SUPREME COURT OF CANADA

CITATION: Canada *v.* GlaxoSmithKline Inc., 2012 SCC 52, [2012] 3 S.C.R. 3

DATE: 20121018
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BETWEEN:

Her Majesty The Queen
Appellant/Respondent on cross-appeal
and
GlaxoSmithKline Inc.
Respondent/Appellant on cross-appeal

CORAM: McLachlin C.J. and Deschamps, Abella, Rothstein, Cromwell, Moldaver and Karakatsanis JJ.

REASONS FOR JUDGMENT: (paras. 1 to 77)

Rothstein J. (McLachlin C.J. and Deschamps, Abella, Cromwell, Moldaver and Karakatsanis JJ. concurring)

Her Majesty The Queen *Appellant/Respondent on cross-appeal*

v.

GlaxoSmithKline Inc. *Respondent/Appellant on cross-appeal*

Indexed as: Canada *v*. GlaxoSmithKline Inc.

2012 SCC 52

File No.: 33874.

2012: January 13; 2012: October 18.

Present: McLachlin C.J. and Deschamps, Abella, Rothstein, Cromwell, Moldaver and Karakatsanis JJ.

ON APPEAL FROM THE FEDERAL COURT OF APPEAL

Taxation — Income Tax — Transfer Pricing — Taxpayer manufacturing and marketing patented and trademarked drug pursuant to Licence Agreement —

Taxpayer purchasing active pharmaceutical ingredient pursuant to separate Supply Agreement with related non-resident company — Minister of National Revenue reassessing taxpayer by increasing its income on basis that taxpayer had overpaid non-arm's length supplier for purchase of drug ingredient — Minister not considering effect of Licence Agreement on reasonableness of price paid for ingredient under Supply Agreement — What circumstances are to be taken into account in determining reasonable arm's length price against which to compare non-arm's length transfer price? — Whether Licence Agreement is a circumstance to be taken into account — Whether Federal Court of Appeal erred in remitting matter to Tax Court for rehearing and reconsideration — Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), s. 69(2).

Between 1990 and 1993, the respondent, GlaxoSmithKline Inc. ("Glaxo Canada"), purchased ranitidine, the active pharmaceutical ingredient in the brand name anti-ulcer drug Zantac, from Adechsa S.A., a related non-resident company, for between $1,512 and $1,651 per kilogram. During the same period, two Canadian generic pharmaceutical companies, Apotex Inc. and Novopharm Ltd., purchased ranitidine from other sources for use in their generic anti-ulcer drugs for between $194 and $304 per kilogram from arm's length suppliers.

A Licence Agreement conferred rights and benefits on Glaxo Canada and a Supply Agreement set the transfer prices of ranitidine. The combined effect of the Licence and Supply agreements enabled Glaxo Canada, among other things, to

purchase ranitidine, put it in a delivery mechanism, and market it under the trademark Zantac.

The appellant, the Minister of National Revenue, reassessed Glaxo Canada for the taxation years 1990, 1991, 1992, and 1993, pursuant to the then applicable s. 69(2) of the Act (now s. 247(2)) on the basis that the prices it paid for ranitidine were greater than an amount that would have been reasonable in the circumstances had they been dealing at arm's length. Glaxo Canada appealed to the Tax Court of Canada, where, with one minor revision, the reassessment was upheld on the basis that the Licence and Supply agreements were to be considered independently. The Federal Court of Appeal allowed the appeal and remitted the matter back to the Tax Court for redetermination of the "reasonable amount" payable for Glaxo Canada's ranitidine transactions.

Held: The appeal and cross-appeal should be dismissed.

Section 69(2) requires the court to determine whether the transfer price was greater than the amount that would have been reasonable in the circumstances, had the parties been dealing at arm's length. If transactions other than the purchasing transaction are relevant in determining this question, they must not be ignored. Section 69(2) does not, itself, offer guidance as to how to determine the "reasonable amount" that would have been payable had the parties been dealing at arm's length. The OECD's 1979 *Guidelines* and the OECD's 1995 *Guidelines* are not controlling as

if they were a Canadian statute. However, they suggest a number of methods for determining whether transfer prices are consistent with prices determined between parties dealing at arm's length.

A proper application of the arm's length principle requires that regard be had for the "economically relevant characteristics" of the arm's length and non-arm's length circumstances to ensure they are "sufficiently comparable". 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 and, if required, transactions other than the purchasing transactions must be taken into account.

Such circumstances will include agreements that may confer rights and benefits in addition to the purchase of property where those agreements are linked to the purchasing agreement. The objective is to determine what an arm's length purchaser would pay for the property and the rights and benefits together where the rights and benefits are linked to the price paid for the property. However, transfer pricing is not an exact science and it is highly unlikely that any comparisons will yield identical circumstances and the court will be required to exercise its best informed judgment in establishing a satisfactory arm's length price.

In this case, Glaxo Canada was paying for at least some of the rights and benefits under the Licence Agreement as part of the purchase prices for ranitidine from Adechsa. As such, the Licence Agreement could not be ignored in determining the reasonable amount paid to Adechsa under s. 69(2), which applies not only to payment for goods but also to payment for services. Considering the Licence and Supply Agreements together offers a realistic picture of the profits of Glaxo Canada. The prices paid by Glaxo Canada to Adechsa were a payment for a bundle of at least some rights and benefits under the Licence Agreement and product under the Supply Agreement. The generic comparators used by the Tax Court do not reflect the economic and business reality of Glaxo Canada and, at least without adjustment, do not indicate the price that would be reasonable in the circumstances, had Glaxo Canada and Adechsa been dealing at arm's length. It is only after identifying the circumstances arising from the Licence Agreement that are linked to the Supply Agreement that arm's length comparisons under any of the OECD methods or other methods may be determined.

