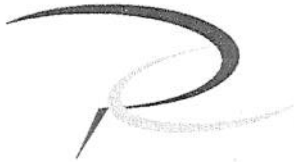

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Economic Analysis of the Taxpayer's Expert Reports in the Matter of Guarantees Made by General Electric Capital Corporation to General Electric Capital Canada, Inc.: 1996 – 2000

by

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I. Assignment & Overview

1. The Department of Justice has asked me to analyze certain topics addressed within the eight expert reports filed by the taxpayer in April 2009 ("GE EXPERT REPORTS"). First, I was asked to determine whether my opinions in my April 2009 report ("FIRST BECKER REPORT")[1] changed after reviewing these reports. I can state that my opinion has not changed.

2. Second, the Department of Justice asked me to provide an opinion on the issues in the GE EXPERT REPORTS that overlapped with the topics addressed in the FIRST BECKER REPORT. Specific points were raised in two reports: the report of Stephen R. Cole ("COLE REPORT")[2] and the report of Mark Fidelman ("FIDELMAN REPORT").[3]

3. The FIRST BECKER REPORT provided detail in defining the characteristics of the guarantor and debtor in the transaction under analysis. Part of that opinion included analyzing the guarantor and the debtor *as parts of multinational companies*—similar to their actual positions. The COLE REPORT, however, diverts from this opinion in two ways:

- Decreasing the analysis' *precision/accuracy* by *altering* the actual corporate structure of the entities under examination: General Electric Capital Corporation ("GE CAPITAL") and General Electric Capital Canada, Inc. ("GE CANADA"). That is, *re-characterizing* the debtor as being *outside* of any multinational corporation.

- Biasing the analysis by applying the standalone structure *only* to GE CANADA, and not also to GE CAPITAL.

4. The FIDELMAN REPORT focuses some of its valuations from the perspective of the guarantor only without consideration of the perspective for the debtor.[4, 5] This one-way focus has the potential to lead to a non-arm's length result. In particular, in this matter, the guarantor's

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[1] Becker, Brian. (April 14, 2009). "Economic Analysis of the Guarantees Made by General Electric Capital Corporation to General Electric Capital Canada, Inc.: 1996 –2000."

[2] Cole, Stephen. (17 April 2009). "Value of the Guarantee Fee Provided by GE Capital Corporation to General Electric Capital Canada Inc. During the Period 1996 to 2000."

[3] Fidelman, Mark. (17 April 2009). "Expert Witness Report for Guarantee Transactions 1996-2000 between General Electric Capital Canada Inc. and General Electric Capital Corporation."

[4] Fidelman, Mark. (17 April 2009). "Expert Witness Report for Guarantee Transactions 1996-2000 between General Electric Capital Canada Inc. and General Electric Capital Corporation," p. 4.

[5] It should be mentioned that the FIDELMAN REPORT is not the only of the GE EXPERT REPORTS to analyze the case from this perspective; however, the issues/critical analysis are similar. See, for example, Hull, John. (7 April 2009). "General Electric Capital's Guarantee of General Electric Capital Canada's Debt," p. 9.

costs of providing a guarantee may exceed the value that such a guarantee would provide to the debtor.

II. Analysis

COLE REPORT

5. In applying the arm's length standard to value a related party transaction, the first step is to construct a *hypothetical* transaction that has the same characteristics as the actual related party transaction except for one: the parties are unrelated. That is, the *only characteristic* changed in creating the hypothetical transaction is setting the parties at issue as independent *of each other*. In the FIRST BECKER REPORT, I accomplish this by setting a hypothetical construct where the guarantor and the debtor are represented by subsidiaries within two *different* multinational companies—having *all* of the other characteristics of GE CAPITAL and GE CANADA, respectively.

6. The COLE REPORT is the only one of the eight expert reports provided by the taxpayer in April 2009 that specifically opines on the appropriate hypothetical corporate structure that would satisfy the arm's length standard, stating: "This basis of determination [of the debtor at issue] may also be described as the 'standalone basis.'"[6] This opinion offers a hypothetical construct that *alters* the actual corporate structure of being within a multinational to being a standalone company. This construct is naturally less precise than a construct where the actual corporate structure is not re-characterized.

7. The COLE REPORT opines for a hypothetical valuation construct that is not only *imprecise*, but also *biased*, as it applies different standards to GE CAPITAL and GE CANADA.[7] That is, it makes the debtor appear to be less strong/financially sound as a standalone company without making any corresponding impact on the guarantor. As seen in **Table 1** below, this choice of hypothetical construct would lead to a relatively *imprecise* result, *biased* towards a *higher* guarantee fee (*e.g.*, lowering the potential transfer pricing adjustment).[8]

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[6] Cole, Stephen. (17 April 2009). "Value of the Guarantee Fee Provided by GE Capital Corporation to General Electric Capital Canada Inc. During the Period 1996 to 2000," p. 4.

[7] Cole, Stephen. (17 April 2009). "Value of the Guarantee Fee Provided by GE Capital Corporation to General Electric Capital Canada Inc. During the Period 1996 to 2000," pp. 16-18.

