The Arm’s Length Comparable in Transfer Pricing: A Search for an “Actual” or a “Hypothetical” Transaction?

Dr Amir Pichhadze

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When searching for an arm’s length comparable in the transfer pricing analysis, does the analysis require (or allow) searching for a transaction that actually took place in the market, or can/should the internal data of the controlled transaction simply be imputed to form a hypothetical uncontrolled transaction in which the parties are assumed to be operating at arm’s length but otherwise dealing under the same circumstances? This article sheds light on this question, based on lessons distilled from recent Canadian jurisprudence; particularly, the case Canada v. GlaxoSmithKline Inc. The author calls on Canada’s courts to reconsider their approach to this issue, and alerts courts in other jurisdictions to avoid transplanting the Canadian approach because otherwise they would risk repeating the same mistake(s).

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1. Introduction

The transfer pricing analysis requires comparing the non-arm’s length income allocation result in a controlled cross-border transaction to the arm’s length allocation result in a comparable uncontrolled transaction. The non-arm’s length result could be adjusted for tax purposes if it fails to reflect the arm’s length result.

When searching for a comparable transaction, does the analysis require (or allow) searching for a transaction that actually took place in the market, or can/should the internal data of the controlled transaction simply be imputed to form a hypothetical uncontrolled transaction in which the parties are assumed to be operating at arm’s length but otherwise dealing under the same circumstances?

In answering this question, valuable lessons can be distilled from Canadian transfer pricing jurisprudence.

In the seminal case Canada v. GlaxoSmithKline Inc. ("Glaxo case"), Canada’s Federal Court of Appeal (“FCA”) and Supreme Court of Canada (“SCC”) decided that it was necessary to use a hypothetical uncontrolled transaction as a comparable. This approach has since been reaffirmed by the Tax Court of Canada (“TCC”) in McKesson Canada Corporation v. The Queen. (a) This article identifies that this approach places Canada’s jurisprudence at odds with the approach adopted by the OECD’s Transfer Pricing Guidelines (“TP Guidelines”),(3) the IRS Treasury Regulations (“the US Regulations”) to section 482 of the Internal Revenue Code (“IRC”)(4) in the United States, and the transfer pricing jurisprudence of other countries (as exemplified in this article by reference to case law in Australia, Germany and the United States). The international consensus appears to be that, if and when it is possible to do so, the comparable should be an actual transaction that took place in the market, in accordance with the market approach to valuation. By this approach, the norm of the marketplace provides an objective measure of the arm’s length result.

The purpose of this article is twofold. First, it calls on Canada’s courts to reconsider their approach on this issue. Second, it alerts courts in other jurisdictions to avoid transplanting this Canadian approach because otherwise they would risk repeating the same mistake(s).

2. An Overview of the Four-Stage Transfer Pricing Comparability Analysis

When related parties (i.e. parties not dealing at arm’s length) engage in a cross-border transaction, their allocation of the income (profits) earned from that transaction is commonly governed by domestic transfer pricing laws. These laws set out the basis on which tax authorities would be allowed to adjust the parties’ income allocation for the purpose of determining the tax consequences of the transaction.

Problem is that if each state (which is affected by the cross-border transaction) applies different and inconsistent approaches to determining income allocation, then a risk arises that the Multinational Enterprise (“MNE”) will be subject to double taxation. As the OECD explains, due to the potential outcome of such frictions between domestic rules, “any adjustment to the transfer price in one jurisdiction implies that a corresponding change in another jurisdiction is

1. The case was first decided by the Tax Court of Canada (“TCC”): GlaxoSmithKline Inc. v. R., 2008 TCC 324 (“Glaxo-TCC”). The case was then appealed by the taxpayer to the Federal Court of Appeal (“FCA”): GlaxoSmithKline Inc. v. R., 2010 FCA 201 (“Glaxo-FCA”). The Minister then made a final appeal to the Supreme Court of Canada (“SCC”): Canada v. GlaxoSmithKline Inc., 2012 SCC 52 (“Glaxo-SCC”).
2. 2013 TCC 404 (CanLII), paras. 128-129.
4. Section 482 sets out the rules for allocating income and deductions arising from controlled transactions.

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appropriate. However, if the other jurisdiction does not agree to make a corresponding adjustment the MNE group will be taxed twice on this part of its profits.\[6\]

To facilitate agreement between states and prevent the risk of double taxation, states have been using a coordinated approach to determining income allocation in cross-border transactions. The US Regulations refer to this as the arm’s length standard ("ALS"),\[6\] while the TP Guidelines refer to this as the arm’s length principle ("ALP").\[7\] By this standard, the income allocation in a comparable arm’s length transaction is presumed to be reasonable and would thus be acceptable to tax authorities. A non-arm’s length allocation that fails to reflect an arm’s length allocation, as evidenced by a comparable arm’s length transaction, could be adjusted by tax authorities to reflect the arm’s length result.

International coordination of this ALS has been achieved by incorporating it into bilateral tax treaties.\[8\] Treaties typically adopt the standard as it has been formulated in article 9 of the model tax treaties.\[9\] Yet, as explained in the United Nations Practical Manual on Transfer Pricing ("UN Manual"):[10]

1.7.1. … Article 9 is not “self-executing” as to domestic application – it does not create a transfer pricing regime in a country where such a regime does not already exist.

1.7.2. It should be recognized that transfer pricing regimes are creatures of domestic law and each country is required to formulate detailed domestic legislation to implement transfer pricing rules. Many countries have passed such domestic transfer pricing legislation which typically tends to limit the application of transfer pricing rules to cross-border related party transactions only.

Hence, the ALS is also given domestic effect by having legislatures incorporate it into their domestic tax legislation. In Canada, for example, Justice Pizzitelli of the TCC recently explained that "[p]aragraphs 247(2)(a) and (c), like former subsection 69(2), is analogous to Article 9(1) of the OECD Model Double Taxation Convention on Income and Capital".\[11\] It should be noted, however, that there is considerable variation in how countries have gone about doing so.\[12\]

The UN Manual goes on to explain that "Article 9 (‘Associated Enterprises’) … advises the application of the arm’s length principle but does not go into the particulars of transfer pricing rules".\[13\] Similarly, the ALS in domestic legislation may not provide such information. In Canada, for example, the SCC acknowledged that section 69(2) of the Income Tax Act ("ITA") "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".\[14\] Further guidance on the application of the standard is therefore required. For this purpose, in the United States the analysis is carried out in accordance with the guidelines which are set out in the US Regulations. As for other countries, by and large they follow the TP Guidelines. Attempts are made to coordinate the approaches taken by the US Regulations and the TP Guidelines.\[15\]

5. Supra n. 3, Preface, para. 12.
7. Supra n. 3, p. 31.
8. According to the UK’s HMRC, the ALS can be found in more than 2,500 double taxation treaties worldwide (HMRC, Double Taxation Treaties, available at http://www.hmrc.gov.uk/taxtreaties/dta.htm).
9. The model tax treaties include: the OECD’s Model Convention on Income and on Capital ("OECD Model"), which focuses on treaties between developed countries; the UN’s Model Double Taxation Convention between developed and developing countries ("UN Model"); and the US’s Model Income Tax Convention ("US Model"). Each of these models contains an article 9, which deals with associated enterprises and sets out the ALS. As the US IRS noted in its Notice 88-123, the OECD, UN, and US Models are essentially the same with respect to article 9 (U.S. Department of the Treasury, "A Study of Intercompany Pricing" (Oct. 19, 1988), Notice 88-123, 1988-2 CB 458, 475).
13. Supra n. 10, p. 21, para. 1.7.1.
15. C.M. Radaelli (1998), Game Theory and Institutional Entrepreneurship: Transfer Pricing and the Search for Coordination in International Tax Policy, Policy Studies Journal, vol. 26, no. 4, pp. 613, 615. Note that in the years following the publication of Radaelli’s paper, the coordination between the TP Guidelines and the US Regulations has become even closer. Most notably, the 2010 version of the TP Guidelines applied a “most appropriate method” principle which is similar to the “best method rule” in the 1994 US Regulations. Also, the OECD abandoned its prior focus on comparing prices, and shifted the focus instead to comparing the arm’s length “outcome”, which is similar to the US approach of comparing the arm’s “result”. Consequently, now both the US Regulations and the OECD’s TP Guidelines do not impose any strict priority of transfer pricing methods, so long as the method used provides the most reliable indication of the arm’s length result/outcome.

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Based on the TP Guidelines and the US Regulations,\[16\] it is possible and convenient to describe the transfer pricing comparability analysis as involving the following four stages.

