

Glaxosmithkline: Transfer Pricing Law in Canada Clarified for Cross-Border Investors

Lorne H. Saltman*

In the recent Glaxosmithkline transfer pricing case, the Canadian Federal Court of Appeal established a realistic framework for applying the abstract rules promulgated by the OECD, by requiring an analysis of the taxpayer's relevant circumstances, including the legal, financial, commercial, and contractual circumstances that any arm's length person "standing in the shoes of the taxpayer" would face in its economic relations with the relevant cross-border related parties. Although this case did not happen to involve a U.S. entity, given the extent of U.S.–Canada business investment—not to mention the ever-increasing exposure to transfer pricing adjustments in cross-border business transactions generally—U.S. taxpayers should find the analysis of great interest.

"A good decision is based on knowledge and not on numbers."

—Plato

Introduction

The recent decision of the Canadian Federal Court of Appeal (FCA) in the case of *Glaxosmithkline Inc. v. The Queen*¹ marks an important crossroad in the development of transfer pricing law in Canada. The Court addressed the omnipresent question: When performing a transfer pricing analysis, of what relevance are the taxpayer's specific circumstances and what weight should be given to them, particularly when the price paid to a related party may appear to the taxation authority to be excessively high, giving rise to depressed local profits? What makes the decision of the FCA in *Glaxosmithkline* so compelling to this writer is the complete reversal from the position of the Tax Court

* Lorne H. Saltman is a partner in Cassels Brock & Blackwell LLP, Toronto. He may be contacted by phone at (416) 869-5386, or by email at lsaltman@casselsbrock.com.

¹ 2010 FCA 201.

on the question of what legal, business, and economic circumstances of the taxpayer should be relevant in the transfer pricing context.

This article will examine the *Glaxosmithkline* decisions at both court levels and attempt to discern emerging principles from this and other recent cases in order to determine what circumstances of the taxpayer should be relevant in the transfer pricing context. Although the particular facts of this case do not happen to involve a U.S. entity, given the extent of U.S.-Canada business investment—not to mention the ever-increasing exposure to transfer pricing adjustments in cross-border business transactions generally—U.S. taxpayers should find the analysis of great interest.

The Facts of the *Glaxosmithkline* Case

The taxpayer, Glaxo Canada, was a member of the U.K.-based Glaxo Group of companies (Glaxo World companies). The Glaxo World companies discovered, developed, manufactured, and distributed a number of branded pharmaceutical products, which were marketed and sold throughout the world through various subsidiaries, such as Glaxo Canada, and arm's-length distributors. In Canada, Glaxo Canada packaged and sold Zantac, a patented and trademarked medication prescribed to treat stomach ulcers without surgery. The Zantac trademark and patents for its active ingredient, Ranitidine, were owned by Glaxo Group, which licensed them to Glaxo Canada for use in Canada. Over time, Zantac overtook its competition as the premier anti-ulcer drug, which allowed Glaxo World to price Zantac at a substantial premium. The manufacturing of Ranitidine was primarily the responsibility of two companies within the Glaxo World companies. Following its manufacture, Ranitidine was sold to a Swiss corporation, Adechsa S.A., a Glaxo World clearing company. In turn, Adechsa sold Ranitidine to Glaxo World affiliates such as Glaxo Canada or to arm's-length distributors throughout the world. The purchasers would generally package Ranitidine into a delivery mechanism such as a tablet, liquid, or gel, and then market and distribute it.

Use of Resale Price Method. Ranitidine was sold by Glaxo World to related and unrelated distributors using the Resale Price Method (RPM) to determine the sale price. Glaxo World and the distributors agreed that a gross margin of 60 percent would be retained by the distributor. The starting point was the in-market price for the finished Ranitidine product, the distributor would get its 60 percent gross margin, and the balance would be remitted to the Glaxo Group by way of transfer price, royalty, or both. Where the distributor was to pay both transfer prices and royalties, they would be added together to determine the distributor's gross profit margin after payment of the royalty.

