
Is There a Sixth Comparability Factor in Canadian Transfer Pricing?

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PRÉCIS

Cet article examine les décisions marquantes récentes sur les prix de transfert au Canada. Il suggère que les tribunaux canadiens aient pu donner naissance à un sixième facteur de comparabilité pour l'application du principe de pleine concurrence qui contrevient à l'intention de l'article 247 de la Loi de l'impôt sur le revenu. Ce nouveau facteur de comparabilité est désigné comme la pertinence des facteurs de dépendance entourant la relation entre les parties liées.

D'abord, l'article récapitule brièvement le processus connu sous le nom d'analyse de comparabilité, tel qu'énoncé dans les lignes directrices publiées par l'Organisation de coopération et de développement économiques et dans l'article 247 de la Loi. Puis, il examine la signification donnée par les tribunaux canadiens à l'analyse de comparabilité. L'auteur souligne comment les tribunaux, par leurs décisions, ont créé un sixième facteur de comparabilité aux fins des prix de transfert. L'article se termine par une brève analyse des conséquences inattendues que ce nouveau facteur de comparabilité pourrait avoir relativement à ce qui constitue des « efforts raisonnables » en vue d'utiliser des attributions ou des prix de pleine concurrence, et de l'application possible de pénalités relatives aux prix de transfert.

ABSTRACT

This article reviews the recent landmark transfer-pricing case law in Canada. It suggests that the Canadian courts may have given birth to a sixth comparability factor for the application of the arm's-length principle that contravenes the intent of section 247 of the Income Tax Act. This new comparability factor is referred to as the relevance of non-arm's-length factors surrounding the relationship between related parties.

First, the article briefly summarizes the process known as the comparability analysis, as set out in the guidelines issued by the Organisation for Economic Co-operation and Development and in section 247 of the Act. Second, the meaning given by the Canadian courts to the comparability analysis is examined. The author highlights how the courts, through their decisions, have created a sixth comparability factor for transfer-pricing purposes. The article concludes with a brief discussion of the unintended consequences

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The opinions expressed in this document are my own.

that this new comparability factor may have for what constitutes “reasonable efforts” to use arm’s-length allocations or prices, and thus for the possible application of transfer-pricing penalties.

KEYWORDS: TRANSFER PRICING ■ COMPARABILITY ■ COMPARABLE UNCONTROLLED PRICE ■ TRANSACTIONAL NET MARGIN ■ TAX POLICY ■ FISCAL POLICY

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INTRODUCTION

In Canada, section 247 of the Income Tax Act¹ pertains to transfer pricing. It has replaced former subsection 69(2). In 1998, the government of Canada modified its transfer-pricing legislation in order “to harmonize the standard contained in section 69 of the Act with the arm’s length principle as defined in the revised [1995] OECD guidelines.”² At the time, the amendments to the Act implemented a “transfer pricing regime based explicitly on the arm’s length principle.”³ For greater certainty, subsection 247(1) included definitions of “arm’s length allocation” (of profit or loss) and “arm’s length transfer price” for the purposes of the transfer-pricing rules. In each case, the allocation or price arranged between the participants in a transaction must reflect what would have occurred “if the participants had been dealing at arm’s length with each other.”⁴

Accordingly, under Canadian tax legislation, the determination of a transfer price for a transaction between a Canadian taxpayer and a non-arm’s-length non-resident

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- 1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.
 - 2 Canada, Department of Finance, 1997 Budget, Budget Plan, February 18, 1997, at 203. See also Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995) (herein referred to as “the 1995 OECD guidelines”).
 - 3 See the summary of the Income Tax Amendments Act, 1997 in (1998) 21:2 *Canada Gazette Part III*, at 2a.
 - 4 Canada, Department of Finance, *Explanatory Notes Relating to Income Tax* (Ottawa: Department of Finance, December 1997), at 505.

must usually abide by the arm's-length principle as defined in the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.⁵ Subsection 247(2) prescribes a transfer-pricing adjustment when "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."⁶

At the onset of a transfer-pricing compliance audit, subsection 247(4) is invoked by the Canada Revenue Agency (CRA) in any requests for contemporaneous documentation.⁷ Specifically, reference to the information requirements listed in subparagraphs 247(4)(a)(i) through (vi) must now be included in the contemporaneous documentation letter "at the stage of initial contact with the taxpayer in all audits" that involve controlled transactions.⁸ Subparagraphs 247(4)(a)(i) through (vi) are extremely important to Canadian taxpayers. They play a crucial role in the eventual application of a transfer-pricing penalty under subsection 247(3) where reasonable efforts were not made to determine an arm's-length price.

Subparagraphs 247(4)(a)(i) through (vi) bear a resemblance to the comparability factors listed in the OECD guidelines. Part D.1 of chapter I of the OECD guidelines provides taxpayers and tax administrations alike with five categories of comparability factors to ensure the proper application of the arm's-length principle,⁹ in a procedure that is widely known as "the OECD comparability analysis." The five categories are

1. the characteristics of property or services,
2. the functional analysis,
3. the contractual terms,
4. the economic circumstances, and
5. the business strategies.

5 Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 2010) (herein referred to as "the OECD guidelines"). This is an updated version of the 1995 guidelines cited in note 2, supra. See also *Information Circular 87-2R*, "International Transfer Pricing," September 27, 1999, at part 3.

6 The Act also includes provisions such as subsections 17(8) (dealing with non-interest-bearing loans to controlled foreign affiliates) and 18(4) (containing thin capitalization rules) governing specific transactions between related parties.

7 See *Transfer Pricing Memorandum TPM-05R*, "Requests for Contemporaneous Documentation," March 28, 2014, appendix A, "Sample Contemporaneous Documentation Letter."

8 *Ibid.*, at paragraph 9.

9 It should be noted that the OECD has released a public discussion draft that proposes modifications to part D of chapter I of the guidelines: See Organisation for Economic Co-operation and Development, *BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)* (Paris: OECD, December 2014). The proposed changes would have no impact on the analysis provided in this article.

