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October 18, 2012

PKN Alert/TCDR Alert - Supreme Court of Canada releases decision in GlaxoSmithKline transfer pricing case

A Transfer Pricing Publication

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On October 18, 2012 the Supreme Court of Canada (SCC) issued its decision in the case of *Her Majesty the Queen v. GlaxoSmithKline Inc.* The Court's decision generally favoured the Taxpayer although final resolution was not realized with today's decision.

This being the first transfer pricing case decided by the SCC, the decision will no doubt have far-reaching effects on how the Canadian transfer pricing legislation is interpreted and applied.

Facts

Between 1990 and 1993, GlaxoSmithKline Inc. (GSK Canada), purchased ranitidine, the active ingredient in the anti-ulcer drug under the brand name Zantac, from Adechsa, a Switzerland-based related party. A licence agreement conferred rights and benefits to GSK Canada. A supply agreement set the terms and price for the supply of ranitidine. The combined effect of the licence and supply agreements allowed GSK Canada to purchase ranitidine, and manufacture and market the final product under the trademark Zantac.



The Canada Revenue Agency (CRA) reassessed GSK Canada on the basis that the price paid for ranitidine was greater than the amount that would have been paid in arm's length circumstances.

The case was heard by both the Tax Court of Canada (TCC), which decided in favour of CRA, and the Federal Court of Appeal (FCA), which set aside the decision and returned the case to the TCC for reconsideration. Both parties appealed.

Issues on appeal

The main issue for the SCC was whether it was appropriate for the TCC to apply a transaction-by-transaction approach to determine an appropriate arm's length price for ranitidine without consideration of the overall business realities to GSK Canada including the rights and benefits available under the licence agreement.

More specifically, the Crown argued that it was inappropriate to consider the license agreement in the determination of an arm's length price for the purchase of ranitidine. It also submitted that transfer prices should be assessed on a "transaction by transaction" basis.

GSK Canada responded that it did not recharacterize or bundle the transactions, but rather considered both agreements because both were relevant to determining the appropriate transfer price (i.e., analyzing the circumstances of the supply agreement included consideration of the licence agreement). This principle (i.e., consideration of relevant circumstances) is endorsed by the OECD Guidelines. GSK Canada also challenged the FCA order to return the matter to the TCC as this effectively extended the statutory limitation period by giving the Minister another "kick at the can." GSK Canada argued that it had successfully "demolished" the assessment at the FCA and was entitled to have the matter set aside.

[For more details of the facts and decisions, please see our PKNs of [June 13, 2008](#) (TCC decision), [July 28, 2010](#) (FCA decision) and [March 25, 2011](#), when the SCC granted leave to appeal.)]

SCC decision and reasons

The SCC held that the "economic and business reality" of a given transaction generally should be considered in setting transfer prices. Specifically, "all circumstances" of a taxpayer that are relevant to the price paid ought to be considered. The Court rejected the Minister's argument that SCC case law required a transaction-by-transaction approach. Rather, Justice Rothstein clarified:

Where there are no related transactions or where related transactions are not relevant to the determination of the reasonableness of the price in issue, a transaction-by-transaction approach may be appropriate. However, "economically relevant characteristics of the situations being compared" may make it necessary to consider other transactions that impact the transfer price under consideration. In each case it is necessary to address this question by considering the relevant circumstances.

In making this determination, the SCC relied heavily on the OECD Guidelines, which, while not controlling, were given significant weight by the Court.

In this instance, the SCC found that there was a link between the licence and supply agreements, such that “the rights and benefits of the licence agreement were contingent on GSK Canada entering into the supply agreement.” This was a direct result of:

- the broader circumstances of the case: that the Glaxo Group of companies controlled the patent, trademark, and other relevant IP that GSK Canada wished to use; and
- the secondary manufacturing and marketing function served by GSK Canada.

Accordingly, “an entity that wished to market Zantac was subject to contractual terms affecting the price of ranitidine that generic marketers of ranitidine products were not.” In particular, GSK Canada was paying for at least some of the benefits of the licence agreement through the price it paid for the ranitidine.

On these grounds, the TCC was found to have erred in its refusal to consider the effect of the licence agreement on the prices paid by GSK Canada. Furthermore, the SCC demolished the TCC’s argument that the generic comparables represent arm’s length prices on the grounds that these comparables did not reflect the “economic and business reality” of GSK Canada.

The SCC, however, agreed with the FCA’s decision to return the matter to the TCC to determine the reasonableness of the prices paid by GSK Canada for the ranitidine. Interestingly, in doing so, the SCC offered this guidance on the redetermination that speaks to transfer pricing more generally:

- Transfer pricing is not an exact science, and that some leeway must be given in determining reasonable amounts. The SCC endorsed the use of a “reasonable range” as a means of supporting and establishing arm’s length prices.
- The respective functions, risks and assets of a Canadian entity vis-à-vis a global group of companies must be taken into consideration.
- Arm’s length prices should be established with regard to the independent interests of each party to a transaction.
- Higher prices are not necessarily indicative of a non arm’s length relationship.

PwC observations

This is the first SCC decision regarding transfer pricing. Although the court did not reach a conclusion on the specific pricing issue, the judgment recognizes several important principles:

- The SCC disagreed with the Crown’s argument that the OECD Guidelines “require” a transaction-by-transaction approach. The court observed that while the transaction-by-transaction approach may be ideal, the OECD Guidelines recognize that it may not be appropriate in all cases.

- The SCC was clear that the requirement in the OECD Guidelines to consider “economically relevant circumstances” in establishing comparability cannot be ignored. All relevant facts and circumstances must be considered.
- Determination of arm’s length prices should take into account the functions performed, risks assumed and assets used by the parties, specifically GSK Canada and other members of the Glaxo Group. “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.”
- “Transfer pricing is not an exact science” as stated in paragraph 1.45 of the OECD Guidelines; as long as a transfer price is within a reasonable range it should not be adjusted.
- The behaviour of arm’s length parties in similar transactions cannot be ignored. The SCC specifically referred to the existence of ranitidine purchases by third parties from Glaxo Group at higher-than-generic prices.

Considering the economically relevant circumstances, the SCC found that it is unlikely that comparable uncontrolled prices (CUPs) are available in this instance. However, the SCC set out as fact that some of the rights and benefits of the licence agreement were part of the purchase price of the ranitidine. The SCC has opened the door for the Tax Court of Canada to consider Part XIII withholding tax on a portion of the ranitidine purchase price in its next round of deliberations.

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