The Supply Agreement. In 1983, Glaxo Canada entered into a Supply Agreement with Adechsa for the purchase of Ranitidine. This price was

reviewed and adjusted annually. For the years 1991 to 1993, the purchase price was between \$1,572.45 and \$1,651.72 per kilo. This Agreement obligated Glaxo Canada to purchase Ranitidine from Adechsa but provided the following: (1) protection against foreign currency exchange, (2) indemnity insurance, and (3) the use of intellectual property to “the extent that [Glaxo Canada] shall not previously have received it or shall not otherwise receive it directly from [Glaxo Group].”²

The License Agreement. The second contractual arrangement relevant to the determination of the case was the License Agreement between Glaxo Canada and Glaxo Group which applied to the entire portfolio of Glaxo World drugs. Glaxo Canada paid Glaxo Group a 6 percent royalty on its net sales of Zantac and other drugs in exchange for:

- The right to manufacture, use, and sell products;
- The right to the use of trademarks owned by Glaxo Group, including Zantac;
- The right to receive technical assistance for its secondary manufacturing requirements;
- The use of the registration materials prepared by Glaxo Group, to be adapted to the Canadian regulatory environment;
- Access to new products, including line extensions;
- Access to improvement in drugs;
- The right to have a Glaxo World company sell to Glaxo Canada any raw materials;
- Marketing support; and
- Indemnification against damages arising from patent infringement.

During the years at issue, Apotex and Novopharm, both Canadian generic pharmaceutical companies, sold generic Ranitidine products in Canada. Both companies purchased their Ranitidine at a price substantially lower than that paid by Glaxo Canada for its Ranitidine, i.e., between \$194 and \$304 per kilo, from unrelated manufacturers that did not hold patent rights and were not Glaxo Group-approved sources.

The Issue at the Tax Court of Canada: Pricing Method Challenged

The Canada Revenue Agency (the CRA) reassessed Glaxo Canada for its 1991–1993 taxation years on two grounds. First, the CRA increased Glaxo Canada’s income for each of those years on the basis that it had overpaid

² Id. at ¶ 15.

Adechsa for the purchase of Ranitidine. The authority for the disallowance was Subsection 69(2) of the Income Tax Act (Canada) (the Act), which then read as follows:

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 . . . payment for . . . any property, . . . 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 . . . be deemed to have been the amount that was paid . . . therefor.³

Second, the CRA assessed Glaxo Canada for having conferred benefits on a related nonresident, by virtue of the overpayments, resulting in dividends deemed to have been paid that were subject to withholding tax under Part XIII of the Act.

³ Since 1997, the transfer pricing rules have been expanded to give the CRA more powers, although the main thrust is still to arrive at an arm's-length price. The current Subsection 247(2) reads as follows:

Where a taxpayer . . . and a non-resident person with whom the taxpayer . . . does not deal at arm's length . . . are participants in a transaction . . . and

(a) the terms or conditions made or imposed, in respect of the transaction . . ., between any of the participants in the transaction . . . differ from those that would have been made between persons dealing at arm's length, or

(b) the transaction . . .

(i) would not have been entered into between persons dealing at arm's length, and

(ii) can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit,

any amounts that, but for this section and section 245, would be determined for the purposes of this Act in respect of the taxpayer . . . for a taxation year . . . shall be adjusted (in this section referred to as an "adjustment") to the quantum or nature of the amounts that would have been determined if,

(c) where only paragraph (a) applies, the terms and conditions made or imposed, in respect of the transaction . . ., between the participants in the transaction had been those that would have been made between persons dealing at arm's length, or

(d) where paragraph (b) applies, the transaction . . . entered into between the participants had been the transaction . . . that would have been entered into between persons dealing at arm's length, under terms and conditions that would have been made between persons dealing at arm's length.

These assessments were appealed by Glaxo Canada to the Tax Court which, in its decision,⁴ held that the amounts paid by Glaxo Canada to Adechsa for Ranitidine exceeded the “fair market value” of Ranitidine and that, consequently, Subsection 69(2) of the Act applied. More particularly, the Tax Court determined that the price which would have been reasonable for Glaxo Canada to pay Adechsa for each kilo of Ranitidine it purchased was the highest price paid by Apotex and Novopharm, subject to an upward adjustment of \$25 per kilo to account for the fact that the Ranitidine purchased by Glaxo Canada was granulated, whereas that purchased by Apotex and Novopharm was not.

The CRA relied on the Comparable Uncontrolled-Price (CUP) Method (tested by the use of the Cost-Plus Method) to conclude that Glaxo Canada ought to have paid the same transfer price for the Ranitidine that was paid by the generic drug companies, as these purchases were comparable transactions, to arrive at an arm’s-length price. The Tax Court upheld this approach and rejected the RPM, implying that its use in conjunction with the taxpayer’s contractual terms would permit any multinational enterprise (MNE) to structure its relationships to avoid having its transfer prices measured against arm’s-length prices.⁵

The Tax Court treated the Supply Agreement and the License Agreement as separate matters/transactions, as they did not explicitly refer to each other. Moreover, the Tax Court was not satisfied that the License Agreement provided an economic benefit to Glaxo Canada in respect of its purchase of Ranitidine.