The assumption that the prices paid by Glaxo Canada for ranitidine were greater than the amount that would have been reasonable in the circumstances had Glaxo Canada and Adechsa been dealing at arm's length has not been demolished. As found by the Federal Court of Appeal, the matter should be remitted to the Tax Court to be redetermined, having regard to the effect of the Licence Agreement on the prices paid by Glaxo Canada for the supply of ranitidine from Adechsa. Whether or

not compensation for intellectual property rights is justified in this particular case is a matter for determination by the Tax Court.

Cases Cited

Distinguished: *Singleton v. Canada*, 2001 SCC 61, [2001] 2 S.C.R. 1046; *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622; **referred to:** *Gabco Ltd. v. Minister of National Revenue* (1968), 68 D.T.C. 5210; *Hickman Motors Ltd. v. Canada*, [1997] 2 S.C.R. 336.

Statutes and Regulations Cited

Act to amend the Income Tax Act and to make certain provisions and alterations in the statute law related to or consequential upon the amendments to that Act, S.C. 1970-71-72, c. 63, s. 1.

Act to amend the Income War Tax Act, S.C. 1939, c. 46, s. 13.

Income Tax Act, R.S.C. 1952, c. 148, ss. 17(3) [rep. 1970-71-72, c. 63, s. 1], 69(2) [ad. *idem*].

Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), ss. 20(1)(*c*)(i), 69(2) [rep. 1998, c. 19, s. 107], 212(1)(*d*), 215(1), 247(2) [ad. *idem*, s. 238].

Income Tax Act, S.C. 1948, c. 52, s. 17(3).

Income Tax Amendments Act, 1997, S.C. 1998, c. 19, ss. 107, 238.

Income War Tax Act, R.S.C. 1927, c. 97, s. 23B [ad. 1939, c. 46, s. 13].

Patent Act Amendment Act, 1992, S.C. 1993, c. 2, s. 11(1).

Authors Cited

Organisation for Economic Co-operation and Development. *Transfer Pricing and Multinational Enterprises: Report of the OECD Committee on Fiscal Affairs*. Paris: The Organisation, 1979.

Organisation for Economic Co-operation and Development. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Paris: The Organisation, 1995.

APPEAL and CROSS-APPEAL from a judgment of the Federal Court of Appeal (Nadon, Layden-Stevenson and Stratas JJ.A.), 2010 FCA 201, 405 N.R. 307, 2010 D.T.C. 5124, [2010] 6 C.T.C. 220, [2010] F.C.J. No. 953 (QL), 2010 CarswellNat 2409, setting aside a decision of Rip A.C.J., 2008 TCC 324, 2008 D.T.C. 3957, [2008] T.C.J. No. 249 (QL), 2008 CarswellNat 1666. Appeal and cross-appeal dismissed.

Wendy Burnham, *Eric Noble* and *Karen Janke-Curliss*, for the appellant/respondent on cross-appeal.

Al Meghji, *Joseph M. Steiner*, *Amanda Heale* and *Pooja Samtani*, for the respondent/appellant on cross-appeal.

The judgment of the Court was delivered by

ROTHSTEIN J. —

I. Introduction

[1] Transfer pricing issues arise when entities of multinational corporations resident in different jurisdictions transfer property or provide services to one another. These entities do not deal at arm's length and, thus, transactions between these entities may not be subject to ordinary market forces. Their absence may result in prices being set so as to divert profits from the appropriate tax jurisdiction. Since 1939, the *Income Tax Act* has included provisions under which a Canadian taxpayer may be reassessed to include, in Canadian profits, the difference between the prices for property paid to a non-resident with which it does not deal at arm's length and what those prices would have been had they been dealing at arm's length.

[2] The Minister of National Revenue reassessed GlaxoSmithKline Inc. ("Glaxo Canada") for the taxation years 1990, 1991, 1992, and 1993, pursuant to the then-applicable s. 69(2) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the "Act"), on the basis that the prices Glaxo Canada paid to a supplier with which it did not deal at arm's length, for ranitidine, the active ingredient in the anti-ulcer drug Zantac, were greater than an amount that would have been reasonable in the circumstances had they been dealing at arm's length. (Section 69(2) of the Act was repealed in 1998 (S.C. 1998, c. 19, s. 107) and has been replaced by s. 247(2) of the Act (ad. *idem*, s. 238)). The reassessment increased Glaxo Canada's income by the difference between the highest price paid by generic pharmaceutical companies and that paid by Glaxo Canada for ranitidine. Glaxo Canada appealed to the Tax Court of

Canada, where Rip A.C.J. (as he then was) upheld, with one minor revision, the reassessment. On Glaxo Canada's further appeal, the Federal Court of Appeal allowed the appeal and remitted the matter to the Tax Court for reconsideration. The Minister has appealed that decision to this Court.

[3] The issue on appeal is the correct application of s. 69(2): in particular, what circumstances are to be taken into account in determining the reasonable arm's length price against which to compare the non-arm's length transfer price. Glaxo Canada cross-appeals the decision of the Federal Court of Appeal to remit the matter to the Tax Court for rehearing and reconsideration. If this Court denies the Minister's appeal, Glaxo Canada argues that the matter should not be remitted because it has successfully demolished the Minister's assumptions, thus fully discharging the taxpayer's burden in appealing the reassessment. For the reasons that follow, I would dismiss both the appeal and the cross-appeal.

II. Facts

[4] Between 1990 and 1993, the respondent, Glaxo Canada, purchased ranitidine, the active pharmaceutical ingredient in the brand-name anti-ulcer drug Zantac, from Adechsa S.A., a related non-resident company, for between $1,512 and $1,651 per kilogram. During the same period, two Canadian generic pharmaceutical companies, Apotex Inc. and Novopharm Ltd., purchased ranitidine from other sources for use in their generic anti-ulcer drugs for between $194 and $304 per kilogram.

