken into account even where they entail intercompany events or facts.¹⁶

In *Glaxo*, a Canadian subsidiary of the Glaxo group procured the various intangibles and operating methods it required to manufacture and sell the drug Zantac by way of a license with the U.K. parent and purchased the active ingredient required to make Zantac from a sister Swiss corporation. The FCA reversed the TCC's conclusion that the license with the U.K. parent should not be taken into account in determining whether the price paid for the active ingredient met the arm's-length principle.¹⁷

The FCA reasoned that if the intercompany license in *Glaxo* should be taken into account, then so should implicit support in *GE*.

But, in so concluding, the FCA did not consider or assess the Glaxo comparable (that is, intercompany events or transactions) by reference to the *generic nature* of the event or fact and did not identify a fundamental difference between the generic nature in *Glaxo* and that in *GE* (if there was, indeed, implicit support at play in *GE*). In particular, the FCA did not consider that the intercompany license in *Glaxo* was a type of transaction that can and does arise every day between unrelated parties—and thus, as matter of straightforward logic, it had to be taken into account in considering what Glaxo would be willing to pay for the ingredient. This is because any third party, standing in place of Glaxo Canada, would have added up the overall costs of the two transactions (the license fee and ingredient price) in deciding whether the overall package would provide it with a basis to make an overall acceptable level of profit from manufacturing and selling the finished product.

A third-party seller of ingredients to Glaxo would be indifferent to whether Glaxo was party to such a license (with either another member of the Glaxo group or a third party) because that fact would *not*, per se, affect

¹⁵ See Kamphuis, note 4.

¹⁶ See *GlaxoSmithKline v. The Queen*, 2008 DTC 3957 (TCC), and *GlaxoSmithKline Inc. v. Canada*, 2010 FCA 201.

¹⁷ The Federal Court of Appeal agreed with the taxpayer that Glaxo Canada is allowed to take into account the terms and pricing of its licensing agreement with the group's parent, Glaxo U.K., in assessing the appropriateness of the price it paid to the Swiss company for the active ingredient. The FCA sent the case back to the lower court to rehear facts and arguments based on fact—but now including the license.

such seller—the seller’s only direct interest would be in being paid by Glaxo the agreed price for the ingredient.

On the other hand, the generic nature of any implicit support in *GE* is that it is a type of event or fact that cannot and does not arise between unrelated parties. And because it cannot and does not, is it not arguable, in principle, that it cannot be a fact or event that a subsidiary can trade on in dealings with third parties where the existence of implicit support, or its disappearance, can affect such third parties? Obviously, no creditor of one multinational could think that another would bail the debtor out if it defaults—unless that party were a specific guarantor.

Implicit support, by definition, is not explicit. If a subsidiary of a multinational approached a third party to guarantee its debt and tried to bargain down the fee by reference to the implicit support of its parent, the prospective third-party guarantor presumably would ask a simple question: Will the parent step in, in the event of default, as the first line of financial support to the subsidiary?

If the answer is yes, the prospective guarantor presumably would want that in writing—in which case it is no longer a matter of implicit support, but rather the explicit position of the parent as the primary, committed, guarantor. Does that not negate the value of “implicit support” in an arm’s-length analysis and therefore suggest it is not a relevant factor?

Can it be argued, on that basis, that the FCA’s failure to identify the generic difference between the particular intercompany transaction in *Glaxo* and the “intercompany implicit support” in *GE* puts into question its conclusions on the role of implicit support? Is not the suggested analysis of how the market for third-party guarantees would react to implicit support a “pull” to the opposite conclusion from the one the FCA arrived at? Is not *GE*’s argument before the courts, that implicit support is rooted in non-arm’s-length dealings and cannot be transported to arm’s-length dealings, itself rooted in this generic difference?