The Federal Court of Appeal’s Decision

Reasonableness Depends on Real-World Circumstances. Justice of Appeal Nadon, writing for a unanimous FCA, held that the issue was whether the amount paid by Glaxo Canada to Adechsa for its Ranitidine exceeded the “reasonable amount,” i.e., the amount which, if the parties had been dealing at arm’s length, would have been “reasonable in the circumstances” for Glaxo Canada to pay for its Ranitidine.

The FCA held that the Tax Court Judge erred, because he misunderstood the test that appears in Subsection 69(2)—i.e., if Glaxo Canada had been dealing with Adechsa at arm’s length, would the price paid by Glaxo Canada for its Ranitidine have been “reasonable in the circumstances”? In order to make that determination, the Judge had to consider all relevant circumstances which an arm’s-length purchaser, “standing in the shoes of the appellant,” would have had to consider.⁶

⁴ *Glaxosmithkline Inc. v. The Queen*, 2008 DTC 3957.

⁵ *Id.* at ¶ 89.

⁶ *Glaxosmithkline*, *supra* note 1, at ¶ 73.

The Tax Court held that there was no evidence that the price or value of Ranitidine had any effect on the price of the medication produced, particularly because the Glaxo Group determined the pricing of Ranitidine based on the ultimate price of the medication under the RPM. Accordingly, the Court viewed “any difference in business strategy between the [taxpayer] and the generic companies [as relating] to the end selling price” of the medication rather than the purchase price of Ranitidine and, thus, concluded that Glaxo Canada’s business circumstances and strategies had no bearing on the transfer pricing issue.⁷

However, in a real business world (unlike the “fictitious business world” posited by the Tax Court, in which the License Agreement was ignored), the FCA opined that an arm’s-length purchaser could always buy Ranitidine at market prices from a willing seller. The question, therefore, is whether that arm’s-length purchaser would be able to sell his Ranitidine under the Zantac trademark. Because it was central to Glaxo Canada’s real business circumstances, and would have continued to be central even if it were dealing at arm’s length with Adechsa, the License Agreement with Glaxo Group was “a circumstance” which had to be taken into account.

Intellectual Property—Instead of Non-Arm’s-Length Relationship—Is the Key. The following elements of the License were relevant:

- Glaxo Group owned the Zantac trademark and would own it even if Glaxo Canada were an arm’s-length licensee.
- Zantac commanded a premium over generic Ranitidine drugs.
- Glaxo Group owned the Ranitidine patent and would have owned it even if Glaxo Canada had been in an arm’s-length relationship.
- Without the License Agreement, Glaxo Canada would not have been in a position to use the Ranitidine patent and the Zantac trademark. Consequently, the only possibility open to Glaxo Canada would have been to enter the generic market where the cost of entry would likely have been high, considering that both Apotex and Novopharm were already well placed and positioned.
- Without the License Agreement, Glaxo Canada would not have had access to the portfolio of other patented and trademarked products to which it had access under the License Agreement.⁸

These circumstances did not arise from the non-arm’s-length relationship between Glaxo Canada and Adechsa or between Glaxo Canada and Glaxo

⁷ *Glaxosmithkline*, supra note 4, at ¶ 90.

⁸ *Glaxosmithkline*, supra note 1, at ¶ 79.

Group. To the contrary, these circumstances arose from the market power attaching to Glaxo Group's ownership of the intellectual property associated with Ranitidine, the Zantac trademark, and the other products covered by its License Agreement with Glaxo Canada.

The FCA quoted with approval the following statement from the decision of the Administrative Appeals Tribunal of Australia in *Roche Product Pty Limited v. Commissioner of Taxation*:⁹

It is the intellectual property which is really the product, not the pill or capsule by which it is dispensed. The intellectual property included patent rights. The intellectual property came from very substantial expenditure on research and development, much of which would have produced no result. The profits from the exploitation of the intellectual property rights was something to which [the parent company which invented the product] had a special claim even though the profit would be collected for Australian sales by the Australian subsidiary.

In arriving at its conclusion, the FCA held that the test required the judge to determine whether, taking into account the relevant circumstances, an arm's-length Canadian distributor of Zantac would have been willing to pay the price paid by Glaxo Canada to Adechsa. The FCA concluded that the facts surrounding the Supply Agreement and the License Agreement were circumstances that would have been present even if Glaxo Canada had been dealing at arm's length with Adechsa and Glaxo Group. Consequently, an arm's-length Glaxo Canada would necessarily have had to consider those circumstances in deciding whether it was willing to pay the price asked for by Adechsa for the sale of the Zantac Ranitidine.

