Date: 20100726

Docket: A-345-08

Citation: 2010 FCA 201

CORAM: **NADON J.A.**
LAYDEN-STEVENSON J.A.
STRATAS J.A.

BETWEEN:

GLAXOSMITHKLINE INC.

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard at Toronto, Ontario, on March 8, 2010.

Judgment delivered at Ottawa, Ontario, on July 26, 2010.

REASONS FOR JUDGMENT BY: NADON J.A.

CONCURRED IN BY: LAYDEN-STEVENSON J.A.
STRATAS J.A.

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REASONS FOR JUDGMENT

NADON J.A.

[1] Between the years 1990 and 1993, the appellant purchased ranitidine, the active pharmaceutical ingredient in a drug marketed by it in Canada under the brand name Zantac, from Adechsa SA ("Adechsa"), a related non-resident company, for an amount of between $1512 and $1651 per kilogram ("kilo"). During that same period, two Canadian generic pharmaceutical companies, namely Apotex Inc. and Novopharm Ltd., purchased their ranitidine from arm's length suppliers for an amount of between $194 and $304 per kilo.

[2] The Minister of National Revenue (the "Minister") reassessed the appellant for taxation years 1990 through 1993. First, under Part I of the *Income Tax Act* (the "ITA"), the Minister, pursuant to, *inter alia*, subsection 69(2) thereof, increased the appellant's income by the difference between the price paid by Apotex and Novopharm for their ranitidine and that paid by the appellant for its ranitidine. Second, the Minister assessed the appellant under Part XIII of the ITA for amounts deemed to have been paid by it as dividends in the years at issue to Glaxo Group, a United Kingdom corporation, in accordance with subsections 56(2), 212(2) and 214(3) of the ITA.

[3] The appellant appealed the Minister's reassessments to the Tax Court of Canada which, save for a minor upward adjustment to the price paid by the appellant for its ranitidine, upheld the reassessments.

[4] This is an appeal from a decision of Rip A.C.J. (as he then was) (the "Judge") , 2008 TCC 324, which allowed the appellant's appeals from assessments made under Part I of the ITA for the 1990, 1991, 1992 and 1993 taxations years, and assessments made under Part XIII of the ITA with respect to the appellant's failure to withhold tax on dividends deemed to be paid to a non-resident shareholder in 1990, 1991, 1992 and 1993, and referred the matter back to the Minister for reconsideration and reassessment only to decrease the excess amounts paid by the appellant for ranitidine by $25 per kilo and to adjust the amounts of withholding tax accordingly.

[5] In this appeal, we are called upon to determine the proper interpretation of subsection 69(2) of the ITA, which reads as follows:

69. (2) 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 is payable therefor.	**69.** (2) Lorsqu'un contribuable exploitant une enterprise au Canada a versé ou convenu de verser à une personne non résidante, avec laquelle il avait un lien de dépendance, à titre de prix, loyer, redevance ou autre paiement pour un bien ou pour l'usage ou la reproduction d'un bien, ou en contrepartie du transport de marchandises ou de voyageurs ou d'autres services, une somme plus élevée que la somme (ci-après appelée "la somme raisonnable") qui aurait été raisonnable eu égard aux circonstances si la personne non résidante et le contribuable n'avaient eu aucun lien de dépendance, la somme raisonnable est réputée, aux fins du calcul du revenu du contribuable provenant de l'entreprise, avoir été la somme payée ou payable dans ce cas.
[Emphasis added]	[Non souligné dans l'original]

[6] More particularly, the appeal requires us to decide whether the Judge erred in his determination of the circumstances relevant to the assessment of the amount referred to in subsection 69(2) of the ITA as "the reasonable amount". For the reasons that follow, I conclude that the Judge erred in his interpretation of the provision and that, as a result, his decision cannot stand.

THE FACTS

[7] The appellant, Glaxo Canada, was a wholly-owned subsidiary of Glaxo Group, itself a wholly-owned subsidiary of Glaxo Holdings plc, also a United Kingdom corporation. Glaxo Holdings was the ultimate parent of the Glaxo Group of companies ("Glaxo World companies").

[8] At all times material to this appeal, the Glaxo World companies discovered, developed, manufactured and distributed a number of branded pharmaceutical products. These products were marketed and sold in local markets throughout the world through various subsidiaries such as the appellant and arm's length distributors.

[9] Beginning in 1982, and during the tax years at issue, the appellant packaged and sold Zantac, a patented and trade-marked drug prescribed to treat stomach ulcers without surgery, in Canada. The Zantac trade-mark and patents for its active ingredient, ranitidine, was owned by Glaxo Group, which licensed them to the appellant for use in Canada.

[10] Prior to the discovery of ranitidine in 1976 by Glaxo Group and its approval for sale in Canada in 1982, the most successful product on the market for the treatment of ulcers was Tagamet. Over time, but prior to the years at issue, Zantac overtook Tagamet as the premier anti-ulcer drug, which allowed Glaxo World to price Zantac at a substantial premium to Tagamet.

[11] The manufacturing of ranitidine was primarily the responsibility of two companies within the Glaxo World companies, namely Glaxochem (Pte) Ltd., a Singapore corporation, and Glaxochem Ltd., a United Kingdom corporation. Following its manufacturing, the ranitidine was sold to Adechsa, a Swiss corporation, or to Glaxo Far East (Pte), another corporation from Singapore, both Glaxo World clearing companies.

