***Canada v GlaxoSmithKline*: "Should We Modify the Arm's Length Principle?"**

Jason T. Kujath
Preferred Email: Jason.Kujath@gmail.com
School Email: Kujath@uwindsor.ca

"*Transfer pricing is the leading edge of what is wrong with international tax"*[1]

-**Lee Sheppard**, Tax Analysts, August 2012

[1] The Author disagrees with this statement in that it is false and an error in logic. It should be modified to read that "*transfer pricing is the leading edge of what is wrong with the international system of taxation*". As it stands, the quote lays the blame on the ends, while leaving the means used to achieve the objective without any responsibility for the outcome. This point is further discussed in "Section C: Transfer Pricing Exposes the Flaws of the International System of Taxation" of the Analysis discussion in this paper.

Author: Jason T. Kujath
Preferred Email: Jason.Kujath@gmail.com
Email: Kujath@uwindsor.ca

Abstract: *GlaxoSmithKline v The Queen*: "Should We Modify the Arm's Length Principle?"

***Canada v GlaxoSmithKline* "Should We Modify the Arm's Length Principle?"** is a review of the first transfer pricing case appealed to and heard by the SCC. It is a commentary on the handling of transfer prices, in general, by both the Canada Revenue Agency as well as the Canadian Border Services Agency.

The SCC's guidance on the proper assessment will greatly impact Canada's international competitiveness. However, the Court did not provide a comprehensive assessment as it ultimately remitted the goods' valuation to the TCC with appropriate guidance pertaining to the breadth of the circumstances that are to be considered under s. 69(2)'s hypothetical inquiry.

The paper provides a critical analysis of the arm's length standard and highlights four subjective considerations that provide the Minister with excessive discretionary powers to a relationship based on clarity, certainty and strict interpretation.

These considerations are the following:

1. The Arm's Length Principle in relation to its subjective application.
2. A review of subjective circumstances that should be considered when the Arm's Length Principle is applied to commercial transactions of Multi-National Entities.
3. The competing interests of the Canada Revenue Agency and the Canada Border Services Agency.
4. International economic competitiveness.

Critics have called the "arm's length" method "a cumbersome creation of stupefying complexity" with "rules that lack coherence and often work at cross purposes."

-**Tax Justice Network,** Experts cited on the subject of the OECD-led "arm's length" approach to transfer pricing.

[Transfer Pricing] is the equivalent of asking the Internal Revenue Service to connect the ends of two different plates of spaghetti.

-U.S. Senator Bryan Dorgan, on the current arm's length transfer pricing rules

Ask any tax vice president what is the biggest issue on their agenda and 99 percent of them will say it's transfer pricing. This is not surprising given that transactions between related subsidiaries dominate world trade. ***From a tax perspective, transfer pricing is where the big bucks lie.***

-Jeffrey Owens, head of the OECD'S Centre for Tax Policy and Administration

TABLE OF CONTENTS

INTRODUCTION

On October 18, 2012, the Supreme Court of Canada ("**SCC**") released its written decision for *Canada v GlaxoSmithKline Inc.*[1] ("***GlaxoSmithKline***"). The Court affirmed the revisions made by the Federal Court of Appeal ("**FCA**")[2], which overturned the Tax Court of Canada's ("**TCC**") decision[3] concerning the applicable transfer pricing standard.

GlaxoSmithKline was the first transfer pricing decision to reach the SCC. It was also the first decision where the SCC considered the force of the Organisation for Economic Co-operation and Development's ("**OECD**") Guidelines (the "**Guidelines**"). Until it, there was a dearth of transfer pricing litigation to aid with a proper assessment of Multinational Entities' ("**MNE**") taxable income, which has been the cause of many issues for the Minister and, in the interest of certainty, is in need of additional clarification.

The fundamental issue throughout the series of appeals was the determination of the appropriate legal test to assess the valuation of purchased products between non-arm's length MNEs. These purchases were made through a complex series of transactions in order to ultimately pay very little income tax.

The FCA laid the groundwork for the SCC to rule in favour of the taxpayer with an identification of the breadth of the "circumstances" under the assessment of an amount that is "reasonable in the circumstances". However, the SCC did not determine whether the

[1] *Canada v GlaxoSmithKline Inc*., 2012 SCC 52.
[2] *GlaxoSmithKline Inc v Canada,* 2010 FCA 201 at para 69, 405 NR 307.
[3] *GlaxoSmithKline Inc v Canada,* 2008 TCC 324, [2008] TCJ No 249 (QL).

specific transfer pricing scheme fell into the ambit of this phrase "reasonable in the circumstances", which was the fundamental question at hand.

Instead, the Court remitted the decision back to the TCC to ultimately determine whether the pricing scheme used by the Taxpayer, GlaxoSmithKline Inc. ("**Glaxo**") was "reasonable in the circumstances" pursuant to the SCC's guidance.

It therefore will be the TCC decision that will have a great impact on the future of Canadian transfer pricing litigation. With that said, the SCC, by not ultimately deciding the valuation and, instead, remitting this portion of the decision back to the TCC, disappointed many within the tax community. There was great hope that the decision would provide guidelines and additional certainty to an ambiguous methodology for valuation.

The FCA and SCC both applied a "reasonable business person" test and broadened the scope of circumstances to be deemed relevant within the hypothetical inquiry required, pursuant to subsection 69(2) of the *Income Tax Act ("***Act"***)*.[4]

By providing clarification to the correct standard to be applied when establishing a transaction's purchase price, the SCC decision should begin to clarify the applicable considerations for transfer pricing. It, however, does not provide an example of how these considerations are to be applied.

The SCC elucidated that the arm's length standard, when used to assess the amount that is "reasonable in the circumstances", includes the economic realities of the Canadian marketplace that MNE's operate under. Furthermore, when considering 69(2), or 247(2),

[4] RSC 1985, c 1 (5th Supp), s 69(2).

the OECD guidance pertaining to transfer pricing is clarified as being only used as guidance, as it has not been ratified into Canadian law.

This paper will contextualize the issues surrounding transfer pricing and its treatment by the CRA. It will focus on its impact on "Corporate Canada" and how the SCC's decision will affect the competing principles of the arm's length principle in relation to transfer pricing.

Courts have loosely developed an approach to this dichotomy: on one hand, we face the reality that MNEs are capable of aggressive tax avoidance through a complex series of international transactions; on the other, this incentive must be balanced with a corporation's right to structure itself in the most tax favourable light possible.[5]

My final point of analysis will be a brief discussion of how the arm's length principle should be modified as well as a discussion of the additional considerations that should be alive to a modern day jurist considering these complex schemes. The purpose of this discussion will only be to highlight the changing landscape that should be considered as globalization continues to pervade the taxation landscape.

[5] *Inland Revenue Commissioners v Duke of Westminster* (1935), [1936] A.C. 1 (U.K. H.L.).

TRANSFER PRICING BACKGROUND

Transfer prices are defined by the OECD as *"the prices at which services, tangible property, and intangible property are traded across international borders between related parties*".[6] As our global economy shrinks, transfer pricing has grown to be a substantial concern for both taxing authorities and global executives.[7] This is enforced by the quote in the preceding footnote.

Through the use of transfer pricing arrangements there is great potential for MNE's to erode the tax base. Essentially, "transfer pricing" schemes spoken of by tax professionals involves the transferring of profits to tax jurisdictions with favourable tax rates in comparison to Canada – or transferring profits to non-arm's length companies suffering losses domestically. To address this, OECD member countries have formally adopted the arm's length principle as the initial standard, or better yet "starting point", to be applied in the valuation and regulation of transfer pricing practices.[8]

For these MNEs the simple market forces that regularly apply to the determination of prices, which are also applicable to ordinary market-place transactions, are not germane to a valuation when paired with corporate transfer pricing methodologies.[9] Instead, these corporate entities that employ transfer pricing strategies are subject to distinct marketplace-barriers that, specifically in the context of the facts at hand, their generic competitors do not

[6] OECD, Committee on Fiscal Affairs, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1979).

[7] "*Ask any tax vice president what is the biggest issue on their agenda and 99 percent of them will say it's transfer pricing. This is not surprising given that transactions between related subsidiaries dominate world trade. From a tax perspective, transfer pricing is where the big bucks lie*." - **Jeffrey Owens**, head of the OECD'S Centre for Tax Policy and Administration

[8] *Supra* note 6.

[9] Francois Vincent, "*Transfer Pricing in Canada: A Legal Perspective*" (Toronto: Carswell 2009) at 1.

face. This principle was a fundamental concern in the *Glaxo* Appeal Courts' decisions; however, there was no express mention of the specific concerns that Glaxo Canada faced.[10]

From a brief consideration of these concerns, I assume that a few of these market barriers may be as follows:

1. Higher costs of production than the generic developers,
2. A larger initial investment leading to greater leverage on the products developed and thereafter manufactured; and, thus
3. A need for higher profit margins to make initial development transactions a business reality.