[5] At the relevant time Glaxo Canada was a wholly owned subsidiary of Glaxo Group Ltd., which itself was a wholly owned subsidiary of Glaxo Holdings plc, a United Kingdom corporation. In addition to its ownership of Glaxo Canada, Glaxo Group was the parent of other companies, which discovered, developed, manufactured and marketed branded pharmaceutical products. These products were then placed in a delivery mechanism such as a tablet, liquid or gel and marketed and sold throughout the world through subsidiaries such as Glaxo Canada or independent arm's length distributors.

[6] During the taxation years in issue, Glaxo Canada acted as a secondary manufacturer and marketer which meant that it acquired the active pharmaceutical ingredient, ranitidine, and put it into a delivery mechanism and packaged and marketed Zantac, a patented and trademarked drug used to treat stomach ulcers. Glaxo Group owned the Zantac trademark and the patent for its active ingredient, ranitidine, and granted rights under the patent and trademark to Glaxo Canada under a Licence Agreement. Glaxo Canada purchased ranitidine from Adechsa, a Glaxo Group clearing company located in Switzerland, under a Supply Agreement.

[7] At the heart of this appeal are these two agreements. The Licence Agreement conferred the following rights and benefits on Glaxo Canada:

1. the right under the patents to manufacture, use and sell Glaxo Group products (s. 3(1)(a));

2. the exclusive right to the use of the trademarks owned by Glaxo Group, including Zantac (s. 3(1)(b));

3. the right to receive technical assistance for its secondary manufacturing requirements (s. 3(4));

4. the use of the registration materials prepared by Glaxo Group, to be adapted to the Canadian environment and submitted to the Health Protection Branch (s. 4(2));

5. access to new products, including line extensions (s. 4(1));

6. access to any inventions or improvement in regard to existing drugs (s. 6(1));

7. the right to have a Glaxo World Group company sell to the appellant any raw materials or materials in bulk form (s. 7(1));

8. marketing support in the form of promotional material, medical papers and literature, market research data, and any other information that may be useful in the marketing of products (s. 10(1));

9. indemnification against damages arising from patent or trademark infringement actions (s. 13(2));

10. technical assistance for setting up new product lines at Glaxo Canada's manufacturing facilities (s. 4(3));

11. if the original trademark for a new product cannot be registered or if additional trademarks are necessary, Glaxo Group to take the necessary steps (s. 4(4));

12. Glaxo Canada to have an opportunity to sub-license any new third party product obtained by Glaxo Group (s. 5(1));

13. in regard to third party products, Glaxo Group to provide any information pertinent to the approval of the product by the Canada Health Protection Branch (s. 5(2));

14. Glaxo Group to arrange that technical information in regard to third party products will be granted to Glaxo Canada (s. 5(4)).

[8] Under the Supply Agreement, Glaxo Group set the transfer prices of the active ingredient, ranitidine, using the resale-price method as described by Rip A.C.J.:

> Glaxo World used what is referred to as a resale-price method to determine the transfer price of the API [active pharmaceutical ingredient]. Glaxo World and its distributors agreed that a gross margin of 60 percent would be retained by the distributors and the ranitidine was priced accordingly. To use a very simple example, if the ranitidine product was sold for $10 in Italy, the transfer price would be $4; if the

> ranitidine product was sold for $20 in France, the transfer price would be $8. Appellant's counsel described the process as follows:
>
> > the starting point for determining the price to the distributor was the in-market price for the finished ranitidine product;
> >
> > from that in-market price the parties agreed, assuming specified conditions were satisfied, a gross profit margin [to] be retained by the distributor (approximately 60%); and
> >
> > the remainder would be remitted back to Glaxo Group in the form of transfer price, royalties, [or both]. Where the distributor was to pay both transfer prices and royalties, they would be considered together to determine the distributor's gross profit margin after payment of the royalty. [para. 47]
>
> (2008 TCC 325, 2008 D.T.C. 3957)

This method resulted in prices of over $1,500 per kilogram for ranitidine paid by Glaxo Canada to Adechsa. The combined effect of the Licence and Supply agreements enabled Glaxo Canada, among other things, to purchase the active ingredient ranitidine, put it in a delivery mechanism, and market it under the trademark Zantac.

[9] During the taxation years in issue, two Canadian generic pharmaceutical companies, Apotex and Novopharm, sold generic anti-ulcer pharmaceutical products in Canada. These companies purchased ranitidine at lower prices than Glaxo Canada, between $194 and $304 per kilogram, from arm's length suppliers. There was no evidence that the supply contracts of Apotex or Novopharm conferred anything beyond the supply of ranitidine.

[10] These generic companies were able to market generic versions of drugs whose patent was still in effect by reason of the compulsory licensing scheme that existed for pharmaceutical products in Canada up to February 1993 (*Patent Act Amendment Act, 1992*, S.C. 1993, c. 2). This scheme allowed generic versions of patented pharmaceutical products to be marketed and sold in Canada in exchange for a royalty payment to the patent owner. The licences granted to Apotex and Novopharm predated December 20, 1991, and therefore continued to subsist, notwithstanding repeal of the compulsory licensing scheme in February 1993 (ad. *idem*, s. 11(1)).

[11] The Minister reassessed Glaxo Canada for its 1990, 1991, 1992, and 1993 taxation years, increasing its income by some $51 million under s. 69(2) of the Act on the basis that it had paid Adechsa more than a reasonable amount for the purchase of ranitidine.