Paragraph 1.15 of the 1995 OECD guidelines (paragraph 1.33 of the 2010 version) suggests that the first step in the comparability analysis is to undertake a “comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises.”¹⁰ This requires the specific comparison of every economically relevant characteristic in the controlled transaction and in an arm’s-length transaction.¹¹ But in order for that comparison to make any conceptual sense with respect to the determination of an arm’s-length transfer price, it is solely the arm’s-length factors that need to be taken into account. Article 9 (associated enterprises) of the OECD model tax convention provides for adjustments when “conditions . . . made or imposed between the two enterprises in their commercial or financial relations . . . differ from those which would be made between independent enterprises.”¹² That is, any such adjustment is meant to correspond to the conditions that would have existed between parties dealing at arm’s length.

Paragraph 1.38 of the OECD guidelines states that

the examination of the five comparability factors is by nature two-fold, i.e. it includes an examination of the factors affecting the taxpayer’s controlled transactions and an examination of the factors affecting uncontrolled transactions.¹³

Such an approach enables the evaluation, as also pointed out in paragraph 1.38, of the “relative importance of any missing piece of information on possible comparables, which can vary on a case-by-case basis.”¹⁴

That methodological precept is at the heart of the arm’s-length principle, which treats the members of a multinational enterprise (MNE) group as “operating as separate entities rather than as inseparable parts of a single unified business.”¹⁵ In reality, non-arm’s-length factors would arise only if the parties were not operating as separate entities. In other words, non-arm’s-length factors are rendered non-existent for the purpose of the application of the arm’s-length principle—that is, for the determination of an arm’s-length transfer price. However, non-arm’s-length factors are not simply ignored or overlooked; they are eliminated by virtue of the comparability analysis carried out with respect to the relevant arm’s-length factors. This is in fact the basis of the arm’s-length principle. More precisely, paragraph 1.6 of the OECD guidelines states:

10 Supra note 2 (1995 guidelines) and note 5 (2010 guidelines).

11 See also the OECD discussion draft, supra note 9, at paragraph 1.

12 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version 2014* (Paris: OECD, July 2014) (herein referred to as “the OECD model tax convention”).

13 Supra note 5 (2010 guidelines).

14 Ibid.

15 Ibid., at paragraph 1.6.

Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the transactions between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions.¹⁶

Such a methodological focus on the nature of the transactions should clearly prevent the inclusion of any non-arm's-length factors in the comparability analysis for transfer-pricing purposes.¹⁷ However, as discussed in detail below, the Canadian courts have taken a different approach to the determination of an arm's-length transfer price for the purpose of former subsection 69(2), and subsequently section 247.¹⁸

On the one hand, the Canadian courts have recognized the relevance of the OECD guidelines in carrying out the comparability analysis; indeed, those guidelines have become part of the Canadian transfer-pricing landscape.¹⁹ On the other hand, as we shall see, the Canadian courts have given birth to a sixth comparability factor, namely, the relevance of non-arm's-length factors surrounding the relationship between related parties.

I argue in this article that in no way were non-arm's-length factors contemplated as either being part of the OECD comparability analysis or being relevant to the application of subsection 69(2) or section 247.²⁰ This methodological quarrel is not simply a theoretical one. It could give rise to serious tax litigation in the future as the gap between the Canadian courts' interpretation of the arm's-length principle and the Canadian legislation on transfer pricing slowly but surely widens.

16 Ibid.

17 This conclusion is also supported by paragraph 1.11 of the OECD guidelines, *supra* note 5, which addresses the issues arising from any transaction that “may not be found between independent parties.” As paragraph 1.11 explains, such a circumstance would not in “itself mean that it [the transaction] is not arm's length.” However, the arm's-length principle would be more difficult to apply “because there is little or no direct evidence of what conditions would have been established by independent enterprises.” (Ibid.) In other words, despite these difficulties, the emphasis must remain solely on the arm's-length factors for the purposes of the comparability analysis, according to the OECD.

18 In *Canada v. General Electric Capital Canada Inc.*, 2010 FCA 344, at paragraph 12, Noël JA, writing for a unanimous panel, indicated that “there is no meaningful difference” between former subsection 69(2) and section 247. That interpretation permeates this article, although nuances may indeed be possible. Accordingly, in the discussion that follows, the two provisions are analyzed as a single provision—that is, as the Canadian representation of the application of the arm's-length principle in the transfer-pricing context.

19 In the case law, the pertinence of the OECD guidelines for Canadian transfer pricing was first stated in *Smithkline Beecham Animal Health Inc. v. Canada*, 2002 FCA 229, at paragraphs 6-9.

20 IC 87-2R, *supra* note 5, also does not consider the inclusion of non-arm's-length factors in the determination of an arm's-length price.

THE OECD COMPARABILITY ANALYSIS

As discussed above, the OECD comparability analysis comprises five categories of factors:

1. the characteristics of property or services,
2. the functional analysis,
3. the contractual terms,
4. the economic circumstances, and
5. the business strategies.

As indicated in paragraph 1.33 of the OECD guidelines, these factors permit “comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises.”²¹ Each of these categories is central to the application of the arm’s-length principle. They ultimately lead to the selection and application of a transfer-pricing method, which in turn enables the determination of an arm’s-length price for a specific transaction between parties not dealing at arm’s length.²² As clarified in *Information Circular 87-2R*, “selecting the most appropriate pricing method depends largely on the assessment of the comparability of transactions.”²³

At the abstract level, comparison implies not only the evaluation of at least two objects considered as wholes but also the examination of the major components of those objects. This, in a nutshell, is what the OECD comparability analysis is all about; it involves an examination of any relevant arm’s-length comparability factor.²⁴ In an analysis based on the comparison of every relevant arm’s-length factor in the controlled transaction and an arm’s-length transaction, any non-arm’s-length factors that are part of the controlled transaction are rendered ineffective.