With that being said, legislative provisions have been enacted to combat tax base erosion and ensure transfer pricing is not used in furtherance of tax avoidance by those MNEs with the capability to evade taxes through complicated transfer pricing schemes. Until 1998, when s. 247 was enacted, s. 69(2) of the *ITA* was the effective legislation to regulate transfer pricing.[11]

Under s. 69(2), the underlying challenge in transfer pricing disputes is to determine the true price of the transaction had the transaction taken place at arm's length. This hypothetical inquiry requires an assumption as to how the parties would operate if the ownership structure of the parent company did not exist.

As proposed by the Minister, the assumption failed to consider whether the transaction would take place at all, had the ownership structure not been in place. However,

[10] *Supra* note 2 & 3 at para 79 & para 52, respectively.
[11] *Supra* note 4.

the proposed inquiry also fails to distinguish that the transaction therefore takes place under terms solely devised by the MNE.

This inconsistency displays the inherent struggle between the two positions in the application of the arm's length principle:

1. A MNE's common law allowance to form and operate a company under the most tax efficient structure possible;[12] while,
2. The Canadian tax authorities are bound to protect the tax base from erosion through evasive and complex corporate tax arrangements.[13]

Legislation

Since January 01, 1998, transfer pricing has been dealt with by s. 247 Part XVI.1 of the *Act* as well as provisions from various tax treaties entered into by Canada.[14] Before it was repealed, s. 69(2) of the *ITA* provided:

> **69(2)** Where a taxpayer has paid or agreed to pay 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 that would have been reasonable in the circumstances if the non-resident person and the tax payer 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.[15]

Subsection 69(2) was repealed for the year after 1997 by the CRA in order to move away from a concept based on reasonableness toward one in line with the OECD's

[12] *Supra* note 6.
[13] *Supra* note 9 at 6.
[14] *Supra* note 4.
[15] *Ibid.*

interpretation of ALP.[16] For this reason, the SCC's recognition and discussion of the OECD's guidelines is an important, but less recognized factor of the Court's decision.

In assessing this provision, it has been suggested that three separate criteria were to be applied in its interpretation:

1. The reasonableness of the amount;
2. The circumstances surrounding the transaction in question; and
3. The arm's length dealings.[17]

Under this approach the danger in assessing the reasonableness of a transaction was in the dearth of comparable transactions available. The distinct comparison of a non-arm's length transaction to a hypothetical one left too many assumptions to lend credence and the certainty required for proper interpretation.[18] This left the opposing parties to argue whether, in a hypothetical dealing, they would agree to pay the same amount as they had while dealing at non-arm's length. This was too subjective of an interpretation to continue as the argument often turned into an assessment of whose evidence led to a more believable taxable amount in the eyes of the Judge, the CRA or the Taxpayer?[19]

Regarding this interpretation, the question at hand is whether the "reasonableness" of the transfer price is one of fact or law. This inquiry to the subjective notion of "reasonableness" in relation to s. 67 was made in *Maduke Foods Ltd. v R*[20].

[16] *Supra* note 9 at 8.
[17] *Ibid* at 9.
[18] *Ibid* at 8.
[19] *Ibid* at 9.
[20] 1989 2 C.T.C. 284, 89 D.T.C.5458 (Fed TD).*[Maduke]*

Maduke was not an inquiry into transfer pricing and nor did it inquire into the assessment of a reasonable amount. For our purposes, it can be noted that it simply found the concept of "reasonableness" to be one "which does not have a precise technical term but is one of a subjective nature being used in an objective context".[21]

In 1998, Canada's legislative authorities repealed 69(2) and enacted s. 247 and 247.1 to assure Canadian legislation was in line with OECD principles.[22] Now, "tax authorities are to look to ensure a transaction is properly reported and assessed in their sphere of authority for liabilities."[23] With its enactment, Canadian principles grew closer to the proposed standards within Art. 9[24] of the OECD's *Model Convention of Income and on Capital.*[25]

Under the new legislation, the CRA has the administrative power to characterize the nature of a transaction, but is limited to doing so when the transaction is one that would not have been entered into between persons dealing at an arm's length. To meet this obligation, the transaction used as a comparison must be one that can be reasonably considered as one that would have been entered into under similar circumstances and include the economic realities faced by the organisation.[26]

---

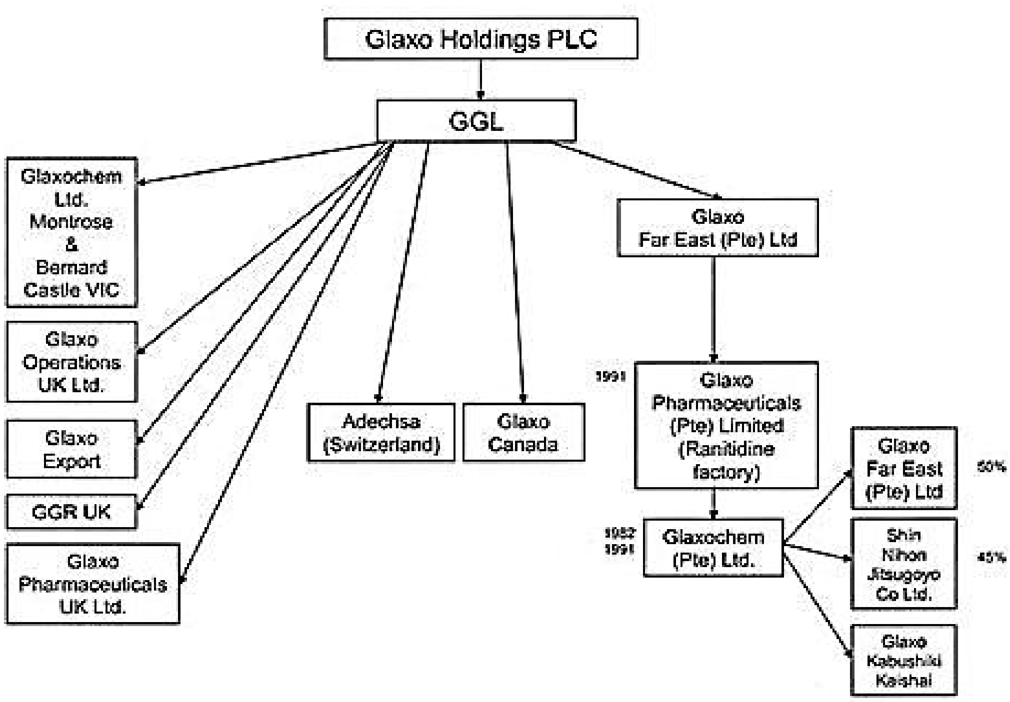
[21] *Supra* note 9 at 10.
[22] *Ibid* at 10.
[23] *Ibid* at 29.
[24] OECD, Model Tax Convention, Paris, 1992, as amended.
[25] *Supra* note 9 at 29.
[26] *Ibid* at 32.

FACTS

A. Company Structure:

The Respondent, Glaxo Canada, is the subsidiary of Glaxo Group who is also a wholly owned subsidiary of the parent company, Glaxo Holdings PLC (UK). Under usual business practices of the pharmaceutical manufacturing industry, Glaxo Canada has licensed the use of the trademark and patent from Glaxo Group for granulated ranitidine, the active ingredient in Zantac – a leading ulcer treatment pharmaceutical product.

The company structure is as follows:



B. Zantac – *i.e.* Ranitidine

Zantac has established its position within the marketplace by displacing a competing drug's market-share – Tagamet. Because of the pharmaceutical's premiere market position it is priced at a premium to its generic substitution.[27]

At all relevant times to this appeal a compulsory licensing system existed in Canada which allowed the marketing and sale of a generic version of patented pharmaceutical products, including ranitidine products, in exchange for a royalty of four percent paid to the patent owner.[28]

Zantac's active ingredient, granulated ranitidine, is produced by two other global subsidiaries of Glaxo Holdings PLC: Glaxochem Limited incorporated out of the United Kingdom; and, Glaxo Pharmaceuticals (Pte) Limited, a company incorporated within Singapore.

These two companies sell their product to Adechsa S.A., a Swiss-based non-arms' length company, who granulates the product. It is this granulated ranitidine that Glaxo Canada uses to manufacture its licensed product.

[27] *Supra* note 3 at para. 8.
[28] *Ibid* at para. 13.

C. The License & Supply Agreements

As a result of two separate agreements, Glaxo Canada is able to produce and market its brand name product, Zantac. These two agreements are:

1. A License Agreement ("**License Agreement**") regarding the trademark and patent of Zantac with Glaxo Group; and
2. A Supply Agreement ("**Supply Agreement**") with Adechsa to purchase the required ingredients for Zantac's manufacture.[29]

By licensing the product, Glaxo Canada was able to enter into the Supply Agreement with Adechsa for purchase of granulated ranitidine. Furthermore, Glaxo was able to produce Zantac in Canada under the set terms.

Without the License Agreement, Glaxo Canada would not have had the ability to produce Zantac or the ability to purchase the granulated ranitidine, whose price-point once manufactured into Zantac under the patent licensed, demanded a premium in the market.