The contrary argument, of course, is that the market does, in fact, reward a subsidiary by reason of implicit support and that was put into the evidence in *GE*. But here one should be alert to context. Rating agencies, as well as financial institutions acting as loan syndicators and selling off any debt instruments in which they become involved, essentially are playing with other people’s money. They may be quite willing to see and assign market value to implicit support as serving to reduce the borrowing costs (or guarantee fee costs) of a borrower purportedly benefiting from the implicit support, while a financial institution, putting its own money at risk, arguably would not.¹⁸ Is this suggestion—respecting the implication of context—necessarily inconsistent with the view of one observer that the role of implicit support can be seen as “just part of the factual matrix”?¹⁹

In particular, it is suggested, “But one can perhaps rationalize the decision [as it relates to implicit support] on the basis that it analyzes the outcome that would

¹⁸ A review of the Tax Court’s decision and in particular paragraphs 65, 72, 90-92, 94-99, 130-149 (especially 141, 142 and 147) as well as paragraphs 69-71 of Federal Court of Appeal’s decision do not reveal evidence of any such specific arrangement.

¹⁹ See Clayson, note 4.

have arisen between hypothetical parties, dealing independently of one another, but where, having regard to the characteristics of the parties, the borrower was a subsidiary of a [AAA] rated parent from whom some measure of implicit support could be assumed. This need not be regarded as an erosion of the arm’s-length principle or abandoning respect for separate legal personality: it is just part of the factual matrix.”²⁰

Separately, consider, in relation to this question, the following comment by another observer,²¹ “The relationship of parent corporation and its subsidiary on the stand-alone credit worthiness of the subsidiary was not ignored, although this was not compatible with an assumed arm’s length relationship between the parties.” Finally, two interrelated comments by another observer²² show the difficulties in assessing this matter. At one point it is noted that “guarantees from third parties are almost unheard of in the corporate world.”²³ But the same source noted that the Tax Court judge “determined that a third-party guarantor of a subsidiary’s obligations (with no legal recourse to the parent company) would not give any significant effect to implicit support since the parent company generally would prefer to have the third-party guarantor pay the subsidiary’s creditors. Thus, the guarantor in effect would displace the parent company as the provider of support.”²⁴

Is the acid test whether a third-party financial institution lender or guarantor that is *not* laying off (syndicating out) the credit risk would reduce the financing charges to a borrower by reason of implicit support? Or, as suggested above, where a subsidiary tries to bargain down either a third-party borrowing rate or a third-party guarantee fee on the basis that its parent would step in, would the lender or guarantor say, “put it in writing,” in which case the support would be explicit rather than implicit?

And if the parent refused to put it in writing, why would anyone assume that the prospective third-party lender or guarantor would reduce its rates or fees on the strength of any comfort or reliance that the parent would step up to the table?

Other Background Factors

It was noted earlier that a parent usually may not charge for the benefits of implicit support. The final U.S. services regulations distinguish between passive

²⁰ See Clayson, note 4 at p. 37. Note that Clayson’s commentary on *GE* interrelates, in a very useful fashion, the specific rules in U.K. transfer pricing law that treat guarantee (explicit or implicit) arrangements—see Part 4, Taxation (International and Other Provisions) Act 2010 (formerly paragraph 1B of Schedule 28AA Income and Corporation Taxes Act 1988).

²¹ Ward, note 4 at p. 516. Ward was the preeminent tax treaty scholar in Canada—and a highly regarded expert worldwide—before his untimely death early last year.

²² See Blessing, note 4.

²³ Blessing, note 4 at p. 161.

²⁴ Blessing, note 4 at p. 160. Blessing concluded his article by recommending, *inter alia*, at page 184, that the concept of passive association should not be applicable to intergroup guarantee fees in most cases. Separately, a recent Finnish court decision on arm’s-length interest rates for intercompany loans also, on first blush, supports the rejection of the notion that implicit support should be accounted for in pricing fees for intercompany guarantees. See Marcus Hoy, “Finnish Ruling Limits Interest Deduction; Court Looks to Company, Not Group, Rating,” 19 *Transfer Pricing Report* 909, 1/13/11.

association benefits, which need not be compensated, and other benefits that must be compensated.²⁵ Does that mean a parent cannot charge when it provides only passive association benefits? In terms of a guarantee, can a charge apply only when an explicit guarantee enhances the benefits beyond already existing passive association benefits? At the 2010 May meeting of the American Bar Association tax section,²⁶ the government panelists seem to have taken the position that the benefit of an explicit guarantee was the enhancement from the passive association benefit and that only such benefit would be compensated, in any further regulations on point.²⁷

The focus of the proponents of accounting for implicit support seems to be (as it was in the *GE* case and on the ABA panel) on the effect of implicit support or specific guarantees on borrowing costs of the subsidiary. But why is it not—as *GE* argued—on the fee the subsidiary would have to pay a third party to provide a specific guarantee if the parent declined to provide it? (There is the related or threshold question of whether any third party would, in fact, provide the same guarantee, discussed above).

