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Transfer pricing alert

Supreme Court of Canada hands down partial victory for GlaxoSmithKline, but saga continues

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On October 18, 2012, the Supreme Court of Canada (SCC) issued its long-awaited decision on the *GlaxoSmithKline Inc*. case, concluding that both the Crown's appeal and Glaxo Canada's cross-appeal should be dismissed, and reaffirming the decision by the Federal Court of Appeal (FCA). The SCC found that a proper application of the arm's length principle requires consideration of other relevant intercompany transactions, and sent the case back to the Tax Court of Canada (TCC) to redetermine the arm's length price on that basis.

While this decision confirms that intercompany transactions should not be priced independently of other relevant intercompany transactions, it leaves open to interpretation a number of questions on how this is to be achieved in practice.

Background facts

The *Glaxo* case involves the transfer pricing for the purchase of ranitidine, a patented active pharmaceutical ingredient used to combat stomach ulcers. Ranitidine was discovered by Glaxo Canada's parent company located in the United Kingdom (Glaxo UK) in 1976, and was determined to have superior properties to existing anti-ulcer medications available at that time. Glaxo UK branded the drug that incorporated ranitidine as "Zantac". Zantac was approved for sale in Canada in 1981, and was launched by Glaxo Canada in 1982. Given its superior properties, Glaxo was able to price Zantac at a premium and still capture a significant market share.

During the relevant taxation years, Glaxo Canada marketed Zantac under a license agreement between Glaxo Canada and Glaxo UK. The license agreement covered the entire Glaxo product portfolio, not just Zantac. The license agreement provided Glaxo Canada with the right to manufacture, use, and sell proprietary products; the right to use trademarks (including Zantac); access to new products and improvements; marketing and product registration materials; and the right to have a related party provide raw materials. Glaxo Canada purchased ranitidine from a related party located in Switzerland, Adechsa S.A. From 1990 to 1993, Glaxo Canada paid over $1,500 per kilogram for ranitidine.

Prior to February 1993, a compulsory licensing system existed in Canada under which generic versions of patented pharmaceutical products could be marketed (subject to compliance with normal approval and registration requirements) in exchange for a 4 percent royalty payable to the patent owner. Generic products would typically be launched at a price point lower than that of branded drugs. Two companies began selling generic versions of ranitidine products in Canada in 1987 and 1989, respectively. Those two companies purchased the ranitidine required for their generic drugs from suppliers that they dealt with at arm's length. From 1990 to 1993 the prices that the generic companies paid for ranitidine were typically less than $300 per kilogram.

The Canada Revenue Agency (CRA) adjusted the transfer prices paid by Glaxo Canada for ranitidine for the 1990 to 1993 tax years under former subsection 69(2) of the Income Tax Act (ITA) (the predecessor to the current transfer pricing rules in section 247of the ITA) to the highest amount paid by the generic companies for ranitidine. The CRA's adjustment increased Glaxo Canada's taxable income by C $51 million. Subsection 69(2) provided that the amount paid to a related non-resident person cannot be more than the amount "that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length".

Lower court decisions

Tax Court of Canada decision

Glaxo Canada appealed the CRA's assessment to the TCC. The TCC trial was conducted in the first half of 2006, and the decision rendered on May 30, 2008.

At trial, the CRA's position was that the generic companies' purchases of ranitidine from arm's length manufacturers were comparable transactions, and that the arm's length price could not exceed this amount. Glaxo Canada's position was that the generics were not an appropriate comparable, because its business circumstances were different from those of the generic companies, and because the ranitidine purchased by the generic companies was not manufactured to the same standard. Glaxo Canada's arguments were based on the position that its license and supply agreements with Glaxo UK and Adechsa should be considered together in establishing a reasonable price. The Crown argued that the license agreement should not be taken into consideration in determining the price for the ranitidine.

The TCC determined that "according to the evidence, the only item of value received by Glaxo Canada under the Supply Agreement was ranitidine". The TCC then concluded, based on prior court decisions, that the Supply Agreement with Adechsa and the License Agreement with Glaxo UK covered separate matters, and should be considered independently. On this basis, the TCC decided in favour of the CRA, setting the price for ranitidine at the amount paid by the generic companies with only a small adjustment of $25 per kilogram for incremental manufacturing performed by Adechsa.

Federal Court of Appeal decision

Glaxo Canada appealed the TCC decision to the FCA on the basis that the trial judge erred in the determination of what circumstances were relevant to establishing "the reasonable amount" under subsection 69(2) of the ITA. Glaxo Canada argued that the real test is whether "any reasonable person, standing in the appellant's shoes but dealing at arm's length with Adechsa, would have paid the amount paid by the appellant". Glaxo's position was, in essence, that the price was reasonable in light of

the ability to sell the finished product as the branded drug Zantac, as well as in light of other factors such as access to Glaxo's other products.