III. Tax Court of Canada, 2008 TCC 324, 2008 D.T.C. 3957 (Rip A.C.J.)

[12] Rip A.C.J. affirmed the Minister's reassessment. He found that *Singleton v. Canada*, 2001 SCC 61, [2001] 2 S.C.R. 1046, required the Licence and Supply agreements to be considered independently. As a result, he did not consider whether the rights and benefits under the Licence Agreement were a relevant circumstance in determining the appropriate arm's length price for the supply of ranitidine.

[13] Rip A.C.J. employed the comparable uncontrolled price ("CUP") method, referred to in the Organisation for Economic Co-operation and Development ("OECD") *Transfer Pricing and Multinational Enterprises: Report of the OECD Committee on Fiscal Affairs* (1979) (the "1979 *Guidelines*") and the OECD's revised 1995 *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995) (the "1995 *Guidelines*"), to test the reasonableness of Glaxo Canada's ranitidine transactions. He found that the appropriate comparator transaction was the highest price paid by the generic pharmaceutical companies for ranitidine from arm's length suppliers. Under this approach, he found the prices Glaxo Canada paid to Adechsa for ranitidine were greater than the reasonable amount had they been dealing at arm's length. Aside from allowing a $25 per kilogram increment for granulation, he upheld the reassessment of the Minister.

IV. Federal Court of Appeal, 2010 FCA 201, 405 N.R. 307 (Nadon, Layden-Stevenson and Stratas JJ.A.)

[14] Nadon J.A., writing for a unanimous panel, found that the Tax Court had erred in not considering the Licence Agreement when determining whether the prices paid by Glaxo Canada for ranitidine were reasonable under s. 69(2). He said that *Singleton* was not relevant and that the test of "reasonable in the circumstances" included all circumstances that an arm's length purchaser would have to consider. Based on *Gabco Ltd. v. Minister of National Revenue* (1968), 68 D.T.C. 5210 (Ex. Ct.), Nadon J.A. adopted the "reasonable business person" test, which required an

inquiry into the circumstances that an arm's length purchaser would consider relevant when deciding what price to pay (para. 69). He found that Rip A.C.J. had erred when he assessed the "fair market value" of ranitidine based on the amounts paid by the generic pharmaceutical companies to arm's length suppliers.

[15] Having determined that *Singleton* did not preclude looking at both the Supply and Licence agreements and applying the "reasonable business person" test, Justice Nadon found that the Licence Agreement was central to Glaxo Canada's business reality, and that it would be so even if the relationship with Adechsa was at arm's length. Therefore, it was a "circumstance" that had to be taken into account when determining whether the prices paid by Glaxo Canada for ranitidine were reasonable. In his view, the Tax Court erred in using the purchase prices of ranitidine of the generic pharmaceutical companies to determine whether the Glaxo Canada prices were reasonable, as the Licence Agreement created fundamentally different circumstances for Glaxo Canada's transactions.

[16] However, Nadon J.A. found that the burden on the taxpayer had not been fully discharged as the "reasonable amount" remained to be determined for Glaxo Canada's ranitidine transactions. He remitted the matter to the Tax Court for redetermination.

V. Analysis

A. *Transfer Pricing in the Income Tax Act*

[17] The first transfer pricing provision in the Canadian *Income Tax Act* was enacted as s. 23B of the *Income War Tax Act*, R.S.C. 1927, c. 97, by *An Act to amend the Income War Tax Act*, S.C. 1939, c. 46, s. 13. The provision was re-enacted as s. 17(3) of *The Income Tax Act*, S.C. 1948, c. 52, and again as s. 17(3) of the *Income Tax Act*, R.S.C. 1952, c. 148. Section 17(3) of the 1952 Act is almost identical to s. 69(2) first enacted in 1971 (S.C. 1970-71-72, c. 63, s. 1), with immaterial modifications in 1985 (R.S.C. 1985, c. 1 (5th Supp.)).

[18] The 1985 version of s. 69(2) applicable to the years 1990-1993 reads:

> (2) Where a taxpayer has paid or agreed to pay to a non-resident person with whom the taxpayer was not dealing at arm's length as price, rental, royalty or other payment for or for the use or reproduction of any property, or as consideration for the carriage of goods or passengers or for other services, an amount greater than the amount (in this subsection referred to as "the reasonable amount") that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, the reasonable amount shall, for the purpose of computing the taxpayer's income under this Part, be deemed to have been the amount that was paid or is payable therefor.

[19] On the facts of this case, the section asks whether the prices Glaxo Canada paid Adechsa for ranitidine were greater than what would have been reasonable if Adechsa and Glaxo Canada had been dealing at arm's length. The challenge is to find an arm's length proxy that replicates the circumstances of Glaxo Canada as closely as possible in respect of its acquisition of ranitidine.

B. *The OECD Methods of Determining Reasonable Transfer Prices*

[20] In the courts below and in this Court, there has been reference to the 1979 *Guidelines* and the 1995 *Guidelines* (the "*Guidelines*"). The *Guidelines* contain commentary and methodology pertaining to the issue of transfer pricing. However, the *Guidelines* are not controlling as if they were a Canadian statute and the test of any set of transactions or prices ultimately must be determined according to s. 69(2) rather than any particular methodology or commentary set out in the *Guidelines*.

[21] Section 69(2) does not, itself, offer guidance as to how to determine the "reasonable amount" that would have been payable had the parties been dealing at arm's length. However, the *Guidelines* suggest a number of methods for determining whether transfer prices are consistent with prices determined between parties dealing at arm's length.

[22] In the Tax Court, the parties relied on four methods from the *Guidelines* to assess the reasonableness of the prices Glaxo Canada paid Adechsa. The Minister relied on the CUP method and the cost plus method (see 1979 *Guidelines*, at paras. 48 and 63). The CUP method compares the prices in comparable transactions between parties dealing at arm's length with the transfer prices paid by the taxpayer being reassessed. The *Guidelines* say this is the most direct way of determining the arm's length price. This is the method under which the Minister compared the Glaxo Canada transfer prices with the prices paid by Apotex and Novopharm.