The License Agreement provided Glaxo Canada with:

1. The use of trademarks owned by Glaxo Group legal ability to manufacture and sell Zantac;
2. Technical assistance for Zantac's further manufacturing;
3. Assistance with the Canadian Health Authorities regulations;
4. Marketing support for Zantac, and
5. Indemnification against damages arising from patent infringement actions.[30]

---

[29] *Ibid* at para. 14.
[30] *Ibid* at para. 16.

Under the separate Supply Agreement that Glaxo Canada has with Adechsa, the price of the granulated ranitidine purchased was to be determined by the price that end-product sells for in purchasing nation. This is valuation method is known as Comparable Uncontrolled Pricing ("CUP").[31]

When Adechsa sells its product to countries where Zantac commands a lower price, the transfer value is lower than it is when the product is sold to countries where Zantac commands a higher price over its competitors. Using this pricing method, Glaxo World and its distributors agreed to a selling price of 60% of the ultimate retail price within the entities purchasing country. Ultimately, the transfer price paid for the ranitidine by Glaxo Canada will be a fully deductible cost and therefore has an effect on taxable net income.

During the time of the assessment, two other generic Canadian pharmaceutical companies had also purchased ranitidine to produce a generic substitute to Zantac. Apotex Inc. and Novopharm Ltd. produced the generic product and, similar to Glaxo Canada, also purchased their ingredients from arm's length companies abroad.

The prices paid by these companies were for amounts between $194 and $304 per kilogram. It is these prices that the Minister asserted were an "amount that would have been reasonable in the circumstances if the non-resident person and the tax payer had been dealing at arm's length" and reassessed Glaxo taxable income for the years 1990 to 1993.

[31] *Ibid* at para. 24.

ISSUES

The issue in question is the application of “reasonable in the circumstances” when determining a valuation of transactions between non-arm’s length parties. We can see that the discussion specifically focuses on the interpretation of “reasonable” standard along with a contextual discussion of “the circumstances” that may apply.

The two issues in throughout the appeals are:

1. In the assessment of the transfer price paid by Glaxo Canada to Adechsa, what is the appropriate standard of “reasonableness” to be applied?
2. In this assessment of the transfer price paid, does the legal test require the Judge to include within the standard of “reasonable in the circumstances” the fundamental business conditions that allow Glaxo Canada to manufacturer, produce and market Zantac, or does the test for a comparable valuation separate the legal reality from the economic circumstances that Glaxo Canada operates under?

THE CRA'S OBJECTION: *UNREASONABLE IN THE CIRCUMSTANCES*

The Minister objected to Glaxo Canada's purchase price of granulated ranitidine from its non-arm's length supplier during the years 1990 to 1993. The amounts paid by Glaxo Canada for its purchases ranged from $1300 to $1400,[32] and were approximately $1100 dollars greater than the amounts paid by generic producers to produce a generic substitute from non-granulated ranitidine.[33]

As valued against these generic products, that the CRA reassessed Glaxo Canada's purchases claiming that it had overpaid its non-arm length supplier.[34] Under the provisions addressed in s. 69(2) of the *ITA*, the CRA reassessed the income and increased it with the hypothetical profit – approximately $1100.

The Minister asserted, under Part XIII of the Act, that Glaxo Canada had failed to remit the withholding tax on the 6% royalty dividend it paid its parent company pursuant to s. 56(2), 212(2) and 214(3) of the *ITA*.[35] In order for this reassessment to be valid, first a determination had to be made regarding the proper transfer price under s. 69(2).[36] Glaxo Canada appealed the reassessment and contended the Minister's claims were without merit. The case was appealed to the TCC, the FCA, and the SCC. The ruling in the first held in favour of the Minister, while it was thereafter successfully appealed to favour the taxpayer at the FCA, and affirmed by the SCC.

[32] *Ibid* at para. 6.
[33] *Ibid* at para. 3.
[34] *Ibid* at para. 7.
[35] *Ibid* at para. 1.
[36] *Ibid* at para. 8.

CASE HISTORY

A. Tax Court of Canada: *GlaxoSmithKline v Canada*

The issue to be determined at trial was whether the license and supply agreements should be considered together or as separate transactions. The Crown posited that the agreements were to be considered separate and that the generic companies' arm's length purchase of ranitidine was a comparable transaction.[37]

The Appellant contented that generic drug producer's prices were not a comparable substitute as: (a) Glaxo Canada's actual business circumstances were wholly different from those of Apotex and Novopharm, insofar as the transactions are not comparable within the meanings of s. 69(2) of the Act; and (b) the ranitidine purchased by the appellant from Adechsa was manufactured under Glaxo World's standards of good manufacturing practices ("GMP"), granulated to Glaxo World standards, and produced in accordance with Glaxo World's health, safety and environmental standards ("**HSE**").[38]

The Court held there to be three key issues to be resolved amongst the parties:

1. Whether the Supply Agreement and the Licence Agreement should be considered together to determine a reasonable transfer price;
2. The meaning of the phrase "reasonable in the circumstances" in s. 69(2) of the Act; *and*
3. The impact of the differences in GMPs and HSEs on the comparability of the ranitidine purchased by the appellant with that purchased by the generic companies.[39]

[37] *Ibid* at para 67.
[38] *Ibid* at para 69.
[39] *Ibid* at para 70.

To the first issue, the Chief Justice Rip, of the TCC, found that the two agreements should be considered independently under the proposition outlined in *Singleton v. Canada.*[40] In *Singleton* the taxpayer had withdrawn equity from a law firm to purchase a house. The equity from the firm was refinanced and the Court ultimately decided that the house had been purchased with funds from the company; it therefore did not allow the interest payment to be deductible.

The Court in *Singleton* did not look at the economic reality of the situation, but rather the legal relationship. Therefore, the interest payments were not to be deductible as the "economic reality" was that the house was financed from funds taken out of the law firm.[41] For our purpose, the *Singleton* Court held that the two agreements were not to operate together.

In regard to the second issue, which was the determination of the meaning of "reasonable in the circumstances", Rip CJ ruled that if the legislature had intended the phrase "reasonable in the circumstances" to include all contractual terms there would be no purpose to s. 69(2) relative to s. 67; and that, any MNE would be able to claim that its parent company would not allow a purchase from other suppliers.[42] This holding was in the favour of the Minister.

Chief Justice Rip determined that there was no question that the Appellant was required to purchase approved ranitidine. However, the issue at bar was whether "a person

[40] 2001 SCC 61, [2001] 2 S.C.R. 1046. *[Singleton]*
[41] *Ibid* at para 43.
[42] *Supra* note 3 at para. 89.

in Canada dealing at arm's length with its supplier would have accepted the conditions and paid the price the appellant did?"[43]

For the sake of clarity, the TCC found the agreement between the parent company and Glaxo Canada to be all but a sham.

With regard to the third issue, Rip CJ held that the comparison between Novapharm and Apotex was limited to only the other generic drug manufacturing companies. Its reasoning was that the two developed similar products in similar markets using similar ingredients, and were subject to the same government regulations while in competition with each other. [44]

Chief Justice Rip determined that the highest generic price was to be used as a comparison reasonable in the circumstances albeit adjusted for the granulating process by $25 a kilogram. The Court ordered the reassessment of the taxpayer with the $25 adjustment from the highest price being used as the comparator to determine price paid and the proper deductible expenses. Glaxo Canada persisted that this was not reflective of the reality they operated within and successfully appealed the decision to the FCA.

[43] *Ibid*
[44] *Ibid* at para 121.

B. Federal Court of Appeal: *GlaxoSmithKline v Canada*

Technically, the TCC did allow Glaxo Canada's appeal from the Minister's reassessments. However, the adjusted amount was only to vary by $25 per kilo. Glaxo Canada appealed the decision to the FCA, which ultimately found that the TCC had erred in law by failing to apply the proper test.[45]

Without the proper test's application, it was impossible to determine "the amount that would have been reasonable in the circumstances" Glaxo Canada would pay for the ranitidine at arm's length.[46]

Justice Nadon found that, in regard to the License and Supply Agreements, the TCC's decision to rely upon the test outlined in *Singleton* was an err in law.[47] Rather, the correct test was outlined in *Gabco v Minister of National Revenue*, [48] and was affirmed recently by *Petro-Canada v The Queen.* [49]

The *Gabco* test required an inquiry into the circumstances that an arm's length purchaser, standing in the shoes of the appellant, would consider relevant when deciding whether it should pay the price paid to Adechsa for its ranitidine. [50] It requires a hypothetical inquiry based upon assumptions being made. This point provides a critical deviance from the TCC's decision, as the Appellant's position hinged on the application of the *Gabco* principle.

[45] *Supra* note 2 at para 6.
[46] *Ibid* at para 79.
[47] *Ibid* at para 68.
[48] [1968] CTC 313, 68 D.T.C. 5210 (Ex. Ct.) [*Gabco*].
[49] [2004] DTC 6329 at para. 62, 2004 FCA 158. [*Petro Canada*]
[50] *Supra* note 2 at para 72.

