Canada v GalaxoSmithKline Inc., 2012 SCC 52

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Relevant Circumstances in Transfer Price Determinations - Consideration of Other Agreements Between the Parties

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There were two issues in this case:

- what circumstances does the transfer pricing provisions of the ITA require one to take account of in determining a comparable arm's-length price - ie what is the appropriate arm's length proxy?
- was it proper to remit the matter back to the TCC for reconsideration?

The SCC in a unanimous decision held that in order to determine the transfer pricing question, one must have regard to all of the circumstances relevant to the price paid to a non-resident, including any agreements that confer rights or benefits in addition to the purchase of the property or service, so long as these are linked to the purchase of the property or service. The Question is: What would an arm's length supplier charge for the property and the rights and benefits together, where the rights and benefits are linked to the price of the property. Only after this determination can one choose the proper method for determining the arm's length price.

The SCC also offered the following additional guidance: (1) the use of "reasonable amount" means that this is not an exact science - not all comparators will be identical in all material respects - thus some leeway must be allowed in determining what is reasonable within some appropriate statistical range; (2) The different roles of the different parts of the multinational must be kept in mind so that no misallocation occurs because the different functions and their resultant risks and resources are not considered; (3) One must look a the independent interests of each party in the transaction; (4) evidence of whether arm's length person have chosen to make purchases at the same prices are relevant when present.

Since the MNR's assumptions included the need to determine the reasoanbleness of the price, and since this was not determined (burden not met by Glaxo Canada), the matter was properly referred back

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NOTE: the SCC stated that if the purchase price included an amount for the rights and benefits, these would be considered royalty payments which carry with them withholding tax obligations.

FACTS

MNR reassessed Galaxo Canada for the 1990-93 tax years, on the basis that the amount it paid to a non-arm's length supplier was greater than the amount that would have been payable between arm's length parties. The TCC upheld the reassessment, but the FCA allowed the taxpayer's appeal but remitted the matter back to the TCC for reconsideration.

Galaxo Canada purchased ranitidine, an active ingredient in Zantac, from a related company paying between $1,512 and $1,651 per kilogram, while during the same period Ranitidine was available from other sources for between $194 and $304 per kilogram. Galaxo Canada acted as secondary manufacturer and marketer - it put the active ingredient into the delivery mechanism, packed, and marketed the drug, which is patented and trademarked. Galaxo Group granted rights to these IP rights under a license agreement.

The Galaxo Group set the transfer price of ranitidine using the resale price method, which uses a gross margin to be retained by the distributor in any jurisdiction to determine the price of the ranitidine.

Intro

Transfer pricing issues arise when multinationals residing in different jurisdictions transfer property or provide services to one another, and because of the lack of arm's-length dealing ordinary market forces are not operating in the transactions. This may result in prices being set to divert profits from the appropriate tax jurisdiction to a lower tax jurisdiction - fiscal avoidance. The ITA requires a reassessment on the basis of the price paid and the price that would have been paid in an arm's length transaction.

The FCA decision

Held that the TCC erred by not taking account the licence agreement when determining the price paid between the parties, and 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.

SCC Analysis

The Court reviewed the history of the transfer pricing provision in the ITA, and said at paragraph 17:

> The first transfer pricing provision in the Canadian Income Tax Act was enacted as s. 23B of the Income War Tax Act, R.S.C. 1927, c. 97, by An Act to amend the Income

> War Tax Act, S.C. 1939, c. 46, s. 13. The provision was re-enacted as s. 17(3) of The Income Tax Act, S.C. 1948, c. 52, and again as s. 17(3) of the Income Tax Act, R.S.C. 1952, c. 148. Section 17(3) of the 1952 Act is almost identical to s. 69(2) first enacted in 1971 (S.C. 1970-71-72, c. 63, s. 1), with immaterial modifications in 1985 (R.S.C. 1985, c. 1 (5th Supp.)).

The relevant provision, being 69(2) in 1990-93, reads:

> (2) <u>Where a taxpayer has paid</u> or agreed to pay <u>to a non-resident person with whom the taxpayer was not dealing at arm's length as price</u>, rental, royalty or other payment for or <u>for</u> the use or reproduction of <u>any property</u>, or as consideration for the carriage of goods or passengers or for other services, <u>an amount greater than the amount</u> (in this subsection referred to as "the reasonable amount") <u>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</u>.

The SCC then looked at the OECD methods for determining transfer prices, noting that they are not controlling as if they were a Canadian statute, and that the test must ultimately refer to the TIA, which does not itself offer guidance on how to determine "reasonable amount" that would have been payable between arm's length parties.