In other words, the precise purpose of the arm’s-length principle is ultimately to adjust the terms and conditions of any controlled transaction to the terms and conditions of an arm’s-length transaction (obviously, not the converse). Canada’s transfer-pricing legislation—in particular, paragraphs 247(2)(a) and (c)—is explicit to that effect.²⁵ Therefore, non-arm’s-length factors are clearly irrelevant to the comparability analysis in transfer pricing—that is, for the application of the arm’s-length principle.

21 *Supra* note 5 (OECD guidelines).

22 Paragraph 2.2 of the OECD guidelines, *ibid.*, explains the relationship between the comparability analysis and the selection and application of a transfer-pricing method.

23 IC 87-2R, *supra* note 5, at paragraph 33.

24 Paragraphs 1.33 to 1.35 of the OECD guidelines, *supra* note 5, are explicit on that matter.

25 The analysis in this article does not include paragraphs 247(2)(b) and (d), which pertain to the recharacterization of any transaction “entered into primarily for bona fide purposes other than to obtain a tax benefit.”

If any non-arm's-length factor is present in the controlled transaction, it must be discarded, since it would logically render an alleged arm's-length transaction fundamentally non-arm's-length. In truth, it is difficult to see how a factor that existed solely in a non-arm's-length environment could be included in a comparison with an arm's-length arrangement, since that factor could not exist in the arm's-length environment. In such a case, comparison could never be claimed, even remotely, for the application of the arm's-length principle in determining an appropriate transfer price.

Contractual terms are among the five categories of factors included in the OECD comparability analysis. In the commercial world, the contractual terms of a transaction are of paramount importance, in particular in ensuring that the interests of every party involved in the transaction are honoured in an orderly fashion. For transfer-pricing purposes, contractual terms as they are defined enable taxpayers to determine the allocation of various "risks" (which is one of the components of the functional analysis). These risks may include market risk; risk associated with property, plant, and equipment; commercial investment risk; financial risk; and credit risk, among others.²⁶

For tax administrations, the examination of the contractual terms in a given controlled transaction or relationship helps in ascertaining whether the "purported allocation of risk is consistent with the economic substance of the transaction."²⁷ Contractual terms are examined by tax administrations because in any arm's-length transaction they "generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties."²⁸ In the context of Canada's transfer-pricing rules, IC 87-2R recognizes the relevance of contractual terms as they "may influence the degree of comparability of transactions."²⁹

In Canadian case law, the courts have postulated that both arm's-length and non-arm's-length economically relevant factors in a specific controlled transaction must be taken into account for the purpose of the comparability analysis—that is, for the application of the arm's-length principle under section 247 (and former subsection 69(2)). In the following section, I will show how the Canadian courts ended up drawing this remarkable conclusion, which infers language that is in fact absent from the OECD guidelines and departs from the intent of the Act.

26 OECD guidelines, *supra* note 5, at paragraph 1.46. The OECD discussion draft, *supra* note 9, deepens the understanding of risks in part D.2.

27 OECD guidelines, *supra* note 5, at paragraph 1.48.

28 *Ibid.*, at paragraph 1.52.

29 IC 87-2R, *supra* note 5, at paragraph 32.

COMPARABILITY ANALYSIS AND THE CANADIAN COURTS

What the Tax Court of Canada First Said on the Relevance of Contractual Terms

The relevance of the contractual terms for the determination of an arm's-length transfer price was first analyzed by the Tax Court of Canada in *GlaxoSmithKline Inc. v. The Queen*³⁰ and *General Electric Capital Canada Inc. v. The Queen*.³¹

In *GlaxoSmithKline*, the Canadian taxpayer appealed income tax assessments by the CRA in a dispute over the price that the taxpayer had paid to its related suppliers for the purchase of ranitidine (an active pharmaceutical ingredient). The taxpayer contended that its dealings with its suppliers were at arm's length on the basis of both the facts and the circumstances surrounding these purchases, and that the amounts paid were "reasonable in the circumstances."³² Applying the comparable uncontrolled price (CUP) method to the transactions at issue, the court essentially dismissed the taxpayer's argument and concurred with the position of the CRA.

The CRA's argument, as it pertains to the comparability analysis, was that the supply agreement and the licence agreement concluded by the Canadian taxpayer with its related suppliers were to be examined separately for the determination of the arm's-length price for the purchases of ranitidine. According to the CRA, this was the correct method for determining an appropriate price since it was consistent with the transaction-by-transaction approach suggested by the OECD guidelines.³³ The CRA also relied on *Singleton v. Canada*³⁴ to support its position. In *Singleton*, the Supreme Court of Canada explained that unless a provision of the Act is ambiguous, a court must apply the statute as it is written "rather than search for the economic realities of the transaction."³⁵ Accordingly, the CRA argued on the basis of *Singleton* that

one must look at the transaction in issue and not the surrounding circumstances, other transactions or other realities because in order to give effect to the legal relations, one has to view the agreements independently.³⁶

30 2008 TCC 324.

31 2009 TCC 563.

32 *GlaxoSmithKline*, supra note 30, at paragraph 8.

33 See paragraphs 1.42-1.44 of the 1995 OECD guidelines, supra note 2 (paragraphs 3.9-3.12 of the 2010 version, supra note 5). However, it must be pointed out that in the 2010 guidelines, paragraph 3.9 also highlights cases where "separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis." Such transactions include the "licensing of manufacturing know-how and the supply of vital components," a situation highly similar to the purchases of ranitidine in the *GlaxoSmithKline* case.

34 2001 SCC 61.

35 *Ibid.*, at paragraph 31.

36 *GlaxoSmithKline*, supra note 30, at paragraph 72.

The CRA argued that the licence agreement was irrelevant since in other instances the Canadian taxpayer had concluded specific arm's-length supply agreements for the purchase of other pharmaceutical ingredients. Those agreements were independent from any licence agreement. The CRA consequently argued that the specific licence agreement concluded by the taxpayer was irrelevant for the determination of the arm's-length price of the purchases of ranitidine. Only the supply agreement mattered.

