Arm’s Length Pricing: Canadian and Australian Perspectives

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1. Introduction

Two recent cases, one in Australia and the other in Canada, in which the tax authorities failed in their attempts to impose their transfer pricing adjustments, lend support to the view that the courts are considering a wider range of circumstances when determining arm’s length price adjustments in transfer pricing cases. In SNF (Australia) Pty Ltd v. Commissioner of Taxation,1 the Australian Federal Court, while rejecting the Commissioner’s attempt to use the transactional net margin method (TNMM), concluded that the price paid for supplies by the Australian taxpayer company reflected comparable prices.

In GlaxoSmithKline Inc v. The Queen2 the Canadian Federal Court opted to consider circumstances surrounding the transaction between the parties in determining the arm’s length price for the purchase of certain material by a Canadian subsidiary. In this case, the Court moved away from ascertaining the comparable price merely by looking at the sale/purchase transaction in isolation.

2. Statutory Position in Australia

Div. 13 of the Income Tax Assessment Act, 1936 contains rules applicable to transfer pricing, including Sec. 136AD(3) regarding the acquisition of property and excessive consideration. Sec. 136AD(3) provides as follows:

Where:
- a taxpayer has acquired property under an international agreement;
- the Commissioner, having regard to any connection between any 2 or more of the parties to the agreement or to any other relevant circumstances, is satisfied that the parties to the agreement, or any 2 or more of those parties, were not dealing at arm’s length with each other in relation to the acquisition;
- the taxpayer gave or agreed to give consideration in respect of the acquisition and the amount of that consideration exceeded the arm’s length consideration in respect of the acquisition; and
- the Commissioner determines that this subsection should apply in relation to the taxpayer in relation to the acquisition,

then, for all purposes of the application of this Act in relation to the taxpayer, consideration equal to the arm’s length consideration in respect of the acquisition shall be deemed to be the consideration given or agreed to be given by the taxpayer in respect of the acquisition.

The division goes on to define an international agreement as an agreement where a non-resident supplies or acquires property under the agreement other than in connection with a business carried on in Australia by the non-resident at or through a permanent establishment of the non-resident in Australia.3

3. Judicial Consideration of Arm’s Length Pricing Adjustments

3.1. Roche Products Pty Ltd v. Federal Commissioner of Taxation

This Australian transfer pricing case was decided by the Administrative Appeals Tribunal (AAT) in 2008.4 The taxpayer, Roche Products Pty Ltd, was an Australian subsidiary of Roche Holdings Ltd of Switzerland, a multinational pharmaceutical company. The group sold prescription drugs, over-the-counter pharmaceuticals and diagnostic equipment. While the products were delivered to the taxpayer in finished form, some secondary manufacturing and packaging was done in Australia. Most of the prescription drugs were received ready for distribution. The Commissioner reassessed the taxpayer on the grounds that the prices paid to Roche Switzerland were excessive.

The AAT considered the issue of whether the prices were excessive by considering each of the three business divisions of the taxpayer. For the prescription division, the AAT determined that the appropriate gross profit margin was to be used. While the taxpayer had used a margin of 37.54%, the Court determined that the margin should be 40%. Consequently, the arm’s length price for prescription drugs was determined to be lower than the actual price paid by the taxpayer, necessitating an increase in the income subject to tax in Australia.

Regarding the consumer and diagnostic divisions, it was found that the prices paid by the taxpayer were arm’s length prices. Here the Tax Office relied, as it always does, on a profit-based methodology, specifically the TNMM, relying on net profit comparisons. The Court did not accept the use of the TNMM, stating:

One of the problems of profit based methodology is that, when applied to transfer pricing, it inevitably attributes any loss to the...

* Fellow of the Taxation Institute of Australia, Sydney.

1. 2010 ATC 10-036.
2. 2010 FCA 201.
3. Sec. 136 AC.
The bad results flowed from operating expenses, not acquisition prices. The Court did not accept the profit-based methodology on the grounds that factors specific to the taxpayer may cause the method not to yield the correct arm’s length price.

