



2009 International Taxation Conference **TRANSFER PRICING: THE YEAR IN REVIEW**

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OVERVIEW

- Introduction**
- The Arm's Length Principle**
- The U.S. Approach**
- The U.K. Approach**
- The Canadian Approach**
- What Does This Mean For MNEs And Their Tax Advisors?**

INTRODUCTION

- Over 49 countries now have transfer pricing legislation (E&Y 2009 Global transfer pricing survey)**
- Tax administrations are increasing resources to address aggressive tax planning**
- Transfer pricing audit and litigation activity is a significant element in these reviews**

INTRODUCTION

- Many day-to-day operations of multinational enterprises are susceptible to transfer pricing adjustments**
- Transfer pricing adjustments often involve significant amounts of tax across multiple taxation years**
- Impact on focus and direction of multinational tax departments**

The Arm's Length Principle

- “[When] conditions are made or imposed between...two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

paragraph 1 of Article 9, OECD Model Tax Convention and Paragraph B 1.6, Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines, September 9, 2009

- The Arm's Length Principle sounds like a simple concept but in practice it is extremely difficult, in most cases, to apply

The Arm's Length Principle

- ❑ **Separate entity approach (“independent enterprises”)**
 - ❑ **“There are some significant cases in which the arm's length principle is difficult and complicated to apply, for example, in MNE groups dealing in the integrated production of highly specialised goods, in unique intangibles, and/or in the provision of specialised services.”**
 - paragraph B 1.9, Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines, September 9, 2009*
 - ❑ **Market Comparability**
 - **definitions of “market”**
 - **impact on identification of differences – no material impact on price or appropriate adjustments can be made**
 - ❑ **Relation between transfer pricing and anti-avoidance (adjusting the transaction as structured vs. disregarding the structuring adopted by a taxpayer and recharacterising a transaction or its terms)**
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The U.S. Approach: Xilinx, Inc. v. C.I.R.

- **The Court of Appeals for the Ninth Circuit in a divided decision held that where the U.S. transfer pricing legislation established a distinct standard which was irreconcilable with the Arm's Length Principle, the U.S. legislation overrode.**
- **Facts:**
 - **Xilinx, Inc. a U.S. corporation agreed in a qualified cost sharing arrangement with its Irish subsidiary to share certain costs.**
 - **the cost of employee stock options for Xilinx, Inc. employees was not included**
 - **IRS challenged the exclusion under the section 482 cost sharing regulations insisting that the regulations were consistent with the Arm's Length Principle**
 - **the Tax Court found that unrelated parties would not treat employee stock option costs as sharable**
 - **the IRS appealed but did not contest the Tax Court's finding that its position was not consistent with the Arm's Length Principle**

The U.S. Approach: Xilinx, Inc. v. C.I.R.

Ninth Circuit Decision

□ *The Arm's Length Principle*

- "the plain language does not permit any exception, even for costs that unrelated parties would not share....Because the all costs requirement is irreconcilable with the arm's length standard, we hold s. 1.482-7(d)(1) controls, in light of the elementary tenet of statutory construction that where there is no clear indication otherwise, a specific statute will not be controlled or nullified by a general one..."
- "the arm's length standard is regulatory gloss on the Secretaries' statutory authority to allocate income to avoid tax evasion..."

□ *The Savings Clause*

- the Irish-U.S. Treaty was not controlling because the savings clause expressly permits a contracting state to apply its domestic laws to its citizens

□ Ninth Circuit has agreed to a rehearing

- If the original decision is confirmed on the rehearing, the associated enterprises, correlative relief and mutual agreement provisions in the U.S. treaties would be effectively nullified

The U.K. Approach: DSG Retail Ltd. v. HMRC

- **The Special Commissioners rejected the comparable uncontrolled price method and instead relied on a profit split to increase the profit allocation to the U.K. taxpayer**
- **Facts:**
 - **DSG sold domestic electrical goods to customers in the U.K.; at “point of sale” in its stores in the early years and later directly with a third party intermediary, customers purchased extended warranties/services**
 - **the third party intermediary reinsured substantially all of the risks with a DSG offshore (Isle of Man) subsidiary**
 - **in later years the third party intermediary also subcontracted to another DSG subsidiary the required repair and service activities**
 - **HMRC challenged under the U.K. transfer pricing rules**
 - **DSG argued that there was no transaction between non-arm’s length parties**
 - **DSG also argued that CUPs derived from market research supported premiums within an acceptable arm’s length range**