[12] In turn, these companies sold the ranitidine to Glaxo World affiliates such as the appellant or to arm's length distributors throughout the world. The purchasers would generally package the ranitidine into a delivery mechanism such as a tablet, liquid or gel, market it and sell it.

[13] The price at which Glaxo World affiliates and arm's length distributors purchased ranitidine (the "transfer price") was determined by what is known as the "resale-price method". The Judge, at paragraph 47 of his Reasons, gave the following explanation in regard thereto:

> [47] Glaxo World used what is referred to as a resale-price method to determine the transfer price of the API [active pharmaceutical ingredient]. Glaxo World and its distributors agreed that a gross margin of 60 percent would be retained by the distributors and the ranitidine was priced accordingly. To use a very simple example, if the ranitidine product was sold for $10 in Italy, the transfer price would be $4; if the ranitidine product was sold for $20 in France, the transfer price would be $8. Appellant's counsel described the process as follows:
>
> > the starting point for determining the price to the distributor was the in-market price for the finished ranitidine product;
> >
> > from that in-market price the parties agreed, assuming specified conditions were satisfied, a gross profit margin to be retained by the distributor (approximately 60%); and
> >
> > the remainder would be remitted back to Glaxo Group in the form of transfer price, royalties,[or both]. Where the distributor was to pay both transfer prices and royalties, they would be considered together to determine the distributor's gross profit margin after payment of the royalty.

[14] At the heart of this appeal are two specific contractual arrangements, namely, a Supply Agreement between the appellant and Adechsa and a License Agreement between the appellant and Glaxo Group.

[15] In 1983, the appellant entered into a Supply Agreement with Adechsa for the purchase of ranitidine. This price was reviewed and adjusted annually. For the years 1990 to 1993, the purchase price was respectively $1,512.00, $1572.45, $1,635.37 and $1,651.72 per kilo. This Agreement provided protection to the appellant against foreign currency exchange, indemnity insurance and the provision of intellectual property to "the extent that the [appellant] shall not previously have received it or shall not otherwise receive it directly from [Glaxo Group]".

[16] The second contractual arrangement relevant to the determination of this appeal is the License Agreement between the appellant and Glaxo Group. Pursuant to this Agreement, which applied to the entire portfolio of Glaxo World drugs, the appellant paid Glaxo Group a 6% royalty on its net sales of Zantac and other drugs in exchange for:

1. the right to manufacture, use and sell products;
2. the right to the use of the trademarks owned by Glaxo Group, including Zantac;
3. the right to receive technical assistance for its secondary manufacturing requirements;
4. the use of the registration materials prepared by Glaxo Group, to be adapted to the Canadian Environment and submitted to the Health Protection Branch ("HPB");
5. access to new products, including line extensions;
6. access to improvement in drugs;
7. the right to have a Glaxo World company sell to the appellant any raw materials;
8. marketing support; and
9. indemnification against damages arising from patent infringement actions.

[17] During the years at issue, Apotex and Novopharm, both Canadian generic pharmaceutical companies, sold generic ranitidine products in Canada. Both companies purchased their ranitidine at a price substantially lower than that paid by the appellant for its ranitidine, i.e. between $194 and $304 per kilo, from unrelated manufacturers that did not hold patent rights and were not Glaxo Group-approved sources.

[18] The basis upon which the Minister reassessed the appellant for its 1991, 1992 and 1993 taxation years was as follows: (i) by increasing its income for each of those years on the basis that it had overpaid Adechsa for the purchase of ranitidine, pursuant to, *inter alia*, subsection 69(2) of the ITA; and (ii) by assessing it for tax under Part XIII of the ITA for amounts deemed to be have been paid by it as dividends in those years to Glaxo Group, in accordance with subsections 56(2), 212(2) and 214(3) of the ITA.

[19] These assessments were appealed by the appellant to the Tax Court which, in its decision dated May 30, 2008, held that the amounts paid by the appellant to Adechsa for ranitidine exceeded the “fair market value” of ranitidine and that, consequently, subsection 69(2) of the ITA applied. More particularly, the Tax Court determined that the price which would have been reasonable for the appellant to pay Adechsa for each kilo of ranitidine that it purchased was the highest price paid by Apotex and Novopharm for a kilo of ranitidine during the years at issue, subject to an upward adjustment of $25 per kilo to account for the fact that the ranitidine purchased by the appellant was granulated, whereas that purchased by Apotex and Novopharm was not.

[20] The Tax Court further determined that the excess of the amounts paid by the appellant to Adechsa for ranitidine over the amount determined to be the "reasonable amount" were benefits that the appellant desired to have conferred on Adechsa, within the meaning of subsection 56(2) of the ITA and, as such, were subject to non-resident withholding tax under Part XIII of the ITA as dividends in Glaxo Group's hands.

The Tax Court Decision

[21] As I have already indicated, the Judge allowed the appellant's appeals from the Minister's reassessments, but only to the extent that the excess amount that the Minister says the appellant paid for its ranitidine should be increased by $25 per kilo to take into account the fact that the ranitidine purchased by the appellant was granulated.