Regarding the Commissioner’s argument that the associated enterprises article of the Australia–Switzerland treaty authorizes the Commissioner to make transfer pricing assessments (in addition to the power of assessment provided under Sec. 136AD(3)), the Court stated:

...I note that there is a lot to be said for the proposition that the treaties, even as enacted as part of the law of Australia, do not go past authorizing legislation and do not confer power on the Commissioner to assess. They allocate taxing power between the treaty parties rather than conferring any power to assess on the assessing body.

In the Decision Impact Statement released after the decision by the AAT, the Tax Office acknowledges that the conclusions reached regarding the determination of the arm’s length consideration were open on the evidence before the AAT, and noted that it will not appeal the decision.

Regarding the associated enterprises article, the Decision Impact Statement sets forth that the Commissioner is not bound by the observations made by the AAT and will continue to follow its position that the business profits or associated enterprises article of the treaty may provide a separate basis for assessing transfer pricing adjustments, independently of Div. 13.

3.2. SNF (Australia) Pty Ltd v. Commissioner of Taxation

The taxpayer, SNF (Australia) Pty Ltd, carried on the business of manufacturing and selling flocculants and coagulants (products) within Australia. The taxpayer also purchased the products from related foreign companies and on-sold them to third parties. Tax assessments were made on the basis that the taxpayer had paid more than arm’s length prices for the products.

Under Australian law, the following conditions must be satisfied before the Commissioner may adjust the taxable income of a taxpayer:

– having regard to any connection between any two or more of the parties to an international agreement, the Commissioner is satisfied that those parties were not dealing at arm’s length with each other in relation to the relevant transaction; and
– the consideration given or agreed to be given in respect of the transaction exceeded the arm’s length consideration in respect of the transaction.

In support of the argument that the consideration paid to the group abroad was too high, the Commissioner asserted that the Australian subsidiary has been continu-ously incurring losses in Australia and that the consideration paid to its group companies, which was more than the arm’s length consideration was the predominate cause of those losses. This was not accepted by the Court, which attributed the losses to low sales and poor management. Further, according to the Court, other factors such as competition in the Australian market and excessive stock levels contributed to the losses. As in Roche, the Court here rejected the application of TNMM.

3.3. GlaxoSmithKline Inc v. The Queen

GlaxoSmithKline Inc. v. Canada’ (known as Glaxo II), which was decided by the Canadian Federal Court of Appeal, sheds refreshing new light on the extent to which courts may go when determining what constitutes arm’s length consideration in international agreements.

Under the Canadian Federal Income Tax Act, the relevant transfer price is that which would have been reasonable in the circumstances if the non-resident person and a taxpayer had been dealing at arm’s length. The relevant provision of the Canadian Income Tax Act, Sec. 69(2), reads as follows:

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 payable therefore.

GlaxoSmithKline Inc (Glaxo, Canada) was a wholly owned subsidiary of Glaxo Group, a UK corporation which in turn was a wholly owned subsidiary of Glaxo Holdings plc, also a UK corporation. Glaxo Holdings “discovered, developed, manufactured and distributed a number of branded pharmaceutical products”. Glaxo Canada packaged and sold Zantac in Canada, a patented and trademarked drug for stomach ulcers. The Zantac trademark and the patent for its active ingredient, ranitidine, were owned by Glaxo Group, which licensed them to Glaxo Canada. Ranitidine was manufactured by two companies within Glaxo Group, and sold to Adechsa or to GlaxoFar East, both Glaxo World clearing companies. Glaxo Canada bought the ranitidine from these two companies.

There were two agreements entered into by Glaxo Canada, namely the supply agreement and the licence agreement. Under the supply agreement, the price paid for ranitidine by Glaxo Canada ranged from CAD 1,512 to CAD 1,652 per kilogram. Under the licence agreement, Glaxo Canada paid a royalty of 6% to Glaxo Group. There was comparable evidence available that two other unrelated Canadian companies (Apotex and Novopharm)

5. Roche. Para. 185.
6. Id. at Para. 191.
7. 2010 FCA 201.

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purchased ranitidine for a price between CAD 194 and CAD 304 per kilogram.