If the subsidiary would have to pay X basis points to a third-party guarantor, is not the savings of that fee the benefit to the subsidiary, and thus the amount it should pay the parent under a simple, straightforward comparable uncontrolled price analysis? In considering that question one can refer to the original contention—that the guarantor would not reduce the fee (the X basis points) for the guarantee on the assumption that if the subsidiary defaults, the parent will come running in and save the hide of the guarantor.

If that were the parent's intention, why would it not advise the subsidiary to save its money and not buy the guarantee? This is a revealing question and is consistent with the obverse, raised by one of the ABA panelists who noted that the attempt to get a third-party guarantor "suggests the parent company is not willing to support the subsidiary" and "takes a bit away from the implicit support."²⁸ This goes to whether, as suggested and argued in *GE*, a third-party guarantor is the true test and such party would, acting rationally, either assume away the implicit support or ask that it be made explicit. In fact, ABA panelist Treasury Associate International Tax Counsel David Ernick seemed to agree in referring to a situation where the intercompany fee would "reach the price unrelated parties would reach." The counter is that although a third-party price is attractive as a CUP, it generally is not available.²⁹

²⁵ See Regs. § 1.482-9(l)(5), Example 19.

²⁶ See note 2.

²⁷ James Croker of Alston & Bird LLP has noted, in correspondence with this author, that under the 1968 version of the Section 482 services regulations that was in place prior to August 2006, most companies took the position that giving guarantees was not an integral part of their businesses (or the businesses of the guaranteed subsidiaries) and accordingly were permitted to charge at cost, of which there was none. The new regulations expressly except financial guarantees from the services cost method (which continues to allow, in quite limited circumstances, the pricing of intercompany services at cost). See also note 9 and the text following note 46.

²⁸ See Moses, note 2, reporting comments by Jean-Paul van den Berg.

²⁹ At the ABA meeting there was discussion of an example in which the third-party fee exceeded the borrower's cost sav-

ing. It may be useful to examine how the 1 percent guarantee fee was chosen. The following excerpt from the Tax Court decision describes the process and rationale.

[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. 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). 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%).

[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.

[16] Mr. Werner testified that he did not believe the Appellant would have been rated AAA without the guarantee. He denied GECUS would necessarily have supported the Appellant's operations; more precisely, he claimed that GECUS could have just walked away if there was no explicit guarantee in place.

The last point is, of course, of considerable interest in the context of the basic issue discussed herein—implicit support.

Finally, the foregoing suggests that the difficulty with this matter may be simply identifying the legal issue. Is it a question of whether:

- an independent party (as guarantor) would charge less for the guarantee;
- an independent party (as borrower) would have been prepared to pay at least that for the guarantee; or
- the benefits to a subsidiary at least equal the amount it paid?

It would be reasonable enough to say the Federal Court of Appeal answered this last question, in paragraph 60 of its judgment, which reads as follows.

[60] There is equally no merit to the respondent's argument that the method used by the Tax Court

ings and the IRS noted that no one would pay more than its benefit. Does this also take one back to the fact that many guaranteed loans and project guarantees are given to subsidiaries that could not obtain the loan or contract without the guarantee, raising the question whether the transactions should be recharacterized under the *Plantation Patterns* case (see note 14)? In this respect, *GE* experts testified that *GE*—a substantial subsidiary—could not have borrowed as much as it did without the parent guarantee (that is, the benefit was not limited to a lower interest rate on the loan).

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

However, that may not entirely dissolve the issue suggested by the tri-part question.³⁰

Canada-U.S. Predilections

The context (platform) for considering the overall, two-way effects of the notion of implicit support in pricing Canada-U.S. intercompany guarantees is the manner in which comparative Canada and U.S. corporate tax rates (the former decreasing significantly in recent years in relation to the latter) raises a bias or predilection for Canada-U.S. groups to minimize southbound intercompany prices for northbound transfers of goods, services, or transfers or licensing of intangibles, and a corollary bias or predilection to maximize northbound intercompany prices for southbound transfers or licenses.

