GlaxoSmithKline Inc. (Glaxo) v. Her Majesty the Queen

Country of decision	Canada
Other countries involved	United Kingdom; Singapore; Switzerland
Case number	A-345-08
Date of decision	26 July 2010
Court/Chamber	Federal Court of Appeal
Parties	GlaxoSmithKline Inc. \(Glaxo\) (the taxpayer) Her Majesty the Queen (the tax authorities)
Treaty article(s) and paragraph(s)	Canada - United Kingdom Income Tax Treaty (1978) Art. 9(1) Canada - Singapore Income Tax Treaty (1976) Art. 9 Canada - Switzerland Income and Capital Tax Treaty (1997) Art. 9(1) Taxable year(s): 1990; 1991; 1992; 1993
OECD equivalent article(s) and paragraph(s)	9(1) (Associated enterprises)
Keywords	transfer pricing; arm's length principle; comparable uncontrolled price method; generic comparables

Summary

Summary of facts

The taxpayer, GlaxoSmithKline Inc. (Glaxo), is a Canadian company that manufactures a drug which is prescribed to treat stomach ulcers and is marketed by the taxpayer in Canada under the brand name Zantac. The active pharmaceutical key ingredient is ranitidine ("API") which the taxpayer purchased from a related non-resident company.

During the period under appeal, other pharmaceutical companies (generic companies) were selling generic versions of Zantac in Canada. These companies purchased ranitidine for much less than the taxpayer. The taxpayer paid Adechsa S.A. (Adechsa), a related party based in Switzerland, a person with whom it did not deal at arm's length, the following amounts for ranitidine during the years in appeal per kilo: 1990 – CAD 1,512, 1991 - CAD 1,575, 1992 - CAD 1,635, 1993 - CAD 1,651. The ranitidine purchased by the taxpayer from Adechsa was manufactured by a related party manufacturer in Singapore. At the same time, the generic companies in Canada paid the following amounts to their suppliers of ranitidine per kilo: 1990 - CAD 292 - 304, 1991 - CAD 244 - 289, 1992 - CAD 220 - 253, 1993 - CAD 194 - 248.

The transfer pricing arrangements between the parties allowed the Singapore related party manufacturer to earn gross profits of approximately 90% on the sale of ranitidine to Adechsa. Adechsa was required to earn a minimum 4% profit (by agreement with the Swiss tax authorities), and Glaxo earned gross profits of approximately 60% on the sale of Zantac.

The tax authorities' position

The tax authorities made a transfer pricing adjustment and reassessed the taxpayer to disallow a deduction insofar as the amounts paid to Adechsa for a kilogram of ranitidine exceeded the highest price paid by the generic companies for a kilogram of ranitidine at the appropriate time. The tax authorities also deemed the excess amount to be a dividend to have been paid to Glaxo Group, a UK company, subject to withholding tax at the reduced rate of 10% under the Canada-UK tax treaty. The tax authorities' position was that Glaxo did not pay a reasonable price for the purchase of ranitidine in order to minimize profit in Canada and move the profit to a related corporation in a low-tax jurisdiction.

The taxpayer's position

The taxpayer argued that the price it paid for the ranitidine "closely mirrored the price paid by independent third parties in comparable circumstances" and the amounts paid by the taxpayer were

"reasonable in the circumstances" within the meaning of subsection 69(2) of the Canadian Income Tax Act (ITA). The taxpayer also submitted that its business model and circumstances are not comparable to those of the generic companies.

Issues

Whether or not Glaxo, who manufactured the drug Zantac, had not dealt at arm's length by overpaying for the key ingredient, ranitidine, which it purchased from a related non-resident company.

Court decision

Decision of the Tax Court

The Tax Court, for the most part, upheld the assessments. The Tax Court endorsed the OECD Commentary on Art. 9(1) of the OECD Model, which relies on the arm's length principle to determine the prices that multinational enterprises would charge for goods and services sold from one jurisdiction to another. The Tax Court also endorsed the OECD's hierarchy of transfer pricing methods. It, therefore, concluded that the comparable uncontrolled price (CUP) method is the preferred method and that the purchase price paid by the generic pharmaceutical producers is an appropriate CUP. The Court indicated that the highest price paid by the generic pharmaceutical producers represents a reasonable price that the taxpayer could have paid Adechsa. The judge did allow an additional CAD 25 per kilogram of ranitidine in acknowledgement that the ranitidine purchased from the related party manufacturer in Singapore was granulated. The Court also allowed for an adjustment of the corresponding withholding tax on the revised amount. In coming to its decision, the Tax Court judge determined that the Supply Agreement with Adechsa and a License Agreement with Glaxo Group covered separate matters and, therefore, the License Agreement should not form part of his consideration in determining the appropriate price.

Decision of the Federal Court of Appeal

The Federal Court of Appeal, while agreeing that the (CUP) method should apply in determining the appropriate price, reversed the Tax Court's decision on the basis that the Tax Court used incorrect comparables. First, the Court found that the Tax Court had erred in disregarding the License Agreement. The Tax Court had erroneously relied on the Supreme Court decision in Singleton ([2001] 2 SCR 1046) to conclude that the licensing and pricing arrangements should have been considered separately. That decision, however, applied to a very different section of the ITA. Glaxo argued that consideration of the License Agreement was crucial for "determining the price that would have been reasonable in the circumstances had the parties been dealing at arm's length." The License Agreement gave the Canadian distributor access to Glaxo's trademark for Zantac, and the trademark gave the company access to the premium prices paid for the product over its generic competitors. Glaxo also said that the Agreement, which required the distributor to purchase Glaxo-manufactured ranitidine, gave the company access to other Glaxo-patented and trademarked products.

Further, the Federal Court of Appeal found that the Tax Court erred in using the generic prices as comparables. An inquiry should be made into those circumstances that an arm's length purchaser, standing in the shoes of the appellant, would consider relevant in deciding whether it should pay the price paid by Glaxo to Adechsa for its ranitidine. The Tax Court failed to consider the business reality of the situation: "In the 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." Therefore, the terms of the License Agreement need to be considered in determining the arm's length price. As a result, the Court sent the case back to the Tax Court to determine the arm's length price based on the terms of the License Agreement.

Editor's notes

This was the first transfer pricing case to be heard by the Tax Court of Canada and subsequently the Federal Court of Appeal.

Decision in favour of	the taxpayer
Other relevant cases	Supreme Court decision in *Singleton* ([2001] 2 SCR 1046)

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