In the first instance, the Canadian Tax Court rejected the assertion of Glaxo Canada that both agreements must be viewed together when determining the arm’s length price for ranitidine. Instead, the Court restricted its analysis merely to the supply agreement, and found that the price paid by Glaxo Canada for ranitidine was high, which resulted in an adjustment increasing its taxable income.

On appeal, the Canadian Federal Court rejected the reasoning of the Tax Court and held that both agreements must be viewed together in determining the reasonable price that should have been paid for the ranitidine. Under the licence agreement, Glaxo Canada was required to purchase ranitidine from the Glaxo clearing companies if it wished to market it as Zantac in Canada. The Zantac trademark and the related patent were owned by Glaxo Group.

The Court stated:

In a 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 could always buy ranitidine at market prices from a willing seller. In my view, as a result of the approach which he took, the Judge failed to consider the business reality which an arm’s length purchaser was bound to consider if it intended to sell Zantac.

The following features of the transaction formed the basis of the judgement:

- Glaxo Group owned the Zantac trademark and would own it even if Glaxo Canada were an arm’s length licensee;
- Zantac commanded a premium over generic ranitidine drugs;
- Glaxo Group owned the ranitidine patent and would have owned it even if Glaxo Canada had been in an arm’s length relationship; and
- without the licence agreement, Glaxo Canada would not have been in a position to use the ranitidine patent and Zantac trademark. Consequently, in those circumstances, the only possibility open to it would have been to enter the generic market where the cost of market entry would likely have been high, considering that both Apotex and Novophram9 were already well placed and positioned.

While the Tax Court considered the determining factor as the price that would be paid for generic products by competitors, for the Court of Appeal the question was whether a producer at arm’s length would be able to sell under the trade name Zantac in Canada if it did not purchase the ranitidine from Glaxo Group.

The Court quoted the following from the Roche decision:

It is the intellectual property which is really the product, not the pill or capsule by which it is dispensed. The intellectual property included patent rights. The intellectual property came from very substantial expenditure on research and development, much of which would have produced no result. The profits from the exploitation of the intellectual property rights was something to which [the parent company which invented the product] had a special claim even though the profit would be collected for Australian sales by the Australian subsidiary.10

Sec. 69(2) was repealed in 1998, and Sec. 247 was introduced into the Income Tax Act. It codifies the OECD Guidelines and provides, in part, as follows:

(2) Where a taxpayer or a partnership and a non-resident person with whom the taxpayer or the partnership, or a member of the partnership, does not deal at arm’s length (or a partnership of which the non-resident person is a member) are participants in a transaction or a series of transactions and

(a) the terms or conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm’s length, or
(b) the transaction or series

(i) would not have been entered into between persons dealing at arm’s length, and
(ii) can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit,

any amounts that, but for this section and section 245, would be determined for the purpose of this Act in respect of the taxpayer or the partnership for a taxation year or fiscal period shall be adjusted (in this section referred to as an “adjustment”) to the quantum or nature of the amounts that would have been determined if,

(c) where only paragraph 247(2)(a) applies, the terms and conditions made or imposed, in respect of the transaction or series, between the participants in the transaction or series had been those that would have been made between persons dealing at arm’s length, or
where paragraph 247(2)(b) applies, the transaction or series entered into between the participants had been the transaction or series that would have been entered into between persons dealing at arm’s length, under terms and conditions that would have been made between persons dealing at arm’s length.

Although it is apparent that Sec. 247 has merely substituted an “arm’s length” amount for “reasonable” amount in Sec. 69, it is arguable that the change introduced a new way of approaching transfer pricing issues.

Indeed, there are two aspects of Sec. 247 that need special consideration:

- Sec. 247 is under Part XVI of the Canadian Income Tax 1985 (Tax Avoidance), whereas Sec. 67 was not; and
- Sec. 247 applies in two different circumstances:
  - where the actual terms or conditions of the transaction differed from terms or conditions that would have been agreed to by parties at arm’s length; and
  - where there was a tax benefit obtained by entering into the transaction.

