

July 28, 2010

A Transfer Pricing
Publication

Pricing Knowledge Network

Focusing on the impact of major intercompany pricing issues

GlaxoSmithKline Inc. v. Her Majesty the Queen: taxpayer wins appeal and "business reality" prevails!

On July 26, 2010, the Federal Court of Appeal (FCA) set aside the Tax Court's May 2008 decision regarding the pricing of the active ingredient, ranitidine, in GlaxoSmithKline's blockbuster ulcer drug, Zantac. In that decision, the Tax Court Judge accepted the Canada Revenue Agency's (CRA) argument that the intercompany price of the drug should be based on comparable uncontrolled prices (CUPs) of generic versions of the drug. (For more details see our PKN dated June 13, 2008). Whereas the Tax Court found that the price of the active ingredient could be established by prices in the generic market, ignoring the fact that the taxpayer's transaction took place in the branded pharmaceutical market; the FCA found that the business realities such as the use of the brand name, and the higher prices that result, should be taken into account, and bring into question the comparability of those generic CUPs. Although the FCA set aside the original decision, it would not make the ultimate determination of an appropriate arm's length price and returned the matter to the Tax Court Judge for reconsideration.

From 1990 to 1993, GlaxoSmithKline Inc. (GSK Canada) had acquired the active ingredient for Zantac from a related company, Adechsa, under the "Supply Agreement", at prices ranging from \$1,512 to \$1,652 per kilogram. Under a second agreement, the "License Agreement", GSK Canada obtained the rights from Glaxo Group to use the trademark, "Zantac", among other benefits, for a royalty of 6%. The Tax Court Judge rejected the taxpayer's arguments that the agreements should be considered together in establishing whether the price paid for the active ingredient was "reasonable in the circumstances", (the arm's length standard at the time as required by section 69 of Canada's Income Tax Act). Instead, the Tax Court Judge restricted his analysis to the Supply Agreement only, which he deemed comparable to supply agreements between generic producers and distributors. The FCA took the opposite view, recognizing that the Licence Agreement is relevant to

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determining the price that would have been reasonable in the circumstances. Specifically Glaxo Group's ownership of the Zantac trademark, the premium that Zantac commanded over generic ranitidine drugs in the market, the inability of the taxpayer to compete in the generic market without the Zantac trademark, and, the portfolio of other products to which the taxpayer had access under the Licence Agreement, were all relevant factors in the view of the FCA.

The FCA's Reasons for Judgement specifically note:

"Clearly, in the circumstances in the case, the Judge's approach was mistaken. In a real business world, presumably an arm's length purchaser could always buy ranitidine at market prices from a willing seller. However the question is whether that arm's length purchaser would be able to sell his ranitidine under the Zantac trademark. In my view, as a result of the approach which he took, the Judge failed to consider the business reality which an arm's length purchaser was bound to consider if he intended to sell Zantac."

In addition: *"the Judge made his determination in a fictitious business world where a purchaser is able to purchase ranitidine at a price which does not take into account the circumstances which make it possible for that purchaser to obtain rights to make and sell Zantac."*

The FCA decision recognizes that the high profitability associated with Zantac (which under the Tax Court decision remained with GSK Canada) did not belong to GSK Canada, but was a function of the market power that Glaxo Group contributed under the Licence Agreement. The FCA referenced "Roche Product Pty. Limited and Commissioner of Taxation" [2008] AATA (July 22, 2008) as follows:

"The intellectual property came from very substantial expenditure on research and development much of which would have produced no results. The profits from the exploitation of the intellectual property rights was something to which [the parent company which invented the product] had a special claim even though the profit would be collected for Australian sales by the Australian subsidiary."

The FCA concluded that the Judge erred in law, failing to apply the proper test in determining the amount that would have been "reasonable in the circumstances". However the FCA returned the matter to the Tax Court Judge for rehearing and reconsideration of what a reasonable amount would be, giving proper consideration to all the relevant facts.

PwC Observes:

This is an exciting win for GSK Canada. Although the final outcome is uncertain, the Tax Court Judge must now consider the Licence Agreement in determining what price was reasonable in the circumstances. In our view, because the generic products sold at a significant discount to Zantac, in a different market segment, the prices from generic producers should never

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have been considered valid "CUPs" and should have been discarded. Other transfer pricing methods, such as the resale price method used by the taxpayer, or the Transactional Net Margin Method, which looks at GSK Canada's profitability after considering both the active ingredient price and the royalty, should be given greater weight

Whereas the original judgement indicated the Tax Court's unwillingness to look at the overall business relationship within the group, the FCA has taken a much broader view, recognizing what a reasonable business person dealing at arm's length would consider. The FCA's reference to "business reality" is a breath of fresh air for taxpayers, (or should we say a dose of Zantac for their heartburn).

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