The U.K. Approach: DSG Retail Ltd. v. HMRC

Special Commissioners Decision

- ***Reasoning:*** no payment by DSG offshore subsidiary for “point of sale” advantage so parties not at arm’s length; similar reasoning in respect of later contracts between customers and the third party intermediary as they were entered into contingent on back-to-back arrangements with the offshore subsidiary and should have been supported by a commission fee, i.e. “indirect provision of a business facility”
- ***CUPs:*** taxpayer’s CUPs were rejected as not acceptable comparables – not possible to make accurate adjustments to account for material differences
- ***Relative bargaining position of DSG:*** profit split method adopted based on OECD Transfer Pricing Guidelines
- ***Role of OECD Transfer Pricing Guidelines:*** The guidelines could be used as an interpretive aid even though no treaty was in place between the jurisdictions of the parties to the transactions even if they were not expressly referenced by the domestic legislation

The Canadian Approach: Legal Framework

- ❑ **The purpose of the Canadian transfer pricing rules is to ensure that the pricing of non-arm's length cross-border transactions conforms to the pricing that arm's length parties would establish for the same transactions**
- ❑ **Subsection 69(2) applies for taxation years beginning prior to 1998**
- ❑ **Subsection 247(2) applies for taxation years beginning after 1997**
- ❑ **Transfer pricing adjustments sometimes lead to consequential adjustments to non-resident withholding tax**

The Canadian Approach: Legislative Provisions

- 69.(2) Where a taxpayer has paid or agreed to pay to a non-resident person with whom he 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**

The Canadian Approach: Legislative Provisions

- **247. (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**

The Canadian Approach: Legislative Provisions

- any amounts that, but for this section and section 245, would be determined for the purposes 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 (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
 - (d) where paragraph (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
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The Canadian Approach: Legislative Provisions

- Subsections 69(2) and 247(2) express the legal standard differently:
 - subsection 69(2): the amount “that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm’s length”
 - subsection 247(2): “the quantum or nature of the amounts that would have been determined if... (c)... 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”

The Canadian Approach: Comparison of Legislative Provisions

- **Section 247 provides for the following features that subsection 69(2) lacks:**
 - **recharacterization of the transaction(s) in issue for assessment purposes**
 - **contemporaneous documentation requirements and penalty provisions**
 - **application to a “series of transaction” (in addition to a “transaction”)**
 - **if the taxpayer has not made reasonable efforts (need for contemporaneous documentation) to determine and use arm’s length transfer prices, then transfer pricing penalties (generally 10% of the transfer pricing adjustment) may be assessed in addition to that adjustment**
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The Canadian Approach: GlaxoSmithKline v. R.

- The leading case on transfer pricing under subsection 69(2) (currently under appeal to the F.C.A.)**
- Facts:**
 - the taxpayer bought ranitidine, the active ingredient for its name-brand pharmaceutical product Zantac, from Adechsa, a related non-resident company**
 - the CRA reassessed to reduce the purchase price paid by the taxpayer to that paid by generic pharmaceutical manufacturers to third-party suppliers**

The Canadian Approach: GlaxoSmithKline v. R.

- **Main issues raised at trial:**
 - **whether the price paid by generic manufacturers for ranitidine constituted a CUP for the taxpayer's purchase of ranitidine from Adechsa for the manufacture of Zantac, considering the different business circumstances and the Glaxo group's manufacturing standards for ranitidine**
 - **whether the licensing fees payable by Glaxo to its parent company in respect of the Zantac trademark should be taken into account in determining the price that would have been reasonable in the circumstances for Glaxo to pay Adechsa for ranitidine**

The Canadian Approach: GlaxoSmithKline v. R.