Nadon J found that the TCC erred in law by not considering the two agreements together, as per the guidance of *Singleton.*[51] In doing so, the TCC applied a test considering a reasonable "*use of funds*" as opposed to one looking to determine an amount that "*would have been reasonable within the circumstances*" at arm's length.[52]

The FCA's decision was an expansion on the transfer pricing inquiry to include not only the individual transaction between the parties but also the circumstances that the purchaser, Glaxo Canada, operates under when the transaction took place. In *Singleton*, the transaction was not an appropriate comparator, while *Gabco* specifically interpreted the phrase "reasonable in the circumstances" in the context of whether a reasonable business person would "*in the circumstances*" undertake the transaction.[53]

This broad interpretation, as opposed to the TCC's narrow holding, allowed Nadon J to reason that there were "a number of 'circumstances' that satisfy [him]" that the License Agreement was a "crucial consideration in determining the amount that would have been reasonable in the circumstances if the Appellant and Adechsa were dealing at arm's length".[54]

---

[51] *Ibid* at para 68.
[52] *Ibid.*
[53] *Ibid* at paras 69-73.
[54] *Ibid* at para 79.

These circumstances were as follows:

1. Glaxo Group owned the Zantac trademark and would own it even if the Appellant was an arm's length licensee;
2. Zantac commanded a premium over generic ranitidine drugs;
3. Glaxo Group owned the ranitidine patent and would have owned it even if the Appellant had been in an arm's length relationship;
4. Without the License Agreement, the Appellant's cost of entry would be different due to regulatory factors;
5. Glaxo Canada could not use the ranitidine patent and the Zantac trademark;
6. Cost of entry was too high to now enter the generic market;
7. Without the License Agreement, the Appellant would not have had access to the portfolio of other patented and trademarked products to which it had access under the License Agreement.[55]

These seven points will assist in the requisite determination by mimicking Glaxo Canada's real business conditions. They, therefore, are to be part of the circumstances considered and applied to the arm's length transaction under the requisite hypothetical inquiry.[56] The only variation to the hypothetical transaction is the consideration that Glaxo Canada is owned by the parent company of the vendor and, therefore, its deemed operating conditions should not be those of another corporation – *i.e.* Novopharm or Apotex.[57]

---

[55] *Ibid.*

[56] The author strongly agrees with the approach of the FCA. The decision is logical and carries substantial consideration of the issues in question. Nadon J included depth to his reasoning and provided consideration of many of the broad issues. Following and affirming his approach was the correct decision although the tax community was hoping that a valuation would be provided.

[57] *Ibid* at paras 80-81.

The Court found that the applicable test requires "the Judge to determine whether an arm's length Canadian distributor of Zantac would have been willing, when taking into account the relevant circumstances, to pay the price paid by the appellant to Adechsa."[58] Under the premise of *Singleton*, the Judge was required to ignore the License Agreement and not to apply the Appellant's circumstances to the interpretation of the phrase. For this reason Singleton was incorrectly applied by the TCC.

The FCA's judgement, therefore, set aside the TCC's misinterpretation, holding that the Court had erred in law. Thus the FCA referred the matter back to the TCC with the guidance set out above. The Minister appealed the decision and was granted leave to the SCC; Glaxo Canada then cross-appealed on the basis that the SCC should make a final determination of the value of the scrutinized ranitidine.

C. Supreme Court of Canada: *Canada v GlaxoSmithKline Inc.*

Again, at the heart of the Minister's appeal was the correct application of s 69(2).[59] In a unanimous decision, Justice Rothstein, who wrote for the Court, broadened the ambit of the pertinent circumstances to those that were "economically relevant".[60]

Glaxo Canada once again argued that their transfer pricing scheme included intangible factors that were relevant to the required valuation.[61] However, Glaxo Canada cross-appealed the FCA decision on the basis that, if the Court agreed with Glaxo Canada and dismissed the Minister's appeal, the SCC should not remit the decision back to the

---

[58] *Ibid* at para 81.
[59] *Supra* note 1 at para 3.
[60] *Ibid* at para 42.
[61] *Canada v GlaxoSmithKline Inc.*, 2012 SCC 52 [**Factum of the Respondent**] at para 55.

TCC but rather that the taxpayer had demolished the Minister's assumptions and thus fully discharged the burden in appealing the reassessment.[62]

The Minister, of course, argued the opposite, taking the position that the appropriate comparable products were the generic version of the ranitidine.[63] In looking to comparable products, the Minister again posited that a transaction-by-transaction approach should be considered under the guidance of *Singleton v Canada*[64] or *Shell Canada v Canada*[65]. This argument was founded on the basis that the OECD guidelines only recommended[66] a transaction-by-transaction approach.[67]

The Court examined the Minister's arguments and systematically ruled out the two cases put forth as supposed guidance. Both *Shell Canada* and *Singleton* were deemed to be appropriate principles only for s. 20(1)(c) and inapplicable to s. 69(2). The Court found that the determination in 69(2) was in regard to a reasonable standard and required the consideration of" transactions other than the purchasing transaction"[68], whereas s. 20(1)(c) should not allow the re-characterization of income beyond the specific purpose that the funds were actually used for.[69] On this basis the *Singleton* test was not appropriate.

---

[62] *Supra* Note 1 at para 3.

[63] *Canada v GlaxoSmithKline Inc.*, 2012 SCC 52 **[Factum of the Appellant]** at para 52**.**

[64] *Supra* note 40.

[65] *Shell Canada v Canada*, [1999] 3 SCR 622, 178 DLR (4th) 26.

[66] OECD, Committee on Fiscal Affairs, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995) at para 1.42.

[67] *Supra* note 1 at para 39

[68] *Ibid* at para 35

[69] *Ibid* at para 36.

Furthermore, the SCC cautioned that the OECD Guidelines are "not controlling as if they were Canadian statute"[70], the determination ultimately rests with the provisions of the *ITA*.[71] The Court, thereafter, addressed the Minister's position that the guidelines required a transaction-by-transaction approach with a further finding that the guidelines only recommend this method, and instead recognize that the transaction must still include the "economically relevant characteristics" to find a sufficient comparable.[72]

In looking to what circumstances were "economically relevant", Rothstein J stated that this will include consideration of all circumstances of the Canadian taxpayer relevant to the price paid to a non-resident supplier. These may be agreements that "confer rights and benefits in addition to the purchase price of property."[73]

Rothstein J further found that an entity wishing to market Zantac would be subject to contractual terms with Glaxo Group affecting the price of ranitidine that generic companies would not be subject to as they only sold ranitidine.[74]

The rights and benefits of marketing Zantac were found to be partly what Glaxo Canada was paying for within the amount paid to Adechsa. These rights were conferred to Glaxo Canada through the license agreement, and thus it was a circumstance that could not be ignored as s 69(2) applies to not only the payment for goods but also to the payment for

[70] *Ibid* at para 20
[71] *Ibid*.
[72] *Ibid* at para 41 and 42
[73] *Ibid* at para 44
[74] *Ibid* at para 48.

services. [75] Simply put, considering them offered a "realistic picture"[76] of the profits of Glaxo Canada, which was the income under scrutiny.

This "realistic picture" was a realization that Glaxo Canada wasn't responsible for the entire production of this product, as were the generic manufacturers. Glaxo Canada was a secondary manufacturer, while the generic producers were primary manufacturers. The latter, much like Glaxo Group, are responsible for the creation of new products, the intellectual property ("**IP**") rights associated with them, and the investment costs associate with the IP. The Court therefore found that the generic products were not suitable comparables as they do not reflect the economic and business reality of Glaxo Canada.[77]

The SCC refused to consider the make-up of the purchase price to Adechsa and left this determination to the TCC. However, the Court did recognize that there are certain rights and benefits conferred by the License Agreement to Glaxo Canada and that these "appear to have some value".[78]

Most importantly, which I will paraphrase below, Rothstein J offered guidance with respect to transfer pricing in general, but also specifically to the redetermination of the effect of the License and Supply Agreements on determining a proper comparison:

---

[75] *Ibid* at para 51.
[76] *Ibid* at para 52.
[77] *Ibid* at para 53.
[78] *Ibid* at para 58.

1. Subsection 69(2) uses the term "reasonable amount", which reflects the fact that "transfer pricing is not an exact science"[79] and that comparators will almost never be identical. Therefore, as long as the transfer price is within a reasonable range, the section's requirements should be satisfied. A court however may select a range it considers reasonable using the evidence that it finds relevant. To do so, a judge is to exercise his/her best informed judgment to establish a satisfactory arm's length price.[80]

2. Assessment of the evidence is a matter for the trial judge. However, in doing so, the respective roles and functions of the distinct entities should be considered. In this case, Glaxo Canada engaged in the secondary manufacturing and marketing of Zantac while Glaxo Group was the owner of the intellectual property. It is imperative that transfer pricing does not result in a misallocation of earnings that fails to consider the different functions, resources, and risks inherent in each.[81]

3. Prices between parties dealing at arm's length are to be established with regard to the independent interests of each party to the transaction. For example, in the case at bar, the interests of both Glaxo Group and Glaxo Canada are to be considered. The determination of the arm's length value under 69(2) should reflect these realities.[82]

4. Lastly, and specifically in regard to this case, there is evidence that other arm's length purchasers bought the ranitidine from Adechsa and other Glaxo Group suppliers instead of from generic sources. This would suggest that the higher-than-generic transfer prices are justified and not an unreasonable amount.[83]

[79] *Supra* note 66 at para 1.45
[80] *Supra* note 1 at para 61
[81] *Ibid* at para 62
[82] *Ibid* at para 63
[83] *Ibid* at para 64.