[22] I now turn to the Judge's analysis with regard to the Part I issue.

[23] The Judge began by stating the issue before him as being "whether the prices paid by Glaxo Canada to Adechsa for ranitidine would have been reasonable in the circumstances if Glaxo Canada and Adechsa had been dealing at arm's length" (paragraph 66 of the Judge's Reasons). He then, at paragraphs 67 through 69, set out the parties' position on that issue. The Judge indicated that the respondent's position was that purchases made by the generic companies for their ranitidine were the comparable transactions that should be used to determine the amount that was "reasonable in the circumstances". Thus, according to the respondent, the arm's length price which the appellant ought

to have paid to Adechsa was that paid by the generic companies for their ranitidine. In formulating that view, the respondent relied on the Cost-Plus method.

[24] With respect to the appellant's position, the Judge stated it to be that the purchases made by the generic companies were not an appropriate comparator for two reasons. First, the appellant argued that its business circumstances were wholly different from those of the generic companies and that, consequently, the generics' transactions were not comparable within the meanings of subsection 69(2) of the ITA and the Comparable Uncontrolled Price method ("CUP method"). Second, the appellant argued that its ranitidine had been manufactured under Glaxo World standards of good manufacturing practices ("GMP"), granulated to Glaxo World standards, and produced in accordance with Glaxo World health, safety and environmental standards ("HSE").

[25] The Judge concluded that part of his Reasons by pointing out that the appellant's submission was that independent third-party licensees in Europe were the best comparator because they purchased ranitidine under the same set of business circumstances as the appellant. The Judge indicated that the appellant relied on the Resale Price method to confirm its CUP method of calculation.

[26] The Judge then noted the areas of dispute between the parties, namely: (i) whether the Supply Agreement and the Licence Agreement should be considered together to determine a reasonable transfer price; (ii) the meaning of the phrase "reasonable in the circumstances" in subsection 69(2) of the ITA, and; (iii) the impact of the differences in good manufacturing practices

and health, safety and environmental standards on the comparability of the ranitidine purchased by the appellant versus that purchased by the generic companies.

[27] The Judge was of the view that the CUP method was the preferred method (which appears to be agreed between the parties) to use in order to establish the arm's length transfer price, but that the differences above had to be considered before he could undertake that analysis.

[28] The Judge was of the opinion that because the Supply Agreement with Adechsa and the Licence Agreement with Glaxo Group covered separate matters, the License Agreement should not form part of his consideration in determining 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". In so concluding, the Judge relied on by the Supreme Court of Canada's decision in *Singleton v. Canada*, [2001] 2 SCR 1046.

[29] At paragraph 78 of his Reasons, the Judge stated that "[i]t may very well be that a 40 percent total profit to Glaxo Group is reasonable; however, the issue before me is whether the purchase price of the ranitidine was reasonable. One cannot combine the two transactions and ignore the distinct tax treatments that follow from each". He further stated that "in the appeals at bar, the business circumstances and strategies that the appellant submits distinguish it from the generic companies have no bearing on the transfer pricing issue." (paragraph 92 of the Judge's Reasons).

[30] The Judge then turned to a consideration of subsection 69(2) and the meaning of the words "reasonable in the circumstances". He found as follows:

> 89 If the legislature intended that the phrase "reasonable in the circumstances" in subsection 69(2) should include all contractual terms there would be no purpose to subsection 69(2); any MNE [Multinational Enterprises] would be able to claim that its parent company would not allow it to purchase from another supplier. No MNE would ever have its transfer prices measured against arm's length prices, because all MNEs would allege that they could purchase only from sources approved by the parent company. The controlling corporation in a MNE would structure its relationships with its related companies, and as between its related companies, in this manner or in some similar manner. There is no question that the appellant was required to purchase Glaxo approved ranitidine. The issue is whether a person in Canada dealing at arm's length with its supplier would have accepted the conditions and paid the price the appellant did.
>
> 90 The circumstances set out in (f), (g) and (h) in paragraph 80 [in paragraph 80 of his Reasons, the Judge sets the business circumstances which the appellant says distinguish its transactions from those of the generic companies] relate to the fact that Zantac was priced at a premium to Tagamet and that the appellant focused its marketing on selling to doctors. Again, there is no dispute that the appellant's marketing and pricing strategies differed from most, if not all, of the generic companies' strategies. However, the issue at hand is the reasonable price to be paid for the purchase of ranitidine, not Zantac. The evidence has established that it was the marketing efforts of Glaxo Canada and the value of the Zantac brand name that resulted in the price premium for Zantac. The evidence of Dr. Bell and Mr. Hasnain was that the perception of the consumer was very important to Zantac's success. There was no evidence that the price or value of the API had any effect on the price of the finished product. In fact, Glaxo World did its pricing the other way around, taking the price of the finished product and determining the price of the API from what it would eventually fetch for the final product. Any difference in business strategy between the appellant and the generic companies relates to the end selling price of the finished product, not the purchase price of the API.
>
> 91 Finally, in (d) and (e) in paragraph 80, the appellant says that it received regulatory approval and marketing assistance from Glaxo World and that it sold its ranitidine product under trademarks owned by Glaxo World. This is irrelevant because intangibles come from the Licence Agreement, which is to be considered separately from the Supply Agreement.
>
> 92 The 1995 Commentary [in 1979, the Organization for Economic Cooperation and Development (the "OECD") issued a Commentary on transfer pricing analysis entitled "Transfer Pricing and Multinational Enterprises", a report of the OECD Committee on Fiscal Affairs (the "OECD Commentary") and updated in 1995 (the "1995 Commentary")]