Background, as well, are the decisions in *Xilinx*,³¹ where the court found a specific (cost sharing) regulation cannot override the basic arm's-length principle in Regs. §1.482-1(b)(1), and *Veritas*,³² where the court similarly upheld the company's arm's-length analysis. The law regulating the pricing of cross-border intercompany transactions should be seen, in principle, as the same in both Canada and the United States and should be seen as law that cannot be enforced through mechanical rules, because ultimately the matter is nothing but facts and circumstances.

This obvious but often overlooked canon of transfer pricing law has been clearly recognized and articulated by the Canadian courts in two decisions almost 50 years apart,³³ as well as by two senior U.S. Treasury representatives almost 20 years apart. In 1992, James Mogle, then International Tax Counsel with the U.S. Treasury, referred to this notion in announcing (in September of that year) that the January 1992 proposal to make the comparable profits method mandatory where there are no exact comparables was being withdrawn.³⁴ Last March, Associate International Tax Counsel David Ernick also referred to the notion in commenting on the

³⁰ Consider, for example, the relationship between this tri-part question and the analysis of Section 247 by Vincent (note 4) in relation to and in support of his argument that implicit support not be taken into account.

³¹ *Xilinx Inc. v. Comr.* 9th Circuit, Nos. 06-74246 and 69, 3/22/10. See 18 *Transfer Pricing Report* 1161, 1171 (decision); 3/25/10.

³² *Veritas Software Corp. v. Comr.*, 133 T.C. No. 14. See 18 *Transfer Pricing Report* 843, 844, 890 (decision); 12/17/09.

³³ See the ruling of the Tax Appeal Board in *Hofert Limited v. M.N.R.*, 62 DTC 50, at 52 as well as the Tax Court's 2009 decision in *GE*.

³⁴ See "Final Rules Likely This Year, Mogle Says; Reduced Priority For CPI Test Predicted," 1 *Transfer Pricing Report* 299, 9/23/92.

September 2009 OECD announcements respecting Chapters I-III of the OECD transfer pricing guidelines.³⁵ In the context of this article, the comments of Justice Robert Hogan's decision in *GE* are particularly apt. In paragraph 273 he states, "In the final analysis, transfer pricing is largely a question of fact and circumstances coupled with a high dose of common sense."

Finally, in reviewing the comments that follow, one should consider the perspective of the IRS. When a U.S. parent is involved, one would think the Service would want to:

- write regulations that specifically require that fees be charged for intercompany guarantees; and
- ignore implicit support so as to increase the fees charged by the U.S. parent or otherwise included in income under Section 482.

Of course, in inbound situations it would be to the IRS's advantage to take the opposite position.

Assuming the Service would not consider it appropriate to write different rules for inbound versus outbound guarantees, which horse will it likely ride?

The Tax Rate Comparative

Given the comparative corporate tax rates, within a Canada-U.S. group there should be a bias toward minimizing prices for intercompany transfers, licenses, or services northbound and maximizing them southbound. The standard U.S. federal corporate rate (once income reaches \$10 million) is 35 percent, and with state (or both state and city), corporate taxes (which are deductible for federal tax purposes), the effective overall U.S. corporate tax rate could be upward of 40 percent.

In Canada, on the other hand, the interrelated effects of the phasing in by 2012 of a net 15 percent federal corporate rate for profits also subject to provincial taxes (the federal rate in 2011 is 16.5 percent) and the adoption by many provinces of an add-on rate in the 10 percent area means comparative effective overall Canadian corporate tax rates for 2011 are mainly between 26.5 percent and 28.5 percent, and by 2012 are roughly between 25 percent and 27 percent.³⁶

Accordingly, at the extreme, based on present legislation, the highest U.S. effective overall rate—some 47 percent applicable to corporate profits earned in New York City—will be double the 23 percent effective overall rate payable in 2012 and subsequent years in New Brunswick. And the New York rate will almost double the 25 percent rate payable in Canada's largest province, Ontario, starting in 2013.

