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The Big Picture - Supreme Court of Canada Sheds Light on Transfer Pricing

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Canada v GlaxoSmithKline Inc., 2012 SCC 52

Making Sense of Transfer Pricing

Multinational corporate groups often have entities which are located in various jurisdictions, according to the needs of the business and where different functions of the organization are conducted. In some instances, there is a need to price the products and services provided between the entities (and therefore between jurisdictions) – and this need is often derived from some advantage to performing certain functions in lower tax jurisdictions. For example, some corporations may price products or services at higher rates so that income in higher tax jurisdictions is decreased as a result of higher expense deductions, with these higher amounts being included in revenue of an entity in a lower tax jurisdiction. Some tax planning in this manner is appropriate, and often highly advantageous for competing successfully within our global economy. Transfer pricing rules are designed and in place to address unjustified skewing of profits and revenue toward lower tax jurisdictions.

A Look at GlaxoSmithKline

Between 1990 and 1993, Glaxo Canada purchased ranitidine (a pharmaceutical ingredient used in the formulation of Zantac©) from Adechsa S.A., a Glaxo Group clearing company located in Switzerland, for between $1,512 and $1,651 per kilogram. These prices were a function of a licensing agreement conferred on Glaxo Canada allowing it to utilize the branding Zantac© when distributing its product. The supply agreement between these parties provided for a resale pricing method, which is most clearly illustrated via the following example by Rip A.C.J (at para 47):

> Glaxo World used what is referred to as a resale-price method to determine the transfer price of the API [active pharmaceutical ingredient]. Glaxo World and its distributors agreed that a gross margin of 60 percent would be retained by the distributors and the ranitidine was priced accordingly. To use a simple example, if the ranitidine product sold for $10 in Italy, the transfer price would be $4; if the ranitidine product was sold for $20 in France, the transfer price would be $8.

The point of contention for the Minister of National Revenue was that during the relevant years, two other Canadian pharmaceutical companies, Apotex Inc. and Novopharm Ltd. (the “Generics”) also purchased ranitidine for use in their products; which were generic versions of Zantac. The prices paid by these corporations ranged from $194 to $304, a substantially lower average dollar amount than paid by Glaxo Canada. Former subsection 69(2) of the *Income Tax Act*, RSC 1985 c1 (5^{th} Supp) (“Act”) which spoke to transactions of this sort, applicable to the relevant years, read as follows:

> (2) Where a taxpayer has paid or agreed to pay to a non-resident person with whom the taxpayer was not dealing at arm’s length as price, rental, royalty or other payment for or for the use or reproduction of any property, or as consideration for the carriage of goods or passengers or for other services, an amount greater than the amount (in this subsection referred to as “the reasonable amount”) that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm’s length, the reasonable amount shall, for the purpose of computing the taxpayer’s income under this Part, be deemed to have been the amount that was paid or is payable therefor.

The discrepancy in amounts paid by the Generics and the amounts paid by Glaxo Canada for ranitidine prompted the Minster to reassess Glaxo Canada for the years in question on the basis that it had paid Adechsa “more than a reasonable amount for the purchase” (para 11) thereby increasing Glaxo Canada’s taxable income pursuant to subsection 69(2). The taxpayer challenged this assessment.

It was up to the Court to determine whether to consider the licensing agreement and its role in the pricing of ranitidine between Glaxo Canada and Adescha, or whether to adopt the approach of cases such as *Singleton v Canada*, 2001 SCC 61 and *Shell Canada v Canada*, [1999] 3 SCR 622. Both *Singleton* and *Shell* stand for the proposition that a transaction-by-transaction approach should have been followed under subsection 69(2). In *Singleton*, the taxpayer withdrew funds from his capital account towards the purchase of a home. These funds were replaced with borrowed funds. This case turned on whether the amount borrowed was “for the purpose of earning income.” Ultimately, the Court in *Singleton* viewed the transactions as being separate. Similarly, *Shell* turned on whether borrowed funds could properly be considered to be used for the purpose of earning income. Again, the transactions were viewed as being separate. Given the case law, the Tax Court of Canada upheld the assessment.