> states that business strategies must be looked at to determine comparability. However in the appeals at bar, the business circumstances and strategies that the appellant submits distinguish it from the generic companies have no bearing on the transfer pricing issue
>
> [Emphasis added]

[31] With regard to the issue of good manufacturing practices ("GMPs") and health, safety and environmental practices ("HSEs"), the Judge found the following:

> 118 Appellant's counsel argued that Glaxo's adherence to GMPs meant that its ranitidine was not comparable to that used by the generic companies. I do not accept this argument. Glaxo's GMP and HSE standards do not change the nature of the good. As Mr. Winterborn stated, "Ranitidine is ranitidine is ranitidine". Bernard Sherman, the Chairman of Apotex, insisted that the Glaxo ranitidine molecule and the generic ranitidine molecule are identical. The appellant has admitted that the generic ranatidine was chemically equivalent and bioequivalent as required by HPB. Thus, were it not for the Licence Agreement and Glaxo World's self-imposed standards, the appellant could have purchased ranitidine from the generic suppliers, packaged it as Zantac and sold it for the same price it was selling the Zantac which contained Glaxo-manufactured ranitidine. However, I do accept that GMPs may confer a certain degree of comfort that the good has minimal impurities and is manufactured in a responsible manner. Granted, this has some value but it does not affect its comparability with the ranitidine used by the generic companies.
>
> [Emphasis added]

[32] Later in his Reasons, the Judge valued the GMPs and HSEs, finding that they added zero value to the price of ranitidine, but that the granulation of ranitidine added $25 to the per kilo price.

[33] The Judge then used the 1979 and 1995 OECD Commentaries criteria to analyze the CUP method, reviewing each of the criteria: economic comparability, comparability of goods, comparability of point in the chain where goods are sold, comparability of functions of the enterprises, comparability of contractual terms and comparability of business strategies. He also

examined whether the European Licensees were comparators using the CUP method, looking into whether the economic circumstances between the Canadian and European Markets were comparable (finding they were not), whether the contractual terms between the appellant and Adechsa were comparable to the contractual terms of the European licensees in the years in question and other differences that arose between the appellant and the European licensees. He found that even if one accepted the appellant's submission that the European co-marketers were the most appropriate comparators, the transfer price paid by the European licensees had not been established to his satisfaction.

[34] Alternatively, the appellant argued that if there was no comparator under the CUP method, then the Resale Price method should be used, using the European licensees as comparators. There was no dispute between the parties that the Cost-Plus and Resale Price methods were secondary methods to be used when the CUP method was not appropriate and that the Transactional Net Margin method was another alternative to be used when the Cost-Plus and Resale Price methods were not appropriate.

[35] The Judge found, essentially for the same reasons which led him to conclude that the European licensees were not good comparators for the CUP method analysis, that they were also not good comparators for the Resale Price method. He also found that the Resale Price Method was not an appropriate method in the case at bar and noted some disagreement between the expert witnesses as to their methodologies in calculating the Resale Price.

[36] As for the Transactional Net Margin method, the Judge did not accept Dr. Ballentine's evidence on the issue (the appellant's expert witness), as his reasoning for excluding companies with higher research and development to sales ratios was not reasonable and there was insufficient evidence of other functions undertaken by the comparators.

[37] As to the use of the Cost-Plus method, the Judge found as follows at paragraph 160 of his Reasons:

> 160 The appellant did not call a witness to rebut Dr. Mintz's conclusions regarding the cost-plus method and his conclusions went largely unchallenged on cross-examination. At no point did the appellant challenge Dr. Mintz's figures, calculations or conclusions on this issue. The appellant's thrust was that Dr. Mintz was not experienced in the pharmaceutical industry. The appellant did establish that Glaxo Group had not used the cost-plus method to set the price of ranitidine. As I have stated several times, the method that Glaxo used to set its prices is not relevant to the issue of whether the price is reasonable.

[38] Ultimately, the Judge concluded that the CUP method was the preferred method and that Apotex and Novopharm were the appropriate comparator. He thus concluded as follows with regard to the appellant's Part I tax liability:

> 161 CUP is the preferred method and the generic companies in Canada are an appropriate comparator using the CUP method. The appellant acquired granulated ranitidine from Adechsa at an amount in excess of the fair market value of ranitidine, and pursuant to subsection 69(2) of the Act the appellant is deemed to acquire it at a reasonable amount. The price that would have been reasonable in the circumstances for Glaxo Canada to pay Adechsa for a kilogram of ranitidine is the highest price the generic companies paid for a kilogram of ranitidine. However, to this amount I would add $25 per kilogram as this was the approximate cost to Singapore for granulation. The ranitidine purchased by the generic companies was not granulated. The GMP performed by a Singapore may have increased the value of its ranitidine but only to the extent that, as stated earlier in these reasons, it gave some degree of comfort to the appellant that the product would probably have less impurities and contaminants than that of its generic competition. No submissions were made as to what this extra consideration should be. There is no evidence before me to consider what increase