With these considerations as guidance, Rothstein J dismissed the appeal and remitted the matter back to the TCC.[84]

In regard to Glaxo Canada's cross-appeal, Rothstein J considered whether the assumptions made by the Minister had been demolished.[85] By specifically citing assumptions 14p[86] & 14r.A[87], the Court highlighted the necessary facts that Glaxo Canada needed to demolish. Assumption 14p, however, remained outstanding;[88] The FCA therefore correctly remitted the matter back to the TCC, where the parties could introduce new evidence, if necessary, and the Court would be in the best position to make a determination.

ANALYSIS

A. An Examination of "*Reasonable*" Canadian Circumstances

i. The Arm's Length Principle

As Canadian jurisprudence surrounding transfer pricing develops, it seemingly is becoming clear that a proper interpretation of the arm's length principle presents the heaviest burden on the Minister's reassessments. Article 9 of the OECD Model Tax Convention defines the taxation principle behind an arm's length transaction as:

> [w]here conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those

[84] *Ibid* at para 65.
[85] *Ibid* at para 70.
[86] *Ibid.*
[87] *Ibid.*
[88] *Ibid* at para 74.

> conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.[89]

Canada v GlaxoSmithKline was solely a task of valuing transactions between non-arm's length companies relative to an arm's length transaction.[90] However, the case at bar involves a series of transactions that comprised of a basket of goods, which include:

1. The tangible assets that make up the designer pharmaceutical drug, Zantac;
2. The expertise navigation of market regulations by the parent company;
3. The marketing facilities offered by the parent corporation; and,
4. The intangible goodwill of a brand-name product.

For a proper assessment, the competing goals of the two parties must be considered. Doing so highlights the arm's length standard principle flaw: on one hand, the CRA's mandate is to unwind complex tax schemes developed for the individual purpose of eroding the tax base; however, on the other, the Taxpayer is accorded the right to operate and structure their affairs under the most favourable tax treatment possible.[91]

These interests operate under unique circumstances that further confuse an already complicated situation: Glaxo Canada argues that the Supply and License Agreements together form the "circumstances" that it operates under and therefore are to be considered by when finding a comparable product for the transaction while the Minister argues the opposite.

[89] OECD, *Model Tax Convention on Income and on Capital* (OECD, 1977).
[90] *Supra* note 1 at para 19
[91] *Supra* note 6.

The FCA and the SCC agreed with the Taxpayer and set aside the TCC's decision.[92] The logic in doing so was that s. 69(2) demanded a broader assessment of the circumstances that were "reasonable" beyond narrow test laid out in *Singleton*.[93]

Under *Singleton* a Taxpayer's transaction is to be judged individually and only in regard to the actual good purchased – *i.e.* without considering the licensing, ownership, marketing or product development that a Taxpayer is subject to for the production of its retail product. With the application of *Singleton*, the ranitidine's "fair market value" ("**FMV**") would amount to a much lower value than the true value of the product actually purchased by the Taxpayer. Without the consideration of these realisms, the hypothetical transaction would not take into account the very circumstances that make it possible for the purchaser to produce the designer product, Zantac, in the first place.[94]

Without the License Agreement, Glaxo Canada, or some variation of this corporate entity, could only produce a generic substitute made with a somewhat similar ranitidine ingredient purchased from a separate vendor, but not Zantac – the drug licensed for production by Glaxo Canada, and not the generic manufacturers.

If either court of appeal had applied the *Singleton* test, it would have failed to consider the circumstances that arise "from the market power attaching to Glaxo Group's ownership of the intellectual property associated with ranitidine, the Zantac trademark and

[92] *Supra* note 1 at para 77; *Supra* note 2 at para 81.
[93] *Supra* note 1 at para 33; *Supra* note 2 at 68.
[94] *Supra* note 1 at para. 78.

the other products covered by its License Agreement with Glaxo Canada".[95] The SCC realized this and refused to apply the principle as it would separate the two agreements from the transaction and would create a fictitious domain that is altogether distinct from the reality that the Taxpayer operates within.

The issue at hand, therefore, was one not of fact but rather of law: s. 69(2), under the TCC's strict interpretation, would assess the Taxpayer in a vague and unlikely domain that only resembles a fiction devoid of reality, rather than the Taxpayer's true circumstances. It was not Glaxo Canada's reporting system that the court should have scrutinized; it was the flawed tool for assessment, s. 69(2) – and more specifically the arm's length principle - that deserved greater attention.[96]

If s. 69(2) was to separate the two agreements, the notional fact that the granulated ranitidine purchased was worth more to the retail-purchaser in conjunction with the License Agreement than it was if it were to be sold as a generic substitute must somehow be recognized by the Court within its assessment. This is precisely the determination that the SCC came to when looking at s. 69(2).

The objective approach of the TCC in applying the arm's length principle to determine FMV, under the guidance of *Singleton*, would not have taken notice of the specific circumstances or the legal reality of a Taxpayer. [97] This flaw highlights the unsuitability of the comparable uncontrollable price method ("**CUP**") for an assessment at

[95] *Supra* note 2 at para. 80.

[96] I provide additional reasoning to this comment within "Section B: A Revised Arm's Length Principle" of my Analysis, which begins at the bottom of page 30 of this document.

[97] *Supra* note 2 at para 80.

arm's length: it fails to recognize foreign subsidiaries as a distinct business organisation, with a distinct business reality, from its generic competitors. Instead, it solely focuses its relevance to the removal of the relationship between the subsidiary and the parent company.

With the removal of the relationship between Glaxo Canada and Glaxo Group, the transaction between Adechsa and Glaxo Canada would still apply; it would be the ability to produce the pharmaceutical Zantac with the granulated ranitidine that would dissipate from the hypothetical leaving only the business acumen of the company to be assessed.

Therefore, in order for such comparisons to be useful, the economically relevant characteristics of the assessment must be sufficiently comparable. 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.[98]

Justice Hogan, in *GE Capital v The Queen*,[99] held that that the OECD's definition of comparable circumstances was a "clear articulation of the importance of maintaining the relevant economic characteristics of the controlled transaction in order to ensure the reliability of the comparisons with uncontrolled transactions."[100]

---

[98] Department of Finance Canada, OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* (Paris: OECD Publishing, 1995).

[99] *GE Capital v. Her Majesty The Queen*, 2009 TCC 563.

[100] *Ibid* at para 208.

Both the FCA and SCC recognized two foundational points in relation to Glaxo Canada's circumstances:

1. The transactions to purchase ranitidine from Adechsa were made in conjunction with the License Agreement; and,
2. Brand-name pharmaceutical held a greater value than its generic substitutes used for the comparison.

Under the standardized assessment of the arm's length principle, the comparison forgets the totality of circumstances that are part of a company's ability to produce the designer product, Zantac, which will be produced at an overall higher cost and sold at a higher price - commanding a 60% profit margin.[101]

Specifically, it is these rights to a higher profit margin that were purchased by Glaxo Canada and included within the agreements between the parties privy to these transactions. These explicit considerations highlight the business circumstances that form the distinction between the incomparable transactions.

ii. GlaxoSmithKline Inc.'s Business Circumstances

In light of the License Agreement with Glaxo Holdings, it must be recognized that the effort expended by a MNE to bring a drug to market is a long and expensive process that holds no certainty of success.[102] For the considerable risk taken by an MNE, the patent holding drug manufacturing company gives up a great deal of profit after the mandatory 20-

[101] *Supra* note 3 at para 48.

[102] Jamal Hejazi, "*Transfer Pricing: The Basics from a Canadian Perspective*", (Toronto: LexusNexus, 2008) at 181.

year patent exclusivity period concludes and generic manufacturing companies are given access to produce the drug in a less expensive form.

For this reason, the research and development of pharmaceuticals is often carried out in jurisdictions where patent protection is relatively strong to the protection afforded by Canada. Jurisdictions that offer weak levels of IP protection such as Canada, therefore attract very little research and development and instead often partake only in the manufacture and distribution of products [103] Thus, the business decisions made by a MNE are often influenced by not only the economic incentives but also the protection of their patents and IP.[104]

In Canada, the industry has faced two major trends that have influenced decisions made by entities transacting across international borders:

1. Rising government regulation; and,
2. Eroding protection of intellectual property.[105]

Because of the research and development costs of the drugs produced, varying degrees of patent protection translate into different tax jurisdictions receiving differing levels of investment by drug manufacturers.[106] Although the patent laws in Canada have strengthened considerably with Bill C-22 coming into force in 1989, and then its successor,

[103] *Ibid* at 169.
[104] *Ibid* at 169.
[105] *Ibid* at 170.
[106] *Ibid* at 171.