[8] The relative strength (goodness of fits) of statistical estimators is often determined based upon their precision (often referred to as "consistency" and "efficiency") and lack of bias. See, for example, Hamburg, Morris and Young, Peg. (1994). Statistical Analysis for Decision Making, Sixth Edition. The Dryden Press: Fort Worth, pp. 272-275.

Table 1: Accuracy and Bias of the Corporate Structure Options in Potential Hypothetical Constructs

Constructs	Guarantor Recast as Standalone	Guarantor Left as Part of Multinational
Debtor Recast as Standalone	Unbiased, Imprecise	**Biased Towards Higher Guarantee Fee, Imprecise**
Debtor Left as Part of Multinational	Biased Towards Lower Guarantee Fee, Imprecise	*Unbiased, Precise*[9]

8. The COLE REPORT supports this conclusion of the debtor assumed as a standalone entity based upon: (a) its contention that the CUP approach does not consider the price impacts of a party's place within a multinational organization; and (b) a standalone basis is *less* complex than to consider the actual places of the entities within multinational organizations.[10] However, the CUP approach and the complexity of the hypothetical construct do not support the COLE REPORT's conclusion that the debtor should be recast as a standalone entity.

9. The CUP approach does not require either party in an unrelated transaction to be part of a multinational, but it also does not require such parties to be standalone either. On this particular aspect, the CUP approach does not point to either the standalone or "part of multinational" approach. However, the CUP and all other valuation approaches focus on finding the most precise, accurate, direct, reliable benchmarks to apply. In that sense, benchmarks that have the same characteristics (including corporate structure) would be preferred to those that did not—all else being equal.

10. The COLE REPORT's contention that it would be *simpler* to create a hypothetical construct where one (or both) of the parties to the transaction were recast as standalone organizations as opposed to remaining in their actual state (part of a multinational) is simply incorrect. That is, it would be relatively easy to describe/imagine a hypothetical company like GE CANADA within a multinational company, as the functions/operations/financial results of GE CANADA could serve as a baseline. By construct, a "standalone" proxy for GE CANADA would have to remove the effects of all intercompany transactions. What GE CANADA would look/operate like without the use of the GE name, without intercompany financing, and any other intercompany relationships is difficult—at best—to imagine/construct. Similar analogous issues exist with regard to any potential recasting of GE CAPITAL as a standalone entity.

FIDELMAN REPORT

11. Generally in transfer pricing and with this issue specifically, economists focus the arm's length standard on the price that would be expected to transpire between two independent parties

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[9] The COLE REPORT is represented by the **bold** text, while the FIRST BECKER REPORT is represented by the *italicized* text.

[10] Cole, Stephen. (17 April 2009). "Value of the Guarantee Fee Provided by GE Capital Corporation to General Electric Capital Canada Inc. During the Period 1996 to 2000," pp. 10 & 42.

under similar circumstances. For a transaction to occur, *both* the guarantor and the debtor must agree to the terms. That is, the resulting price would fall within the "bargaining range" [11] where both parties would be made better off than not transacting.

12. In this case, the potential existence of an implicit guarantee leads to discontinuity in the value of an explicit guarantee to the guarantor and the debtor. That is, the value of an explicit guarantee to the debtor (who might already benefit from some level of implicit guarantee from its parent) may be *less* than the cost of such an explicit guarantee to an unrelated company (who would not receive the benefit of the parent's implicit guarantee). In that sense, the debtor may only have a modest benefit for an explicit guarantee if it is already receiving a substantial implicit guarantee. Thus, by considering only the guarantor and the debtor, there may not be a bargaining range over which a guarantee fee could result.

13. While the discontinuity for the guarantor and the debtor alone might not lead directly to a bargaining range, there is another party that is potentially impacted by such a transaction. Its economic incentives can balance out the above stated discontinuity. That is, the explicit guarantee could provide benefit to the *debtor's parent*, as the explicit guarantor would typically be called upon to guarantee the debtor *before* resorting to any implicit guarantee of the latter's parent.[12]

14. Put more directly, the *explicit guarantee could benefit not only the debtor (GE CANADA), but also its parent*, as the latter would not be required to incur the costs of an implicit guarantee any more. Depending upon the strength of such guarantee (*i.e.,* probability that the parent would guarantee the debtor upon default), some portion of the value of the explicit guarantee could be enjoyed by the debtor's parent. In this sense, the amount of fees the debtor itself is willing to pay may only represent a fraction of the costs incurred by the guarantor in providing such services. Thus, analyzing the guarantee only from the perspective of the guarantor—as was done in certain iterations in the FIDELMAN REPORT—has the potential to overstate the amount that the debtor alone would be willing to pay.

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[11] For a more detailed discussion of bargaining power/range, see Friedman, James W. (1986). Game Theory with Applications to Economics. Oxford University Press: New York.

[12] That is, the debtor's parent would primarily benefit from an explicit guarantee signed by the debtor—unless a "side deal"/understanding was reached between the debtor and its parent.