The Canadian taxpayer contended that the two commercial agreements were in fact specific "circumstances" that surrounded the controlled transaction and as such both had to be considered in accordance with the OECD guidelines. The supply agreement defined the terms and conditions of the purchases of ranitidine and also the payment of royalties (through the licence agreement), among other things. From that point of view, both agreements had to be included in the comparability analysis, and not just the supply agreement.

Ultimately, the Tax Court agreed with the CRA's position. Although the licence agreement concluded by the taxpayer pertained indirectly to the purchases of ranitidine, it had to be ignored in determining an appropriate arm's-length transfer price. The agreement did not constitute a relevant "circumstance" in that determination. Rip ACJ concurred with the CRA that "the two agreements covered distinct subject matters."³⁷ Moreover, taking into account the distinct tax treatment of the purchases of ranitidine and the payments of royalties, the court could not reach any other conclusion.³⁸ In short, an arm's-length factor (the licence agreement) was deemed irrelevant to the comparability analysis both on the contractual terms and for the determination of an arm's-length price. The court's direct application of the CUP method was sufficient to quash the taxpayer's position.³⁹

In *General Electric Capital Canada*, the Canadian taxpayer appealed the CRA's income tax assessments on the basis that the guarantee fee paid by the taxpayer to its US parent company in respect of debts owing to third-party creditors represented the actual arm's-length price of that service.⁴⁰ The appeals were allowed and the CRA assessments ultimately vacated.

With regard to the comparability analysis, the issue pertained to the relevance of a non-arm's-length factor for the determination of an arm's-length price. At the Tax Court of Canada, the CRA suggested that the taxpayer had "implicit support" from its parent company, an obvious condition arising from the non-arm's-length nature of the relationship. According to the CRA, this in itself should have precluded the

37 Ibid.

38 Ibid., at paragraphs 77-78.

39 See *ibid.*, at paragraphs 119-161, in particular paragraphs 141 and 161. I will return to *GlaxoSmithKline* below, since the decision was appealed first to the Federal Court of Appeal and then to the Supreme Court of Canada, before a confidential settlement was announced in early January 2015 pending the return of the case to the Tax Court of Canada.

40 *General Electric Capital Canada*, *supra* note 31, at paragraph 1.

relevance of any payment of fees by the taxpayer to its parent company to guarantee its debts owed to third-party creditors.⁴¹

Of note, the CRA relied on paragraph 7.13 of the OECD guidelines, which discusses the “incidental benefits attributable solely to being part of a larger concern.”⁴² The CRA contended that the taxpayer would not have entered into the guarantee contract if the parties had been dealing at arm’s length. The implicit support was a specific circumstance (that is, a non-arm’s-length factor) that surrounded the controlled transaction, according to the CRA. However, it should be pointed out that the OECD guidelines state that in such cases no transaction has occurred; in short, no service has been received.

The taxpayer disagreed with the CRA’s position, arguing that the proper application of the arm’s-length principle required that “all distortions that arise from the parties’ relationship . . . be eliminated to arrive at an arm’s length result.”⁴³ The comparability analysis can then be carried out to determine an arm’s-length price, which may in fact be nil if paragraph 7.13 were indeed to apply to the transaction.

After a careful examination of the meaning of “arm’s length,”⁴⁴ Hogan J concluded that the concept of implicit support could not be ignored in determining an arm’s-length price. In his view, “[t]hat concept has nothing to do with the exercise of *de facto* or *de jure* control which defines a non-arm’s length relationship.”⁴⁵ In other words, the implicit support provided by the parent company to its subsidiary, a recognizable non-arm’s-length factor, was considered relevant by the court for the determination of the arm’s-length price in a commercial transaction between parties not dealing at arm’s length.

On the one hand, in *GlaxoSmithKline* the Tax Court rejected an explicit commercial agreement between the related parties because it did not constitute a relevant circumstance in determining an arm’s-length price. On the other hand, in *General Electric Capital Canada* the court included in the relevant circumstances a factor that clearly arose from the non-arm’s-length relationship between the taxpayer and its parent company. Both decisions were appealed, as will be discussed below.

These two decisions of the Tax Court of Canada set the path for a deeper examination of what may constitute “relevant circumstances” in order to carry out the analysis of the contractual terms between parties not dealing at arm’s length and the comparability analysis applied to transfer pricing.

41 Ibid., at paragraphs 167-172.

42 OECD guidelines, supra note 5. An OECD public discussion draft issued in 2014 does not modify this position: see Organisation for Economic Co-operation and Development, *BEPS Action 10: Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines Relating to Low Value-Adding Intra-Group Services* (Paris: OECD, November 2014), at paragraph 7.14.

43 *General Electric Capital Canada*, supra note 31, at paragraph 173.

44 Ibid., at paragraphs 178-198.

45 Ibid., at paragraph 199.

Conceptual Tensions Arise on the Relevance of Non-Arm's-Length Factors

In *GlaxoSmithKline*, the Federal Court of Appeal⁴⁶ was asked if the two agreements (the licence agreement and the supply agreement) were indeed relevant circumstances to be considered in the comparability analysis and, subsequently, in determining an arm's-length price for the purchases of ranitidine. Nadon JA, writing for a unanimous panel, enumerated five "circumstances" that showed that the licence agreement was clearly useful and central to the determination of the arm's-length price of the ranitidine.⁴⁷

The Federal Court of Appeal rejected the relevance of the *Singleton* case for an arm's-length transfer-pricing determination. The court basically indicated that there was no similarity between subparagraph 20(1)(c)(i) and subsection 69(2) (the predecessor of section 247). Accordingly, the decision of the Supreme Court in *Singleton* not to recharacterize a transaction in light of its economic realities was irrelevant for transfer-pricing purposes.⁴⁸