The OECD suggested the CUP method as the primary method, and this was the one relied on by the MNR. The court noted that the guidelines require careful consideration to ensure that the is a compatible transfer price, and stated that prices are only comparable if (at para 23):

> 1. None of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or
>
> 2. Reasonably accurate adjustments can be made to eliminate the material effects of such differences. (See 1995 Guidelines, at para. 1.15.)

The cost plus method looks at the supplier's cost plus an appropriate markup, and the MNR used this to verify the arm's length price determined using the CUP method.

Galaxo Canada relied on the resale price method that uses net margins, which is a method the OECD says is best applied to marketing operations.

The MNR argued that *Singleton* requires a transaction by transaction approach to be followed when dealing with transfer pricing, and therefore the supply agreement and licence agreement would have to be considered separately. The SCC said that the MNR ignored the difference between the provision involved and the provision applicable at bar. Unlike interest deductibility, transfer pricing required an assessment as to whether the price was greater than would have been reasonable in the circumstance if the parties were dealing at arm's length, and transactions other than the purchase may be relevant.

The SCC noted that the OECD guidelines don't' require a transaction by transaction approach, but says that sometimes separate transactions are so closely linked or continuous that they can't be evaluated on their own. The guidelines require looking at the economically relevant characteristics in finding an appropriate comparator :

> Application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. <u>In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable</u>. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. [Emphasis added.]

The SCC said that the licence agreement was relevant and ought to be considered in order to find the reasonable price that would have been paid by an arm's length person. Such a person would consider "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." (para 44). The licence agreement would be something that an arm's length person would have to deal with.

Galaxo Canada was paying for some of the rights and benefits under the licence agreement as part of the purchase price. Galaxo Canada's business did not involve a great number of risks that it would have to undertake it if did not have the licence agreement. It if for this reason that the generic prices don't consider the economic and business realities of Galaxo Canada.

The Court agreed with the FCA that “the amount that would have been reasonable in the circumstances” if Glaxo Canada and Adechsa had been dealing at arm’s length has yet to be determined. This will require a close examination of the terms of the Licence Agreement and the rights and benefits granted to Glaxo Canada under that Agreement." (para 54).

The SCC also noted that the payment to non-residents for rights are royalty payments, which require withholding taxes to be paid - this did not happen on any of the purchase prices paid.

The Court said at paragraph 60 that all features of the licence agreement require some recognition in determining what an arm's length purchaser would be prepared to pay for the same rights and benefits. "It is only after identifying the circumstances arising from the Licence Agreement that are linked to the Supply Agreement that arm’s length comparisons under any of the OECD methods or other methods may be determined."

The SCC also offered some additional guidance:

[61] would offer the following additional guidance with respect to the redetermination. First, s. 69(2) uses the term “reasonable amount”. This reflects the fact that, to use the words of the 1995 Guidelines, “transfer pricing is not an exact science” (para. 1.45). It is doubtful that comparators will be identical in all material respects in almost any case. Therefore, some leeway must be allowed in the determination of the 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 within a 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. I repeat for emphasis that it is highly unlikely that any comparisons will yield identical circumstances and the Tax Court judge will be required to exercise his best-informed judgment in establishing a satisfactory arm’s length price.

> [62] Second, while assessment of the evidence is a matter for the trial judge, I would observe that the respective roles and functions of Glaxo Canada and the Glaxo Group should be kept in mind. Glaxo Canada engaged in the secondary manufacturing and marketing of Zantac. Glaxo Group is the owner of the intellectual property and provided other rights and benefits to Glaxo Canada. Transfer pricing should not result in a misallocation of earnings that fails to take account of these different functions and the resources and risks inherent in each. As discussed above, whether or not compensation for intellectual property rights is justified in this particular case, is a matter for determination by the Tax Court judge.
>
> [63] Third, prices between parties dealing at arm’s length will be established having regard to the independent interests of each party to the transaction. That means that the interests of Glaxo Group and Glaxo Canada must both be considered. An appropriate determination under the arm’s length test of s. 69(2) should reflect these realities.

> [64] Fourth, in this case, there is some evidence that indicates that arm's length distributors have found it in their interest to acquire ranitidine from a Glaxo Group supplier, rather than from generic sources. This suggests that higher-than-generic transfer prices are justified and are not necessarily greater than a reasonable amount under s. 69(2).

The SCC then dealt with the matter being sent back to the TCC by the FCA because Galaxo Canada had not discharged its burden of showing what a reasonable arm's length price would have been in the circumstances. This turned on what the basis of the re-assessment was. The SCC looked through the assumptions made by the minister in the re-assessment and found that one dealt with the reasonableness of the price paid and not just with the method used by the MNR. Thus, this remained to be determined by the TCC.

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