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by Salvatore Mirandola and Patrick Lindsay

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HIGHLIGHTS

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Canada's *Glaxo* Ruling Provides Transfer Pricing Guidance

by Salvatore Mirandola and Patrick Lindsay

The Supreme Court of Canada (SCC) on October 18 released its unanimous decision in *GlaxoSmithKline Inc. v. The Queen*, 2012 SCC 52, which provides guidance on the Canadian transfer pricing rules. Although the transfer pricing provisions in Canada's Income Tax Act have changed since the years at issue in this case, *GlaxoSmithKline* is nevertheless expected to have a major influence on the interpretation and application of Canada's transfer pricing rules. In a nutshell, the SCC has confirmed a broadening of the economic circumstances that can be considered in determining an appropriate transfer price between non-arm's-length parties. (For the text of the SCC's judgment, see *Doc 2012-21575* or *2012 WTD 203-16*.)

Some Background

Between 1990 and 1993, GlaxoSmithKline Inc. (Glaxo Canada) purchased ranitidine, the active ingredient in the brand-name anti-ulcer drug Zantac, from a related nonresident vendor, for between C $1,512 per kilogram and C $1,651 per kilogram. During the same period, two generic pharmaceutical companies in Canada purchased ranitidine from other arm's-length sources for use in their generic anti-ulcer drugs for between C $194 per kilogram and C $304 per kilogram. Glaxo Canada was reassessed under section 69(2) of the ITA (now section 247(2)) based on the Minister of National Revenue's (MNR) assumption that the purchase price paid by Glaxo Canada was greater than an amount that ''would have been reasonable in the circumstances'' if the parties had ''been dealing at arm's length.''

There were two agreements that figured prominently in the transfer pricing analysis conducted at each judicial stage of this appeal:

- *Supply Agreement*: Glaxo Canada purchased ranitidine from Adechsa S.A., a related company located in Switzerland, under a supply agreement. As a secondary manufacturer, Glaxo Canada acquired the ranitidine, put it into a delivery mechanism, and then packaged and marketed it as Zantac, a patented and trademarked drug.
- *License Agreement*: Glaxo Group Ltd. (Glaxo Group), another related company, owned the Zantac trademark and the patent for ranitidine. Glaxo Group granted rights under the patent and trademark to Glaxo Canada under a license agreement. The license agreement conferred other rights and benefits on Glaxo Canada, including: access to new products, the right to the supply of raw and bulk materials, marketing support, and technical support for setting up new product lines.

Arguments

Glaxo Canada argued that the determination of the appropriate transfer price for ranitidine should be influenced by the rights and benefits conferred by the license agreement because it was inextricably linked to the supply agreement. The MNR argued that the appropriate transfer price should be determined on a transaction-by-transaction basis (that is, on the basis of the supply agreement, without regard to the license agreement).

Tax Court of Canada

The Tax Court of Canada (TCC) held that the license agreement and the supply agreement must be considered independently and, accordingly, it did not consider whether the rights and benefits under the license agreement were ''relevant in the circumstances'' when determining the arm's-length price for the supply of ranitidine.

The TCC selected the comparable uncontrolled price method as the preferred transfer pricing methodology and accepted the highest price paid by the generic pharmaceutical companies to arm's-length suppliers as the relevant CUP. Aside from allowing a minor increment of C $25 per kilogram, the TCC affirmed the reassessment.

Federal Court of Appeal

The Federal Court of Appeal (FCA) held that the TCC erred by not considering the license agreement. Relying on jurisprudence regarding whether an amount paid was ''reasonable'' under section 67 of the ITA, the court adopted the ''reasonable business person test,'' which requires an inquiry into the circumstances that an arm's-length purchaser would consider relevant when deciding what price to pay.

The FCA remitted the matter back to the TCC to determine the reasonable amount in the circumstances, with a direction that the TCC consider the license agreement as a relevant circumstance. The MNR appealed on the basis that the TCC had made no error. Glaxo Canada cross-appealed to the SCC on the basis that the matter should not have been remitted back to the TCC because it had ''demolished'' all of the assumptions underlying the revenue minister's assessments.

Supreme Court of Canada

The SCC denied both the appeal and the cross appeal and remitted the matter back to the TCC with the same direction as the FCA — that the license agreement is a relevant consideration — and provided further guidance.