Instead, the court relied upon *Gabco Limited v. MNR*.⁴⁹ The court noted that the "reasonable business person" standard was relevant for the determination of an arm's-length transfer price.⁵⁰ In other words, an examination of the business circumstances was required in order to determine an arm's-length price. As the court stated,

the test set out in *Gabco, supra*, requires an inquiry into those circumstances which an arm's length purchaser, standing in the shoes of the appellant, would consider relevant in deciding whether it should pay the price paid by the appellant to Adechsa [the supplier] for its ranitidine.⁵¹

The two agreements were therefore part of the comparability analysis. They "[did] not arise from the non-arm's length relationship between the appellant and Adechsa or between the appellant and Glaxo Group."⁵² By extension, the supply agreement was also considered pertinent since it put forward the terms and conditions of the ranitidine purchases, including the benefits and rights obtained by the taxpayer through the licence agreement. In other words, every arm's-length circumstance considered to be relevant from the taxpayer's perspective was truly appropriate for the determination of the arm's-length price.

46 *GlaxoSmithKline Inc. v. Canada*, 2010 FCA 201.

47 *Ibid.*, at paragraphs 79-81.

48 *Ibid.*, at paragraphs 63-68.

49 68 DTC 5210 (Ex. Ct.).

50 *GlaxoSmithKline*, *supra* note 46, at paragraphs 69-72.

51 *Ibid.*, at paragraph 73.

52 *Ibid.*, at paragraphs 80-81.

In *General Electric Capital Canada*, the Federal Court of Appeal⁵³ reanalyzed the relevance of the inclusion of any non-arm's-length factor for the determination of an arm's-length price. The issue of the "implicit support" received by the taxpayer from its parent company was back on stage. It was at the heart of the argument submitted by the CRA in its appeal. Writing for a unanimous panel, Noël JA explained that the inclusion of the implicit support as an economically relevant factor in determining an arm's-length price "gives rise to a pure question of statutory construction which must be assessed on a standard of correctness."⁵⁴ After examining paragraphs 247(2)(a) and (c), the court stated:

The concept underlying subsection 69(2) and paragraphs 247(2)(a) and (c) is simple. The task in any given case is to ascertain the price that would have been paid in the same circumstances if the parties had been dealing at arm's length. This involves taking into account all the circumstances which bear on the price whether they arise from the relationship or otherwise.

This interpretation flows from the normal use of the words as well as the statutory objective which is to prevent the avoidance of tax resulting from price distortions which can arise in the context of non arm's length relationships by reason of the community of interest shared by related parties. The elimination of these distortions by reference to objective benchmarks is all that is required to achieve the statutory objective. Otherwise all the factors which an arm's length person in the same circumstances as the respondent would consider relevant should be taken into account.⁵⁵

Simply put, the Federal Court of Appeal in *General Electric Capital Canada* stated that "any" factor deemed relevant, whether by the taxpayer or by the tax administration, may be included in the comparability analysis for the determination of an arm's-length price. Remarkably, the court pointed out that this comparability analysis could include factors that existed solely because the parties were not dealing at arm's length if those factors were considered pertinent to the determination of an arm's-length price.⁵⁶ The court did not consider that the sole purpose of the comparability analysis was in fact to render ineffective the non-arm's-length factors in the determination of an arm's-length price.

The court indicated that its conclusion on this point was based on the "test" set out by the Federal Court of Appeal in *GlaxoSmithKline*.⁵⁷ According to the court, a person deemed to deal at arm's length—or the court, for that matter—should have to consider any relevant non-arm's-length factor in addition to relevant arm's-length factors in order to properly apply the arm's-length principle as prescribed by

53 *General Electric Capital Canada*, supra note 18.

54 *Ibid.*, at paragraph 51.

55 *Ibid.*, at paragraphs 54-55.

56 *Ibid.*, at paragraphs 52-53.

57 *Ibid.*, at paragraphs 58-59, in reference to *GlaxoSmithKline*, supra note 46.

subsection 247(2). In *General Electric Capital Canada*, the implicit support provided by the parent company to its subsidiary hence became a relevant factor in the characterization of the contractual terms and, for that reason, in the determination of an arm's-length price.

However, it should be noted that in *GlaxoSmithKline*, the Federal Court of Appeal never suggested that non-arm's-length factors were relevant for the determination of an arm's-length price, but quite the opposite. The court clearly indicated that the two agreements were relevant circumstances. They unequivocally “[did] not arise from the non-arm's length relationship between the appellant and Adechsa or between the appellant and Glaxo Group.”⁵⁸ The court also added:

I again wish to emphasize that the above circumstances were circumstances that would have been present even if the appellant had been dealing at arm's length with Adechsa and Glaxo Group. Consequently, an arm's length appellant would necessarily have had to consider those circumstances in deciding whether it was willing to pay the price asked for by Adechsa for the sale of the Zantac ranitidine.⁵⁹

In short, obvious conceptual tensions were persisting in light of these two decisions of the Federal Court of Appeal with respect to what were “relevant circumstances” in carrying out the analysis of the contractual terms between parties not dealing at arm's length, in performing the comparability analysis, and ultimately in determining an arm's-length price.

The Relevance of Non-Arm's-Length Factors Is Put to the Test

In *Alberta Printed Circuits Ltd. v. The Queen*,⁶⁰ the main issue before the Tax Court pertained to arm's-length fees paid in relation to prototype circuit boards. The taxpayer was disbursing a setup fee to its related counterparty located in Barbados for the “functions of validation, formatting, and panelizing” provided through specialized software.⁶¹ Although the taxpayer's appeals were allowed, approximately 25 percent of the transfer-pricing adjustment made by the CRA was sustained on the basis that the taxpayer had “not met the onus of establishing that it did not overpay” its related counterparty for the services provided.⁶²

With respect to the comparability analysis, the court examined every function performed in Barbados in return for the setup fees.⁶³ Regarding the contractual terms, Pizzitelli J remarked that the annual contracts between the taxpayer and its

58 *GlaxoSmithKline*, supra note 46, at paragraph 80.