### 2.1. Stage 1: Ascertaining the taxpayer’s circumstances and the true nature of the actual controlled transaction

Article 9(1) requires the arm’s length comparability analysis to be based on the “commercial and financial relations” of the actual parties who entered into the controlled transaction under review. Accordingly, in the first stage, it is necessary to delineate the actual controlled transaction under review. As the TP Guidelines recommend, “every effort should be made to determine the actual nature of the transaction and apply arm’s length pricing to the accurately delineated transaction.”\[17\] “A tax administration should not disregard the actual transaction or substitute other transactions for it unless the exceptional circumstances described in … paragraphs 1.122-1.125 apply.”\[18\] Delineating the actual transaction requires taking into account its economically relevant characteristics.\[19\] The TP Guidelines explain that “[w]here a transaction has been formalised by the associated enterprises through written contractual agreements, those agreements provide the starting point for delineating the transaction between them and how the responsibilities, risks, and anticipated outcomes arising from their interaction were intended to be divided at the time of entering into the contract.”\[20\] “However, the written contracts alone are unlikely to provide all the information necessary to perform a transfer pricing analysis, or to provide information regarding the relevant contractual terms in sufficient detail. Further information will be required by taking into consideration evidence of the commercial or financial relations provided by the economically relevant characteristics in the other four categories (see paragraph 1.36): the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, together with the characteristics of property transferred or services provided, the economic circumstances of the parties and of the market in which the parties operate, and the business strategies pursued by the parties. Taken together, the analysis of economically relevant characteristics in all five categories provides evidence of the actual conduct of the associated enterprises.”\[21\]

### 2.2. Stage 2: Searching for a comparable uncontrolled transaction

The second stage involves finding transactions that are comparable to the actual controlled transaction and the taxpayer’s circumstances. “The comparability analysis always aims at finding the most reliable comparables. Thus, where it is possible to determine that some uncontrolled transactions have a lesser degree of comparability than others, they should be eliminated.”\[22\] “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.”\[23\]

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17. OECD BEPS Final Report, supra n. 3, para. 1.121. See also, paras. 1.33
19. OECD BEPS Final Report, supra n. 3, para. 1.36
20. While the terms will typically be formally set out in writing, they could also be inferred from the parties’ conduct (OECD BEPS Final Report, supra n. 3, para. 1.49).
21. Ascertaining the true terms of the contract requires: identifying the terms, determining what the parties intended based on the terms they agreed to, and verifying that the parties’ formally conveyed intentions are reflected by the transaction they actually executed in reality. For more, see A. Pichhadze, Contract Interpretation in Transfer Pricing: Turning of the Tide in the Aftermath of Dr. Amir Pichhadze’s proposal and the OECD’s BEPS Project, Tax Notes International (vol. 80, no. 11) (Forthcoming 14 Dec. 2015), Exposing Unaddressed Issues in the OECD’s BEPS Project: What About the Roles and Implications of Contract Interpretation Law and Private International Law in the Transfer Pricing Arm’s Length Comparability Analysis?, 7 World Tax J. 1 (2015), Journals IBFD.
22. For a more detailed overview about the importance of ascertaining and giving effect to the parties’ contractual intentions, see A. Pichhadze, Contract Interpretation in Transfer Pricing: Turning of the Tide in the Aftermath of Dr. Amir Pichhadze’s proposal and the OECD’s BEPS Project, Tax Notes International (vol. 80, no. 11) (Forthcoming 14 Dec. 2015).
23. OECD BEPS Final Report, supra n. 3, para. 1.42.
24. OECD BEPS Final Report, supra n. 3, para. 1.43. See also para. 1.36.
25. Supra n. 3, para. 3.2.
26. Supra n. 3, para. 1.33. IRS Treasury Regulations, section 1.482-1(d)(2). Regarding the option of conducting comparability adjustments, these are adjustments “made to the conditions of the uncontrolled transaction in order to eliminate the effects of material differences which exist between them and the controlled transaction”. (OECD (July 2010), Comparability Adjustments, para. 3, available at http://www.oecd.org/tax/transfer-pricing/45765363.pdf.) Note that such adjustments would only be appropriate if the difference that is being corrected would have “a material effect on the comparison”. (Supra n.3, para. 3.51) and the adjustment would improve the reliability of the comparability analysis (Supra n.3, para. 3.50). Also, “the need to perform numerous or substantial adjustments to key comparability factors may indicate that the third party transactions are in fact not sufficiently comparable” (Supra n.3, para. 3.51).
It should be emphasized again that, when searching for comparables, the key question is “not whether the same transaction can be observed between independent parties,” but rather it “is whether the actual transaction possesses the fundamental economic attributes of arrangements between unrelated parties”.[27]

2.3. Stage 3: Applying an appropriate transfer pricing method to value the "price" or "profit margin"

The third stage involves applying an appropriate valuation method by which to determine a “price” or “profit margin” (or a price or margin within an acceptable range[28] of figures) resulting from the sale of goods and/or services in the arm’s length comparable.

The menu of valuation methods consists of the traditional transactional methods,[29] such as the comparable uncontrolled price method (CUP),[30] resale price method (RPM),[31] and cost-plus method (CPM).[32] There are also non transactional methods,[33] which include the transactional net margin method (TNMM)[34] and the profit split method (PSM).[35] While the TP Guidelines and US Regulations recognize that unspecified “other methods” may also be used, they emphasize the need to ensure that such methods are consistent with the arm’s length principle.[36]

2.4. Stage 4: Testing the transfer price

Having identified a comparable uncontrolled transaction and derived from it the arm’s length result, it becomes possible to finally test the result in the controlled transaction under review. If the unrelated parties’ income allocation reveals a specific “price” or “profit margin” (or a price or margin within an acceptable range[37] of figures) that is consistent with that chosen by the related parties (in the controlled transaction under review), then the transfer price (in the controlled transaction) ought to be respected by the tax authorities. If it does not then the allocation (in the controlled transaction) could be adjusted by the tax authorities (to reflect the arm’s length result) for the purpose of determining the tax consequences of the controlled transaction.

To prevent double taxation, the other state affected by the transaction would then be expected to make a corresponding adjustment[38] to its taxation of the profits from this controlled transaction[39] Note, however, that such a corresponding adjustment is not automatic. The other state could disagree with the transfer pricing adjustment, in which case the two states may need to resolve their dispute through their treaty’s dispute resolution mechanism(s).

3. A Closer Look at Stage 2

3.1. The search for actual transactions based on the market approach to valuation

3.1.1. Using the market approach as an objective benchmark

Brauner explains that “[t]he arm’s length standard is basically an articulation of the traditional market approach to valuation”.[40] Valuations are generally used to determine the reasonable estimated worth of assets or liabilities. “The premise of valuation is that we can make reasonable estimates of value for most assets, and that the same fundamental principles determine the values of all types of assets, real as well as financial. Some assets are easier to value than others, the details of valuation vary from asset to asset, and the uncertainty associated with value estimates is different.

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27. Supra n. 18, p. 25, para. 84.
29. Supra n. 3, part II.
30. Supra n. 3, pp. 24, 63-64; IRS Treasury Regulations, sec. 1.482-3(b).
31. Supra n. 3, pp. 28, 65-70; IRS Treasury Regulations, sec. 1.482-3(c).
32. Supra n. 3, pp. 26, 70-75; IRS Treasury Regulations, sec. 1.482-3(d).
33. Supra n. 3, part III.
34. Supra n. 3, pp. 30, 77-92.
35. Supra n. 3, pp. 28, 93-105; IRS Treasury Regulations, sec. 1.482-6.
36. Supra n. 3, para. 2.9; IRS Treasury Regulations, secs. 1.482-3(e), 1.482-4(d).
37. Supra n. 3, pp. 123-125.
38. This is “an adjustment to the tax liability of the associated enterprise in a second tax jurisdiction made by the tax administration of that jurisdiction, corresponding to a primary adjustment made by the tax administration in a first tax jurisdiction, so that the allocation of profits by the two jurisdictions is consistent” (Supra n. 3, Glossary, p. 25).
39. Supra n. 3, p. 139.
for different assets, but the core principles remain the same."[41] As for the “market approach" specifically, this involves estimating the reasonable price of an asset/liability based on how an equivalent asset/liability was priced in transactions that actually took place in the market under comparable circumstances. The inquiry, therefore, does not involve calculating the reasonable price. Rather, it involves observing what the reasonable price is by looking to the market.[42] Hanlin and Claywell explain that “[t]he foremost reason to use the Market Approach is that, when suitable data are available, it provides a verifiable and objective measure of value. Actual sales, in a public market at arm’s length of similar interests, are compelling evidence."[43] This objective approach is central to the transfer pricing arm’s length analysis. As the US Court of Appeals for the Second Circuit explained, the arm’s length standard “is meant to be an objective standard that does not depend on the absence or presence of any intent on the part of the taxpayer to distort his income”.44 The court went on to state that this is achieved by applying the standard of “an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer”, 45 The role of a market valuation approach was explained by Stanley S. Surrey, “the greatest tax scholar of his generation”,[46] as follows:[47]

The use of this arm’s length standard is a natural reaction. Tax administrators do not question transactions that are governed by the marketplace. If Company A sells goods to unrelated Company B at a certain price or furnishes services at a particular price, the income of both companies is determined by using that price. One company may be large and the other small; one may be a monopoly; one may be financially strong and the other in a weak condition. But these and other factors which may affect the price at which the transaction occurs are not the concern of the tax administrator. His tasks is not to correct the injustices or unfairness of the marketplace nor to turn bad bargains into fair arrangements [...] Given this acceptance of the marketplace, a tax system – and tax administrators working within it – when faced with intra-group transactions not governed by that marketplace but instead by the policies and goals of the overall enterprise, naturally seeks to replace the intra-group arrangement with the norm of the marketplace. Presumably, most transactions are governed by the general framework of the marketplace and hence it is appropriate to seek to put intra-group transactions under the general framework. Thus, use of the standard of arm’s length, both to test the actual allocation of income and expenses resulting under controlled intra-group arrangements and to adjust that allocation if it does not meet such standard, appears in theory to be a proper course.