The matter was referred back to the Tax Court judge for re-determination.

Analysis and Practical Implications of Decision

The CRA in its information circular IC 87-2, entitled "International Transfer Pricing," dated February 27, 1987, interpreted the test in Subsection 69(2) of "reasonable in the circumstances" to be the equivalent of "fair market value" and, accordingly, endorsed the arm's-length principle in the 1979 OECD Report on Transfer Pricing (later succeeded by the "Transfer Pricing Guidelines"). The Canadian courts supported this approach.¹⁰

The Canadian courts have also come to accept, as the working definition of "fair market value," Justice Cattanach's comments in *Henderson*

⁹ [2008] AATA 639 (July 22, 2008), at ¶ 153.

¹⁰ See, e.g., *Indalex Ltd. v. Her Majesty the Queen*, 86 DTC 6039 (F.C.T.D) at 6047, aff'd, 88 DTC 6053 (F.C.A), and *Irving Oil Ltd. v. Her Majesty the Queen*, 88 DTC 6138 (F.C.T.D) at 6153.

Estate and Bank of New York v. M.N.R.,¹¹ wherein he said that fair market value means

the highest price an asset might reasonably be expected to bring if sold by the owner in the normal method applicable to the asset in question in the ordinary course of business in a market not exposed to any undue stresses and composed of willing buyers and sellers dealing at arm's length and under no compulsion to buy or sell.

Factors in Choosing a Pricing Method. One may then ask: How can the Transfer Pricing Guidelines move us from this rarefied legal doctrine toward a recognition of the taxpayer's real business-world conditions to arrive at an acceptable arm's-length price? As a starting point, it is worth noting that the Transfer Pricing Guidelines provide that, as a general rule, the CUP method may be the best approach in cases of product comparability, but the RPM may be the most suitable for marketing operations with comparable functional and risk profiles.¹²

In the current version of IC 87-2R, dated September 27, 1999, the CRA incorporates by reference from the Transfer Pricing Guidelines a number of factors that may influence the degree of comparability of transactions as follows:

- the characteristics of the property or services being purchased or sold;
- the functions performed by the parties to the transactions (taking into account assets used and risks assumed);
- the terms and conditions of the contract;
- the economic circumstances of the parties; and
- the business strategies pursued by the parties.¹³

Arguably, the Tax Court in *Glaxosmithkline* did not take the foregoing into consideration, in particular a comparison of the functions actually performed by Glaxo Canada and Glaxo Group. While Glaxo Canada performed routine functions, including local marketing, sales, and distribution, Glaxo Group performed the discovery research that developed Zantac, engaged subsidiaries to manufacture the drug to quality specifications, developed marketing strategies to outsell its brand name competitor(s), and provided Glaxo Canada with all of the intangibles (patent rights, trademarks, etc.) necessary to market the product successfully in Canada.

¹¹ 73 DTC 5471 at 5476: (F.C.T.D.)

¹² See ¶ 2.14 of the current Transfer Pricing Guidelines (2009).

¹³ Paragraph 32 of IC 87-2R.

In a current Transfer Pricing Memorandum, the CRA also deals with closely linked or continuous transactions, as follows:

We acknowledge that it may be necessary to combine transfers when the properties or services are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. . . . [E]xamples of closely linked or continuous transactions are . . .

- long term contracts for the supply of commodities or services—Where the price of a commodity would otherwise be low and easily discerned in the marketplace but for the fact that it is provided (presumably with a guarantee of supply) over a specified period of time; this term or condition of the transaction may contribute to and increase the price the commodity would otherwise command;
- rights to use intangible property—Where the synergy or integration between intangible and/or tangible properties is so significant that neither element can be valued separate and apart from the other. A possible indicator of integration is significant differences in the end-market selling price of the final product—where customers perceive value in the way the various products or services are combined . . .¹⁴

Despite the admonition in the Transfer Pricing Guidelines and their own publications, the CRA refused to recognize in *Glaxosmithkline* the synergy or integration between the taxpayer's right to use the intangibles associated with the brand Zantac under the License Agreement and the Ranitidine purchased under the Supply Agreement. Although the Tax Court mistakenly followed the CRA's view, the FCA did recognize that business reality. Perhaps the FCA is saying to both taxpayers and tax administrators that the transfer pricing rules require that the analysis start with the taxpayer's contractual arrangements, and then examine the commercial, financial, legal, and general economic circumstances to arrive at what an arm's-length party would have paid/received in comparable circumstances.