59 *Ibid.*, at paragraph 81.

60 2011 TCC 232.

61 *Ibid.*, at paragraph 45.

62 *Ibid.*, at paragraphs 234-245; the quoted text is taken from paragraph 243.

63 *Ibid.*, at paragraphs 41-49.

counterparty in Barbados “did not contain many material terms, such as terms relating to liability or warranty with respect to poor work, terms dealing with dispute or jurisdiction issues, or other usual contractual terms one would expect in an international agreement.”⁶⁴ In short, the contractual terms demonstrated that the parties were clearly not dealing at arm’s length.

It followed that the Tax Court again had to identify the comparability factors that were relevant to the determination of an actual arm’s-length price. That determination was also required because the taxpayer and the CRA had made different assumptions prior to the selection and application of a transfer-pricing method.⁶⁵

For the determination of the relevant comparability factors, Pizzitelli J relied on the “guidelines” put forward in *GlaxoSmithKline* by the Federal Court of Appeal.⁶⁶ According to the court, it followed that the contractual terms should reflect the “real business world.”⁶⁷ Therefore, as reiterated by the court, “the test requires a consideration of all relevant factors that a reasonable business person in the Appellant’s shoes would consider.”⁶⁸

After listing the five OECD comparability factors, Pizzitelli J stated that the list was not intended to be exhaustive, citing the decisions in *GlaxoSmithKline* and *General Electric Capital Canada*.⁶⁹ Interestingly, the court emphasized that this meant that the reasonable business person may have to consider relevant “factors or circumstances that exist solely because of the non-arm’s length relationship of the parties.”⁷⁰ On that point, Pizzitelli J deferred unequivocally to the Federal Court of Appeal in *General Electric Capital Canada*, which had stated that there was no error in law in taking into consideration the implicit relationship between the non-arm’s-length parties.⁷¹

Pizzitelli J reiterated that “in short, all circumstances means ‘all’ the circumstances an appellant finds himself in before a reasonable businessman steps into his shoes” when the time comes to determine an arm’s-length price.⁷² As previously discussed, this interpretation contradicts what was established by the Federal Court of Appeal in *GlaxoSmithKline*.

64 Ibid., at paragraph 78.

65 Ibid., at paragraph 127.

66 Ibid., at paragraphs 156-157.

67 Ibid., at paragraph 158.

68 Ibid., at paragraph 159.

69 Ibid., at paragraph 162.

70 Ibid., at paragraph 160. The court added that this had been demonstrated in *GlaxoSmithKline* (FCA), supra note 46.

71 Ibid., at paragraph 162.

72 Ibid., at paragraph 163.

The Supreme Court Officially Gives Birth to a Sixth Comparability Factor

Following the Federal Court of Appeal's decision in *GlaxoSmithKline*, the CRA appealed to the Supreme Court of Canada⁷³ to inquire about the correct application of subsection 69(2): "in particular, what circumstances are to be taken into account in determining the reasonable arm's length price against which to compare the non-arm's length transfer price."⁷⁴ The taxpayer also appealed to the court, to contest the decision to remit the transfer-pricing matter to the Tax Court of Canada, on the basis that the taxpayer had "successfully demolished the Minister's assumptions, thus fully discharging the taxpayer's burden in appealing the reassessment."⁷⁵ Both appeals were dismissed.⁷⁶

Although this is not explicitly mentioned in the decision, the Supreme Court was likely aware of the conceptual tensions between the decisions rendered by the Federal Court of Appeal in *General Electric Capital Canada* and *GlaxoSmithKline*, with respect to the exact nature of "economically relevant characteristics" to be included in the comparability analysis and ultimately in the determination of an arm's-length price. The court aptly remarked that

section 69(2) does not, itself, offer guidance as to how to determine the "reasonable amount" that would have been payable had the parties been dealing at arm's length. However, the [OECD] *Guidelines* suggest a number of methods for determining whether transfer prices are consistent with prices determined between parties dealing at arm's length.⁷⁷

Starting from that premise, the court took upon itself the task of identifying the meaning of "comparability" with the respect to the application of the OECD guidelines.⁷⁸

Essentially, the Supreme Court confirmed that other transactions may be useful to the determination of an arm's-length price. In other words, other transactions may be relevant to "determine whether the actual price was or was not greater than the amount that would have been reasonable had the parties been dealing at arm's length."⁷⁹ In *GlaxoSmithKline*, the relevance of the two agreements concluded by

73 *Canada v. GlaxoSmithKline Inc.*, 2012 SCC 52.

74 *Ibid.*, at paragraph 3.

75 *Ibid.*

76 The case was returned to the Tax Court of Canada (see file 98-712(IT)G) but was settled prior to trial, although (according to the *Financial Post*) the details remain confidential: see Julius Melnitzer, "GlaxoSmithKline Transfer Pricing Case Settled," *Financial Post*, January 12, 2015 (<http://business.financialpost.com/legal-post/glaxosmithkline-transfer-pricing-case-settled>).

77 *GlaxoSmithKline*, supra note 73, at paragraph 21.

78 *Ibid.*, at paragraph 23.