Conducting the arm’s length analysis based on a market approach to valuation requires comparing the controlled transaction to a comparable uncontrolled transaction that actually took place. As explained by the OECD, this could be a transaction “between two independent enterprises, neither of which is a party to the controlled transaction”-[48] i.e. an “external” comparable. It could also be a “transaction between one party to the controlled transaction and an independent party”;[49] i.e. an “internal” comparable. Apparently, both the 1968 US Regulations and the OECD’s 1979 Report were based on the assumption that, by and large, actual comparables in the marketplace could be found. Accordingly, they prioritized the use of transfer pricing methodologies that were based on the market approach to valuation (e.g. the CUP method). These would produce the most reliable objective indication of the arm’s length price.[50]

Arguably, in the socio-economic contexts of the early and mid-twentieth century this approach was not unreasonable. As McLure identifies, in that time period “international trade consisted primarily of tangible products; most international trade occurred between unrelated entities; telecommunications services operated only in one country; intangible assets were

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42. Supra n. 40, p. 104.
45. Id. at p. 947.
48. Supra n. 3, paras. 3.24, 3.29-3.36.
49. Supra n. 3, paras. 3.24, 3.27-28.
50. E.B. Dix. (Fall, 2010), From general to specific: the arm’s-length standard’s evolution and its relevancy in determining costs to be shared in cost-sharing agreements, 64 Tax Lawyer 197, pg 200, at 214-215.
relatively unimportant; although international investment existed, capital was relatively immobile internationally.”

Under these conditions, as McLure goes on to explain, “Comparable Uncontrolled Price was an adequate test of transfer prices in most cases, and either Cost Plus or Resale Price provided a satisfactory fallback test in many others; little resort to ‘other’ methods of determining arm’s length prices was needed”.

As Professors Avi-Yonah and Benshalom similarly acknowledged, the belief that transactions among unrelated parties can be found and used as meaningful benchmarks “might well have made sense eighty years ago, when the legislative language underlying today’s arm’s length standard for income tax purposes was first developed. At that time, although multinational groups existed, available transportation and communications technology did not permit close centralized management of geographically dispersed groups. Therefore, members of multinational groups functioned largely as independent entities, and benchmarking their incomes or transactions based on uncontrolled comparables probably made good sense.”

Following the Second World War, however, the world experienced numerous socio-economic changes that hindered the application of this market approach. Particularly notable are the following developments: globalization and the resulting changes in corporate practices and arrangements; the emergence of new technology-based industries (such as e-commerce); a growing importance of international trade of services and intangible products; an increase in international trade between related parties such as MNEs, the operations of which have become increasingly integrated, and which often trade services that have no comparable external market; and an increase in foreign direct investment.

Let us consider more closely how the increasingly integrated operations of MNEs created new hurdles to the application of the market approach. Steiss and Blanchette described the trend towards integration as follows:

The new trend among MNEs was to coordinate multiple cross-border transfers of components, which would ultimately be delivered to one destination and there assembled into a final product. MNEs were unbundling and centralizing varied activities in chosen countries. Location decisions were sensitive to such factors as cost, availability of labour, accessibility to financial markets, and, of course, fiscal policy.

Sadiq’s study exposes the difficulties in applying a market approach to business arrangements of multinational banks. The difficulty is in finding comparables. “Everything a multinational bank does is unique to that bank, which means that it is impossible to find separate unrelated taxpayers entering into similar transactions.” Moreover, economically significant functions or activities of a multinational bank may be so integrated that they cannot be allocated with any certainty to the separate parts of the bank. Despite this commercial and economic reality of how MNEs operate, the “fiscal myth that every subsidiary and permanent establishment within a group is a separate entity which conducts trade under free-market conditions with other entities in the group” is nonetheless being applied by the transfer pricing regime. As Sadiq cautioned, this approach “turns reality into fancy and then pretends it is in the real world.”

These emerging hurdles (to finding comparable uncontrolled transactions) led critics to argue that the ALS no longer provides an adequate benchmark. As Professors Avi-Yonah and Benshalom explain:

That situation changed, however, with the technological changes precipitated by the Second World War. Today, it is possible to exercise close managerial control over multinational groups, and these groups develop in all industries and geographic market segments in which the efficiencies of common control pose significant economic advantages. Moreover, in those industries and markets where common control poses advantages, it is typically

52. Id. at pp. 218-219.
54. Supra n. 51, pp. 219-220.
57. Id., p. 81.
58. Id., p. 67.
59. Id., p. 67.
60. Supra n. 53, p. 377.

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economically infeasible to remain in the market using a non-commonly controlled structure (for example, by maintaining distributors that are economically independent of manufacturers). Therefore, in those markets in which multinational groups operate—that is, in those markets in which transfer pricing issues arise—it is unlikely that reasonably close “uncontrolled comparables” can easily be found.

This is true of virtually every other industry that is conducted on a large global scale. In sum, no matter how assiduously one performs “functional analyses” designed to identify “uncontrolled comparables” that are reasonably similar to members of multinational groups, one is rarely going to find them. Certainly, such comparables will not be—and have not been—found with sufficient regularity to serve as the basis for a workable transfer pricing system. If the transfer pricing rules are going to be made tolerably administrable, policymakers around the world will need to restate them on a basis other than that of reliance on uncontrolled comparables.

In response to these changing realities, the US modified the approach in its regulations. Unlike the 1968 regulations which prioritized the traditional transaction based methods, section 1.482-1(c)(1), of the proposed regulations in 1992, allowed the use of whichever method would, under the facts and circumstances, provide “the most reliable measure of an arm’s length result” (this is referred to as the “best method rule”). Therefore, in those circumstances where there is insufficient external data (from actual comparables) to produce a reliable measure of an arm’s length price range, the best method may be the TNMM, which involves comparing the controlled transaction’s net profits (derived from the controlled transaction’s internal data) with those of a comparable uncontrolled transaction. Where actual comparables do not exist, PSM could be used, which applies a formula to allocate profits.\[61\] Dix described the role of these additional methods as follows: \[62\]

The final regulations under section 482 significantly expand upon the guidance provided in the 1968 regulations by providing taxpayers with various methods by which they might achieve an arm’s-length result. The new approach allows for establishment of an arm’s-length range that was to be based upon all reasonable comparables. From the range’s inter-quartile band, the taxpayer selects a price, which, by regulatory fiat, will be deemed an arm’s-length result. Moreover, where the 1968 regulations required reference only to comparable transactions, the 1994 regulations require, in some instances, reference to average profits earned by a broad group of unrelated-party actors. In other instances, the regulations counsel parties to determine transfer prices based on the profit split method, which allocates profit on the basis of a formula—without reference to any comparables. In requiring parties to extrapolate arm’s-length prices from such factors as industry-wide metrics of profitability and internal features of the related-party transaction, the final regulations of 1994 represent a departure from the traditional comparables-driven arm’s-length method.

[...]

Where the 1968 regulations retained a plain meaning of “arm’s length”, requiring imitation of unrelated-party transactions, the 1994 regulations supplanted that meaning with a complex system of formulas, the application of which enables a taxpayer to reach a result deemed “arm’s-length” by the Service.

Also notable is Wittendorff’s observation of how the PSM departs from the traditional market approach by allowing greater reliance on the controlled transaction’s internal data, instead of having to rely on external data of actual comparables.\[63\]

However, in the section 482 regulations there are also arm’s length rules and methods which are based wholly or in part on a hypothetical arm’s length test. Thus, in relation to cost sharing, the arm’s length test is based on internal data. [...]
The PSM relies either wholly or in part on internal data. As a consequence, this method is usually considered to produce less reliable measures of an arm’s length result than other methods. In relation to unspecified methods it has also been held that the reliability of a method is reduced to the extent that it relies on internal data rather than market data. The IRS recognizes the income method as a specified method for the evaluation of platform contributions to cost sharing arrangements and as an unspecified method for the evaluation of intangibles and services. The income method involves a hypothetical arm’s length test since it is based on internal data. There is thus a tendency for the IRS to want to use a hypothetical arm’s length test when there is a lack of empirical market data, or where the transfer pricing methods lead to results that are regarded as departing from the arm’s length principle.