The preference for southbound prices obviously will be facilitated where there is any restraint available in the U.S. rules on prices. That may arise for guarantees as discussed below.

If the clear tax rate arbitrage in favour of reducing U.S. income and increasing Canadian income does, in fact, cause attempts to minimize prices for northbound guarantees or maximize prices for southbound guarantees, the result should be more disputes with the IRS

³⁵ See 18 *Transfer Pricing Report* 1221, 4/8/10.

³⁶ In 2011, the rates in oil-rich Alberta and Canada's two largest Provinces, Ontario and Quebec, will be respectively, 26.5 percent, 28 percent (as of July 1), and 28.4 percent. By 2012-13, those rates will be 25 percent, 25 percent, and 26.9 percent, and in New Brunswick there will be the lowest corporate rate in North America, 23 percent.

and less with the CRA. But this is not an easy matter to forecast and assess because it has, in a way, been an evolving inversion from a time when there was a tax rate arbitrage in favour of the United States that saw pricing for northbound transactions on the high, not low, side—or at least it was seen that way by the CRA. In that context, it was the IRS that had no concerns.

But with the presumably irresistible unfolding allure of the substantial corporate rate differential just outlined, a predilection to pushing the pricing envelope toward optimizing Canadian corporate profits should take hold. And if it does, the respective positions and concerns or lack thereof should reverse, and it presumably will be the IRS, not the CRA, that brings a jaundiced eye to examining Canada-U.S. pricing of any transfers, including guarantees.

In the foregoing context, the following patterns and underlying factors logically would be seen in pricing Canada-U.S. intercompany financial guarantees.

North Bound Guarantee, Southbound Fee

If, as in the case of *GE*, a guarantee by a U.S. parent of a Canadian subsidiary is at issue for which there is a southbound fee, there should be a bias to minimize the fee. The Canadian tax authorities would, of course, welcome this (as they undoubtedly welcomed the years (1988-1995) when *GE U.S.* did *not* charge a fee to its Canadian subsidiary for an explicit guarantee of its debt) and three current evolving U.S. factors could well facilitate it.

Uncertainties in U.S. Law

There is a basic uncertainty in the United States on the nature of a guarantee, which militates against fixed Section 482 rules thereon and has been acknowledged by Treasury and the IRS as an impediment to writing such rules. For these purposes, two elements can be examined chronologically.

First, in the introductory portions of both the August 2006 temporary regulations on services and July 2009 final regs issued thereon,³⁷ a question was raised in the context, in both cases, of deferring any specific rules on whether a financial guarantee entails the provision of a service. Both sets of rules stated that “no inference is intended that financial transactions (including guarantees) would otherwise be considered the provision of services for transfer pricing purposes.”

It is useful to note the full statement of this matter in both the 2006 and the 2009 regulations. The preamble to the 2006 temporary regulations at 11. d., on guarantees, states:

The proposed regulations appear to have created confusion on the part of some taxpayers regarding the appropriate characterization of financial guarantees for tax purposes. The provision of a financial guarantee does not constitute a service for purposes of determining the source of the guarantee fees. See *Centel Communications, Inc. v. Commissioner*, 920 F.2d 1335 (7th Cir. 1990); *Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1980). Nevertheless, some taxpayers have suggested that guarantees are services that could qualify for the cost safe harbour and that the pro-

vision of a guarantee has no cost. This position would mean that in effect guarantees are uniformly non-compensatory. The Treasury Department and the IRS do not agree with this uniform no charge rule for guarantees. As a result, financial transactions, including guarantees, are explicitly excluded from eligibility for the [services cost method] by §1.482-9T(b)(3)(ii)(H). However, no inference is intended by this inclusion that financial transactions (including guarantees) would otherwise be considered the provision of services for transfer pricing purposes. The Treasury Department and the IRS subsequently intend to issue transfer pricing guidance regarding financial guarantees, in particular, along with other guidance concerning the treatment of global dealing operations. See Section A.12.e of this preamble for a discussion of coordination with global dealing operations. Such guidance will also include rules to determine the source of income from financial guarantees.