[23] However, the 1995 *Guidelines* also say that the arm's length transactions must be carefully considered for comparability with the transfer price transactions. Transactions are only comparable if:

1. None of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or

2. Reasonably accurate adjustments can be made to eliminate the material effects of such differences. (See 1995 *Guidelines*, at para. 1.15.)

[24] The cost plus method is based upon the foreign suppliers' costs, plus an appropriate mark-up. However, the 1979 *Guidelines* say that the method "raise[d] problems both as regards assessing costs . . . and the appropriate mark-up for profit" (para. 63). They suggest its usefulness may be as a means of verifying prices after other methods have been applied. The Minister used the cost plus method to verify the arm's length prices he determined under the CUP method.

[25] Glaxo Canada relied on the resale price, the transactional net margin and the CUP methods, using a set of European comparators. As described above, the resale-price method starts with the price charged by the reseller (Glaxo Canada) in the market for the product (Zantac). The price is then reduced by the proportion representing the reseller's cost and appropriate profit, i.e. the reseller's gross profit

margin. The balance is the transfer price for the product purchased from the related non-resident supplier (Adechsa). This gross profit margin is then compared to the gross profit margin earned by independent arm's length resellers. The 1979 *Guidelines* observe that this method is the most useful when applied to marketing operations. Glaxo Canada compared its gross profit margin with those of independent European distributors of Zantac.

[26] The transactional net margin method looks at the net profit relative to a base such as costs, sales or assets in a controlled transaction as compared to the net profit ratio earned by the same taxpayer in comparable uncontrolled transactions. If this is not possible, consideration may be given to the net profit relative to costs, sales or assets of an independent enterprise, provided the circumstances are comparable and adjustments may be made to obtain reliable results.

[27] Glaxo Canada's CUP approach utilized the prices paid by European independent distributors of Zantac which Glaxo Canada submitted approximated the prices paid by Glaxo Canada to Adechsa.

C. *The Transactional Approach Adopted by the Tax Court*

[28] Rip A.C.J. rejected Glaxo Canada's evidence and submissions. Utilizing the CUP method, Rip A.C.J. compared the prices paid by Glaxo Canada with those paid by the Canadian generic companies for ranitidine and found that the highest

generic prices paid were in the range of $300 per kilogram, while Glaxo Canada was paying over $1,500 per kilogram.

[29] Glaxo Canada had argued that the comparison with generic companies was inappropriate. It said that the Licence Agreement must be taken into account, as it conferred certain rights and benefits related to the purpose for which its ranitidine was purchased.

[30] However, Rip A.C.J. found that *Singleton* precluded him from considering the Licence Agreement. Absent the Licence Agreement, the prices paid under the Supply Agreement had to be considered as being only for ranitidine. There could thus be no compensation for other rights or benefits under the Supply Agreement. Because the prices paid by Glaxo Canada and the generic companies were both solely for ranitidine, there were no differences between the transactions that might justify higher transfer prices than the prices paid by Apotex and Novopharm (aside from a $25 per kilogram charge for granulation that Glaxo Canada was allowed).

[31] The question before Rip A.C.J. was the determination of the reasonable price under s. 69(2). Critical to that determination was whether the Licence Agreement was a circumstance to be taken into account.

[32] The Minister argues that this Court's decisions in *Singleton* and *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622, along with the *Guidelines*, require a transactional, sometimes called a transaction-by-transaction, approach when determining the reasonable transfer price under s. 69(2). In the Tax Court, the Minister explained that the transaction-by-transaction approach is one in which the transaction in issue must be considered independently from surrounding circumstances, other transactions, or other realities. In this Court, the Minister submitted that "each transfer is to be treated as a separate transaction" (A.F., at para. 46). Accordingly, the Licence Agreement would be irrelevant.

(1) *Singleton*

[33] The Minister submits that *Singleton* and *Shell*, decided under s. 20(1)(*c*)(i) of the Act, are authority for the proposition that a transaction-by-transaction approach must be followed under s. 69(2). *Singleton* involved the deductibility from income of interest paid and payable on borrowed money under s. 20(1)(*c*)(i), of the *Income Tax Act*. In *Singleton*, the taxpayer used funds from his capital account at his law firm to assist in financing the purchase of a home. He then used borrowed funds to replace the funds he was withdrawing from his capital account. The sole issue was whether borrowed money was "used for the purpose of earning income". This Court found that the borrowed funds were used to invest in the law firm for the purpose of earning income and, therefore, the interest payable thereon was deductible for income tax purposes. The fact that the borrowing

occurred because the taxpayer wanted to use his equity in the firm to buy a house was irrelevant for determining the use of the borrowed funds. For purposes of s. 20(1)(*c*)(i), it would be wrong to collapse the transaction withdrawing funds from the firm to purchase the house and the borrowing transaction to replenish the capital account at the firm. It was the requirement to treat the two transactions separately that caused Rip A.C.J., at para. 78, to say that s. 69(2) required the Supply and Licence agreements to be treated separately.

[34] With respect, the approach of the Tax Court judge and the argument of the Minister ignore the difference between s. 20(1)(*c*)(i) and s. 69(2). Nothing in s. 20(1)(*c*)(i) entitles a court to search for anything other than the use to which the borrowed funds are put. The factual determination is simply whether the use of borrowed funds was for the purpose of earning income.

[35] Section 20(1)(*c*)(i) does not ask whether it is unreasonable to claim the interest deduction; nor does it require a comparison of transactions to determine if the deduction is reasonable. By contrast, s. 69(2) requires the court to determine whether the transfer price was greater than the amount that would have been reasonable in the circumstances, had the parties been dealing at arm's length. If transactions other than the purchasing transaction are relevant in determining this question, they must not be ignored.