The Tax Court Decision

- ❑ ***The issue***: whether the prices paid by Glaxo to Adechsa for ranitidine would have been reasonable in the circumstances if Glaxo and Adechsa had been dealing at arm's length
 - ❑ ***Transfer pricing methods***: the CUP method is the best method where comparators are available; otherwise, the hierarchy of methods set out in the OECD Transfer Pricing Guidelines may be followed (relying on *SmithKline Beecham Animal Health Inc. v. Canada* (2002))
 - ❑ ***CUPs***: generic companies in Canada are an appropriate comparator using the CUP method: the price that would have been reasonable in the circumstances for Glaxo to pay Adechsa for a kilogram of ranitidine was the highest price the generic companies paid for a kilogram of ranitidine
 - ❑ ***"Bundling"***: only the amount paid for ranitidine was relevant: amounts paid as licensing fees were not taken into account (relying on *Singleton v. Canada*, (2001), *Bausch & Lomb, Inc. v. Commissioner*, 1989 U.S. Tax Court)
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The Canadian Approach: Additional Cases Referencing Subsection 69(2)

- **Other Canadian cases concerning the arm's length principle:**
 - ***SmithKline Beecham Animal Health Inc. v. Canada* (2002) – motion decision related to an appeal concerning whether the amount paid to the taxpayer's non-resident affiliates for the active ingredient cimetidine in its drug Tagamet met the arm's length standard (the appeal has settled)**
 - ***Safety Boss Limited v. R.* (2000) – a bonus and fees paid by the taxpayer to its president and his company were fully commensurate with services rendered by him in oilfield firefighting and were not in excess of amounts that it would have been reasonable to pay had the parties been at arm's length**
 - ***Indalex Ltd. v. R.* (1988) – the price paid by the taxpayer to a related non-resident company for certain aluminum products was reduced to the amount that the related non-resident company had paid to third-party suppliers for those products**

The Canadian Approach: General Electric Capital Canada Inc. v. The Queen

- To date no cases have considered the transfer pricing analysis under subsection 247(2) at length**
- The Tax Court has, however, established that motivation is irrelevant in transfer pricing cases where paragraph 247(2)(b) is not in issue for the following reasons:**
 - appeals were on basis of paragraph 247(2)(a) and subsection 69(2), which do not refer to motive**
 - Minister's Reply withdrew reference to paragraph 247(2)(b) and thus the question of motive was irrelevant in assessing the reasonableness of the fees**

The Canadian Approach: General Electric Capital Canada Inc. v. The Queen

- Concerns the application of the Arm's Length Principle in the context of financial guarantees**
 - the taxpayer paid fees to General Electric Capital Corporation, its non-resident parent company, for unconditional guarantees of several billions of dollars of publicly-issued commercial paper and medium-term notes**
 - the amount of the guarantee fee was, in general, 1% (or 100 basis points) of the principal amount of debt outstanding in the year**
 - the Minister disallowed the deductions of the guarantee fees payable by the taxpayer on the basis that the arm's length price for the guarantees under subsections 69(2) and 247(2) was nil**

The Canadian Approach: Role of the OECD Transfer Pricing Guidelines

- Courts have said that the OECD Transfer Pricing Guidelines may inform the interpretation and application of subsection 69(2)
 - “it appears to be common ground that the OECD Guidelines inform or should inform the interpretation and application of subsection 69(2) of the *Income Tax Act*. ... (*SmithKline Beecham* (F.C.A.) at para. 8)
 - the Court in *Glaxo* cited from *SmithKline Beecham* and also referred to Article 9(1) of the *OECD Model Double Taxation Convention on Income and Capital* and the Minister’s information circulars on transfer pricing
- Courts will likely say the same in respect of section 247 because that provision was intended to conform with the 1995 OECD Transfer Pricing Guidelines
- In *Glaxo*, the Court reviewed the transaction methods described in the OECD Transfer Pricing Guidelines and concluded that the CUP method was the best method where comparators were available

What Does This Mean For MNEs And Their Tax Advisors?

- **OECD proposed revisions to the Transfer Pricing Guidelines**
 - **“most appropriate method to the circumstances of the case”**
 - **typical process for evaluating a transaction and identifying appropriate comparables**
 - **“timing” discrepancies between prior expectations and actual results – foreseeability**
- **Blurring of divisions between ALP/TP concepts and tax avoidance**
- **Transfer Pricing studies in future will balance the mechanics of methodology against a more nuanced understanding of a taxpayers specific circumstances**

THANK YOU!