Transfer pricing case sent back

By DONALEE MOULTON

The Supreme Court has for the first time dealt with the nuanced issue of transfer pricing, suggesting in an Oct. 18 ruling that context is critical in determining an acceptable cost for goods and services purchased between related companies in different jurisdictions.

In *Canada v. GlaxoSmithKline Inc.* [2012] S.C.J. No. 52, the drug company was appealing a reassessment by the Canada Revenue Agency for four tax years, 1990-93, during which the company bought the active pharmaceutical ingredient for its anti-ulcer drug Zantac from a related Swiss company for between $1,512 and $1,651 a kilogram. Over the same period, two generic Canadian pharmaceutical companies purchased the same ingredient from other sources for $194 to $304 a kilo.

According to the CRA's reassessment under then-applicable s. 69(2) of the *Income Tax Act* — which notes that for tax purposes, the applicable cost is what "would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length" — the difference amounted to a $51-million overpayment for the ingredient, Supreme Court Justice Marshall Rothstein said in his ruling.

The Crown took the position that transfer pricing must focus exclusively on assessing the specific price of the commodity in question. The court, however, agreed with the taxpayer, Glaxo Canada, that other "economically relevant" circumstances had to be considered.

"What the court says will influence how the landscape is shaped … [and] the court basically said transfer pricing requires one to take into account commercial reality and commercial context," said Al Meghji, a tax litigation partner with Osler,Hoskin & Harcourt in Toronto who, together with Joseph Steiner, Amanda Heale and Pooja Samtani, represented GlaxoSmithKline before the court.

"Transfer pricing is a very big issue in Canadian tax law, and it is an international issue. Governments are concerned that global transactions are not being priced properly, and the amounts involved are significant."

The court identified several elements that needed to be factored into transfer pricing above and beyond the cost of the item being bought. Included in this case was a licence agreement between the related companies that was precluded from consideration "in error" in an earlier Tax Court of Canada ruling (*GlaxoSmithKline Inc. v. The Queen* [2008] DTC 3957), Justice Rothstein wrote.

"[T]he respective roles and functions of Glaxo Canada and the Glaxo Group should be kept in mind," Justice Rothstein wrote. "Glaxo Canada engaged in the secondary manufacturing and marketing of Zantac. Glaxo Group is the owner of the intellectual property and provided other rights and benefits to Glaxo Canada.

"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," he concluded.

"One of the lessons of this case is that transactions can't be reviewed in isolation. All of the relevant surrounding circumstances should be taken into account as should the business realities of the situation," said David Spiro, a lawyer specializing in taxation with Fraser Milner Casgrain in Toronto.

The Canada Revenue Agency has hired more auditors specifically in this area, and the field has burgeoned, along with a backlog. "There are so many audits right now waiting for this case [to settle]," said John Tobin, a partner with Torys in Toronto.

The comprehensive nature of the court's finding is significant, he said. "The way the court approached this was on a holistic basis, and that is noteworthy. It will make cases more difficult, but it will create a new approach [to the issue]."

Another important takeaway from the decision is that the CRA must be more flexible in its approach, said Spiro. "It is hoped that it will now be more sensitive to the business realities of the taxpayer in deciding whether to issue a transfer pricing assessment or settle a transfer pricing dispute."

The Supreme Court sent the case back to the Tax Court for redetermination, which puts the taxpayer at square one unless a settlement is reached. Yet over all, Tobin said, the decision is taxpayer-friendly. "This case could have been much more draconian on the taxpayer side."

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