The rules and methods discussed are still exceptions to the main rule on the empirical arm’s length test, which is firmly rooted in the American legal tradition. Thus, the IRS has stated that the results actually realized in similar transactions under similar circumstances ordinarily provide significant evidence for determining whether a controlled transaction meets the arm’s length principle. It must nevertheless be stated that the arm’s length test in U.S. law has changed. Thus, hypothetical assumptions based on economic theory about economically rational conduct are increasingly used as the basis for the arm’s length test, as there is a move away from the price-based CUP to the gross margin-based [resale price method] and cost plus method and to the net margin-based [cost-plus method] and PSM. For instance, the application of the [cost-plus method] is based on a significant degree on both empirical data and on hypothetical assumptions based on economic theory. As a consequence of de facto dominance of the profit methods in the United States, in reality the arm’s length principle has developed into a hybrid arm’s length test incorporating both empirical and hypothetical elements.

As Radaelli explains, this move by the United States had the effect of destabilizing the cooperative equilibrium in the international transfer pricing regime’s coordination game; i.e. it broke away from the prior consensus that the traditional transaction methods should be prioritized.[64] Notably, these proposed regulations of 1992 were issued without waiting for prior consensus from, and coordination with, the OECD.[65]

The OECD reacted by setting up a special task force that analysed the US proposed regulations and recommended amendments to the regulations.[66] The United States in turn responded by making changes to its proposals. Following this dialog between the United States and the OECD, the United States issued its final regulations in 1994. Soon after, the OECD released its own revised TP Guidelines in 1995. It explained that its “project to revise the 1979 transfer pricing report was prompted by a number of factors, not the least of which were the increase in number and complexity of crossborder transactions, the proliferation of MNEs, and the difficulty in finding comparable market transactions to price controlled transfers involving non-routine intangible property”.[67] As Radaelli identifies, attempts were made to coordinate the revised TP Guidelines with the approach of the United States.[68]

At present, both the US Regulations and the TP Guidelines set out a requirement of applying the “best”[69] or “most appropriate”[70] transfer pricing method for determining the arm’s length “result”[71] or “outcome”. The best method is, according to the US Regulations, that which “provides the most reliable measure of an arm’s length result”. Similarly, in seeking the most appropriate method pursuant to the OECD Guidelines, the objective is “to find a reasonable estimate of an arm’s length outcome based on reliable information”. None of the alternative transfer pricing methods is given priority,[72] nor does the application of one method necessarily require proving that the other methods were inappropriate.[73]

64. Supra n. 15, p. 610.
65. Id., p. 611.
66. Id., p. 612.
68. Supra n. 15, pp. 613, 615.
70. Supra n. 3, para. 2.2.
72. Supra n. 3, para. 1.13.
73. US: Treas. Reg. sec. 1.482-1(c)(1).
74. Supra n. 3, para. 1.13.
75. US: Treas. Reg. sec. 1.482-1(c)(1); Supra n. 3, para. 2.2, p. 59.
76. Id.
Nevertheless, this does not mean that the methods are equally reliable. As the US Regulations acknowledge, “[d]ata based on the results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction are arm’s length”.\textsuperscript{77} Similarly, the OECD Guidelines acknowledge that “[t]raditional transaction methods are regarded as the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm’s length”. Accordingly, as the Guidelines go on to explain:

"Where, taking account of the criteria described at paragraph 2.2, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method. Moreover, where, taking account of the criteria described at paragraph 2.2, the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred."

Considering that methods vary in the extent of their reliability, the best or most appropriate method is that which is most reliable. In assessing reliability, different factors need to be taken into account. As the US Regulations explain:\textsuperscript{78}

"In determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm’s length result, the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis."

Similarly, the TP Guidelines set out criteria for determining which method is most reliable and thus appropriate.\textsuperscript{79} Among other things, it would be necessary to consider “the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods; and the degree of comparability between controlled and uncontrolled transactions […]”.\textsuperscript{80}

Therefore, in those cases where adequate comparables do exist in the market, methodologies based on the market approach would be treated as most reliable and preferred. If adequate comparables that actually took place do not exist then one of the alternative transfer pricing methods, as set out in the TP Guidelines and US Regulations, may be more reliable. These alternative methods are based on other approaches to valuation. For example, the TNMM and PSM are based on the income approach to valuation, whereas the CPM is based on the cost approach to valuation.\textsuperscript{81}

It should be emphasized that the quest for an objective benchmark guides both the transactional and non-transactional methods. As the TP Guidelines explain, when applying the TNMM, it is necessary to select an appropriate net profit indicator. For this purpose, it is necessary to use a denominator that is “consistent with the comparability (including functional) analysis of the controlled transaction, and in particular it should reflect the allocation of risks between the parties”. The Guidelines go on to state that “[t]he denominator should be reasonably independent from controlled transactions, otherwise there would be no objective starting point.”\textsuperscript{82}

### 3.1.2. The market approach exemplified by the TCC’s analysis in the Glaxo case

Glaxo Canada is a subsidiary of Glaxo Group, a UK company which itself is a subsidiary of Glaxo Holding Plc.\textsuperscript{83} This multinational enterprise has been discovering, developing, manufacturing and distributing pharmaceutical products throughout the world.\textsuperscript{84} Glaxo Canada is a distributor of Glaxo pharmaceutical products in Canada.\textsuperscript{85} This case involved Glaxo Canada’s distribution of the Zantac drug.

\textsuperscript{77} US: Treas. Reg. sec. 1.482-1(c)(2).
\textsuperscript{78} Id.
\textsuperscript{79} Supra n. 3, para. 2.2.
\textsuperscript{80} Id.
\textsuperscript{82} Supra n. 3, para. 2.88.
\textsuperscript{83} Glaxo-TCC, para. 10.
\textsuperscript{84} Glaxo-FCA, para. 8.
\textsuperscript{85} Glaxo-TCC, para. 10.

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According to Glaxo Canada’s witness at trial,[86] Glaxo Group’s policy was that it should receive 40% of the local distributors’ profits from the sale of Zantac, thus leaving distributors (including Glaxo Canada) with a 60% gross margin. To achieve this objective, Glaxo Group used different types of contractual arrangements with its distributors worldwide. As the trial judge explained:[87]

Contractual arrangements varied from country to country. In some countries, there was a Licence Agreement with Glaxo Group; in others, with the local Glaxo subsidiary. In most countries intangibles, for example the right to use a Glaxo Group trademark and the right to marketing support, were included in the purchase price of the ranitidine and the royalty payment, if one was specified, was waived. This can be contrasted with Canada, where there was a royalty payable to Glaxo Group pursuant to the Licence Agreement. Under the terms of each Licence Agreement, all local Glaxo distributors were required to purchase granulated ranitidine from a Glaxo Group approved source and to sell the licensed product under a trademark owned or controlled by Glaxo Group. This is similar to the appellant’s agreement.

Hence, in order to obtain the rights to sell Zantac, Glaxo Canada had to enter into a licence agreement with Glaxo Group, the holder of the Zantac patent.[88] The licence agreement gave Glaxo Canada numerous services and intangibles, including the right to manufacture and sell Glaxo Group’s drugs.[89] This licence agreement required Glaxo Canada to pay “a six percent royalty to Glaxo Group on its net sales of Zantac”. It also required Glaxo Canada to enter into a supply agreement to purchase Zantac ranitidine from a Glaxo Group approved source, which happened to be Adechsa (a Swiss affiliate of Glaxo Group).[90] Zantac ranitidine is the primary active pharmaceutical ingredient of Zantac. Glaxo Canada required it in order to manufacture the Zantac drug.

The Minister of National Revenue (“Minister”) reassessed Glaxo Canada’s income tax for the years 1990-1993. At issue was the supply agreement between Glaxo Canada and Adechsa. The Minister argued that the price paid to Adechsa was not “reasonable in the circumstances” within the meaning of section 69(2) of the ITA. At the time of this assessment, section 69(2) contained Canada’s transfer pricing rule. Because Adechsa is not a resident in Canada and is an affiliate of Glaxo Group, the supply agreement was a cross-border controlled transaction that could fall within section 69(2).

At trial, both the Minister and Glaxo Canada invited the trial judge to compare the transfer price in the supply agreement to the arm’s length price in comparable uncontrolled transactions that actually took place in the market, though they disagreed as to which transactions where properly comparable.