Bill C-91, coming into force in 1993, the protection offered by Canadian authorities still lacks behind many of its counterparts without the possibility of patent term restoration.[107]

This inequality between Canada and other developed patent jurisdictions is unexplainable and highlights another inefficiency that increases the risk and costs that companies, such as Glaxo Canada, must face if they wish to solicit their product within foreign marketplace.

With lackluster protection afforded to Canadian drug manufacturers by the regulating authorities, one would expect that Canada must offer some form of financial incentive to the distributors of pharmaceutical products. Unfortunately, this is not the case.

In 1987, to ensure that the drug companies did not charge excessive amounts for their patented drugs, the Patented Medicine Price Review Board ("PMPRB") was created. Under the oversight of the PMPRB, drug prices in Canada have approximated 5-12 percent below the median of foreign prices within comparable countries.[108] However, with that said, Canada does offer many positives for manufacturers to participate within its highly desirable marketplace *that consists of a population with unfettered access to health care service.*

These incentives, however, are mitigated by the most costly aspect of the pharmaceutical industry, the investment in research and development, which necessitates that these innovative processes are taken to other jurisdictions as the protection of the IP

[107] *Ibid.*
[108] *Ibid.*

remains as the most important factor when a company is developing its manufacturing and development process chain – i.e. which jurisdiction will host each step of the product development process.

As we can see, patent protection is a primary concern for Glaxo Holdings, as well as throughout the pharmaceutical industry in totality. Given that the pre-clinical testing of pharmaceuticals requires a remarkable investment by drug manufacturers, the return on investment required by these producers is much greater than other industries would necessitate.[109]

In the case at bar, Glaxo Canada is subject to a weaker patent protection market than their product is within other industrialized countries. Thus, we can make the inference that in order for Glaxo Holdings to market their product in Canada, the drug manufacturer must undertake a greater amount of risk with much less opportunity for profit than they are accorded in many competing jurisdictions.

Access to the designer pharmaceutical products is a luxury granted to the Canadian marketplace that is not returned by the PMPRB to the manufacturers. By removing the product from the Canadian marketplace, as explained below, the generic pharmaceutical firms would also lose access to drug's patent mandatorily granted by the patent's holders – in this case Glaxo Holdings. However, the exclusive right to sell this product is vitiated by the PMBPR.

---

[109] *Ibid* at 81.

Furthermore, the effective term of exclusivity is significantly lower once all considerations are included. Although Zantac was granted patent protection for a 20-year period, this protection begins immediately upon the date of application while the pharmaceutical is then subject to a lengthy health regulatory approval before it may be brought to market and sold to the public.[110]

The discussion above is for the purpose of highlighting additional circumstances that Glaxo Canada must operate within as opposed to those of the two generic manufacturers.

From a discussion of the challenges that Glaxo Canada faces in its operations in North America, we can see that the economic returns of the product's distribution are subject to the following limitations:

1. patent concerns;
2. marketing restrictions;
3. compulsory competition; and,
4. Lower profit margins.[111] [112]

The road to bringing a drug to market is clearly long and expensive; however, the law in Canada has enabled generic companies to invest significantly less into research and development while having the ability to sell competing products at a fraction of the

[110] *Ibid.*

[111] *Ibid* at 182.

[112] These are a standard set of market forces that *Jamal Hejazi* has recognized as applying to almost all of the pharmaceutical manufacturing companies who enter into transfer pricing practices for the purpose of protecting their IP or for other means. The purpose of stating these forces is to show that these are not irregular considerations that should be separate from consideration. The generic comparators were not subject to these forces and thus these forces provide additional reasoning as to why a higher price was charged for the production of the Zantac, as opposed to the generic ranitidine.

price.[113] This is precisely the problem with Canada's approach to pharmaceutical regulation: it fosters transfer pricing concerns by damaging the pharmaceutical industry's ability to pursue a typical expected profit. The Canadian pharmaceutical regulators have forced the developing firms to enter the Canadian market only as distributors rather than by investing vast sums in the Canadian economy by way of research and development.

Under these conditions, the ability for the pharmaceutical developing firms to produce the requisite profit to recover the significant investment, and therefore make their business a success, is greatly diminished relative by the generic manufacturers who operate under completely different business circumstances.[114]

These circumstances effect are to be considered by the TCC when it re-evaluates the business circumstances of Glaxo Canada.

iii. **Competing Interests – Assessment of Tax/Duty**

As applied by the CRA and the Canadian Border Services Agency ("**CBSA**"), the arm's length standard is a flawed measurement tool.

Transfer pricing involves the sale of goods into and out of Canada and, therefore, the arm's length principle is applicable to both taxation and customs valuation. However, these two means of assessment require competing interests and competing goals for the valuation of the good in question.

[113] *Supra* note 102 at 183.
[114] *Ibid.*

As expressed by the World Trade Organization, the "arm's length principle" is the international assessment standard for importation valuation.[115] While for accounting purposes, GAAP principles of expenses incurred for the purpose of business are preferred by the OECD, as stated in the 1995 transfer pricing guidelines.[116]

Thus, when applied by these two agencies for the purposes of good's valuation, the arm's length standard is a varying standard, or rather a "moving target":

- On importation, the good is subject to an initial duty on the value entering the country, where the CBSA's motivation is to assess it at the highest value; while,
- For taxation purposes, the CRA's incentive is for the good's assessment to be its lowest valuation possible to produce a higher taxable net income.

With regard to the CBSA's valuation methodology, *the Customs Act*[117] sets out in s. 47 that "goods shall be appraised on the basis of the transaction value of the goods in accordance with the conditions set out in section 48".[118] Subsection 48 of the *Customs Act* lists similar valuations to IC 87-2R, which briefly mentions transfer pricing's effect on customs valuations in part 12.[119]Consequently, the proposed narrowing of the arm's length interpretation - to not include all of the business circumstances that Glaxo Canada is subject

[115] *Supra* note 9 at 1.
[116] *Supra* note 66.
[117] *Customs Act*, R.S.C. 1985, c. 1 (2nd Supp.), s. 47.
[118] *Ibid s. 48.*
[119] Canada Revenue Agency, Interpretation Bulletin IC-87-2R, "*International Transfer Pricing and Other International Transactions*" (February 27, 1987).

to, would punish the taxpayer and give incentive to the importer to lower its transfer prices negating the balancing of principles that currently exists.

In the case at bar, if the transaction price of the granulated ranitidine is held to be that of the generic Apotex and Novopharm product, Glaxo Canada would be subject to penalties against Zantac's valuation on both its importation valuation as well as its gross income under one vague standard applied by two authorities in two completely different methods. The CRA addressed this issue with IC-872R:

> The methods for determining value for duty under the current provisions of the *Customs Act* resemble those outlined in this circular. However, differences do remain. The department is not obliged to accept the value reported for duty when considering the income tax implications of a non-arm's length importation.[120]

Under this vague and unhelpful guidance the "arm's length" principle is clearly an arbitrary standard that allows for a selective reading by either the CBSA or the CRA in order to determine the amount of taxation or duty applicable by either authority respectively. In doing so, there evidently is an arbitrary ability for the Minister to reassess gross income using a subjective standard in order to come to a predetermined valuation - no matter the facts which lead to the assessment. This is precisely what has occurred in the case at bar: the Minister has reassessed Glaxo Canada on the basis that the CRA has deemed the selected comparator as appropriate, although obvious distinctions existed in this comparator relative to the product sold by Glaxo Canada.

[120] *Ibid* at Part 12

These competing interests have recently begun to be addressed by the international community with greater regulation by the border authorities in approving methodologies before their application.[121] However, until recently, there has been little consideration of customs valuation methodologies by MNEs who have simply been left to adapt their accounting and custom valuation policies to comply with both sets of regulations.[122]

Furthermore, despite the obvious importance of clarifying the appropriate valuation method for each distinct use of transfer pricing, the amount of litigation surrounding the valuation for the importation of goods is even less than the dearth that has taken place surrounding the transfer pricing issues on the taxation of profit.

For the purpose of discussing the proper considerations when determining a value behind transfer pricing schemes, I have discussed these competing principles with the intention to outline a fundamental flaw in the arm's length standard as it applies to 69(2): it is an arbitrary valuation of an amount that is "reasonable in the circumstances" made by a party with a vested interest in the outcome of the decision. In this instance, it is the Minister's discretion that creates an unfair imbalance of power in the assessment.

The uncertainty underlying transfer pricing has exposed companies, such as Glaxo Canada, to the dichotomy of whether to risk facing penalty on the importation of goods valued at an allegedly "undervalued" rate in order to avoid duty; or, to risk an alleged over valuation and be confronted with reassessment by the Minister, as is the case with Glaxo Canada in the case at bar.

---

[121] *Supra* note 101 at 191.
[122] *Ibid* at 197.