(2) *Shell*

[36] The issue in *Shell* similarly involved s. 20(1)(*c*)(i). Again the issue involved whether borrowed funds were used for the purpose of earning income. In *Shell*, the taxpayer had entered into an agreement to borrow $150 million in New Zealand currency at an interest rate of 15.4 percent. The taxpayer converted these funds into U.S. currency, which was then used for business purposes. Through a series of foreign currency transactions relating to the devaluation of the New Zealand currency over the course of the loan, Shell was able to reduce its effective rate of interest to 9.1 percent, while still claiming an income tax deduction based on the 15.4 percent interest rate on the initial transaction.

[37] The issue in *Shell*, as in *Singleton*, turned on whether the borrowed funds, once converted into U.S. currency, could properly be considered to be used for the purpose of earning income. The Court found that it was irrelevant that the funds had been converted into U.S. currency as part of a sophisticated tax scheme. The Minister was not entitled to re-characterize the taxpayer's *bona fide* legal relationships.

[38] This differs significantly from s. 69(2). The requirement of s. 69(2) is that the price established in a non-arm's length transfer pricing transaction is to be redetermined as if it were between parties dealing at arm's length. If the circumstances require, transactions other than the purchasing transactions must be taken into account to determine whether the actual price was or was not greater than the amount that would have been reasonable had the parties been dealing at arm's length. *Shell* is therefore also inapplicable to a determination under s. 69(2).

(3) *Guidelines* Do Not Require a Transaction-by-Transaction Approach

[39] The Minister also relied on para. 1.42 of the 1995 *Guidelines* to justify the transaction-by-transaction requirement. Paragraph 1.42 provides:

> Ideally, in order to arrive at the most precise approximation of fair market value, the arm's length principle should be applied on a transaction-by-transaction basis.

The Minister submits that para. 1.42 requires the court to focus only on the particular transaction at issue and, thus, does not permit the Licence Agreement to inform the determination of the reasonableness of the prices paid for ranitidine under the Supply Agreement.

[40] However, para. 1.42 is not as restrictive as the Minister submits. It also provides:

> . . . there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis.

Thus, while a transaction-by-transaction approach may be ideal, the 1995 *Guidelines* themselves recognize that it is not appropriate in all cases.

[41] Further, the general statement in the 1995 *Guidelines* regarding the arm's length principle at para. 1.15 also provides guidance as to when related transactions should be taken into account:

> Application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. [Emphasis added.]

[42] Thus, according to the 1995 *Guidelines*, a proper application of the arm's length principle requires that regard be had for the "economically relevant characteristics" of the arm's length and non-arm's length circumstances to ensure they are "sufficiently comparable". 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.

D. *The Licence Agreement Is Relevant in the Circumstances*

[43] For the above reasons, in my respectful opinion, Rip A.C.J. was in error when he found that he was precluded from considering the Licence Agreement. Nonetheless, while consideration of the Licence Agreement was not precluded, the question still remains as to whether he should have considered it.

[44] Because s. 69(2) requires an inquiry into the price that would be reasonable in the circumstances had the non-resident supplier and the Canadian taxpayer been dealing at arm's length, it necessarily involves consideration of all the circumstances of the Canadian taxpayer relevant to the price paid to the non-resident supplier. Such circumstances will include agreements that may confer rights and benefits in addition to the purchase of property where those agreements are linked to the purchasing agreement. The objective is to determine what an arm's length purchaser would pay for the property and the rights and benefits together where the rights and benefits are linked to the price paid for the property.

[45] The business of Glaxo Canada was the secondary manufacturing and marketing of brand-name pharmaceuticals, including Zantac. Glaxo Canada also engaged in research and development although there is no indication that its research and development work pertained to Zantac. Glaxo Canada's purchase of ranitidine must be understood, having regard to this business reality.

[46] Rip A.C.J. found, at para. 86, that "it was by virtue of the Licence Agreement that the appellant was required to purchase its ranitidine from Glaxo approved sources". The parties have not disputed this finding.

[47] There were only two approved sources, one of which was Adechsa. Thus, in order to avail itself of the benefits of the Licence Agreement, Glaxo Canada was required to purchase the active ingredient from one of these sources. This requirement was not the product of the non-arm's length relationship between Glaxo Canada and Glaxo Group or Adechsa. Rather, it arose because Glaxo Group controlled the trademark and patent of the brand-name pharmaceutical product Glaxo Canada wished to market. An arm's length distributor wishing to market Zantac might well be faced with the same requirement.

[48] The effect of the link between the Licence and Supply agreements was that 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.

[49] As such, the rights and benefits of the Licence Agreement were contingent on Glaxo Canada entering into a Supply Agreement with suppliers to be designated by Glaxo Group. The result of the price paid was to allocate to Glaxo Canada what Glaxo Group considered to be appropriate compensation for its secondary manufacturing and marketing function in respect of ranitidine and Zantac.

[50] Rip A.C.J. appears to have been concerned that a multinational organization, by requiring a Canadian subsidiary to acquire a product from a specified supplier, would escape the requirement to have its prices measured against arm's length prices (para. 89). However, whatever price was determined by Glaxo Group would be subject to s. 69(2) and the requirement that the transfer pricing transactions be measured against transactions between parties dealing with each other at arm's length.

[51] Thus, it appears that Glaxo Canada was paying for at least some of the rights and benefits under the Licence Agreement as part of the purchase prices for ranitidine from Adechsa. Because the prices paid to Adechsa were set, in part, as compensation to Glaxo Group for the rights and benefits conferred on Glaxo Canada under the Licence Agreement, the Licence Agreement could not be ignored in determining the reasonable amount paid to Adechsa under s. 69(2), which applies not only to payment for goods but also to payment for services.