The Minister argued that the supply agreement was essentially an agreement to pay for the raw material received from Adechsa (i.e. goods) and nothing more.[93] Accordingly, the transfer price could be compared to the price paid by Apotex and Novopharm, for the generic version of ranitidine, in arm’s length purchases from manufacturers of the generics. Both Glaxo Canada and the Minister agreed that the Zantac ranitidine and the generic ranitidine were chemically equivalent and bioequivalent.[94] Moreover, Apotex and Novopharm were also paying for the raw material (i.e. goods) and nothing more. Hence, as the Minister argued, it was appropriate to determine the arm’s length price using the CUP method, and to use the CPM to verify this CUP method.[95]

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[86] Glaxo-TCC, para. 76.
[90] Glaxo-TCC, para. 14. These “[r]oyalty payments in Canada are subject to withholding tax and the profit will accrue to Glaxo Group and be taxed in the United Kingdom” (Glaxo-TCC, para. 77).
[91] For this reason, the SCC stated that “the rights and benefits of the Licence Agreement were contingent on Glaxo Canada entering into a Supply Agreement with suppliers to be designated by Glaxo Group.” (Glaxo-SCC, para. 49).
[92] While the ranitidine was produced in Singapore, by Glaxochem (Pte) Singapore (Glaxo-TCC, para. 80), it was then distributed by Adechsa to local distributors around the world (Glaxo-TCC, para. 166).
[93] It based this assertion on the fact that the only thing of value which Glaxo Canada actually received under the supply agreement was the raw material (Glaxo-TCC, para. 16). It also suggested that the supply agreement had to be considered without regard to any other transactions (i.e. without regard to the licence agreement); this being the transaction-by-transaction approach that was applied by the SCC in Singleton v. R (Glaxo-TCC, para. 72). Moreover, it alleged that the licence agreement was a non-arm’s length condition that had to be stripped away from the notional arm’s length transaction in order to determine the arm’s length result (Transcript of Her Majesty the Queen v. GlaxoSmithKline Inc. (33874), pp. 18-19. Cited with the permission of the Supreme Court of Canada, 2012)
In this comparison, it was found that the price of the Zantac ranitidine ranged between CAD 1,512 to CAD 1,651 per kilogram, whereas the fair market value ("FMV") of the generic ranitidine ranged between CAD 193 to CAD 304 per kilogram. For this reason the Minister adjusted the price paid by Glaxo Canada, and disallowed deductions of its payments [to Adechsa] to the extent that they were "in excess of the highest monthly price per kilogram of ranitidine paid by Apotex and Novopharm to their arm's length manufacturers".\(^{96}\)

In contrast, Glaxo Canada asserted that in the supply agreement its intention was to bundle payments for the goods (received from Adechsa) as well as rights and services received from Glaxo Group under the Licence Agreement.\(^{97}\) This bundled payment would ultimately be received by Glaxo Group. Doing so was necessary in order to pay Glaxo Group 40\%, from the profits earned in the sale of the Zantac drug, as consideration for the right to sell the Zantac brand.

Notice that this description of the supply agreement as a “bundled” payment made it possible for Glaxo Canada to distinguish its supply agreement from the purchases of the generic ranitidine by Apotex's and Novopharm,\(^{98}\) so that the latter could not be treated as proper comparables. They would be distinguishable because the supply agreement, according to Glaxo Canada, was an agreement to pay for the goods (i.e. the raw materials) and the rights and benefits received under the licence agreement, whereas Apotex and Novopharm were only paying for goods.\(^{99}\)

Having suggested that the purchases of the generic ranitidine were not comparable, Glaxo Canada moved on to assert that purchases of Zantac ranitidine by Glaxo Group’s European arm’s length distributors were comparable in circumstances; these being internal comparables. This is because “they purchased the same ranitidine under the same set of business circumstances as the appellant”.\(^{100}\) More specifically, they:\(^{101}\)

entered into licence agreements with Glaxo Group and supply agreements with Adechsa on terms substantially similar to those entered into by Glaxo Canada in respect of the intellectual property, product support and API necessary to sell Glaxo-brand ranitidine products. Like Glaxo Canada, arm’s length distributors were required to purchase ranitidine for sale under Glaxo trade marks from Glaxo Group-approved sourced.

Glaxo Canada suggested that this comparison could be based on the CUP method, RPM or TNMM.\(^{102}\)

The trial judge, Associate Chief Justice Rip, agreed with the Minister “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”.\(^{103}\) With his exclusive focus on the supply agreement, Rip found that the only thing of value which Glaxo Canada received [in this supply agreement] was the raw material [i.e. goods], as was suggested by the Minister.\(^{104}\) Apparently, from that conclusion he implicitly inferred Glaxo Canada’s intention to pay for the goods and nothing more. In his words:\(^{105}\)

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…”\(^{106}\) the issue in these appeals is not what is a reasonable price for Glaxo Canada to pay to sell Zantac in Canada; it is what is a reasonable price for Glaxo Canada to have paid for a kilogram of ranitidine…

Based on this interpretation of the supply agreement, Rip accepted the Minister’s submission that the supply agreement was comparable to the arm’s length purchases of the generic ranitidine. These transactions similarly involved a purchase/
sale of an equivalent raw material and nothing more. As for Glaxo Canada’s assertion that the transactions with the European distributors were comparable, Rip explained his rejection of this assertion as follows:

The transactions between Glaxo Canada and Adechsa were for a kilogram of ranitidine with no intangibles included in the purchase price. The transactions with the European licensees between 1990 and 1993 generally included the ranitidine and a variety of intangibles for a single consideration. This makes the Glaxo Canada transaction fundamentally different from the transactions involving the European licensees and makes comparisons between the two inappropriate. Transfer pricing policies differed between Glaxo Canada and European distributors as well. Special incentives like promotional goods were applied to European distributors, unlike Glaxo Canada.

Accordingly, Rip treated the FMV of the generic raw material (in these arm’s length purchases) as representing the “reasonable” price. Because the transfer price paid by Glaxo Canada was significantly higher than the FMV, Rip held that Glaxo Canada may not deduct the excess amount it paid to Adechsa. Moreover, this excess amount would have to be treated as royalty payments to Glaxo Group, which are subject to a 10% withholding tax under section 215(6) of the ITA.

3.2. The FCA’s approach in the Glaxo Case

3.2.1. The FCA’s approach: Interpreting section 69(2) of the ITA as requiring the use of a “hypothetical” arm’s length comparable

In its appeal to the FCA, Glaxo Canada sidestepped the need to rely on the internal comparables; i.e. the comparison to agreements with Glaxo Group’s European distributors. It did so by convincing the FCA that section 69(2) required comparing the controlled transaction to a hypothetical uncontrolled transaction. Justice Nadon, who delivered the court’s decision, gave alternative views about who the parties in this hypothetical are. At one point he stated that they consist of Glaxo Canada and Adechsa, with the assumption that they are dealing at arm’s length. At another point he stated that the parties are hypothetical parties which are assumed to be dealing at arm’s length but otherwise under the same circumstances.

On final appeal to the SCC, the Minister questioned whether the FCA erred in its interpretation of section 69(2). The SCC affirmed the FCA’s decision.

Before proceeding further, it is necessary to consider whether the FCA’s analysis in this case is also relevant and applicable to disputes under the current section 247 of the ITA, which replaced section 69(2). This question was recently addressed by the TCC in McKesson Canada Corporation v. The Queen, where Justice Boyle held as follows: “While GlaxoSmithKline involved the former subsection 69(2) transfer pricing rule, which was worded differently, I see no compelling reason to depart from the Supreme Court of Canada’s approach and comments in GlaxoSmithKline.”

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109. As Rip explained: “Appellant’s counsel did not offer an explanation as to whom he believed was entitled to the excess amounts. He stated it was not Glaxo Group. If not Glaxo Group, then who? It was Glaxo Group who was entitled to the excess amounts. But for the direction of Glaxo Holdings and the concurrence of Glaxo Group in setting the transfer price, the appellant would not have transferred the excess amounts to Adechsa. The excess amounts would have remained in the hands of the appellant and at some point in time all or part would have been distributed to Glaxo Group in the form of dividends. Glaxo World’s tax strategy was to divert profits to Singapore before being paid to Glaxo Group as dividends. Ultimately, the amounts were indeed received by Glaxo Group.” (Glaxo-TCC, para. 174).
110. Glaxo-TCC, para. 175.
111. Glaxo-FCA, para. 58.
112. Glaxo-FCA, para. 58.
113. Glaxo-FCA, para. 81.
114. Supra n. 96, p. 9.
115. While the SCC referred the case back to the TCC for retrial (Glaxo-SCC, para. 63), the case was settled by the parties.
116. 2013 TCC 404 (CanLII), para. 121.
3.2.2. But did Parliament require (or allow for) using a “hypothetical uncontrolled transaction”? A “textual, contextual and purposive” interpretation of section 69(2)

3.2.2.1. Canada’s approach to statutory interpretation: "Textual, contextual, and purposive" analysis

As the FCA stated, in the Glaxo case it was “called upon to determine the proper interpretation of subsection 69(2) of the ITA...”[117] In Canada, statutory interpretation requires applying a unified “textual, contextual and purposive” analysis. This approach to statutory interpretation was described by the SCC as follows:[118]

The interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole. When the words of a provision are precise and unequivocal, the ordinary meaning of the words plays a dominant role in the interpretive process. On the other hand, where the words can support more than one reasonable meaning, the ordinary meaning of the words plays a lesser role. The relative effects of ordinary meaning, context and purpose on the interpretive process may vary, but in all cases the court must seek to read the provisions of an Act as a harmonious whole.