> I might add to the generic price per kilogram of ranitidine on account of GMP. It would appear to be modest in any event. The evidence does not suggest any addition to the price of the ranitidine due to any HSE by Singapore. The appellant, in computing its income for a particular year, may not deduct the excess amount it paid to Adechsa. For example, if the appellant paid Adechsa $1,300 per kilogram for ranitidine and the highest price the generic companies paid for ranitidine was $380 per kilogram, the appellant would be permitted to deduct the amount of $380 per kilogram plus $25 per kilogram for granulation, a total of $405. The excess amount, $895, is not deductible in computing the appellant's income.
>
> [Emphasis added]

THE APPELLANT'S SUBMISSIONS

[39] The appellant formulates the issues for determination in this appeal as follows:

1. whether the Trial Judge relied on a mistaken understanding of the legal standard mandated by subsection 69(2) of the Act and the inquiry that it directed him to make;
2. whether the Trial Judge, had he interpreted subsection 69(2) of the Act correctly, would have found that the amounts paid by the appellant to Adechsa for ranitidine in the years at issue would have been reasonable in the circumstances if the appellant had been dealing at arm's length with Adechsa;
3. whether the Trial Judge erred in finding that any part of the amounts paid by the appellant to Adechsa for ranitidine in the tax years at issue was subject to withholding tax under Part XIII of the Act.

[40] The appellant argues that a subsection 69(2) inquiry directs a trier of fact to assess whether any reasonable business person, standing in the appellant's shoes but dealing at arm's length with Adechsa, would have paid the amount paid by the appellant to Adechsa. In the appellant's view, if

any reasonable business person would have paid the price paid by the appellant, subsection 69(2) would not apply. For this proposition, the appellant relies on the Exchequer Court's decision in *Gabco Limited v. Minister of National Revenue* (1968), 68 D.T.C. 5210 (Ex.Cr.).

[41] The appellant says that the Judge erred in his interpretation of subsection 69(2) by not inquiring into whether any reasonable person in the appellant's business circumstances and dealing at arm's length would have paid the amounts that the appellant paid to Adechsa, pointing out that the Judge instead determined that the amounts paid by the appellant to Adechsa were unreasonable because they exceeded the "fair market value" of ranitidine.

[42] The appellant takes issue with the Judge's findings which disregard the Licence Agreement, as an arm's length appellant could not have sold Zantac-branded products without the existence of the Licence Agreement, since Glaxo Group owned the Zantac trademark. More particularly, the appellant says that the Licence Agreement (and the Judge so found), required the appellant to purchase ranitidine for the sale of Zantac from Adechsa, adding that if the Licence Agreement were terminated, it would have found itself without any product. The appellant says that by not considering the Licence Agreement, the Judge ignored a crucial business circumstance.

[43] The appellant also argues that the Judge ignored the economic circumstances of its transactions because of his concern about the consequences of those transactions on its liability for tax internationally. The appellant says that this is irrelevant to an inquiry under subsection 69(2) which applies only to tax liability in Canada.

[44] At paragraph 73 of its Memorandum of Fact and Law, in dealing with the question of whether the amounts it paid to Adechsa were reasonable in the circumstances under subsection 69(2), the appellant makes the following submission:

> 73. The question that subsection 69(2) required the Trial Judge to answer was whether any reasonable person in Glaxo Canada's business circumstances would pay a premium to an arm's length supplier to acquire an API if doing so were the "price" of being able to tablet, package and sell a trademarked drug which commands a price premium over competing generic drugs, and preserves the purchaser's rights to an entire portfolio of current and future branded pharmaceutical products. Had the Trial Judge asked himself that question, he would have concluded that a reasonable business person would undoubtedly behave in this fashion.

[45] Moreover, according to the appellant, purchasing ranitidine from those companies which supplied ranitidine to the generic companies was not an option realistically available to it and, thus, the purchases of ranitidine by the generic companies were not comparable to its purchases of ranitidine from Adechsa.

[46] As to the Part XIII tax, the appellant argues that the non-resident withholding tax only applied to the amounts deemed to be received by Glaxo Group as a dividend (under subsections 56(2) and 214(3)(a) of the ITA) – which were the amounts paid by the appellant to Adechsa for ranitidine that exceeded the "reasonable amount" referred to in subsection 69(2). If the amount paid did not exceed the "reasonable amount", then subsection 56(2) and paragraph 214(3)(a) of the ITA were inapplicable.

THE RESPONDENT'S SUBMISSIONS

[47] The respondent submits that the proper comparables were those transactions in which only ranitidine was sold and that, if it was proper to consider both the Licence Agreement and the Supply Agreement together to determine if the transfer price was reasonable in the circumstances, the applicant failed to present credible evidence of what an unrelated party would pay in circumstances similar to those of the appellant, given the functions it performed, the risks it undertook and the market in which it operated.

[48] The respondent says that the question to be reviewed attracts a standard of correctness, as the appellant has not alleged that the Judge made any palpable or overriding error in his findings or inferences of fact.

[49] The respondent also argues that the consideration, paid by the appellant to Adechsa under the Supply Agreement and to Glaxo Group under the Licence Agreement, should not be considered one price for the right to sell Zantac. There is no legal basis for this, and there is no evidence to link the two transactions.