[52] Considering the Licence and Supply agreements together offers a realistic picture of the profits of Glaxo Canada. It cannot be irrelevant that Glaxo Canada's function was primarily as a secondary manufacturer and marketer. It did not originate new products and the intellectual property rights associated with them. Nor did it undertake the investment and risk involved with originating new products. Nor did it have the other risks and investment costs which Glaxo Group undertook under the Licence Agreement. The prices paid by Glaxo Canada to Adechsa were a payment

for a bundle of at least some rights and benefits under the Licence Agreement and product under the Supply Agreement.

[53] I agree with the Federal Court of Appeal that Rip A.C.J. erred in refusing to take account of the Licence Agreement. It was that refusal which led him to find that the prices the generic pharmaceutical companies paid for ranitidine were comparable under the CUP method. However, the generic comparators do not reflect the economic and business reality of Glaxo Canada and, at least without adjustment, do not indicate the price that would be reasonable in the circumstances, had Glaxo Canada and Adechsa been dealing at arm's length.

[54] I agree with Justice Nadon that "the amount that would have been reasonable in the circumstances" if Glaxo Canada and Adechsa had been dealing at arm's length has yet to be determined (para. 79). This will require a close examination of the terms of the Licence Agreement and the rights and benefits granted to Glaxo Canada under that Agreement.

[55] However, with respect to royalties, I would observe that the Licence Agreement expressly provides under clause 11(1)(b):

> (ii) in the event that GLAXO CANADA purchases raw materials or bulk or finished Product from GROUP or an Associate it is the parties' express intention that no royalties be payable by GLAXO CANADA on the importation of such raw materials or bulk or finished Product but only on GLAXO CANADA's Net Sales of Product in the Territory;

(iii) GLAXO CANADA shall not be required to pay any royalty or license fee as a condition of the sale by GROUP or its Associates to GLAXO CANADA of merchandise for export to the Territory and such merchandise shall be priced in accordance with a separate agreement between the parties without regard to royalties payable hereunder [as contemplated in sub-clause 7(1) hereof]

(iv) no royalty shall be payable by GLAXO CANADA on its manufacture or use of the Products but only on its sales of the Products; [Text in brackets in original.]

[56] Glaxo Canada's pleadings in the Tax Court did not rely on s. 212(1)(*d*) or s. 215(1) of the Act, which provide for tax payable by non-residents on royalties or similar payments for the right to use any patent or trademark in Canada and for withholding tax on behalf of the non-resident. There is no evidence that Glaxo Canada withheld any amounts of the prices it paid to Adechsa in respect of royalties for the use or the right to use the ranitidine patent or Zantac trademark.

[57] Although I said above that the purchase price appeared to be linked to some of the rights and benefits conferred under the Licence Agreement, I make no determination in these reasons as to whether the rights under the ranitidine patent granted to Glaxo Canada to manufacture and sell Zantac and the exclusive right to use the Zantac trademark are linked to the purchase price paid by Glaxo Canada to Adechsa. However, arguably, if the purchase price includes compensation for intellectual property rights granted to Glaxo Canada, there would have to be consistency between that and Glaxo Canada's position with respect to Part XIII withholding tax. This issue was not specifically argued in this Court and may be addressed by the parties in the Tax Court and considered by the Tax Court judge

when considering whether any specific rights and benefits conferred on Glaxo Canada under the Licence Agreement are linked to the price for ranitidine paid to Adechsa.

[58] In any event, there are rights and benefits under the Licence Agreement referred to in para. 7 above, other than the patent and trademark rights granted to Glaxo Canada. For example, guaranteed access to new products, the right to the supply of raw materials and materials in bulk, marketing support, and technical assistance for setting up new product lines all appear to have some value.

[59] In addition, while, as Rip A.C.J. found, Glaxo Canada's ranitidine and generic ranitidine are chemically equivalent and bio-equivalent, he also found that there was value in the fact that Adechsa's ranitidine manufactured under Glaxo Group's "good manufacturing practices" "may confer a certain degree of comfort that the good has minimal impurities and is manufactured in a responsible manner" (para. 118). Zantac is priced higher than the generic products, presumably, at least in part, because of that "degree of comfort" that Rip A.C.J. acknowledged.

[60] These are all features of the Licence Agreement and the requirement to purchase from a Glaxo-approved source that add value to the ranitidine that Glaxo Canada purchased from Adechsa over and above the value of generic ranitidine without these rights and benefits. They should justify some recognition in determining what an arm's length purchaser would be prepared to pay for the same

rights and benefits conveyed with ranitidine purchased from a Glaxo Group source. It is only after identifying the circumstances arising from the Licence Agreement that are linked to the Supply Agreement that arm's length comparisons under any of the OECD methods or other methods may be determined.

[61] I would offer the following additional guidance with respect to the redetermination. First, s. 69(2) uses the term "reasonable amount". This reflects the fact that, to use the words of the 1995 *Guidelines*, "transfer pricing is not an exact science" (para. 1.45). It is doubtful that comparators will be identical in all material respects in almost any case. Therefore, some leeway must be allowed in the determination of the reasonable amount. As long as a transfer price is within what the court determines is a reasonable range, the requirements of the section should be satisfied. If it is not, the court might select a point within a range it considers reasonable in the circumstances based on an average, median, mode, or other appropriate statistical measure, having regard to the evidence that the court found to be relevant. I repeat for emphasis that it is highly unlikely that any comparisons will yield identical circumstances and the Tax Court judge will be required to exercise his best informed judgment in establishing a satisfactory arm's length price.