The introductory notes to the 2009 final regulations, which similarly defer rules for financial guarantees, provide much less explanation:

Financial transactions, including guarantees, are exclusively excluded from eligibility for the [services cost method] by §1.482-9(b)(4)(viii), however, no inference is intended that financial transactions (including guarantees) would otherwise be considered the provision of services for transfer pricing purposes. The Treasury Department and the IRS intend to issue future guidance regarding financial guarantees.

Significantly, in that respect, at the above-mentioned 2010 May ABA meeting, IRS Associate Chief Counsel (International) Steven Musher was reported to have said that guarantee fees are an area in which he hopes to issue guidance but noted that it is not a project that Treasury and the IRS have completed or issued in proposed form.³⁸

Second, the prescience of the shortened reference to guarantees in the preamble to the 2009 regulations was seen in the decision a year ago by the U.S. Tax Court in *Container Corp.*,³⁹ where it found that a guarantee arrangement does not comprise or entail, *per se*, the provision of a service. But the court did, in fact, conclude that for purposes of determining the geographical source of a fee paid and received for the provision of a guarantee under U.S. rules (which impose U.S. tax on items of income not effectively connected to a U.S. trade or business but having a U.S. source), a guarantee arrangement is more analogous to a contract of service than to a financing, and the source should be the place where the guarantor operates and is based and from where it is in a position to honour the guarantee if called upon. On that basis the fee earned by the foreign guarantor of debts of the U.S. obligor was held to have a non-U.S. source and therefore was not subject to U.S. non-effectively-connected taxation.

³⁸ See Stewart, note 2. Earlier predictions were more hopeful. See Alison Bennett, “Hicks, Musher Outline Guidances, Tax Treaties,” 14 *BNA Daily Tax Report* G-3, 1/23/07, which reported that the IRS planned to address both the sourcing and pricing of guarantees in rules on global dealing.

³⁹ See note 11.

³⁷ See note 9.

Three tangential points are worth noting. First, the decision in *Container Corp.* conceptually could be relevant in Canada given that the Canadian jurisprudence that has involved guarantee fees has not required and has not specifically and conclusively addressed this characterization question.⁴⁰ Second, there was a bill in Congress last year that would reverse *Container Corp.* by deeming an outbound guarantee fee to have a U.S. source. Third, in the latter context Canada has been substantially ahead of the United States in that there has long been a statutory rule⁴¹ that deems an outbound payment of a guarantee fee to be interest on the debt that is guaranteed for purposes of Canada withholding tax on outbound Canadian-sourced non-effectively connected income payments. But recent amendments generally would exempt third-party interest payments and the Canada-U.S. treaty now specifically exempts most intercompany interest and guarantee fee payments.⁴²

Regulations on Passive Association

The second factor is that the current Section 482 regulations would not require that a fee be charged for any benefit purportedly realized by the subsidiary from any implicit support. Under the U.S. services rules, in particular Example 19 of Regs. § 1.482-9(l)(5), any benefit from any implicit support would be seen as derived from passive association, for which a U.S. parent is not required to charge a fee. If there were no explicit guarantee, and therefore no fee at all (for implicit support), the result would conform with how the arm's-length principle generally is viewed and applied by both multinationals and governments.

Emerging Views on Implicit Support

The third factor is that it would appear that current thinking by the U.S. government is such that if specific Section 482 regulations (whether for services or otherwise) were written for intercompany financial guarantees, they would permit a reduction in a fee otherwise required to be charged by a U.S. parent to a foreign subsidiary for specifically guaranteeing its debts by an amount representing the quantifiable benefit it was receiving by reason, only, of implicit support.

That probable approach clearly was suggested by government officials at the 2010 May ABA panel discussion referred to above.⁴³

Therefore it can be seen that implicit support, and accounting for it in specific parent guarantees, should assist in minimizing the amount of fees U.S. parent companies have to charge Canadian subsidiaries. And in light of the basic corporate tax rate arbitrage-driven benefits of having maximum U.S. group profit allocated to Canadian subsidiaries, that should, in concept, be seen as a good result.

Southbound Guarantee, Northbound Fee

If a Canadian parent guarantees the obligations of a U.S. subsidiary for which the subsidiary pays a fee to

the Canadian parent, there should be a bias to maximize the fee, subject to a few conceptual uncertainties.