The judgment was appealed to the Federal Court of Appeal where Nadon J.A. adopted the “reasonable business person” test, which included the circumstances that an arm’s length purchaser would consider relevant when deciding what price to pay (para 69). As a result of this new approach, the decision was overturned. The Federal Court of Appeal found that the Tax Court had erred in not considering the license agreement when determining whether the prices paid by Glaxo Canada for ranitidine were reasonable under subsection 69(2), and remitted the matter back to the Tax Court. Both parties appealed to the Supreme Court of Canada; Glaxo Canada appealed on the basis that it had demolished all of the Ministers assumptions, and the Minister appealed on the basis that the prices paid for the ranitidine were, as the Tax Court originally found, not reasonable.

Recent Supreme Court of Canada Decision

On October 18^{th} 2012, the Supreme Court affirmed the Federal Court’s choice to see the facts in *GlaxoSmithKline* as substantially differing from those of *Singleton* and *Shell*, choosing to apply the 1995 OECD Guidelines in their approach to subsection 69(2):

> …a proper application of the arm's length principle requires that regard be had for the "economically relevant characteristics" of the arm's length and non-arm's length circumstances to ensure they are "sufficiently comparable." Where there are no related transactions or where related transactions are not relevant to the determination of the reasonableness of the price in issue, a transaction-by-transaction approach may be appropriate. (*GlaxoSmithKline,* SCC, at para 42).

Applying the contextual approach to subsection 69(2), the Supreme Court found a consideration of all circumstances of the transaction were relevant to the price paid in this case, stating (at para 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.

With respect to the practical determination of the price paid, the Court commented (at para 61) that transfer pricing is not an exact science, allowing for some leeway in the determination of a reasonable amount:

> As long as a transfer price is within what the court determines is a reasonable range, the requirements of the section should be satisfied. If it is not, the court might select a point on the range it considers reasonable in the circumstances based on an average, median, mode, or other appropriate statistical measure, having regard to the evidence that the court found to be relevant.

In the end, both the appeals were dismissed and the Supreme Court remitted the case back to the Tax Court to determine what effect the license agreement had on the pricing of ranitidine. A win for Glaxo, for now.

Going Back to the Tax Court

There is no doubt that a transfer pricing decision has been highly anticipated by both the Minister and the taxpayer. The *GlaxoSmithKline* decision will definitely inform pending transfer pricing cases, allowing parties to better plan their respective approach and reaction to these sorts of transactions. However, two doors were opened by the Supreme Court, and left to the Tax Court to close.

Firstly, it is true that the Supreme Court has provided some guidance with respect to how the courts should view transactions of this sort, it is also true that by sending this matter back to the TCC to decide, a new problem may have presented itself: what amounts, if any, of the purchase price should be allocated to intellectual property rights in this particular case. This crucial question was left unanswered by the Canada's top court, falling upon the Tax Court to decide.

Secondly, if an allocation is made towards intellectual property, the Court noted (at para 57) the following concern when considering the royalty provisions of the Canada U.K. Tax Treaty:

> …If the purchase price includes compensation for intellectual property rights granted to Glaxo Canada, there would have to be consistency between that and Glaxo Canada's position with respect to Part XIII withholding tax.

This issue was not resolved at the SCC, though again will surely be one of the issues addressed during reconsideration by the Tax Court.

On the Horizon

In the end, perhaps not enough light has been shed onto this issue; as always, the devil is in the details. It should be noted that since this case began, subsection 69(2) has been replaced by subsection 247(2), introducing a 'series' concept which at least partially allows a consideration of licensing agreements. However, two reasonably clear take-aways for taxpayers have been outlined. First, anytime a taxpayer engages in a transaction with a non-arm's length foreign entity, be it a parent, subsidiary or affiliate, the transfer pricing rules in the Act must be kept in mind and there is a non-trivial risk that transfer pricing disputes may arise. Second, the new standard for determining appropriate arm's length pricing will take into account salient information relevant to the transaction; informed with this knowledge, taxpayers should plan accordingly.