[50] Moreover, the respondent argues that the "reasonable in the circumstances" standard incorporates the standard of "arm's length" and "reasonable business judgment" and must also be tested against the arm's length standard.

[51] As to the issue of the arm's length price, the respondent says that even if the appellant is correct in its argument that the Supply Agreement and the Licence Agreement should be considered together, the appellant failed to prove that an arm's length party would have paid the same price for the right to sell Zantac in Canada.

[52] As to the Part XIII Tax issue, the respondent makes no submissions other than to note that "[t]he parties are in agreement that the Part XIII issue is completely consequential upon the disposition of the Part I tax issue." (Respondent's Memorandum of Fact and Law at para. 62).

ANALYSIS

(a) The Part XIII Issue

[53] The Judge found that the amount paid by the appellant for its ranitidine in excess of the "reasonable amount" was deemed to be a dividend paid to Adechsa, a non-resident. Although subsection 212(2) of the ITA imposed a 25% withholding tax on such dividends, the effect of paragraph 10(1)(a) of the *Canada-United Kingdom Tax Convention (1978)* was to reduce the withholding tax to 10%. Thus, the appellant was required to withhold 10% by reason of subsection 215(1) of the ITA and was liable for its failure to withhold such amounts under subsection 215(6).

[54] The appellant does not argue that the Judge made any error in respect of the Part XIII tax, other than saying that he erred in regard to the determination of the "reasonable amount" pursuant to subsection 69(2). Consequently, if the Judge erred in regard to that determination, his determination of the Part XIII tax is also in error.

[55] The Part XIII issue rises and falls on how we determine the Part I issue. Thus, if we cannot agree with the appellant that the Judge erred in respect of subsection 69(2), it follows that his findings with regard to the Part XIII tax must stand.

(b) The Part I Issue

[56] I begin by citing again, for ease of reference, subsection 69(2):

69. (2) 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 is payable therefor.	**69.** (2) Lorsqu'un contribuable exploitant une enterprise au Canada a versé ou convenu de verser à une personne non résidante, avec laquelle il avait un lien de dépendance, à titre de prix, loyer, redevance ou autre paiement pour un bien ou pour l'usage ou la reproduction d'un bien, ou en contrepartie du transport de marchandises ou de voyageurs ou d'autres services, une somme plus élevée que la somme (ci-après appelée "la somme raisonnable") qui aurait été raisonnable eu égard aux circonstances si la personne non résidante et le contribuable n'avaient eu aucun lien de dépendance, la somme raisonnable est réputée, aux fins du calcul du revenu du contribuable provenant de l'entreprise, avoir été la somme payée ou payable dans ce cas.
[Emphasis added]	[Non souligné dans l'original]

[57] The text of the provision is clear. For the provision to be engaged, the following requirements must be met:

1. There must be a taxpayer (as defined in subsection 248(1);

2. who paid or agreed to pay;
3. to a non-resident;
4. with whom the taxpayer was not dealing at arm's length;
5. an amount and as a 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;
6. the amount must be "greater than 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".

[58] Requirements 1 to 5 are met and there is no dispute in that regard. The issue before us pertains to the sixth requirement which, as the appellant says, posits a hypothetical situation, *i.e.* that the parties to a non-arm's length transaction are dealing at arm's length. On that assumption, the Judge had to determine whether the amount paid by the appellant to Adechsa for its ranitidine exceeded the "reasonable amount", i.e. the amount which, if the parties had been dealing at arm's length, would have been "reasonable in the circumstances" for the appellant to pay for its ranitidine.

[59] There does not appear to have been any dispute between the parties before the Tax Court that the methods for determining the price which would have been reasonable in the circumstances, had the parties been dealing at arm's length, were based on the OECD Commentaries. Nor is there any dispute in that regard between the parties in this appeal.

[60] The appellant's main complaint in this appeal is that the Judge failed to consider relevant circumstances in determining the price that would have been reasonable in the circumstances had the parties been dealing at arm's length. More particularly, the appellant says that the Judge erred in failing to consider the License Agreement between it and Glaxo Group. The appellant further says that if the Judge had considered the License Agreement, he would not have disregarded circumstances which, in the appellant's submission, were highly relevant to a determination of what the appellant, had it been dealing at arm's length with Adechsa, would have been ready to pay for its ranitidine. Specifically, the appellant says that the following circumstances were key and ought to have been considered, namely: Glaxo Group's ownership of the Zantac trademark, the premium that Zantac commanded over generic ranitidine drugs in the market, Glaxo Group's ownership of the ranitidine patent, the appellant's inability to compete in the generic market without the availability of the Zantac trademark, and the portfolio of other patented and trademarked products to which the appellant had access under the License Agreement.

[61] Before addressing the appellant's submissions, I briefly turn to the Judge's reasons for concluding that he should not consider the License Agreement in his attempt to determine whether the price paid by the appellant for its ranitidine was "reasonable in the circumstances".

[62] As I have already indicated, the Judge noted that the parties were in disagreement with regard to three points. The first of these points was whether both the Supply Agreement and the License Agreement should be considered to determine the reasonable transfer price. In the Judge's opinion, the License Agreement was not to be considered in making the required determination.

