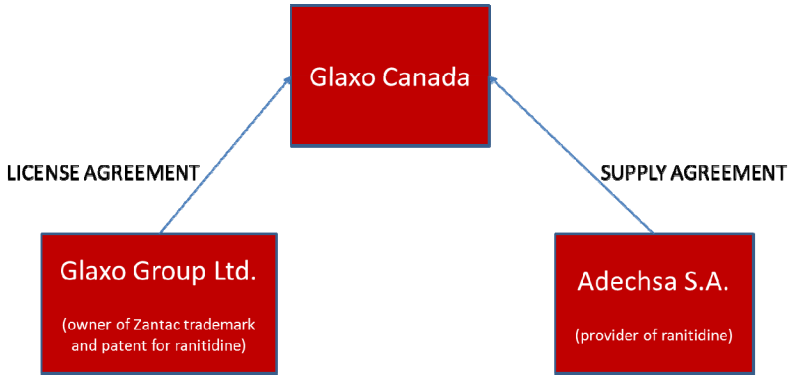
EMG Summary of GlaxoSmithKline
Canada's Never-Ending Transfer Pricing Dispute

Between 1990 and 1993, GlaxoSmithKline Inc. ("Glaxo Canada") purchased ranitidine, the active pharmaceutical ingredient in the brand name anti-ulcer blockbuster 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. ("Apotex") and Novopharm Ltd. ("Novopharm") 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.

Glaxo Canada paid a 6% royalty on net sales of Zantac, as well as other drugs, in the Canadian market through a license agreement (the "License Agreement'). The License Agreement granted Glaxo Canada the right to manufacture, use and sell the listed products, and the right to use the trademarks owned by the Glaxo Group, including Zantac. The License Agreement enable Glaxo Canada to purchase ranitidine through a supply agreement (the "Supply Agreement") with Adechsa.



Round One: ***The Canada Revenue Agency ("CRA") Throws the First Punch.***

Glaxo Canada's 1990 to 1993 fiscal years were audited by the CRA and reassessed in 1996 for the difference between the price paid for ranitidine from Adescha to what Apotex and Novopharm paid to an arm's length supplier. The total reassessment was for $51 million. The CRA was of the view that the License Agreement and the Supply Agreement were to be tested on a "transaction-by-transaction" approach. That is, there was no adjustment or reassessment based on the License Agreement transaction, but solely on the price of the ranitidine through the Supply Agreement.

Glaxo Canada was reassessed under section 69(2)[1] of Canada's Income Tax Act ("ITA") based on the Minister of National Revenue's ("MNR") assumption that the purchase price paid by Glaxo Canada was greater than an amount that "*would have been reasonable in the circumstances*" if the parties had "*been dealing at arm's length*."

In 1998, Glaxo Canada appealed to the Tax Court of Canada ("TCC").

Round Two: ***Glaxo Canada Takes a Few Hits in Round Two.***

Approximately 10 years later, the TCC judgment was released on May 30, 2008. The TCC found for the Crown that Glaxo Canada had overpaid Adechsa for ranitidine. The judge did allow a minor increment of $25 per kilogram for differences in the processing of the ranitidine.

The TCC used the Comparable Uncontrolled Price ("CUP") method using the generic purchase price of ranitidine as the comparable. The TCC decision was on the basis that the Supply Agreement is the sole issue for the price of the ranitidine. The License Agreement was not considered as per the TCC judgment that "*one must look at the transaction in issue and not the surrounding circumstances, other transactions or other realities*".

What Transfer Pricing Method was Being Followed by Glaxo?

The transfer pricing method followed by Glaxo for ranitidine was the resale-price method. Specifically, the worldwide Glaxo distributors followed a policy where they generated a 60% gross margin. As described in the TCC decision, the process to determine the transfer pricing process is 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.*

[1] The comparable section of the ITA today would be found in section 247(2).

The resale-price method tied the License Agreement together with the Supply Agreement in the application of the transfer pricing method. That is, the transfer pricing method applied targeted a 60% gross margin that included the 6% royalty paid through the License Agreement. The TCC relied on the jurisprudence of Singleton v. Canada[2] on using the CUP method on the transaction-by-transaction approach. However, there were key business circumstances of the CUP that, as a result of the transaction-by-transaction approach, did not receive consideration in the judgment.

Key Business Circumstances of the CUP Used by the MNR:

- The product sold by the generic pharmaceutical companies did not use the Zantac trademark. Glaxo had the exclusive license for the Zantac trademark through the License Agreement. The Zantac branded product commanded a significant price premium compared to the generic product sold by Apotex and Novopharm;
- Through the License Agreement, Glaxo Canada was precluded from purchasing ranitidine from sources other than approved sources in order to use the Zantac brand; and
- Apotex and Novopharm were granted a license to sell generic versions of patented pharmaceutical products in exchange for a royalty payment to the patent owner. Apotex and Novopharm received this license during the historic period of the compulsory licensing scheme that existed for pharmaceutical products in Canada.

The TCC decision was unexpected in the transfer pricing community. This decision provided a strong reason for taxpayers to avoid the TCC and to proceed directly to competent authority. The lack of consideration to the business realities defied some degree of common sense in an already inexact science we know as transfer pricing. Fortunately, these business realities played a stronger role at the Federal Court of Appeal ("FCA").

Round Three: *Glaxo Canada Gets their First Win.*

The FCA released their judgment on July 26, 2010 and found the TCC had erred in the interpretation of "*reasonable in the circumstances*". The FCA found the application of Singleton for transfer pricing purposes to pursue a transaction-by-transaction approach was not appropriate.