79 *Ibid.*, at paragraph 38.

the taxpayer (the licence agreement and the supply agreement) for the purpose of the comparability analysis was clear.⁸⁰

The Supreme Court indicated that other transactions could be used to carry out the comparability analysis if they were “economically relevant circumstances” in the determination of an arm’s-length price—that is, if they were part of the contractual relationships between the parties not dealing at arm’s length, as stated in the OECD guidelines.⁸¹

The court concurred with the reasoning of the Federal Court of Appeal and rejected the applicability of *Singleton*.⁸² The court based its conclusion solely on paragraph 1.15 of the 1995 OECD guidelines, which it quoted as follows:

Application of the arm’s length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. *In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable.* To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.⁸³

This led the court to find that the licence agreement was relevant.⁸⁴ But in a somewhat surprising turn of events, the court went further and also specified that “according to the 1995 *Guidelines*, a proper application of the arm’s length principle requires that regard be had for the ‘economically relevant characteristics’ of the arm’s length and non-arm’s length circumstances to ensure they are ‘sufficiently comparable.’”⁸⁵

In essence, the Supreme Court was following the somewhat flawed reasoning put forward by the Federal Court of Appeal in *General Electric Capital Canada*. It is worth emphasizing that there is no mention whatsoever of the relevance of non-arm’s-length circumstances or factors in either paragraph 1.15 or anywhere else in the OECD guidelines (both the 1995 and the 2010 versions), for the purposes of the comparability analysis or for the selection and application of a transfer-pricing method. Paragraph 1.15 of the 1995 OECD guidelines (paragraph 1.33 of the 2010 version) does suggest that the comparability analysis starts with the “comparison of

80 Although not mentioned by the court, this conclusion also loosely ties in with paragraph 3.9 of the OECD guidelines, *supra* note 5, which highlights cases where “separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis.”

81 See *ibid.*, at paragraph 1.52.

82 *Shell Canada Ltd. v. Canada*, [1999] 3 SCR, was also rejected on the same grounds—namely, because there was no similarity between subparagraph 20(1)(c)(i) and subsection 69(2).

83 *GlaxoSmithKline*, *supra* note 73, at paragraph 41 (emphasis added). See the 1995 OECD guidelines, *supra* note 2, and paragraph 1.33 of the 2010 version, *supra* note 5.

84 *GlaxoSmithKline*, *supra* note 73, at paragraphs 43–65, in particular paragraphs 55–60.

85 *Ibid.*, at paragraph 42.

the conditions in a controlled transaction with the conditions in transactions between independent enterprises.” But as I pointed out in the introduction to this article, in order for that comparison to make any conceptual sense, it is solely the arm’s-length factors that should be considered with respect to the determination of an arm’s-length transfer price.

I also noted in the introduction that this methodological approach pertaining to the comparability analysis is aligned with article 9 of the OECD model tax convention, which provides for transfer-pricing adjustments when “conditions . . . made or imposed between the two [associated] enterprises in their commercial or financial relations . . . differ from those which would be made between independent enterprises.”⁸⁶ That is, that any such adjustment is meant to correspond to the conditions that would have existed between parties dealing at arm’s length.

Non-arm’s-length conditions, circumstances, and factors must be excluded for the purpose of the application of the arm’s-length principle and the determination of an arm’s-length transfer price. Non-arm’s-length factors are eliminated by virtue of the comparability analysis carried out, an analysis that directly pertains to the relevant arm’s-length factors in the transaction itself, the parties involved in the transaction, and the conditions and circumstances surrounding the transaction. In this respect, it is worth repeating the following statement in paragraph 1.6 of the OECD guidelines:

Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the transactions between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions.⁸⁷

As discussed above, a methodological focus on the nature of the transaction clearly should prevent the inclusion of any non-arm’s-length factor in the comparability analysis for transfer-pricing purposes. After all, in the end, the objective of the comparability analysis is to properly apply the arm’s-length principle—that is, to identify a transfer price that reflects the terms and conditions that would be found between unrelated parties. It is therefore those terms and conditions found between unrelated parties that must be the definitive focus of the comparability analysis for the determination of any transfer price in accordance with the arm’s-length principle.

This specific point was introduced by the Federal Court of Appeal in *GlaxoSmith-Kline*, where the court stated unequivocally that the two agreements between the parties not dealing at arm’s length had to be considered in determining an arm’s-length price because they were circumstances that did “not arise from the non-arm’s-length relationship between the appellant and Adechsa or between the appellant

86 *Supra* note 12.

87 OECD guidelines, *supra* note 5.

and Glaxo Group.”⁸⁸ This was, and still is, the proper application of the “economically relevant characteristics” test suggested by the Supreme Court of Canada in *GlaxoSmithKline*, in carrying out the comparability analysis applied in transfer pricing. That test reflects the intent and spirit of the OECD guidelines with respect to the comparability analysis and the intent of section 247.⁸⁹

As discussed above, the non-arm’s-length factors are rendered ineffective in the arm’s-length price determination. It is worth repeating that the purpose of the arm’s-length principle in international taxation is to adjust the terms and conditions of any controlled transaction to the terms and conditions of an arm’s-length transaction. Accordingly, non-arm’s-length factors included in the controlled transaction must be discarded. A factor that exists solely in a non-arm’s-length environment cannot be compared with an arm’s-length arrangement since that specific factor does not exist in the arm’s-length environment.

All of this to say that in *GlaxoSmithKline* the Supreme Court went too far. After inferring language that is absent from the OECD guidelines and departs from the intent of the Act, the court indicated that the application of the arm’s-length principle through the lens of subsection 69(2) (current section 247) required that both the arm’s-length and the non-arm’s-length economically relevant factors be taken into account for the purpose of the comparability analysis.

Like the Federal Court of Appeal in *General Electric Capital Canada*, the Supreme Court did not appreciate that the sole purpose of the comparability analysis for transfer-pricing purposes is to render ineffective the non-arm’s-length factors in the determination of an arm’s-length transfer price.

A Sixth Comparability Factor: Non-Arm’s-Length Factors Surrounding the Relationship

While the Supreme Court’s conclusions may be unfortunate, they cannot be ignored by lower courts. The quarrel over the correct transfer-pricing methodology is therefore not just theoretical in nature. In *McKesson Canada Corporation v. The Queen*,⁹⁰

88 *GlaxoSmithKline*, supra note 46, at paragraph 80.