[63] After setting out the parties' respective submissions with regard to the relevance of the License Agreement, the Judge held, at paragraph 78 of his Reasons, that he agreed with the view espoused by the respondent that since the two Agreements covered separate matters, they were "to be considered independently as required by *Singleton* [*supra*]". The Judge sought to buttress his opinion by indicating that the United States Tax Court had come to a similar conclusion in *Bausch and Lomb v. Commissioner*, 92 T.C. 525, 1989 U.S. Tax Court, also a transfer-pricing case.

[64] At paragraph 78 of his Reasons, the Judge wrote as follows:

> I agree with the respondent that the Supply Agreement with Adechsa and the Licence Agreement with Glaxo Group cover separate matters and that they are to be considered independently as required by *Singleton.* The United States Tax Court came to a similar conclusion in a transfer pricing case, *Bausch & Lomb, Inc. v. Commissioner*. It may very well be that a 40 percent total profit to Glaxo Group is reasonable; however, the issue before me is whether the purchase price of the ranitidine was reasonable. One cannot combine the two transactions and ignore the distinct tax treatments that follow from each.

[65] In my view, the Judge erred in concluding, on the basis of *Singleton, supra*, that the License Agreement was an irrelevant consideration. First, it is my view that the Supreme Court's decision in *Singleton, supra,* is of no relevance to a determination under subsection 69(2) of the ITA. The facts in that case were that the taxpayer withdrew equity from his law firm in order to buy a house and then refinanced his law firm equity with borrowed money. The issue before the courts was whether the transaction should be re-characterized so that the taxpayer was deemed to have used the borrowed money to purchase the house, rather than to make a capital contribution to his law firm.

The Supreme Court determined that the transactions were to be viewed independently, rather than as one. In other words, what the taxpayer had done was to be respected and not re-characterized in accordance with “economic realities”. It is in that context that the Supreme Court held that other transactions entered into by the taxpayer in connection with the borrowing of funds were not relevant in determining the use to which the borrowed funds were put.

[66] At issue in *Singleton* was subparagraph 20(1)(c)(i) of the ITA, which did not call not upon the Court to consider circumstances relevant to the borrowing of the funds. Rather, the provision required the Court to determine whether the monies borrowed were “used for the purpose of earning income”.

[67] The Supreme Court concluded that the Tax Court Judge had erred in searching for the “true economic purpose” of the funds because that was not the relevant test under subparagraph 20(1)(c)(i) which, in essence, seeks an answer to the question: “to what use were the borrowed funds put?”. The transactions in *Singleton, supra*, built on each other (they were part of a series of transactions intended to get the taxpayer from point A to point B), and thus led the Supreme Court to opine that the “shuffle of cheques” could not be ignored, as it defined “the legal relationship which must be given effect” (para. 32 of the Supreme Court’s Reasons).

[68] With respect, I have difficulty seeing how *Singleton, supra*, can be of any help to the disposition of the issues before us in this appeal. Paragraph 20(1)(c)(i) of the ITA and subsection 69(2) bear no similarity or any possible link. A determination pursuant to subparagraph 20(1)(c)(i)

must answer the question “to what use were the borrowed funds put?”, while a determination pursuant to subsection 69(2) is directed to “the reasonable amount”, i.e. “that would have been reasonable in the circumstances” if the parties to the transaction had been dealing at arm’s length.

[69] Second, I believe the Judge erred because he misunderstood the test that appears in subsection 69(2), i.e. if the appellant had been dealing with Adechsa at arm’s length, would the price paid by the appellant for its ranitidine have been “reasonable in the circumstances”? In my respectful view, in order to make that determination, the Judge had to consider all relevant circumstances which an arm’s length purchaser would have had to consider. In that regard, the appellant says that the classic statement of the standard set out at subsection 69(2) is the one which Cattanach J. of the Exchequer Court enunciated in *Gabco, supra*, at page 5216:

> It is not a question of the Minister or this Court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or the Court coming to the conclusion that no reasonable business man would have contracted to pay such an amount having only the business considerations of the appellant in mind.
>
> [Emphasis added]

[70] Relying on *Gabco, supra*, the appellant argues that what the Judge had to decide was whether any reasonable business person, dealing at arm’s length with Adechsa, would have paid the price paid by the appellant for its ranitidine.

[71] Although *Gabco, supra*, dealt with section 67 of the ITA and, in particular, with that part of the section which limits deductible expenses to the amounts that are “reasonable in the circumstances”, it is my view that the opinion of Cattanach J. is entirely apposite to the issue before

us. In *Safety Boss Limited v. The Queen*, 2000 D.T.C. 1767, Chief Justice Bowman of the Tax Court held that the “reasonable business person” standard enunciated in *Gabco* was also applicable in matters arising under subsection 69(2). At paragraphs 27 and 28 of his Reasons, Chief Justice Bowman made the following remarks:

> [27] "Reasonable" in section 67 is a somewhat open-ended concept requiring the judgment and common sense of an objective and knowledgeable observer. "Reasonable amount" in subsection 69(2) as between non-arm's length persons, is essentially defined as an amount that would have been reasonable in the circumstances had the non-resident and the taxpayer been dealing at arm's length.
>
> [28] If there is a difference between the concepts in the two provisions it is not readily apparent.

