FOCUS ON *Tax Law*

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In January, the Supreme Court of Canada heard a case over transfer pricing practices involving drug company GlaxoSmithKline. Above, a GlaxoSmithKline building in London, UK.

Glaxo transfer pricing under spotlight

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Transfer pricing practices by multinationals have come under Canada Revenue Agency's (CRA) spotlight out of concern that they may be used inappropriately to shift profit to low-tax jurisdictions from high-tax regions.

In January, the Supreme Court of Canada heard its first such case, involving drug company GlaxoSmithKline Inc. Started 14 years ago, the case deals with a transfer pricing provision, under subs. 69(2) of the *Income Tax Act*, that has not been in force since 1997. It was replaced by subs. 247(2), which provides that, where a resident and a non-resident are not acting at non-arm's length, their transactions should be priced at a rate that would apply to transactions between arm's length parties. Subsection 69(2), by contrast, merely limited deductions for payments made to a non-arm's length non-resident to a "reasonable amount."

Still, to the extent that what a "reasonable amount" is depends upon the arm's-length principle, what the court has to say in the GlaxoSmithKline case will have significant implications for future transfer pricing cases. Moreover, the case raises a procedural issue that is potentially significant for tax cases of all types.

Glaxo manufactured and sold in Canada the ulcer drug Zantac. Its British parent company owned the Zantac trademark and patents for its active ingredient, ranitidine. Glaxo operated under a licence from a subsidiary of the parent company that required it to purchase ranitidine from approved sources and to pay a six per cent royalty on its Zantac sales. Glaxo acquired its ranitidine from a Swiss affiliate, Adeschsa S.A., paying \$1,500 to \$1,650 per kilogram. Other pharmaceutical companies, which produced generic versions of Zantac, bought ranitidine from unrelated suppliers for \$194 to \$304 per kilogram.

CRA denied Glaxo a deduction for the full amounts paid to Adeschsa, on the basis that those prices were not, in the words of subs. 69(2), "reasonable in the circumstances." In essence, the CRA's view was that Glaxo ought to have acquired ranitidine from Adeschsa at the price the generic manufacturers paid to their suppliers. Glaxo argued that its position was not comparable to the generic companies and that a "reasonable" (arm's length) price for ranitidine could not be determined without considering the terms of the licence agreement.

The Tax Court of Canada dismissed Glaxo's appeal but the company persevered. The Federal Court of Appeal allowed the appeal on the basis that the trial judge had erred in disregarding the licence agreement in determining the "reasonable amount" that a purchaser would pay to an arm's length supplier for the ranitidine. It held that the judge's failure to consider the licence agreement meant that he had "made his determination in a fictitious business world," in which a purchaser can buy ranitidine "at a price which does not take into account the circumstance which makes it possible for that purchaser to obtain the rights to make and sell Zantac."

The court also emphasized that the existence of the licence agreement was a circumstance that would have been

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Trust me, this isn't what it looks like

Tax law geeks call it "form over substance" — how Canadians are taxed on their actual relationships and transactions rather than what they intended those to be.

However, mistakes can be made — and sometimes the tax assessed is not reflective of the true nature of the situation at hand.

One solution is to seek an order of rectification, which is an equitable remedy granted by a provincial superior court that has the effect of correcting mistakes in documents that don't accord with the parties' agreement.

Generally, a court will only grant rectification where the taxpayer is able to demonstrate that the parties to an agreement had a common and continuing intention and that the written instrument does not reflect the true agreement of the parties.

The use of the equitable doctrine of rectification to correct mistakes in tax matters has become more common since the ground-breaking decision in *Juliar v. Canada (A.G.)* ([1999] O.J. No. 3554 (Ont. S.C.J.), affd [2000] O.J. No. 3706 (Ont. C.A.), leave to appeal to S.C.C. denied ([2000] S.C.C.A. No. 621)), in which the court rectified a share transfer document.

Additionally, the courts have in recent years ordered rescission for mistake or made declaratory orders to provide relief from unintended and adverse tax consequences.

For tax purposes, a court order of rectification or rescission must be respected by the Canada Revenue Agency (CRA). However, the courts have repeatedly emphasized that rectification and rescission are not available where the taxpayer is engaged in "retroactive tax planning."

TIMOTHY FITZSIMMONS

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>
> Timothy Fitzsimmons, Fraser Milner Casgrain LLP

Since *Juliar*, the courts in the common law provinces have rectified or rescinded articles of amalgamation, articles of amendment, an arrangement under the *Companies' Creditors Arrangement Act*, corporate resolutions, share transfers, a retirement plan under a collective agreement and trust deeds. (Whether rectification operates under Quebec's civil law is in dispute; the Supreme Court of Canada will consider the issue in *Québec (Sous-ministre du Revenu) c. Services environnmentaux AES inc.*, [2011] J.Q. no 1911 and *Riopel v. Agence de revenue du Canada*, [2011] J.Q. no 5720.)

