

Canadian Court Overturns Decision on International Pharmaceutical Transfer Pricing Case

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The Canadian Federal Court of Appeal recently overturned the Tax Court of Canada's 2008 decision regarding the international transfer pricing of cross-border supplies of pharmaceutical ingredients in the case of *GlaxoSmithKline Inc. v. Canada*. At issue was the price GlaxoSmithKline (Glaxo Canada) paid to a related non-resident supplier for the drug ranitidine, the active pharmaceutical ingredient in the stomach ulcer drug Zantac. The Tax Court had accepted the Canada Revenue Agency's position that Glaxo Canada had paid an unreasonable amount for the ranitidine, thereby adding some \$51 million to Glaxo Canada's income for the years in question.

Background

Under a supply agreement with the supplier for the purchase of ranitidine, Glaxo Canada had paid between \$1,512 and \$1,651 per kilogram between 1990 and 1993. The Tax Court found that generic drug companies had paid between \$194 and \$304 per kilogram during the same period for substantially the same drug (although not produced in Glaxo Canada's own facilities). Separately, Glaxo Canada had entered into a licence agreement with its parent company, Glaxo Group Limited. The licence agreement provided for the right to use the parent's trademarks and patents, including the right to market ranitidine under the Zantac brand, as well as provide access to a portfolio of other drugs. Glaxo Canada agreed to pay Glaxo Group a 6% royalty on net sales of Zantac and other drugs.

The Tax Court Decision

At trial, the Tax Court considered the application of former subsection 69(2) of the *Income Tax Act*, which provided that the deductibility of amounts paid to a non-resident related party is limited to an amount that would have been "reasonable in the circumstances." The trial judge relied on the Supreme Court of Canada's decision in *Singleton v. Canada* and held that the licence agreement was not to be considered when determining the reasonableness of the price paid under the supply agreement because the two agreements covered separate matters. Using this approach, the trial judge used the prices that generic drug companies paid for their purchases of ranitidine as comparables and ruled that the reasonable price for Glaxo Canada to pay the supplier was the highest price paid by the generics for their supply of ranitidine plus a small adjustment.

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The Federal Court of Appeal Decision

On appeal, the Federal Court of Appeal (FCA) overturned the Tax Court's decision regarding the relevance of the licence agreement. It found that the trial judge had erred in law by failing to apply the proper test and had erroneously equated "fair market price" with the "reasonable in the circumstances" test set out in *Gabco Limited v. MNR*. The FCA held that what is reasonable in the circumstances "requires an inquiry into those circumstances which an arm's length purchaser, standing in the shoes of [Glaxo Canada], would consider relevant" in deciding a reasonable amount to pay for ranitidine.

The FCA identified five circumstances that made the licence agreement a crucial factor in determining the amount that would have been "reasonable in the circumstances" if Glaxo Canada and the supplier had been in an arm's-length relationship:

1. Glaxo Group owned the Zantac trademark and would own it even if Glaxo Canada was arm's length.
2. Zantac (sold under that brand name) commanded a premium in the marketplace over generic ranitidine drugs.
3. Glaxo Group owned the ranitidine patent and would have owned it even if Glaxo Canada had been in an arm's-length relationship.
4. Without the licence agreement, Glaxo Canada would not have been in a position to use the Zantac trademark or the ranitidine patent. Therefore, the only other possibility available to Glaxo Canada would have been to enter the generic market, where the barriers to entry would have been high, with established companies already well-positioned.
5. Without the licence agreement, Glaxo Canada would not have had access to Glaxo Group's portfolio of other patented and trademarked products.

The FCA made an important finding for transfer pricing cases. It noted that the particular circumstances of the case arose through Glaxo Group's ownership of specific intellectual property rights associated with the drug, which were granted to Glaxo Canada, and not from the non-arm's-length relationship between Glaxo Canada and the supplier or Glaxo Group. However, the FCA chose not to render a decision on the appropriate amount of the transfer price. Instead, the matter was sent back to the Tax Court for redetermination with instructions to consider the full "business realities" of the case.

Further Considerations

The FCA did not discuss the reasonableness of the amounts paid under the licence agreement and avoided the question of the appropriate allocation to each agreement. It merely stated that the licence agreement is a circumstance that the Tax Court must take into account. The Tax Court's ultimate valuation determination will likely be unable to consider whether the amounts paid under the licence agreement were reasonable in the circumstances because the prices paid under the licence agreement were not in issue before the courts. The only issue raised by Canada Revenue Agency on assessment was whether the payments for ranitidine were too much in the circumstances (i.e., given the royalty rate already set out in the licence agreement). In view of the existing licence agreement, it may well be that Glaxo Canada paid a reasonable price for ranitidine.

The argument made by counsel in the FCA case was intuitively attractive: a reasonable person would pay more to get ranitidine that it can sell as "Zantac" because it expects to get a premium price for its product; however, it is not clear that this argument holds up when the entire relationship is viewed together. Is the

price for ranitidine high and therefore justifiable because the royalty rate is low? Or if the royalty rate was “on market,” was the price for ranitidine too high?

It may be that, taken as a whole, the combined purchase price for the royalty plus the raw drug is reasonable in the circumstances, but having chosen to split the two agreements among two counterparties, the taxpayer faces the difficult situation of having one part unchallenged and the other reduced.

The FCA decision does not give much guidance to the Tax Court. Given the licence agreement, the Tax Court will find it exceedingly difficult to find an appropriate comparable or to apply normal transfer pricing methodologies. There is unlikely to be a comparable in which an arm’s-length party has the rights at a specific level of royalty to market a given product and then buy the raw material from a third party.

In the end, the Federal Court of Appeal has taken the much broader view, consistent with that held by most taxpayers, that the proper approach in assessing transfer pricing disputes is to take into account the full extent of the business and market realities pertaining to the situation. What remains to be seen is how the Tax Court will tackle the difficulties inherent in establishing an appropriate transfer price without guidance on the methodology to adopt or specific instructions on how to deal with the challenges of finding an appropriate arm’s-length comparable when there are several contracts (with associated pricing) between several counterparties. **1**