[72] It is worth noting that the *Gabco* test was recently referred to with approval by this Court in *Petro-Canada v. The Queen*, 2004 D.T.C. 6329, 2004 FCA 158, where Sharlow J.A., writing for the Court, stated at paragraph 62 that the leading case on the statutory predecessor to section 67 was *Gabco*.

[73] In my view, 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 for its ranitidine.

[74] Consequently, it is my view that the Judge was bound to consider those circumstances which an arm’s length purchaser would necessarily have had to consider. In other words, the test

mandated by subsection 69(2) does not operate regardless of the real business world in which the parties to a transaction participate.

[75] This is not what the Judge did. Rather, he determined the "fair market value" of ranitidine, which he found to be the price paid by Apotex and Novopharm, and then found that anything paid by the appellant over that amount, save for a $25 per kilo upward adjustment, was in excess of "the reasonable amount".

[76] Clearly, in the circumstances of this case, the Judge's approach was mistaken. 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 would be able to sell his ranitidine under the Zantac trademark. 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 he intended to sell Zantac.

[77] I now turn to the circumstances which, in my view, the Judge should have considered in determining whether the price paid by the appellant for its ranitidine was in excess of "the reasonable amount".

[78] Because it was central to the appellant's business reality, and would be so if it were dealing at arm's length with Adechsa, the License Agreement with Glaxo Group was "a circumstance" which had to be taken into account by the Judge. In my respectful view, failing to consider that

Agreement meant that the Judge made his determination in a fictitious business world where a purchaser is able to purchase ranitidine at a price which does not take into account the circumstances which make it possible for that purchaser to obtain the rights to make and sell Zantac. As the appellant argued at paragraph 54 of its Memorandum of Law

> 54. … As a result, the Trial Judge ignored the key business circumstances of Glaxo Canada's purchase of ranitidine from Adechsa, and assumed a set of circumstances that did not exist in reality and would not exist in an arm's length transaction. …

[79] In my view, there are a number of "circumstances" which satisfy me that the License Agreement was a crucial consideration in determining "the amount that would have been reasonable in the circumstances" if the appellant and Adechsa had been dealing at arm's length:

1. Glaxo Group owned the Zantac trademark and would own it even if the appellant was an arm's length licensee.
2. Zantac commanded a premium over generic ranitidine drugs.
3. Glaxo Group owned the ranitidine patent and would have owned it even if the appellant had been in an arm's length relationship.
4. Without the License Agreement, the appellant would not have been in a position to use the ranitidine patent and the Zantac trademark. Consequently, in those circumstances, the only possibility open to the appellant would have been to enter the generic market where the cost of entry into that market would likely have been high, considering that both Apotex and Novopharm were already well placed and positioned.

5. Without the License Agreement, the appellant would not have had access to the portfolio of other patented and trademarked products to which it had access under the License Agreement.

[80] The appellant submits, and I agree entirely with that view, that these circumstances do not arise from the non-arm's length relationship between the appellant and Adechsa or between the appellant and Glaxo Group. To the contrary, these circumstances, and I quote the appellant, "arose from the market power attaching to Glaxo Group's ownership of the intellectual property associated with ranitidine, the Zantac trademark and the other products covered by its License Agreement with Glaxo Canada". As the Administrative Appeals Tribunal of Australia stated in *Roche Product Pty Limited and Commissioner of Taxation*, [2008] AATA 639 (July 22, 2008) at paragraph 153:

> 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.

[81] I now return to subsection to 69(2) of the ITA and the test which it sets out. That test required the Judge to determine whether an arm's length Canadian distributor of Zantac would have been willing, taking into account the relevant circumstances, to pay the price paid by the appellant to Adechsa. With respect, the Judge ignored all of those circumstances because of his view that *Singleton, supra*, required him to ignore the License Agreement. 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.

[82] As a result, I conclude that the Judge erred in law in failing to apply the proper test in determining "the amount that would have been reasonable in the circumstances" if the appellant and Adechsa had been dealing at arm's length. Counsel for the appellant argued that in the event that we agreed with him that the Judge erred in not considering the License Agreement, we should then determine "the reasonable amount". In my view, that determination ought to be made by the Judge, who heard the parties for well over forty days, and not by this Court.

[83] Whether the consideration of the License Agreement as a circumstance relevant to the determination of "the reasonable amount" will lead the Judge to the conclusion sought by the appellant is not for us to say. For example, the Judge may find that the generic companies are no longer a good comparator and that another group is more appropriate. On the other hand, he may determine that no comparator is necessary for him to make a final determination. Consequently, I am not inclined to make the ultimate determination which the appellant seeks, but prefer leaving the matter to the Judge to make such a determination or any other determination which he finds to be warranted in the light of a full record on the issue. Whether the present record is sufficient to allow the Judge to perform that task, I cannot say. The Judge may be satisfied that the record is sufficient or he may request the parties to adduce additional evidence and submissions as a result of this Court's decision.

Disposition

[84] I would therefore allow the appeal with costs, set aside the Tax Court's decision and I would return the matter to the Judge for rehearing and reconsideration of the matter in the light of these Reasons.

"M. Nadon"
J.A.

"I agree.
Carolyn Layden-Stevenson J.A."

"I agree.
Stratas J.A."

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

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