Under the competing interests of these two authorities, it is impossible for a Taxpayer to comply with both pieces of legislation when needing to assess tax owed relative to these goods importation value when solely left with a single arbitrary pricing instrument – the arm's length standard.

Although this paradigm has previously been exposed, there is a dearth of Canadian jurisprudence surrounding either interest – the cost of goods sold or importation value. Relative to the CRA, the CBSA has provided somewhat greater insight through the "Memorandum on Income Tax Transfer Pricing and Customs Valuation". However, neither agency has stated much more than an arbitrary position that justifies their individual interest without much consideration of the objectivity of the principle.[123]

Therefore, with the lack of guidance that these MNEs are faced with, it was hoped that the SCC's decision would provide clarity to the taxing authorities' position. Additional guidance would facilitate a MNE's ability to remain internationally competitive, while conforming to the taxing authority's guidelines. Unfortunately, therefore, it is Canadian-based MNE's international economic competitiveness that will suffer if these contradicting positions are not coordinated appropriately by the agencies applying this arbitrary principle.

[123]Canadian Border Services Agency, "Income Tax Transfer Pricing and Customs Valuation, "Memorandum D-13-3-6 (October 18, 2006).

B. A Revised Arm's Length Standard

After the above criticism, it is only prudent that I provide a suggestion for the entrenched standard's improvement. Just for clarification, it is not the application of the standard that I am critical of; it is the standard's vague and arbitrary ability to be applied one-way in one instance, and exactly opposite fashion, in another.

The previous standard allows for a broad conversation of interests to be included or excluded based upon the intended outcome. For this reason, I believe the Arm's Length Principle should, in certain circumstances, be applied in a narrower form or with specific guidance. This was the intention that was lightly achieved by the SCC's guidance; however, without greater direction, or an example by way of its application, it will be difficult to assure that it is applied with the exact intentions of its designers.

What the SCC did provide however was instructions for the TCC to think broadly and focus on the bigger picture of transfer pricing and that the idea that the arm's length price is not the same thing as finding the FMV of the product.[124] The Court found that the OECD guidelines included that the economically relevant characteristics should be considered in applying the Arm's Length Principle.[125] This is exactly how I suggest the Arm's Length Principle needs to be formally modified with a strict set of instructions that are applied in a range of circumstances.

For example, if the goal of the transfer pricing valuation is the assessment of taxes on income produce by the goods or services in question, then it should be certain that the

[124] *Supra* note 1 at para 38.
[125] *Ibid.*

economic considerations regarding the circumstances that enable the transaction should be included within the valuation. If the goal of the valuation is the assessment of duty on the goods being brought into the country, these same economic circumstances must also be considered. With the mandatory broad application of the "business reality test" in both forms of transfer pricing valuations, the Arm's Length Principle would facilitate access to justice through the judicial certainty provided to otherwise complex scenarios.

It is hard to believe that access to justice may be considered an issue when considering the ability of MNEs to increase profits through transfer pricing initiatives. However, when considered in its broader context, the objective of facilitating certainty throughout the law is an objective that is very much in line access to justice. Corporations are people and, therefore, may expect the same goals to set the legal foundations for the law that applies to them as may a natural person.

Therefore, as we can see from the dearth of existing transfer pricing case law, it is the Court's previous arbitrary use of the Arm's Length Principle's ability to conform that is responsible for muddling the existing transfer pricing precedents, rendering them all but useless beyond the specific factual scenarios in question.

In its current form the Arm's Length Principle provides an arbitrary tool for administrative agencies to carry out their underlying objectives – *e.g.* either the assessment of tax or duty. For this reason, the TCC's judgment will be anticipated by the tax community

C. Transfer Pricing Exposes the Flaws of the International Taxation System

This point leads us to my comment within the footnotes of the quote provided on the very first inside page of this document.[126] My remark may be found in the sole footnote before the abstract summary; I will, however, expand on these thoughts below. The quote is the following:

> *"Transfer pricing is the leading edge of what is wrong with international tax"*[127]

It is not that I fail to see author's underlying intention;[128] it is that, as it currently stands, the veracity of it the quote is false and it is an error in logic. To accurately represent the issues faced by national taxing authorities, the quote should be modified to read

> *"Transfer pricing is the leading edge of what is wrong with the international system of taxation".*[129]

The former quotation lays the blame on the ends achieved, leaving the means used to reach the objective without responsibility for its outcome. I believe that transfer pricing cannot be "*what is wrong with international tax*" if MNEs are able to strictly follow the existing taxation system's vague guidelines, yet still they result in an outcome that offends taxing authorities - as well as Mr. Sheppard.

[126] Please see the page right before the abstract of this document that has the aforementioned quote.
[127] Lee Sheppard, *Tax Analysts*, August 2012
[128] The intention is to obviously show that it is being used to grossly avoid taxes by multinational entities in a manner that would offend taxation authorities.
[129] This is only what the Author proposes is a better representation if accuracy is a concern to its original author – *i.e.* Lee Sheppard.

Transfer pricing is what keeps governments and taxing authorities honest. In my humble opinion, it is all that is correct in the existing, and admittedly, confused taxation system that ultimately works toward fostering international economic competitiveness.

If an economic sovereignty intentionally assesses less tax on certain goods, or taxes certain sources of income differently, than does another, the sovereignty who ultimately loses the amount that it otherwise would have assessed on the good or income should not simply lay blame that multinational entities have aggressively avoided tax or duty. Rather, it is my opinion that, the MNE's business capacity has simply been won by the transfer pricing friendly jurisdiction in the unfortunate game of international economic competitiveness – a zero-sum competition.[130]

i. A Brief Discussion of "Global Economic Business Units"

Continuing with the discussion above, let's begin with the premise that at any one time there is a limited capacity of total "economic business units" [131] that may be utilized. This capacity may only be increased through efficiency or innovation and these economic business units are not locked in to any one jurisdiction; they are portable. If a jurisdiction intends to foster the business of those who produce the economic business units, they compete with other jurisdictions for these units to be expended within their locality.

[130] What is lost by one party will always amount to a value that is gained by another. This principle extends to global economic competitiveness. It is represented by the opportunity to capture the units of economic business by one jurisdiction and thus the lost opportunity of another

[131] This is a term coined by the Author to represent the total amount of business that may be done at any one time globally. It may or may not be in use by other Authors for other purposes. For the purpose of this academic exercise, it is used to express the individual unit that would represent the corporation's ability to produce an economic benefit to a sovereign jurisdiction.

Of the many ways that a sovereign nation may encourage a business to bring these units to and then expended within their jurisdiction,[132] one is by offering tax credits[133] or means of tax relief – *e.g.* the fostering of transfer pricing schemes. Another may be through financial incentives, such as forgivable loans or even with less/more stringent regulation of certain industries – *e.*g. the stronger IP protection offered by other jurisdictions.

The focus of this paper is taxation. And for that reason, I will limit my discussion on the economic aspects of transfer pricing to the above. However, with the above, I have intended to point out the global economic realities that now must be considered when holding a conversation on transfer pricing. You can expand on these ideas yourself with a critical analysis of how jurisdictions foster economic competitiveness. For example, Japan has recently been accused[134] of doing so through the devaluation of their currency.[135]

With the continued rise of globalisation, jurists should not only consider the interest of the taxing jurisdictions. There exists a broad range of academic topics that extend beyond the realm of taxation that must be alive to a jurist when considering transfer pricing issues. If a taxpayer is truly allowed to organise his or her affairs as they wish, then how a

[132] Or within their realm of taxation.

[133] It is not uncommon for sovereignties to offer tax credits to certain industries that it intends to foster the growth of within its borders. I ask, how is this different than the allowance of mechanisms that enable transfer pricing opportunities to take place within the jurisdiction's borders to capture the benefit provided by the resulting MNEs actions? – *e.g.* through the development and sale of an ingredient to another jurisdiction at a higher price. This would facilitate job growth and other economic stimulants within the jurisdiction's border.

[134] US Federal Reserve Chairman Ben Bernanke, to an audience at the London School of Economic, rejected worries that the world's troubled large economies were competitively cutting their currency values and hurting smaller, healthier ones in the process. **[Dawn.com, March 2013] <<u>Online</u>: http://dawn.com/2013/03/26/competitive-devaluation-worries-rejected/>**

[135] This accusation has, of course, been rejected by economic scholars in fear that other countries would follow suit.

nation has, or has not, fostered or encouraged global economic competitiveness within their borders must certainly be part of the transfer pricing conversation.

Additional questions must be asked like, whether the MNE was forced to use select jurisdictions instead of the locality of the taxing authority for other means than lower taxation? Was there a *bona fide* reason for their operation elsewhere?

In the case at bar, it was impossible for any of the Glaxo Holdings Group of Companies to research and develop the drug within Canada. Doing so would have forced the corporation to hold its IP in a country with weak IP laws and make the product even more susceptible to reproduction.

With the guidance of the SCC, these questions should be considered as part of the TCC's task in its re-evaluation of *Canada v GlaxoSmithKline Inc.* Without their inclusion, transfer pricing in Canada will not keep pace, or remain current, with globalisation's effect on competitive marketplaces.