Surprisingly, neither court (in the Glaxo case) explicitly indicated that it undertook the task of statutory interpretation by applying this textual, contextual and purposive analysis. It appears that the courts were focused on a textual reading of section 69(2). Let us turn to examine, therefore, how this interpretation could, or ought to have been, conducted.

3.2.2.2. Who are, or may be, the entities in the comparable uncontrolled transaction? – A textual analysis

Section 69(2) stated as follows:

Where a taxpayer has paid or agreed to pay to a non-resident person with whom the taxpayer was not dealing at arm's length as price, rental, royalty or other payment for or for the use or reproduction of any property, or as consideration for the carriage of goods or passengers or for other services, an amount greater than the amount (in this subsection referred to as "the reasonable amount") that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, the reasonable amount shall, for the purpose of computing the taxpayer's income under this Part, be deemed to have been the amount that was paid or is payable therefor.

Notice that Parliament referred to the entities in the comparable uncontrolled transaction using the following terms: “if the non-resident and the taxpayer had been dealing at arm’s length [...]”. Question is, did section 69(2) require a hypothetical assumption that “the taxpayer” and “the non-resident” in the comparable uncontrolled transaction be the same entities as those in the controlled transaction under review?

In Commissioner of Taxation v. SNF (Aust) Pty Ltd,[119] the Commissioner invited the Federal Court of Australia to consider the approach of Canada’s courts in the Glaxo case. The Federal Court of Australia refused to rely on the Canadian case “because the text of the relevant provision – section 69(2) of the Income Tax Act RSC 1985, c 1 (5th supp) – was materially different”.[120] The court stated that “[t]he hypothesis which that provision required expressly involved the taxpayer (‘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’)”.[121] This wording, according to the Australian court, was distinguishable from the wording in Australia’s statute which referred to the entities in the uncontrolled transaction using the following vague language: “independent parties dealing at arm’s length”. Notice that the words in the Australian statute are vague enough to allow different interpretations about the intended identity of the parties in the uncontrolled transaction.[122]

117. Glaxo-FCA, para. 5.
119. 2011 FCAFC 74 (“SNF”).
120. SNF, para. 123.
121. SNF, para. 123.
122. SNF, paras. 97-99.
Turning back to section 69(2), it may be that Parliament intended for the court to assume that “the taxpayer” in the controlled transaction is the same entity as “the taxpayer” in the comparable uncontrolled transaction. As the FCA noted:\textsuperscript{123}

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. \textit{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.}

This, however, is not the only possible interpretation based on the plain meaning of the words used. It is also possible that “the taxpayer”, for the purposes of the controlled transaction, refers to Glaxo Canada, whereas “the taxpayer”, for the purposes of the comparable uncontrolled transaction, needs to be another Canadian taxpayer. This could be any other Canadian taxpayer from a comparable uncontrolled transaction that actually took place, or it could be a hypothetical Canadian taxpayer if an actual comparable does not exist. The FCA itself alluded to this alternative interpretation as follows: “[t]hat test required the Judge to determine \textit{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}”.\textsuperscript{124}

Hence, the ordinary meaning of the statutory words in section 69(2), with respect to the intended identity of “the taxpayer” in the uncontrolled transaction, was not precise and unequivocal.

With respect to the intended identity of the “non-resident”, it is possible that Parliament intended for the courts to assume that the non-resident is the same entity in both the controlled and comparable uncontrolled transactions, which would require constructing a hypothetical uncontrolled transaction. For example, where the controlled transaction involved Glaxo Canada (“the taxpayer”) and Adechsa (“the non-resident”), it would then be hypothetically assumed that, for the purposes of the comparable uncontrolled transaction, Glaxo Canada and Adechsa were dealing at arm’s length but otherwise under the same circumstances. Alternatively, however, it is also possible that Parliament intended that the “non-resident” in the comparable uncontrolled transaction be an entity other than Adechsa; assuming of course that a comparable uncontrolled transaction that actually took place in the market exits. This could be, for example, Glaxo Group’s European arm’s length distributors (assuming that the transactions with those European distributors were indeed properly comparable).

Hence, the ordinary meaning of the statutory words in section 69(2), with respect to the intended identity of the “non-resident” in the comparable uncontrolled transaction, is not precise and unequivocal.

Notably, Parliament’s apparent intention to preserve a degree of vagueness, in its formulation of the identity of the parties in the comparable uncontrolled transaction, was more clearly and explicitly conveyed through its subsequent amendment of the transfer pricing rule in section 247 of the ITA, which replaced section 69(2). In section 247, Parliament abandoned its use of the word “the taxpayer” and “the non-resident” with respect to the parties in the comparable uncontrolled transaction. Instead, it referred to them as “persons”. As stated in section 247(2)(c), the comparable transactions are “those that would have been made between persons dealing at arm’s length [...]”\textsuperscript{125} Notice that Parliament’s use of the word “persons” is more akin to the words “independent parties” in the Australian statute. Both convey a degree of vagueness about the possible identity of the parties in the comparable uncontrolled transactions. As Tremblay explained in his analysis of section 247:\textsuperscript{126}

Nothing in this provision requires us to assume that the hypothetical ‘persons’ are or are not in fact exactly who they really are, i.e., parent/subsidiary or otherwise related [...] The only stated requirement is that the reference “persons” in fact deal at arm’s length [...] Of course, if the Canadian Parliament intended that we determine the price that would have been arrived at if the actual parties were the “persons,” it could have drafted the provision to say that

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{123} Glaxo-FCA, para. 58.
\item\textsuperscript{124} Glaxo-FCA, para. 81.
\item\textsuperscript{125} \textit{See also} section 247(2)(b)(i) of the ITA, which uses the terms “would not have been entered into between persons dealing at arm’s length”.
\end{enumerate}
\end{footnotesize}
Considering that the words in section 69(2) do not appear to be precise and unequivocal, the courts in this case should have given less weight to the ordinary meaning of the terms and more weight to the purpose and contexts of section 69(2). Let us assume, however, that any reasonable court would nonetheless find the wording in section 69(2) to have been precise and unequivocal. Canada's unified approach to statutory interpretation would still require the courts to interpret the meaning of the words in light of the purpose and contexts of section 69(2). Therefore, either way it was necessary to consider the relevant purpose and contexts of Canada's transfer pricing provision in order to ascertain whether, and to what extent, Parliament intended for the courts to rely on a hypothetical uncontrolled transaction as a comparable.

3.2.2.3. The purpose and contexts of section 69(2)

It was not, and should not have been, an issue of contention that the purpose of section 69(2) was to implement the ALS of article 9, which has been incorporated into Canada's bilateral tax treaties. As Justice Pizzitelli of the TCC acknowledged, "[p]aragraphs 247(2)(a) and (c), like former subsection 69(2), is analogous to Article 9(1)" of the OECD Model.\[127\] In its submissions to the SCC in the Glaxo case, the Minister thus explained that by basing its transfer pricing provision on the ALS, Canada was "in keeping with her obligations as a member of the OECD and its Model Tax Convention on Income and on Capital".\[128\]

The application of the ALS requires consideration of the relevant contexts, which inform how this standard ought to operate in order for the domestic transfer pricing rule to achieve its purpose. Recall that the purpose of incorporating the ALS into bilateral tax treaties and domestic legislation has been to internationally coordinate a common standard for income allocation, in order to reduce the risk of double taxation. Achieving this shared objective necessarily depends on also having the ALS applied based on coordinated guidelines, otherwise differences (particularly, irreconcilable differences) in the application of the standard could also result in double taxation. Considering this role of the TP Guidelines, they were necessarily a relevant part of the contexts of section 69(2). As such, the Guidelines should have informed the courts' interpretation of section 69(2).