The section deals with the consequences under two heads:

- if there was no tax benefit, the transfer pricing adjustment would be determined by comparing the actual terms or conditions of the transaction with the corresponding terms or conditions that would have been

8. Glaxo, Para. 76.
9. Apotex and Novopharm were Canadian generic pharmaceutical companies selling ranitidine products in Canada.
agreed by parties at arm’s length. Adjustments would be made to reflect the differences between terms or conditions; and

– if there was a tax benefit, the adjustment would be determined by comparing the actual transaction with the transaction that parties at arm’s length would have entered into.

In the second case, the issue is tax avoidance and therefore a comparison is made against a counterfactual, whereas in the first case the law calls for a term-by-term comparison between the actual transaction or series and an arm’s length transaction or series.

It is noteworthy that the reference is not merely to a transaction but also to a series, thus requiring an examination of matters that might have been agreed between the parties when they entered into the transaction. Therefore, assuming the first test is applied to the facts in GlaxoSmithKline, the courts would be required to consider the fact that more was paid to get ranitidine because Glaxo Canada wanted to sell the Zantac in Canada and obtain a premium price. The question to ask is whether arm’s length parties, one of which wanted to sell Zantac in Canada and obtain a premium price, would have been willing to pay a higher price for ranitidine. The answer could very well be in the affirmative.

4. Position of the OECD Guidelines

In Australia, both the courts and the Tax Office have been reluctant to follow the OECD Guidelines fully. In SNF, the Court drew attention to the position of the Guidelines. It referred to the position of the Guidelines in the United Kingdom, especially to Schedule 28AA of the Income and Corporation Taxes Act 1988 (UK). Although the incorporation of the OECD Guidelines in the Act is not wholesale, Para. 2 of the Schedule requires effect to be given to the Guidelines as they apply to treaties following the OECD Model Convention.

In contrast, in Australia, there is no incorporation of the OECD Guidelines to any degree. In SNF, the Court did not think resort should be had to the OECD Guidelines, it being clearly stated that the wording in Sec. 136AD(3) is quite clear.

Another significant instance where the position of the OECD Guidelines was referred to was in Taxation Ruling 2011/1 (application of transfer pricing provisions to a business restructuring by multinational enterprises), which deals specifically with business restructuring and transfer pricing. This ruling was finalized after the OECD issued Chap. IX of the Transfer Pricing Guidelines in July 2010.

In Para. 9.169, the Guidelines specify the circumstances in which the consideration agreed by the parties in a restructuring may not be accepted by tax authorities:

– the economic substance of the transaction or arrangement differs from its form; or
– independent enterprises in comparable circumstances would not have characterized or structured the transaction or arrangement as the associated enterprises have, and arm’s length pricing cannot be reliably determined for that transaction or arrangement.

Only in one of the above two cases may the tax authorities disregard the characterization of the transaction by the entities and recharacterize it in accordance with its substance. However, Para. 18 of Taxation Ruling 2011/1 states that in exceptional cases where it is not possible or practicable to achieve an arm’s length outcome, the transaction may be recharacterized to an agreement that might reasonably be expected between independent parties dealing at arm’s length in comparable circumstances.

In the light of different approaches to recharacterization of transactions, it is noteworthy that the words in Para. 21 of the draft ruling TR 2010/D2 (which was issued in 2010), stating that the Tax Office will generally follow OECD Guidelines, were deleted and replaced with words to the effect that the Tax Office has regard to the OECD Guidelines.

5. Conclusion

The decision in GlaxoSmithKline was influenced by the need to consider not merely the business situation that arm’s length parties would have found themselves in, but the actual situation faced by the actual parties when they agreed on the consideration in the transaction. Consideration in excess of that in comparable transactions may have been agreed in order to benefit from intellectual property rights belonging to the seller (e.g. the trademark and right to sell goods made out of materials purchased from the related party).

In Australia, the SNF decision has been appealed. The position of the Tax Office in transfer pricing disputes has been that the transaction under consideration must be viewed in isolation and comparison must be made with another transaction that might have been entered into by parties at arm’s length. The wording of the statute is the basis of this restrictive position. Sec. 136AD(3) refers only to the transaction, leaving no room for consideration of other factors that may have influenced the determination of the price paid. Unlike the Canadian Sec. 247, Sec. 136 AD(3) does not refer to a “series”, which may be construed as allowing an examination of other factors affecting pricing.

11. SNF, Para. 48.