[62] Second, while assessment of the evidence is a matter for the trial judge, I would observe that the respective roles and functions of Glaxo Canada and the Glaxo Group should be kept in mind. 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. As discussed above, whether or not compensation for intellectual property rights is justified in this particular case is a matter for determination by the Tax Court judge.

[63] Third, prices between parties dealing at arm's length will be established having regard to the independent interests of each party to the transaction. That means that the interests of Glaxo Group and Glaxo Canada must both be considered. An appropriate determination under the arm's length test of s. 69(2) should reflect these realities.

[64] Fourth, in this case, there is some evidence that indicates that arm's length distributors have found it in their interest to acquire ranitidine from a Glaxo Group supplier, rather than from generic sources. This suggests that higher-than-generic transfer prices are justified and are not necessarily greater than a reasonable amount under s. 69(2).

[65] I would dismiss the appeal, and for the reasons below, dismiss the cross-appeal and remit the matter to Rip A.C.J. (now Chief Justice) for redetermination.

VI. Cross-Appeal

[66] Glaxo Canada cross-appeals, arguing that the decision of the Federal Court of Appeal to remit the matter to the Tax Court for redetermination should be overturned. It asks this Court to set aside the reassessment on the basis that it has satisfied its burden as a taxpayer because it has "demolished" the assumptions of the Minister.

[67] The Federal Court of Appeal remitted the matter to the Tax Court on the basis that Glaxo Canada had not discharged its burden of demonstrating that the prices it paid Adechsa for ranitidine were reasonable under s. 69(2):

> As a result, I conclude that the Judge erred in law in failing to apply the proper test in determining "the amount that would have been reasonable in the circumstances" if the appellant and Adechsa had been dealing at arm's length. Counsel for the appellant argued that in the event that we agreed with him that the Judge erred in not considering the License Agreement, we should then determine "the reasonable amount". In my view, that determination ought to be made by the Judge, who heard the parties for well over forty days, and not by this Court. [para. 82]

The Federal Court of Appeal declined to make such a determination on the basis that it could not properly assess the adequacy of the record on this point and remitted the matter to the Tax Court judge to consider whether a decision can be made on the basis of the existing record or whether additional evidence is necessary.

[68] Glaxo Canada argues that the choice of the generic comparator transactions by the Minister constitutes the basis of the Minister's assessment. Therefore, the burden on Glaxo Canada was only to demonstrate that the transactions

of the generic pharmaceutical companies were not the proper comparator. In Glaxo Canada's view, such a finding would demolish the basis of the assessment, thus, discharging its burden.

[69] The Minister argues that the basis of the assessment was the determination that the prices Glaxo Canada paid for ranitidine were not reasonable. The selection of the generic comparators was only a means which the Minister had chosen to demonstrate the unreasonableness.

[70] The basis of the assessment is found in the assumptions in the Minister's Amended Reply to Glaxo Canada's Amended Notice of Appeal. Assumptions 14p) and r.A) provide:

> p) the Appellant paid Adechsa, with whom it was not dealing at arm's length, a price for ranitidine which was greater than the amount that would have been reasonable in the circumstances if the Appellant and Adechsa had been dealing at arm's length;
>
> r.A) any amounts paid by the appellant to Adechsa over and above the prices paid by other Canadian pharmaceutical companies (as detailed in Schedule A attached) were not for the supply of ranitidine;

[71] Glaxo Canada argues, in effect, that only assumption 14r.A) constitutes the basis of the assessment and that it has demolished that assumption. The Minister argues that the basis of the assessment is assumption 14p). The text of the assumptions supports the position of the Minister. Here assumption 14p) sets out the statutory basis for the reassessment, placing the reassessment squarely under s. 69(2).

The taxpayer's liability is governed by the Act and the Minister's authority to reassess arises from invoking a particular provision or provisions of the Act.

[72] In *Hickman Motors Ltd. v. Canada*, [1997] 2 S.C.R. 336, Justice L'Heureux-Dubé states that the taxpayer's burden is to "'demolish' the exact assumptions made by the Minister but no more" (para. 92 (emphasis deleted)). Here, it is safe to say that assumption 14r.A) by the Minister of the prices paid by Apotex and Novopharm as CUP transactions, without adjustments, was indeed demolished. However, assumption 14p) was not.

[73] Indeed, at the Tax Court, Glaxo Canada sought to establish the reasonableness of the prices it paid, though its evidence and argument were not accepted by the Tax Court judge. In other words, it accepted the burden of demonstrating that the prices it paid were reasonable within the meaning of s. 69(2). Had it been successful in establishing that the prices it paid were reasonable, assumption 14p) as well as 14r.A), would have been demolished.

[74] As it stands, the assumption that the prices paid by Glaxo Canada for ranitidine were greater than the amount that would have been reasonable in the circumstances, had Glaxo Canada and Adechsa been dealing at arm's length, has not been demolished. Therefore, assumption 14p) remains standing.

[75] At the Federal Court of Appeal, Glaxo Canada argued that that court could determine "the reasonable amount". If the Federal Court of Appeal could determine the reasonable amount, I cannot see why it could not remit the matter to the Tax Court for that very determination.

[76] Like the Federal Court of Appeal, I would remit the matter to the Tax Court to be redetermined, having regard to the effect of the Licence Agreement on the prices paid by Glaxo Canada for the supply of ranitidine from Adechsa. The Tax Court judge should consider any new evidence the parties seek to adduce and that he may choose to allow.

VII. Conclusion

[77] I would dismiss the appeal with costs throughout; dismiss the cross-appeal with costs in this Court and remit the matter to the Tax Court for redetermination.

Appeal and cross-appeal dismissed with costs.

Solicitor for the appellant/respondent on cross-appeal: Attorney General of Canada, Ottawa.

Solicitors for the respondent/appellant on cross-appeal: Osler, Hoskin & Harcourt, Toronto.