Neither should this assertion have been a matter of contention. It is a conclusion that was already acknowledged by Justice Sharlow of the FCA in Smithkline Beecham Animal Health Inc. v. Canada. Justice Sharlow stated as follows: "[i]t appears to be common ground that the OECD Guidelines inform or should inform the interpretation and application of subsection 69(2) of the Income Tax Act".\[128\] More recently, Justice Sheridan of the TCC similarly explained that "[b]ecause the Act is silent as to how to carry out the analysis contemplated by subsection 247(2), Canadian courts have endorsed the use of the OECD Guidelines. The OECD Guidelines do not have the force of law but rather, are intended as tools to assist in determining what a reasonable business person would have paid if the parties to a transaction had been dealing with each other at arm's length."\[130\]

As Nadon acknowledged in the Glaxo case, Rip "used the 1979 and 1995 OECD Commentaries criteria to analyze" the transfer pricing methodologies that were relied on by the parties.\[131\] After the trial judge issued his decision, commentators were quick to highlight the significance of his reference to the TP Guidelines. For example, Dujsic, Goldberg, Barsalo and Fleming commented as follows:\[132\]

> Important aspects of the decision include: recognition of the 1995 OECD Guidelines as a relevant source of guidance for resolving transfer pricing disputes in Canada, even though the Guidelines are not formally part of the legislative framework in Canada; [...]
Yet, on appeal to the SCC, even though the Minster referred the SCC to *Smithkline Beecham Animal Health Inc. v. Canada*, Justice Sharlow’s comments were not even mentioned in the SCC’s reasons for judgment. Instead, the SCC took the opportunity to emphasize that “the Guidelines are not controlling as if they were a Canadian statute and the test of any set of transactions or prices ultimately must be determined according to section 69(2) rather than any particular methodology or commentary set out in the Guidelines.” This (apparent) oversight of the purpose and contexts of section 69(2) is unfortunate. It prevented the SCC from identifying (or acknowledging that it identified) the (seemingly) necessary inference of Parliament’s intention to have its transfer pricing rule applied in a manner consistent with the TP Guidelines. A contrary legislative intention would not have been sensible for the following reasons.

In the Bill of its recent legislation, Australia set out several justifications in support of its decision to introduce a legislative requirement that the transfer pricing analysis ought to be conducted in a manner consistent with the TP Guidelines. It acknowledged that the guidelines represent the internationally coordinated approach to the transfer pricing analysis:

The OECD Guidelines, in particular, expand on the application of the arm’s length principle and contain authoritative international know-how on the application of transfer pricing rules. The OECD Guidelines are widely used by both member and non-member tax administrations, and were described by the UK Special Commissioners as “the best evidence of international thinking on transfer pricing.

It also acknowledged that following the guidelines makes it possible to ensure a consistent application of domestic transfer pricing rules, in order to avoid either double taxation or double non-taxation:

Most of Australia’s major trading and investment partners look to the OECD Guidelines to ensure consistent application of transfer pricing rules. In the event that different standards were used there would be a greater risk that jurisdictions might each tax the same amount under their transfer pricing rules (resulting in double taxation), or not tax an amount at all (leading to double non-taxation).

Notably, these justifications are relevant generally and applicable to other OECD member states, such as Canada, as well as to non-member states.

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133. *Supra* n. 96, para. 43.
136. Id. para. 3.25.
True, the guidelines are non-binding Recommendations.[137] As such, domestic courts are not legally bound to consider or follow the Recommendations, unless otherwise required by domestic hard law, as exemplified by the UK and Australian legislations.[138] Yet, at least from the perspective of the domestic executive and legislative branches of OECD member states, the Recommendations have greater force than mere ‘soft law’. As the OECD explains:[139]

Recommendations are “submitted to the Members for consideration in order that they may, if they consider it opportune, provide for their implementation” (Article 18 of the Rules of Procedure of the OECD). Recommendations are not legally binding, but practice accords them great moral force as representing the political will of Member countries and there is an expectation that Member countries will do their utmost to fully implement a Recommendation. Thus, Member countries who do not intend to do so usually abstain when a Recommendation is adopted, although this is not required in legal terms.

The Australian Bill pointed out that Australia, as an OECD member state, participated in this international coordination game; suggesting that the Recommendations also represent the political will of Australia. As stated in the Bill,[140]

The OECD’s Committee on Fiscal Affairs (CFA) is the primary international tax policy forum for Australia and other developed countries. The OECD Guidelines are initially developed by working parties of the CFA, vetted by that Committee, and finally approved or adopted at Council level. Australia is represented at each of these stages and the OECD consults extensively with the international business community as part of this process.

Accordingly, similar to the UK, Australia recognized the need to take into account the TP Guidelines when conducting the transfer pricing analysis. Much like Australia and the UK, Canada has also taken part in this coordination game. It is therefore not surprising that, as Boidman and Lawlor pointed out, “it would seem that the Canadian tax authorities do not wish to be out of step with the principles and practices being followed by most other developed countries in these matters.”[141] Likewise, it appears unlikely that Canada’s Parliament intended to have its transfer pricing rule, as it was set out in section 69(2) and as it is now set out in section 247, applied in a way that is at odds with the approach adopted by

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137. As Vega explains, the TP Guidelines “were approved by the Committee on Fiscal Affairs on 27 June 1995 and are the object of the Recommendation of the OECD Council C(95)126/FINAL, of 13 July 1995. This recommendation is not legally binding since it is based on Art. 5(b) of the Convention on the OECD and therefore, the tax administrations of the OECD member states are simply encouraged to follow the Guidelines”. (A. Vega, 2012, International Governance Through Soft Law: The Case of the OECD Transfer Pricing Guidelines, Transstate Working Papers, no. 163, pp. 11-12, available at http://www.sfb597.uni-bremen.de/pages/pubApBeschreibung.php?SPRACHE=en&ID=204.)


139. The domestic treatment of the TP Guidelines varies considerably. (Vega analyses the extent to which different jurisdictions refer to the TP Guidelines in their domestic transfer pricing practice), though the courts nonetheless follow the guidelines to whichever extent. It is for this reason that the SCC recently stated that “the Guidelines are not controlling as if they were a Canadian statute and the test of any set of transactions or prices ultimately must be determined according to section 69(2) rather than any particular methodology or commentary set out in the Guidelines”, though the court nonetheless relied on parts of the Guidelines in support of its analysis. (Glaxo-SCC, paras. 20, 40-41) In contrast, the domestic legislation of some countries explicitly requires conducting the transfer pricing analysis in a manner that is consistent with the TP Guidelines. Among the OECD member countries, a notable example is the United Kingdom. (Section 164(1) of the Taxation (International and Other Provisions) Act 2010 requires the transfer pricing analysis to be carried out in a manner that best secured consistency with the TP Guidelines. See also DSG Retail Ltd and others v. Revenue and Customs Commissioners, where the UK’s Special Commissioners stated that “the Sch 28AA regime, by virtue of para 2 requires effect to be given to the Transfer Pricing Guidelines as they apply to treaties following the OECD model…” ([2009] STC (SCD) 397, para. 77).

140. For Australia, see secs. 815-135, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013. For the United Kingdom, see sec. 164(1), Taxation (International and Other Provisions) Act 2010.


140. Supra n. 135, para. 3.24.

its partners internationally. Such an intention would: (i) belittle Canada’s role within the OECD, and (ii) undermine and frustrate the objective of avoiding double taxation through a coordinated application of the ALS.

4. The FCA’s Approach is at Odds With the International Thinking on Transfer Pricing

At the hearing before the SCC, Madam Chief Justice McLachlin asked Mr. Al Meghji, Counsel for Glaxo Canada, the following question: “Can you tell us what the courts have held in the United States, for example?”[142] He replied as follows:[143]

The thing about the – the courts in the United States and the courts in Australia and the cases that I am familiar with; I am not familiar with a single authority which says that the arm’s length test is anything other than taking the parties to the transactions; situating them as independent parties; and then testing the transaction in that way.

Mr. Meghji’s approach, which was accepted and applied by the FCA, is actually at odds with the approach of the OECD, of courts in other jurisdictions, and even with the approach of Canada’s courts with respect to the statutory provision from which they [Counsel for Glaxo Canada and the FCA] transplanted the ‘reasonableness’ standard.

More specifically, as explained next, both the OECD and courts in other jurisdictions have conveyed reluctance towards relying on what a ‘reasonable business person’ would have done (under the same circumstances) as the basis for the ALS. Moreover, the OECD, the courts in other jurisdictions, and even Canada’s courts with respect to the ‘reasonableness’ standard as applied in section 67 of the ITA (from which the standard was being transplanted for the purpose of section 69(2)), have conveyed a preference to rely on actual comparables as objective measures of the ALS, if and where actual comparables are available.