The corporate tax rate arbitrage in favour of Canada is an obvious reason for the basic bias. The qualification—some conceptual uncertainty—comprises three factors as discussed below. Where those factors lead to not maximizing fee charges, a proposed Canadian statutory safe harbour should accommodate.

Potential U.S. Constraints

Quite apart from the effects of implicit support, there are three factors that may inhibit maximizing guarantee fee charges to a U.S. subsidiary.

First, as noted above, the United States has yet to write specific rules for pricing financial guarantees and that, itself, creates uncertainty that the fee paid will be fully deductible by the U.S. subsidiary.

Second, associated with the first concern is that the previous regulations on intercompany services generally did not see an arm's-length requirement to charge fees for guarantees.⁴⁴ Will that influence the manner in which regulations will be written?

Third, there is some domestically focused U.S. case law to the effect that fees paid by U.S. corporations to shareholders who guarantee, proportionate to their shareholdings, corporate debt is not deductible. The case law has, in fact, gone both ways.⁴⁵ Two (*Tulia and Jones*) are discussed in two IRS memorandums more than 30 years old, which discuss whether the 1968 Section 482 regulations required that a U.S. parent charge a fee to a foreign subsidiary for guaranteeing its debts.⁴⁶ Both TAMs took the position that there should be a fee, but that it should not exceed the actual costs to the U.S. parent of providing it. In Canada, there are specific rules permitting deductibility of guarantee fees (not specifically identifying the status of the guarantor). See Section 20(1)(e.1) of the Act. In *GE*, there was no suggestion that there is any generic block to deducting an outbound fee paid to a shareholder.

The bottom-line concern is, therefore, that the Canadian-owned group could emerge with fees taxable in Canada, but not fully deductible in the United States.

Proposed Canadian Safe Harbour

Where the U.S. deductibility concern—or, separately, perhaps a loss position of the U.S. subsidiary—inhibits or discourages the charging of a fee, proposed Canadian amendments to transfer pricing law would accommodate.

Quite apart from a number of reasons why Canada's transfer pricing laws may not, in principle, require that a Canadian parent charge a fee to a foreign subsidiary the debts of which it is guaranteeing, in March 2003, the government announced an addition—yet to be enacted—to the transfer pricing rules in Section 247 of the Act that in specified circumstances (generally complied with if the guaranteed party is a wholly owned or

⁴⁴ See note 26, text following note 46, and the section above concerning regulations on passive association.

⁴⁵ See *Seminole Thriftway Inc. v. U.S.*, 42 Fed. Cl. 584 (1998); *Tulia Feedlot Inc. v. U.S.*, 513 F. 2d 800 (5th Cir. 1975), cert. denied 96 S. Ct. 362 (1976), and *A.A. & E.B. Jones v. Comr.*, 19 T.C.M. 1561 (1960).

⁴⁶ See Technical Advice Memorandums 77-12-2289960A (12/28/77) and 7822005 (2/21/78).

⁴⁰ Not all U.S. observers agree with the decision in *Container Corp.*; see Blessing (note 4) at note 30 and related text.

⁴¹ Section 214(15) of the Act.

⁴² See Articles XI and XXII(4) of the treaty.

⁴³ See note 2.

controlled subsidiary and the guaranteed debts arise in the conduct of active business) obviate the need to charge a guarantee fee.

The draft proposal is linked to and piggybacks rules in Section 17 of the Act, which specify in what circumstances a Canadian corporation must charge or otherwise recognize interest income on loans to foreign persons and in what circumstances such recognition is not required. An accompanying Department of Finance “comfort” letter states that the department will

recommend to the Minister of Finance that the Act be amended to provide that subsection 247(2) of the Act will not apply to adjust the amount of consideration paid, payable or accruing to a corporation resident in Canada (the “Parent”) in a particular taxation year of the Parent for the providing of a guarantee of the repayment, in whole or in part, of an amount owing by a non-resident person to a person or partnership (the “Lender”) if

- the Parent provided the guarantee pursuant to an agreement in writing entered into with the Lender or with a person related to the Lender;
- the non-resident person is a controlled foreign affiliate of the Parent for the purpose of section 17 of the Act throughout the period in a particular year during which the amount owing is owing, and
- it is established that the amount owing would, if the amount owing were an amount owing to the Parent, be an amount owing described in paragraph 17(8)(a) or (b).