89 The Federal Court of Appeal in *GlaxoSmithKline* was basically confirming the government’s intent in modifying its transfer-pricing legislation in 1998 in order “to harmonize the standard contained in section 69 of the Act with the arm’s length principle as defined in the revised OECD guidelines” (1997 Budget Plan, supra note 2, at 203). As discussed in the introduction to this article, the amendments implemented a transfer-pricing regime based explicitly on the arm’s-length principle. New subsection 247(1) included definitions of “arm’s length allocation” (of profit or loss) and “arm’s length transfer price,” to ensure that transactions between Canadian taxpayers and non-arm’s-length non-residents would reflect what would have occurred if those parties had been dealing at arm’s length. The inclusion of any non-arm’s-length factor in the determination of an arm’s-length price is not considered in these definitions for the application of section 247.

90 2013 TCC 404 (appeal filed at the Federal Court of Appeal on 10 January 2014: files A-48-14 and A-49-14).

the Tax Court had to determine whether the value of pools of receivables sold at a discount by the Canadian taxpayer to its Luxembourg parent company met the arm's-length standard in section 247. The transactions were regulated by a receivable sales agreement and a servicing agreement—that is, by alleged arm's-length contractual terms.⁹¹

Deferring to the Supreme Court's decision in *GlaxoSmithKline*, Boyle J stated that

[a] judge is to take into account all transactions, characteristics and circumstances that are relevant (including economically relevant) in determining whether the terms and conditions of the transactions or series in question differ from the terms and conditions to which arm's length parties would have agreed.⁹²

Boyle J also noted that the OECD guidelines were not written by legislators. Accordingly, the legal provisions of the Act were predominant in the “fact finding and evaluation mission by the Court.”⁹³ Furthermore, the determination of an arm's-length price required an examination of the contractual terms from the perspectives of both the Canadian taxpayer and its related counterparty.⁹⁴

Going one step further, in *McKesson Canada Corporation*, the court took it upon itself to address the issue of “factors that exist only because of the non-arm's length relationship.”⁹⁵ Following in the footsteps of Pizzitelli J in *Alberta Printed Circuits*, Boyle J pointed out that the question whether non-arm's-length factors are relevant in an arm's-length analysis may not arise in the context of a single transaction. However, “[t]he question does appear significant in the context of a long-term commitment to do things over a period of time.”⁹⁶

This assertion crystallized what appears to be characterized as a sixth distinctive comparability factor in Canadian transfer pricing—the relevance of non-arm's-length factors surrounding the relationship between related parties. Boyle J justified his conclusions on the scope of the comparability analysis by inferring that without a thorough examination of these relevant non-arm's-length factors,

companies within wholly controlled corporate groups could enter into skeletal agreements conferring few rights and obligations to the non-resident participant . . . all with the view to obtaining a more favourable transfer price to reduce Canadian taxes.⁹⁷

91 Ibid., at paragraph 20.

92 Ibid., at paragraph 120.

93 Ibid.

94 Ibid.

95 Ibid., at paragraph 128.

96 Ibid., at paragraph 129.

97 Ibid., at paragraph 132.

However, in offering this rationale, Boyle J seemed to disregard his own analysis of paragraphs 247(2)(b) and (d),⁹⁸ which were included in the legislation specifically for the purpose of addressing non-arm's-length arrangements entered into primarily to obtain a tax benefit.⁹⁹

In *McKesson Canada Corporation*, the court was seemingly drawing transfer-pricing policy from the conclusions of the Supreme Court in *GlaxoSmithKline*.

CONCLUSION

The sixth distinctive comparability factor in Canadian transfer pricing created by the courts does not reflect the actual intent of the Act. Although the government modified its transfer-pricing legislation in 1998 to implement changes aligned with the 1995 OECD guidelines, the arm's-length principle as a transfer-pricing policy principle in Canada has never been challenged since its original inception in section 23B of the Income War Tax Act in 1939.¹⁰⁰

The 1998 amendments reaffirmed a "transfer pricing regime based explicitly on the arm's length principle."¹⁰¹ In no way are non-arm's-length factors part of the arm's-length principle; in fact, quite the opposite. From a Canadian transfer-pricing perspective, it follows that non-arm's-length factors should not be included in the comparability analysis or in the examination of the "reasonable efforts" made by the taxpayer to use arm's-length allocations or prices.

The latter point may lead to some controversy in future Canadian transfer-pricing cases, since "reasonable efforts" are of the utmost importance to the taxpayer wary of potential transfer-pricing penalties under subsection 247(3). *Transfer Pricing Memorandum* TPM-09 clearly states:

A reasonable effort means the degree of effort that an independent and competent person engaged in the same line of business or endeavour would exercise under similar circumstances. What is reasonable is based on what a reasonable business person in the taxpayer's circumstances would do, having regard to the complexity and importance of the transfer pricing issues that arise in the taxpayer's case.¹⁰²

As discussed above, for Canadian transfer-pricing purposes, the Canadian courts have adopted an interpretation of "reasonable business person" that now includes the consideration of non-arm's-length factors in the determination of an arm's-length price. But that interpretation substantially differs from the views of the OECD and the CRA on the matter.

98 *Ibid.*, at paragraphs 125-127.

99 See *Explanatory Notes*, supra note 4, at 508-15.

100 Income War Tax Act, 1939, SC 1939, c. 46, section 13; repealed.

101 See the summary of the Income Tax Amendments Act, 1997, supra note 3.

102 *Transfer Pricing Memorandum* TPM-09, "Reasonable Efforts Under Section 247 of the Income Tax Act," September 18, 2006, at 4.

By way of its decision in *GlaxoSmithKline*, the Supreme Court of Canada simply made new legislation. This singular interpretation of the OECD guidelines by the Supreme Court introduced a sixth comparability factor in Canadian transfer pricing—the relevance of non-arm’s-length factors surrounding the relationship between related parties.

In short, what seems to have been a methodological oversight by the Supreme Court of Canada in regard to the proper application of the arm’s-length principle through the comparability analysis is more than just unfortunate. It may have repercussions on what constitutes “reasonable efforts” and the ensuing application of transfer-pricing penalties. It is to be hoped that future transfer-pricing cases will help to correct, and not intensify, this misunderstanding of the comparability analysis in applying the arm’s-length standard.