D. GAAR Was Not Argued Due To Genuine Legal Relationships

Absent any provision to the contrary, a business person is able to arrange their affairs in the most tax efficient manner possible in accordance with the letter of the law.[136] If a party enters into genuine legal relationship for a *bona fide* non-tax purpose, it will not satisfy the second step of the three-step GAAR test that was recently revisited in *Copthorne*

[136] *Supra* note 5.

Holdings Ltd. v Canada[137]. Without being classified as an avoidance transaction, s. 245 of the ITA may not apply.

It trite law that courts should not disregard legal relationships genuinely created.[138] Without purchasing granulated ranitidine, the production and sale of Zantac would have been impossible. Furthermore, without Zantac's Canadian regulatory approval, the generic licensing of the product would be non-existent.

In *Univar Canada LTD v the Queen*,[139] the TCC held that the alternative transaction that the Minister proposes to substitute may not be one that the Taxpayer would not have performed. In the case at bar, it would still be impossible to negate the legal reality that the business operates within. Devoid of the License Agreement with Glaxo Holdings, there would not have been a transaction for the Minister to reassess to start with.

Prima facie, we should not characterize corporate transfer pricing practices as avoidance transactions when they are conducted for a *bona fide* purpose – *i.e*. producing Zantac not a generic substitute. Furthermore, transactions may not be labeled abusive when they could not otherwise be conducted and are not expressly prohibited.

Without the agreement, it was the ability to manufacture Zantac entirely, and not the purchase of granulated ranitidine, that would cease to exist – *i.e.,* Glaxo Canada would not have the selected product within its portfolio of available products to produce and sell had it not entered into this series of agreements under the terms negotiated by Glaxo Group.

[137] *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63 at paras 39-41, 59 and 64.
[138] *Stubart Investments Ltd. v. The Queen*, [1984] 1 S.C.R 536, 84 D.T.C. 6305 at para. 14
[139] 2005 TCC 723, [2006] 1 C.T.C. 2308.

For these reasons, this was not a series of transaction that could be considered under the GAAR **–** *i.e.* s. 245 of the *ITA.*

CONCLUSION

With the SCC affirming the FCA's decision, the contextual determination of a "transfer-price" that is "reasonable in the circumstances" should be limited to transfers in the ordinary course of business, which is a much broader approach than argued for by the Minister.[140]

The reality is, however, that the arm's length principle has failed in its measurement of taxable income to satisfy the CRA's reassessment prerogative. Apparently, the previous transfer pricing legislation was written too broadly and was therefore repealed by Parliament and then re-enacted as s.247. From a look at the case law concerning 69(2) reassessments, it is clear that the repealed subsection empowered the Taxpayer to a greater degree than it did the CRA.

Consequently, in reaction to *GlaxoSmithKline*, the sentiment of the legal and accounting professions has been somewhat negative as the current interpretation provides inadequate certainty to an already complicated and muddled area of transactional tax law.

With that said, the tax community was grateful that the SCC decision gave consideration to the legal relationships genuinely created where the agreements' legal form is absent a sham.[141] However, the required inquiry is a legal fiction; it is a creature of

[140] *Supra* note 1.
[141] *Supra* note 84.

statute providing that the Minister should not be allowed to pick and choose what is and isn't included within it to bolster his/her prerogative. The inclusion of these relationships should not surprise; the *bona fide* purpose of the transaction must be respected. It is a matter of fact part of Glaxo Canada's operating conditions.

Glaxo Canada specifically functions under a distinct set of circumstances. These circumstances should not be disregarded to force an unsuitable comparator to be somewhat suitable. Glaxo Holding's business reality involves the financial risk of developing the product as well as the inability to earn the inherent returns needed to make their business a success because of environmental forces imposed by the regulating authorities. The generic companies are not subject to either of the market forces, without which the hypothetical comparison would simply be a fiction devoid of reality.

The SCC's decision will have a similar impact on transfer pricing as did the FCA's, which is viewed by the global tax community as a disappointment.[142] However, it has provided additional guidance for the TCC to proceed with the ultimate determination. There was hope that the SCC would provide certainty to MNEs using transfer pricing schemes. Instead, the SCC dodged the ultimate issue and merely added considerations for the TCC to take into account.

Without adding certainty, the SCC's finding will simply facilitate the continued use of vague pricing standards that empower the Minister with arbitrary tools perpetuating the very reasons why s. 69(2) was repealed.

---

[142] KPMG, *GlaxoSmithKline Inc. — Supreme Court Sends Transfer Pricing Dispute Back to Square One,* (October 18, 2012, online: http://www.kpmg.com/ca/en/issuesandinsights/articlespublications/tnf/pages/tnfc1232.htm).

TABLE OF AUTHORITIES

LEGISLATION:

Customs Act, R.S.C. 1985, c. 1 (2^{nd} Supp.) as amended.

Income Tax Act, R.S.C. 1985 c. 1 (5^{th} Supp.) as amended.

COURT DOCUMENTS

Canada v GlaxoSmithKline Inc., 2012 SCC 52 [Factum of the Appellant].

Canada v GlaxoSmithKline Inc., 2012 SCC 52 [Factum of the Respondent].

JURISPRUDENCE:

Alberta Printed Circuits Ltd. v. Canada, 2011 TCC 232, 2011 D.T.C. 1177.

Canada Trustco Mortgage Co. v. Canada, 2005 SCC 54, [2005] 2 S.C.R. 601.

Ciba-Geigy Canada Ltd. v. Apotex Inc., [1992] 3 SCR 120, 95 D.L.R. (4th)

Gabco Limited v. M.N.R., [1968] C.T.C. 313, 68 D.T.C. 5210 (Ex. Ct.).

GE Capital v Her Majesty the Queen, 2009 TCC 563, 2010 D.T.C. 1007 (Eng.); *aff'g* 2010 FCA 344, 2010 CarswelllNat 4858 (Fed. C.A.).

Canada v GlaxoSmithKline 2012 SCC 52

Canada v GlaxoSmithKline 2010 FCA 201, 405 N.R. 307

*GlaxoSmithKline v Canada 2*008 TCC 324, 2008 D.T.C. 3957

Peach Hill Management Ltd v. Canada (2000), 257 N.R. 193, [2000] G.S.T.C. 45 (FCA).

R v. Zeolkowski, [1989] 1 S.C.R. 1378, 61 D.L.R. (4th) 725.

Safety Boss Limited v. Canada, 2000 D.T.C. 1767, [2000] 3 C.T.C. 2497 (TCC)

Singleton v. Canada, 2001 SCC 61, [2001] 2 S.C.R. 1046.

GlaxoSmithKline Beecham Animal Health Inc. v. Canada, 2002 FCA 229, 291 N.R. 113.

Stubart Investments Ltd. v. The Queen, [1984] 1 S.C.R 536, 84 D.T.C. 6305.

SECONDARY SOURCES: RESEARCH TEXTS

Ruth Sullivan, Statutory Interpretation (Concord: Irwin Law, 1997).

Ruth Sullivan, Sullivan on the Construction of Statutes, 5th ed (Markham: LexisNexis Canada Inc, 2008).

Elmer A Driedger, Construction of Statutes, 2d ed (Toronto: Butterworths, 1983).

Francois Vincent, Transfer Pricing in Canada: A Legal Perspective, (Toronto: Carswell, 2009).

Jamal Hejazi, Transfer Pricing: The Basics from a Canadian Perspective, (Toronto: LexisNexis, 2008).

Peter W. Hogg, Joanne E. Magee & Jinyan Li, *Principles of Canadian Income Tax Law 7th Ed.* (Thompson Carswell: Toronto, 2010).

SECONDARY SOURCES: ARTICLES

Andrew F McCrodan & Salvador M Borraccia, "The Dilemma of GlaxoSmithKline: Unreasonable in the Circumstances?", Report of Proceedings of the Sixtieth Tax Conference convened by the Canadian Tax Foundation at the Calgary Telus Convention Centre, Calgary November 30 - December 2, 2008 (Toronto: Canadian Tax Foundation, 2009).

Emma Purdy, "What‟s the Deal? Arm's Length Pricing and Bundled Transactions", Canadian Forum on Advanced Transfer Pricing, February 24-25, 1999, Toronto (Toronto: Insight Press, 1999).

Canadian Border Services Agency, "Income Tax Transfer Pricing and Customs Valuation", Memorandum D-13-3-6 (October 18, 2006).

Canada Border Services Agency, Memorandum D13-4-13, "Post-Importation Payments or Fees Subsequent Proceeds" (8 July 2009).

Canada Revenue Agency, Interpretation Bulletin IT-87-2, "International Transfer Pricing and Other International Transactions" (27 February 27 1987).

Canada Revenue Agency, Interpretation Bulletin IT-87-2R, "International Transfer Pricing" (27 September 1999).

OECD, Committee on Fiscal Affairs, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Paris: OECD, 1979).

OECD, Committee on Fiscal Affairs, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Paris: OECD, 1995).

OECD, Committee on Fiscal Affairs, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Paris: OECD, 2010).