The SCC considered and responded to the main reasons why the TCC had concluded that the license agreement was not a relevant consideration:

- *Jurisprudence*: The TCC pointed to jurisprudence, including earlier SCC decisions in *Singleton v. Canada*, 2001 SCC 61, and *Shell Canada Ltd. v. Canada*, [1999] 3 SCR 622. The SCC concluded that those cases were not relevant, primarily on the basis that the tax provisions involved did not expressly call for an examination of ''relevant circumstances,'' whereas the examination is expressly required in section 69(2).
- *OECD Guidelines*: Regarding the OECD guidelines, published in 1979 and 1995, the SCC acknowledged (as pointed out by the TCC) that the guidelines state that ''ideally,'' the ''arm's length principle should be applied on a transaction-by-transaction basis.'' However, the SCC noted that the guidelines also provide that ''[t]here are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis.''

After rejecting the revenue minister's view that the license agreement cannot be considered, the SCC next addressed whether the license agreement *should* be considered. Again adopting the OECD guidelines, the SCC held that a separate agreement such as the license agreement should be considered when ''the economically relevant characteristics of the situations being compared [are] sufficiently comparable.'' The license agreement was relevant because ''Glaxo Canada was paying for at least some of the rights and benefits under the license agreement as part of the purchase prices for ranitidine from Adechsa.''

The SCC summarized its approach as follows (at paragraph 44):

> Because s. 69(2) requires an inquiry into the price that would be reasonable in the circumstances had the non-resident supplier and the Canadian taxpayer been dealing at arm's length, it necessarily involves consideration of all circumstances of the Canadian taxpayer relevant to the price paid to the non-resident supplier. Such circumstances will include agreements that may confer rights and benefits in addition to the purchase of property where those agreements are linked to the purchasing agreement. The objective is to determine what an arm's length purchaser would pay for the property and the rights and benefits together where the rights and benefits are linked to the price paid for the property.

Potential Effect of Linked Intangibles

Interestingly, the SCC observed that the separate agreements may have resulted in the effective conversion of a royalty (on which withholding tax would be payable) to a purchase price (which was not subject to withholding tax) and, if so, any resulting tax advantage might affect the price an arm's-length party would pay in the circumstances. The SCC suggested, without deciding the point, that if the price paid for ranitidine included compensation for intellectual property rights granted to Glaxo Canada under the license agreement, that fact would have to be consistent with Glaxo Canada's position regarding withholding tax. Ultimately, the SCC left it open for the parties and the TCC to address that issue before the TCC.

Additional SCC Observations

In addition to concluding that the matter must be returned to the TCC to determine the reasonable arm's-length price, considering the rights and benefits received by Glaxo Canada under the license agreement, the SCC provided the following additional observations and guidance:

- Without making any determination, the SCC noted that Glaxo Canada appears to have received some value for rights and benefits under the license agreement that may affect the price that will be determined by the TCC. ''For example, guaranteed access to new products, the right to the supply of raw materials and materials in bulk, marketing support, and technical assistance for setting up new product lines all appear to have some value,'' it said.
- The SCC agreed with the TCC that there was evidence supporting some enhanced value for the ranitidine purchased from Adechsa because, unlike the generic comparables, Adechsa was obligated to comply with Glaxo Group's approved ''good manufacturing practices.''
- The respective roles and functions of the parties must be considered, the SCC said, and it will be up to the TCC to determine ''whether or not compensation for intellectual property rights is justified in this particular case.'' Further, the price arrived at by the TCC must carefully take into account the independent interests of each party.

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- The setting of a transfer price by a trial judge is not an exact science, and the trial judge should be afforded deference and ''some leeway in the determination of the reasonable amount.''

Cross Appeal

In the cross appeal, Glaxo Canada argued that it had demolished the MNR's assumptions and, as such, the reassessment should be set aside without returning the matter to the TCC to determine the appropriate transfer price. The SCC reviewed the pleadings and held that the taxpayer had not demolished the MNR's assumption, as set out in its reply, that Glaxo Canada ''paid a price for ranitidine which was greater than the amount that would have been reasonable in the circumstances'' if the parties had been dealing at arm's length.

Conclusion

GlaxoSmithKline provides important guidance on the factors that taxpayers (and tax authorities and judges) can or should consider in determining appropriate transfer prices in non-arm's-length transactions. However, the decision also cautions that if non-arm's-length parties enter into international agreements in which value is shifted from one agreement to another, for tax or other reasons, that value shift can also inform the determination of the appropriate transfer price. Ultimately, it may be up to the trial judge to determine the extent to which the shifted value and any tax savings that flow from the shifted value may be relevant considerations. ◆

♦ *Salvatore Mirandola and Patrick Lindsay are with Borden Ladner Gervais LLP in Toronto and Calgary.*

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