The FCA concluded that the trial judge had indeed erred in concluding that the license agreement with Glaxo UK was an irrelevant consideration. The FCA agreed with Glaxo Canada's argument that the correct test to apply is whether any reasonable person would agree to pay the amount that was paid to Adechsa. The FCA noted that while anyone might be able to buy ranitidine at market prices from a willing seller, the business reality was that if such a purchaser wanted to market the finished product as Zantac and obtain a price premium, the license agreement was "a circumstance" that had to be taken into account. On this basis, the FCA concluded that the TCC judge made an error of law in determining that the generic price was the appropriate price under subsection 69(2) of the ITA. The FCA therefore referred the matter back to the TCC for a determination of the correct arm's length price, taking into account the circumstances of the license agreement.

Appeals to the Supreme Court

The Crown's appeal

The Crown appealed the FCA's decision to the SCC. In its appeal, the Crown argued that the search for an arm's length price must focus on the particular good, the particular transaction, and the particular parties to that transaction. The Crown asserted that the reasonable business person test, which was developed in the context of other provisions in the ITA, was ill-suited to resolving transfer pricing matters. The Crown argued that this test, as adopted by the FCA, requires the Minister of National Revenue to accept circumstances (such as the license with Glaxo UK) as they are, whereas, according to the Crown, the legislation should be viewed as requiring the minister to ignore such non-arm's length circumstances. The Crown further argued that the FCA's approach would be at odds with that of other OECD member countries, resulting in significant uncertainty.

Glaxo Canada's cross-appeal

Glaxo Canada appealed the FCA's decision, arguing that the FCA erred in referring the matter back to the TCC to reascertain the arm's length price taking into account the appropriate circumstances. Glaxo Canada's position was that it had successfully demolished the minister's assessment of tax, and it was therefore inappropriate to have the matter reheard on the basis of an alternative approach. Having concluded that the minister's assessment was not correct, the FCA should have set the assessment aside.

Supreme Court decision

The SCC concluded that both the Crown's appeal and Glaxo Canada's cross-appeal should be dismissed, sending the transfer price determination back to the TCC. The court agreed with the previous FCA decision that a proper application of the arm's length principle requires regard for "economically relevant characteristics" ,and that this includes consideration of other transactions that impact the transfer price under consideration, in this case the License Agreement. The SCC found that Glaxo Canada may have paid for some of the rights and benefits conferred to it under the License Agreement through the prices paid to Adechsa for ranitidine, and that considering the License and Supply agreements together "offers a realistic picture of the profits of Glaxo Canada".

While noting that the 1979 and 1995 Transfer Pricing Guidelines of the Organisation for Economic Co-operation and Development (OECD) "are not controlling" since they

are not statutory provisions, the SCC nonetheless relied on these guidelines in arriving at its decision. Although the “reasonable in the circumstances” test of subsection 69(2) of the ITA has since been replaced with an “arm's length” test in section 247, the issues are common to both.

The SCC also concluded that the arm’s length price for the ranitidine must still be determined, and that this will require an examination of the circumstances arising from the License Agreement that are linked to the Supply Agreement. It referred this determination back to the TCC, while providing the following additional guidance:

1. Transfer pricing is not an exact science and “some leeway must be allowed”. The court goes on to say that “as long as a transfer price is within what the court determines is a reasonable range, the requirements of the section should be satisfied”. This point is important in that it supports the widely held view that arm’s length prices should be determined on the basis of reasonable ranges, which is not inconsistent with the CRA’s own guidance on the subject.

2. In assessing the evidence, the “respective roles and functions of Glaxo Canada and Glaxo Group should be kept in mind”, and the “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”. While it is not entirely clear, the SCC in this instance appears to use “Glaxo Group” to refer to Glaxo UK as well as the global group of companies under it. As such, it is not clear whether the guidance is suggesting earnings should not be misallocated between Glaxo Canada and all other related parties taken as a whole, or whether the guidance is suggesting that there should not be a misallocation of earnings to any individual Glaxo entity.

3. The SCC reminds the TCC that the interests of each party to the transaction must also be considered. This is a core element of the arm’s length principle and consistent with the OECD Transfer Pricing Guidelines and CRA guidance. In particular, the court suggests that reasonable economic alternatives of the parties to the transaction must be considered in the determination of transfer prices.

4. The fact that arm’s length distributors have acquired ranitidine from a Glaxo Group supplier at higher than generic prices should be considered. While this guiding point is specific to facts of this case, it also serves as a reminder that other arm’s length arrangements should be considered in guiding a comparability analysis or transfer pricing determination, even if those specific arm’s length arrangements are insufficiently comparable to be relied on outright.

Conclusion

The SCC decision provides some needed clarity for taxpayers and their advisors in the area of “bundled” transactions. However, it leaves the more difficult part -- the actual determination of an arm’s length price -- to the TCC. The guidance provided may be difficult to apply based on the facts that have been previously argued at the lower courts, and taking into account that most of the relevant time period is more than 20 years old.

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