



CFO Briefing

Transfer Pricing Still Causes Indigestion

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The recent Tax Court of Canada decision in GlaxoSmithKline Inc. (Glaxo) is important for Canadian transfer pricing even though the case is currently under appeal with the Federal Court of Appeal.

Introduction

Transfer pricing is a critical issue for many international companies that share products, services and intangibles among affiliates. Transactions between affiliates in different jurisdictions need to be priced on an arm's length basis that may have to be acceptable to tax authorities in multiple jurisdictions. In 1995, the Organization for Economic Co-operation and Development published transfer pricing guidelines whose general principles have been incorporated into many countries' transfer pricing policies and audit practices, including those of Canada. The Canada Revenue Agency (CRA) sets out an outline of its administrative practices about transfer pricing in Information Circular (IC) 87-2R *International Transfer Pricing*. Further guidance on its administrative position on various issues has been published in Transfer Pricing Memoranda¹.

Arm's length price

While the principle of an arm's length price is straight forward, arriving at such an amount is not an exact science and often involves significant professional judgement in interpreting and adjusting publicly available financial information. The CRA in IC 87-2R sets out a clear hierarchy of transfer pricing methods. It notes that the method known as the Comparable Uncontrolled Price (CUP), if applicable, clearly provides the highest degree of comparability. Under this method, the transfer price is determined by reference to an internal or external sale or purchase with an arm's length party under similar terms and conditions. IC 87-2R also notes that alternative methods may have to be used when there is insufficient quality information about uncontrolled transactions or when the differences between controlled and uncontrolled transactions cannot be reliably quantified. Rather than comparing the product or service price, as is the case with the CUP method, the alternative methods compare gross or net margins earned.

¹ www.cra-arc.gc.ca/tx/nrrsdnts/cmmn/trns/menu-eng.html

Potential consequences arising from a transfer pricing challenge

Establishing and documenting defensible transfer pricing policies is a key objective for many international companies. With the ever increasing level of financial scrutiny and audit activity in this area globally, the potential costs of a dispute are far too great to ignore. Consider the following potential consequences arising from a transfer pricing challenge by any tax authority:

- 1) Costs are incurred when responding to audit queries and information requests.
- 2) Additional taxes and interest may result from a transfer pricing adjustment.
- 3) There is the potential for a secondary adjustment that treats any excess payment by a Canadian subsidiary to its foreign parent as a deemed dividend with any applicable withholding taxes.
- 4) A penalty may be charged, not based on any tax adjustment, but rather a percentage of the adjustment made to the transfer price. So a penalty could be imposed even though the taxpayer is not taxable in Canada in the period concerned.
- 5) Double tax may result if Competent Authority relief is not available and there is a cost to applying for such relief.

The Glaxo case

The Glaxo case is instructive in several respects². While this decision was rendered under the previous provisions of the Income Tax Act of Canada, it provides very interesting insight on the Court's approach towards transfer pricing.

GlaxoSmithKline Inc. (Glaxo) is a Canadian subsidiary of Glaxo Group Ltd. (Glaxo Group), a UK corporation. Glaxo purchased the active ingredient for a drug used to relieve stomach ulcers and heartburn from an affiliate under the terms of a supply agreement. In addition, under a separate licence agreement, Glaxo paid the Glaxo Group a 6% royalty on the sales of the final product, in exchange for various services and intangibles, including the rights to sell the product and acquire raw materials, use the trademarks and registration materials, and receive technical assistance, marketing support, and indemnification against patent infringement actions. Meanwhile, two other Canadian pharmaceutical companies were selling generic versions of the drug and purchasing the same active ingredient from arm's length suppliers in Canada for considerably less.

Glaxo maintained that the price paid for its ingredient was reasonable in the circumstances, and supported this view by reference to European licensees which earned similar margins. It argued that its circumstances were not comparable to those

2 The Tax Court of Canada's judgment is reported under docket number 98-712(IT)G and can be accessed at <http://decision.tcc-cci.gc.ca/en/2008/2008tcc324/2008tcc324.html>

of the generic companies. The ingredient it purchased was manufactured according to Glaxo's international health, safety and environmental standards that the generic companies were not subject to. Glaxo also argued that the total cost of its ingredient should include the royalties paid and that the benefits under the licence agreement were relevant in determining a proper arm's length price.

Glaxo's view did not prevail. The Tax Court agreed with the CRA who argued that the price of the ingredient should be limited to the highest price paid by the generic companies. As well, the judge agreed with the CRA that the supply and licence agreements covered separate matters and were to be considered independently. Accordingly, the judge did not address the overall commercial arrangement. Had the overall commercial arrangement been considered, the 6% royalty may have been found to be too low, and the end result may have been closer to Glaxo's approach.

Reflections on the Glaxo case

This case is important because it endorses the Organization for Economic Co-operation and Development's and the CRA's hierarchy of methods for transfer pricing. In particular, it clarifies that the comparable uncontrolled price (CUP) method is the preferred method when comparable pricing information exists. It seems likely that this decision will persuade companies to undertake an in-depth analysis of comparable transactions to see if these can be used, before using a profit-based method to determine price. The starting point for this type of analysis, which is often overlooked by companies, is its own internal sales, purchases or licenses with third parties. However, the issue of comparability should be carefully addressed and particularly where comparables in other markets are used. As the case highlights, market differences are very difficult to quantify.

Another important aspect of the decision is the court's agreement with the CRA that the transfer price should focus only on the transaction at hand rather than the commercial arrangement as a whole, including brand, patent rights and research and development costs. In the Glaxo case, the existence of separate supply and licence agreements contributed to the court's narrow view of the transactions as the legal arrangements had to be respected and there were no cross references in either agreement. This aspect of the decision may lead companies to review and reconsider the relationship of activities set out in different inter-company agreements to ensure that the total economic circumstances of a transaction are clear. Although it is not clear from the case, the fact that the ingredient was purchased from a low tax jurisdiction should be a warning sign to companies that CRA would pursue these type of cases more aggressively.

Finally, companies may contemplate how long transfer pricing issues take to resolve in the courts in addition to the uncertainty that they pose, and consider other alternatives such as the CRA's Advance Pricing Arrangement program.

Conclusion

The world's tax collectors recognize the significance of transfer pricing. A recent international survey of multinational entities found that over half had undergone a transfer pricing audit since 2003. As well, more than three quarters of the respondents believed that a transfer pricing audit would be likely in the next two years. In Canada, companies with cross-border dealings with related parties can expect a request from the CRA for their required transfer pricing documentation prior to or during the course of an audit. Regardless of the final outcome of the Glaxo case, Canadian companies with foreign related parties may wish to review their transfer pricing policies to ensure that they meet current expectations.



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