There have been several cases in the past few years that indicate that the provincial courts are increasingly comfortable granting rectification or rescission to provide relief from mistakes in a wide variety of transactions and arrangements.

In *TCR Holding Corp. v. Ontario*, [2009] O.J. No. 3430, affd [2010] O.J. No. 5573, the unintended result was the potential liability of an amalgamated company because one the predecessor companies had guaranteed the debt of a bankrupt company. TCR brought an application asking the court to apply rectification principles to set aside (i.e. rescind) the amalgamation. The court stated that the parties intended to amalgamate with a corporation with no liabilities. Accordingly, the court ordered that the amalgamation be set aside.

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In *1756215 Ontario Inc. v. 2095417 Ontario Inc.*, [2011] O.J. No. 4909, the unintended result was the dissolution of a company, which would have had the effect of preventing a civil dispute from being heard on the merits. The parties sought to have the dissolved company revived. The facts are somewhat unclear in the decision, but there was clearly an error — someone's father had signed articles of dissolution, no one knew who presented the articles to the father for signing, no one knew if professional advisors had been consulted. Over all, the court was satisfied that the dissolution was a mistake and the court revived the company.

In *McPeake Family Trust (Trustee of) v. Canada*, [2012] B.C.J. No. 160, the unintended tax result was the attribution of income after a share sale to the taxpayer (the settlor of a trust) under s. 75 of the *Income Tax Act*. The wrinkle: this was the *second* application for rectification, following an initial successful rectification of the trust deed in 2009. However, the CRA had maintained its tax assessments against the taxpayer on the basis that there were two additional errors in the trust deed. In the second application, the B.C. Supreme Court found there was a common intention to reduce the tax payable by the settlor and the beneficiaries of the trust. The court rectified the trust deed to make it accord with the parties' intentions.

Even where an application for rectification is not successful, taxpayers may be able to obtain declaratory relief. In the recent case of *Orman v. Marnat Inc.*, [2012] O.J. No. 304 , the bad result was the taxation of amounts as investment income in the hands of two Canadian companies that had unwittingly invested (and lost) money in a U.S. Ponzi scheme. The applicants sought to rectify the financial statements and tax returns of the companies and thus reduce the tax payable. The Ontario Superior Court of Justice dismissed the application for rectification on the basis that, despite being victims of a fraud, the applicants intended that the corporations were in receipt of investment income. Yet the court went on to declare that the Ponzi scheme distributions were not investment income but rather were a return of capital to the duped investors.

Taxpayers (or their advisors) may make mistakes in arrangements or transactions, but there are ways that some of these mistakes can be fixed so as to avoid unintended and adverse tax consequences. The recent decisions of the provincial superior courts demonstrate that there are many ways that these bad tax consequences may be fixed so that only the intended amount of tax is payable. ■

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Case started 14 years ago

Glaxo

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present even if the parties had been dealing at arm's length and that the Zantac trademark meant the supplier could command a premium over generic drugs. Consequently, an arm's length purchaser would have had to consider these circumstances in deciding whether it was willing to pay the price charged by Adeschsa.

However, the court conceded it was "unable to say" whether, if the licence agreement were considered relevant, this would lead the trial judge to conclude the amount paid by Glaxo to Adeschsa was reasonable. It therefore returned the matter to the judge for rehearing and reconsideration of that question.

The Crown appealed to the Supreme Court. Glaxo cross-appealed, claiming it had discharged the onus on it by "demolishing" all of the assumptions on which the CRA had relied to make its reassessment. Therefore, it contended, the appeal simply should be allowed. At the hearing the court peppered Crown counsel with questions that focused on the relevance of the licence agreement to the issue of what pricing was "reasonable in the circumstances."

While the term "reasonable in the circumstances" no longer appears in the *Income Tax Act*'s transfer pricing provision, the court's comments on this issue will no doubt be relevant in applying the arm's length principle for purposes of subs. 247(2). The impact of the OECD "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" also remains to be seen.

Some members of the court appeared to have difficulty with Glaxo's argument on cross-appeal and suggested that the company had the onus of proving what the "reasonable amount" was. But if a taxpayer shows that the methodology used in making a reassessment was incorrect, is it obliged to do no more than that, or does it also have to prove what the "correct" amount is, based on the methodology that it endorses? If Glaxo is successful on this issue, which is by no means certain, it may cause taxpayers to rethink the extent of their obligation to adduce evidence in future tax appeals. ■

Adrienne Woodyard and David Nathanson are counsel at Davis LLP in Toronto. Their practices focus on tax dispute resolution and planning.

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