[2] 2001 SCC 61

The FCA listed circumstances relating to the License Agreement to be considered in determining the transfer price of ranitidine purchased by Glaxo Canada. This included:

- Zantac commanded a premium over the generic ranitidine drugs;
- Glaxo Canada did not own the Zantac trademark or the ranitidine patent;
- Glaxo Canada is not positioned to compete in the generic market – a market which has different marketing, distribution and relationship structures; and
- Without the License Agreement, Glaxo Canada would not have had access to patented products and trademarks that included ranitidine and Zantac.

According to the FCA, to make a finding without considering the circumstances which were the business realities of Glaxo Canada was tantamount to making a determination in a fictitious business world. The FCA found that the TCC should have taken both the License Agreement and the Supply Agreement into consideration in coming to a decision. The FCA did not make any finding as to the proper transfer price but instead referred the matter back to the TCC for rehearing and reconsideration of the ultimate transfer price, having regard to the guidance which the FCA has put forth.

The Supreme Court of Canada ('SCC') granted both an appeal to the Crown as well as Glaxo Canada's application to cross-appeal. This is the first transfer pricing case decided by the SCC.

Round Four: ***Still No Knock-Out in Sight. But the MNR Took Some Strong Blows.***

The SCC released the decision on October 18, 2012. The SCC denied the appeal from the MNR and denied the cross appeal from Glaxo Canada. There was no final resolution and the SCC sent the parties back to the TCC and is allowing for new evidence to be provided.

The SCC provided constructive guidance that provided greater certainty on certain Canadian transfer pricing issues, and will be of benefit to Glaxo Canada in future rounds of this dispute. However, there is some expectation that Glaxo Canada and the MNR may settle at this juncture. The constructive guidance included:

- Business and economic factors that an arm's length party would consider in determining a transaction price are also to be considered by non-arm's length parties in determining a transaction price. The SCC rejected the MNR position of viewing one transaction in isolation without considering business factors such as a license agreement that provided Glaxo rights to the product in question;

- There should be no adjustment to a transfer price when it falls within a reasonable range. If the price is not in a reasonable range, then some point in the range should be selected based on the specific factors of that transaction. This point may be a statistical measure such as the average, median, or other; and
- The scope of the parties' functions and their risks should be consistent with the transfer pricing policy. In the case of Glaxo, the position of the MNR would result in an increase of income to Glaxo Canada of $51 million. Glaxo Canada has the scope and responsibility of a secondary manufacturer and marketer. Glaxo Group Ltd. has the scope and responsibility of the owner of the intellectual property and also provides other benefits to Glaxo Canada.

What Functions do a Secondary Manufacturer and Marketer Perform?

In the case of Glaxo Canada, they acquire the ranitidine as the active raw ingredient and combine it with other ingredients to form pills. These pills are then marketed and sold under the brand name Zantac. Glaxo Canada's functions are considered to be routine as they do not own the patent for ranitidine nor the trademark associated with Zantac.

The Importance of Garbo Ltd. v. MNR and Singleton v. Canada

The MNR positioned their transaction-by-transaction basis, of which they were successful in the TCC, based on the Singleton jurisprudence. Singleton involved the deductibility from income of interest paid and payable on borrowed money. This was tested under a different section of the Income Tax Act than that of transfer pricing. The test for Singleton was to address only information to determine that the use of the borrowed funds is for the purpose of earning income. In the case of Singleton, another transaction was excluded from this test.

This jurisprudence broke down in the FCA and SCC on the basis that the transfer pricing section of the ITA has a very different factual determination. This determination is 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. Garbo jurisprudence provided a test to apply in the FCA. The FCA determined the test was to consider the circumstances which an arm's-length purchaser would consider relevant in deciding whether it should pay the price for ranitidine. One important circumstance that was not included in the TCC was the issue if the arm's length purchaser of ranitidine could sell the pill form under the band Zantac that commands a market premium price. This circumstance was then again emphasized by the SCC as a circumstance that must be taken under consideration.

Shell Canada Ltd. v. Canada[3] was also referenced with Singleton for similar test to perform a transaction-by-transaction approach. The SCC specifically confirmed and refused this interpretation for a transaction-by-transaction approach for transfer pricing purposes.

Glaxo Canada's Withholding Tax Puzzle

The MNR lost on their key position that the License Agreement for Zantac and the Supply Agreement of the raw ingredient ranitidine can be tested and priced separately, the "transaction-by-transaction" position. The SCC's rationale for rejecting the MNR position is based on their understanding that the Supply Agreement included a bundle of certain rights and benefits above that granted to Glaxo Canada from the License Agreement. That is, the purchase price of ranitidine is for both the tangible product as well as intangibles. This is where the withholding tax issue now arises. The intangible portion of the purchase price typically is associated to be a royalty that has Part XIII withholding tax implications. The SCC simply raised this issue. Because of their loss of their key position, it would be safe to assume this withholding tax exposure for Glaxo-Canada will not be out-of-mind for the MNR.

Denial of Cross Appeal:

The SCC found that Glaxo Canada had not "demolished" all of the assumptions underlying the assessment. The rationale for cross-appeal denial by the SCC is essentially taxpayers cannot simply say the CRA's position is wrong but must provide evidence and support that their transfer prices meet the arm's-length principle.

And finally, in paragraph 61 the SCC did quote the OECD guidelines that "*transfer pricing is not an exact science*". Of all the lessons learned by Glaxo Canada to date, this paragraph may very well be the most referenced in the future.

[3] [1999] 3 S.C.R. 622