The text of the proposed amendment is set out in the comfort letter and is as follows:

Exclusion for guarantees in respect of certain controlled foreign affiliates

(7.1) Subsection (2) will not apply to adjust the amount of consideration paid, payable or accruing to a corporation resident in Canada (referred to in this subsection as the “parent”) in a particular taxation year of the parent for the providing of a guarantee of the repayment, in whole or in part, of an amount owing by a non-resident person to a person or partnership (referred to in this subsection as the “lender”), if

- (a) the parent provided the guarantee pursuant to an agreement in writing entered into with the lender or with a person or partnership related to the lender,
- (b) the non-resident person is a controlled foreign affiliate of the parent for the purpose of section 17 throughout the period in the particular year during which the amount owing is owing, and
- (c) it is established that the amount owing would, if the amount owing were an amount owing to the parent, be an amount owing described in paragraph 17(8)(a) or (b).

The amendment would apply retroactively to years beginning after 1997 (the year the current provisions of the Act dealing with transfer pricing took effect). Finally, two years later, on January 24, 2005, the department issued a second comfort letter that would modify the proposal by eliminating the requirement for written agreements.

The proposal is not yet enacted, but—as with U.S. proposed regulations—taxpayers have the option of fol-

lowing them. Therefore, where a Canadian parent decides not to charge a guarantee fee, there generally should be no issue in Canada—or, of course, the United States.

Role of Implicit Support

But where the U.S. deductibility concern is discounted and a Canadian group would like to maximize a fee charge,⁴⁷ what role will implicit support play?

From the Canadian perspective, the CRA would not, of course, object—notwithstanding *GE*—if the Canadian parent did not reduce the fee to account for any apparent implicit support. Conversely, the CRA could not object, in light of *GE*, if the Canadian parent did.

Therefore the focus of the effect of implicit support would be on the U.S. view. In that respect, the initial views (expressed at the May 2010 ABA meeting) of senior U.S. government officials to the effect that implicit support be taken into account were seen above. To that extent there would be a potential restraint on the quantum of the fee the Canadian parent might consider charging. But thought certainly could be given to the factors discussed above that would tend to reject the relevance of implicit support in pricing intercompany guarantee fees. In the absence of any specific U.S. law (whether statutory, regulatory or judicial) on point, the matter could turn on assessing the consequences of a challenge to a fee set without reduction for implicit support. Should Canadian groups simply rely on the salutatory effects of a treaty-based mutual agreement procedure resolution, in the event of a challenge so as to, in effect, see no material downside—but only potential upside—in adopting such a pricing approach?

Conclusion

The foregoing indicates that even before the advent of the 2006 temporary and 2009 final Section 482 services regulations and the decisions in *GE* (particularly the issue of implicit support raised therein), there were several issues and uncertainties respecting the proper pricing of intercompany guarantees within a Canadian-U.S. group. The latter developments could be seen to exacerbate the situation, although Canada’s proposed statutory safe harbour (Section 247(7.1)) and the emergence of a clear corporate tax rate arbitrage in favour of Canada may serve to reduce issues with the CRA, if not with the IRS.

However, the full story cannot be said to have been told until Treasury and the IRS issue rules on financial guarantees—and also, perhaps, not until outstanding litigation on cross-border guarantees has been resolved.⁴⁸

⁴⁷ Note that the new exemption under the Canada-U.S. treaty with withholding tax on cross-border guarantee fees (see note 42) will help facilitate such arrangement. That would be required if Congress legislatively reverses *Container Corp.* (note 11).

⁴⁸ See, for example, the pending litigation in *HSBC Bank of Canada and Her Majesty the Queen*, Docket: 2006-3579 (IT) G. However, recent Australian government guidance on intercompany financing has shied away from specifying rules in this area. See the 2009 draft and 2010 final versions of an Australian Taxation office ruling, TR 2010/7. As noted by Blessing (see note 4), the 2009 draft did not include rules on guarantee fees contained in a 2007 draft, TD 2007/D20.