Substance vs. Form. The recent Australian case of *SNF (Australia) Pty. Ltd. v. Commissioner of Taxation*¹⁵ offers a further dimension to this teleological approach in transfer pricing. The Australian taxpayer purchased flocculant and coagulant products from related nonresident suppliers for resale to end users in the mining, paper, and sewage treatment industries in

¹⁴ TPM-06, entitled "Bundled Transactions," dated May 16, 2005.

¹⁵ [2010] FCA 635 (Federal Court of Australia)(hereinafter "*SNF*").

Australia. Even though the Commissioner of Taxation acknowledged that the taxpayer may be able to demonstrate that it did not pay more than the price paid by unrelated parties, the taxpayer's view ought not to prevail, because the prices it paid generated losses year after year. It was in this context that the Commissioner asserted that the proper test for transfer pricing (having regard to the domestic legislation which is similarly worded to Subsection 247(2) of the Act, the relevant tax treaties, and the OECD Guidelines, and the U.K. case of *DSG Retail Limited v. Commissioners for the Majesty's Revenue and Customs*¹⁶) was "to determine what consideration an arm's length party *in the position of the taxpayer* would have given for the products." In other words, the Commissioner ought to disallow the purchase price having regard to the financial losses of the taxpayer, regardless of whether the transfer prices complied with the relevant rules. The Federal Court disagreed with this approach and adopted one that focused on whether the transfer prices complied with arm's-length prices. It held:

*Just as in a valuation, the focus is not on the subjective or special factors of the parties involved in the transaction (e.g. whether they were financially sound or not), but is on the transaction itself and the consideration paid.*¹⁷

It is hoped that the FCA can provide clarity on this issue when deciding the appeal in the case of *Canadian General Electric Capital Corporation v. The Queen*,¹⁸ where a Canadian issuer of debt paid a guarantee fee to an upstream, related nonresident (U.S.) guarantor. The CRA disallowed the deduction of the fee on the basis that the borrower could have derived the same economic benefit from an implicit guarantee and, therefore, did not have to pay a fee for an explicit guarantee. In the Tax Court, the taxpayer's counsel submitted that the Canadian transfer pricing rules were premised on a hypothetical arm's-length relationship between the parties and, thus, any implicit support by way of indirect ownership was not relevant to the issue. Nonetheless, the Tax Court examined the actual financial, economic, and legal relations between nonresident and resident, as contended by the CRA (a curious reversal of roles from *Glaxosmithkline*). However, the Tax Court found that in the debt market, the taxpayer would have had to obtain a written guarantee and pay a fee at least as large as it paid to the related guarantor in order to issue the relevant debt with the appropriate rating and debt service cost.

¹⁶ (2009) UKFTT 31(TC)1, at ¶ 44.

¹⁷ *SNF*, supra note 15, at ¶ 44 (emphasis added).

¹⁸ 2010 DTC 1007 (TCC).

Conclusion

While the tax administrators and the courts recognize that the purpose of the transfer pricing rules is to prevent MNEs from improperly shifting profits from high-tax to low-tax jurisdictions, they nevertheless ought not to be unduly influenced by apparently low effective tax rates for the local and/or global operations of an MNE. See, for example, the critical pronouncement by the Tax Court in *Glaxosmithkline* regarding global tax minimization by an MNE or the Commissioner's preoccupation with the generation of tax losses year after year in *SNF(Australia) Pty Ltd. v. Commissioner of Taxation*.

In this writer's view, what is required when examining the *relevant circumstances of the taxpayer* is a subtle exercise in balancing two distinct factors:

1. On the one hand, a focus on the particular transaction being tested to determine if the transfer pricing complies with the applicable law, administrative guidelines, and administrative practices; and
2. On the other hand, a focus on the legal, business, and economic characteristics of the relationship between the contracting parties to identify those factors that any arm's-length person *standing in the shoes of the taxpayer* would have been faced with in determining the amount it would be willing to pay in the circumstances, excluding those factors that are personal to the taxpayer and/or the relationship which are extraneous to the transfer pricing analysis.

"The life of the law has not been logic; it has been reason."

—Oliver Wendell Holmes



Electronic Copy

This electronic copy is authorized solely for the use of the subscriber. This material may not be photocopied, e-mailed, or otherwise reproduced or distributed without the expressed written permission of Civic Research Institute, and any such reproduction or redistribution is a violation of copyright law.