Consequently, as the Minister cautioned in its submissions to the SCC, the FCA’s approach has placed “Canadian jurisprudence at odds with the approach adopted by its partners in the OECD”[144] as well as, as explained in this paper, at odds with the judicial approach of courts in other jurisdictions. For the purpose of the FCA’s interpretation of section 69(2), it appears inconceivable that such an outcome was intended by Parliament.

4.1. Reluctance towards basing the ALS on a “reasonable business person” test

4.1.1. The OECD’s approach

Recall that, according to the TP Guidelines and the US Regulations, comparisons to transactions that actually took place, if such transactions exist, are most reliable and thus preferable. The OECD’s preference for relying on actual uncontrolled transactions, if and when they are available, is also evident from its description of the exceptional circumstances in which it could be necessary to recharacterize the actual controlled transaction.

More specifically, the TP Guidelines explain that, after having delineated the actual controlled transaction (in the first stage of the analysis), the search for a comparable (in the second stage) may reveal that the fundamental underlying basis of the arrangement in the actual controlled transaction (i.e. the transaction’s attributes/factors/conditions) cannot be found (in an arm’s length transaction) because parties trading at arm’s length, and behaving in a commercially rational manner, would not have entered into an arrangement that possesses such attributes/factors/conditions.[145] In such a case, it would not be appropriate to rely on the actual transaction in order to find the arm’s length result.[146] It would be permitted to recharacterize the actual transaction by replacing it with an alternative transaction that affords the parties the opportunity to enhance or protect their commercial or financial position. The replacement structure should be guided by the fundamental economic attributes of arrangements between unrelated parties and comport as closely as possible with the commercial reality of independent parties in similar circumstances”. [147] The alternative replacement transaction would represent the contractual terms which commercially rational arm’s length parties would have agreed to.[148]

143. Id., p. 35.
144. Supra n. 96, para. 1.
145. Supra n.3, para. 1.65.
146. Supra n.18, p. 26, paras. 87-88.
147. Supra n. 18, p. 27, para. 93.
Yet, the TP Guidelines also caution as follows:\[149\]

9.171 ... tax administrations should not ordinarily interfere with the business decisions of a taxpayer as to how to structure its business arrangements. A determination that a controlled transaction is not commercially rational must therefore be made with great caution, and only in exceptional circumstances lead to the non-recognition of the associated enterprise arrangements.

9.172 Where reliable data show that comparable uncontrolled transactions exist, it cannot be argued that such transactions between associated enterprises would lack commercial rationality. The existence of comparables data evidencing arm’s length pricing for an associated enterprise arrangement demonstrates that it is commercially rational for independent enterprises in comparable circumstances. On the other hand, however, the mere fact that an associated enterprise arrangement is not seen between independent enterprises does not in itself mean that it is not arm’s length nor commercially rational (see paragraph 1.11).

### 4.1.2. Foreign judicial approaches

What about the judicial approaches of other courts around the world? As Professor Avi-Yonah explains, in early U.S. case law “the courts applied a wide variety of standards to determine what constituted a transaction that clearly reflected the taxpayer’s income.”\[150\] In Frank v. International Canadian Corporation, for example, the Court of Appeals for the Ninth Circuit held:\[151\]

[\[W\]e do not agree with the Commissioner’s contention that “arm’s length bargaining” is the sole criterion for applying the statutory language of section 45 in determining what the “true net income” is of each “controlled taxpayer.” Many decisions have been reached under section 45 without reference to the phrase “arm’s length bargaining” and without reference to Treasury Department Regulations and Rulings which state that the talismanic combination of words-“arm’s length”-is the “standard to be applied in every case.” For example, it was not any less proper for the District Court to use here the “reasonable return” standard than it was for other courts to use “full fair value,” “fair price, including a reasonable profit,” “method which seems not unreasonable,” “fair consideration which reflects arm’s length dealing,” “fair and reasonable,” “fair and reasonable” or “fair and fairly arrived at,” or “judged as to fairness,” all used in interpreting section 45.]

However, US courts eventually abandoned their reliance on a “reasonableness” standard. Professor Avi-Yonah went on to explain that, in Oil Base, Inc. v. Commissioner,\[152\] “[i]n effect, the Ninth Circuit overruled Frank, holding that the ALS must be applied not only when comparables exist, but also when they do not exist, as the court can hypothesize a comparable. This abrupt reversal was very likely influenced by the egregious facts of Oil Base and by the difficulties in applying a reasonableness standard.”\[153\]

In Lufkin Foundry & Machine Co. v. Commissioner,\[154\] the US Court of Appeals for the Fifth Circuit made it clear that reasonableness had to be determined by means of the arm’s length comparability analysis, rather than by means of a “reasonableness” standard.\[155\]

Among the different transfer pricing regimes around the world that follow the TP Guidelines, Germany’s statutory arm’s length provision is particularly notable and distinguishable in that it explicitly allows for the use of a hypothetical uncontrolled transaction based on the “prudent and conscientious business manager’ standard.”\[156\] Yet, even in Germany the hypothetical uncontrolled transaction is an option of last resort where actual comparables do not exist. As held by

148. Unlike the TP Guidelines, the US Regulations do not authorize transactional adjustments based on the terms that would have been agreed to by commercially rational arm’s length parties. (Hui Ling Quek (Jan 24, 2011), Economic Substance in U.S. Transfer Pricing Rules and the Regulation of Taxpayer Behavior, 61 Tax Notes Intl 311).

149. Supra n.3, paras. 9.171-2.
150. Supra n. 61, p. 98.
151. 308 F.2d 520 (1962), at 528-529.
152. 362 F.2d 212 (1966).
153. Supra n. 61, p. 105.
154. 468 F.2d 805 (1972).
155. Supra n. 61, p. 111.

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Germany’s Federal Tax Court: “it is correct that the arm’s length test applied in tax law should be inferred from actual established comparable values, if possible”.[157] Voegele and Zhang explain Germany’s approach as follows:[158]

Under the revised International Transactions Tax Act (“ASTG”), effective from 2008, the application of the transfer pricing method is dependent on the availability and quality of third-party comparable data. With respect to their availability and quality, the §1 (3) of the ASTG differentiates between fully comparable third party data and partially comparable third party data.

If fully comparable data is available for the transaction, the traditional OECD methods, i.e., the Comparable Uncontrolled Price (CUP) Method, the Resale Price Method, and the Cost Plus Method (CPM), are theoretically preferred. Increasingly, the tax authorities encourage the use of Profit Split Methods. For cases where only data with limited comparability is available, an appropriate method should be used, including, for example, the Transactional Net Margin Method (TNMM). In cases where neither fully nor partially comparable data can be identified, the taxpayer has to use a so-called “hypothetical arm’s length method” to determine the arm's length price of the transaction. This “hypothetical arm’s length method” can be calculated by using Profit Split Methods.

It is also noteworthy that Germany equates its hypothetical test to the PSM, which further helps it establish consistency with the OECD Guidelines.[159]

The courts’ apprehension about the use of a "reasonableness" standard, and their preference in relying on actual comparables as a benchmark, appears to be rooted in the risk of having to reach arbitrary results. As Professor Avi-Yonah explained with regards to the withdrawal from a ‘reasonableness’ standard in the U.S., “[t]he main reason was the courts’ stated awareness of the morass they would be getting into by seeking to determine transfer prices in the absence of comparables. Decisions (not based on comparables) that cover hundreds of pages only to reach unpredictable and arbitrary results seem to justify this conclusion.”[160]

Notably, judicial apprehension about having courts assess the "reasonableness" of contractual terms was also conveyed by the SCC, albeit in a different context. In Syncrude Canada Ltd. v. Hunter Engineering Co., Justice Wilson cautioned as follows: “the courts, in my view, are quite unsuited to assess the fairness or reasonableness of contractual provisions as the parties negotiated them. Too many elements are involved in such an assessment, some of them quite subjective”. [161]

4.2. The role of actual comparables as a source of “objective measures”

4.2.1. The role of objective measures of reasonableness in section 67

Recall that where actual comparables are used, the norm of the market is treated as an "objective measure" by which to assess the reasonableness of the transfer price. What is the measure where the comparable is hypothetical?

The FCA accepted Glaxo Canada’s assertion that section 69(2) requires applying a reasonableness standard (i.e. a "reasonable business person" test) similar to that which has been applied for the purpose of section 67 of the ITA.[162] Nadon explained his decision to apply this standard as follows:

69 ... 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.

[157] Supra n. 47, at 310.
[160] Supra n. 61, p. 119.
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.

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 Ltd. v. R., 2000 D.T.C. 1767 (T.C.C. [General Procedure]), 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.

It is worth noting that the Gabco test was recently referred to with approval by this Court in Petro-Canada v. R., 2004 D.T.C. 6329, 2004 FCA 158 (F.C.A.), 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.

Section 67 states that “[i]n computing income, no deduction shall be made in respect of an outlay or expense in respect of which any amount is otherwise deductible under this Act, except to the extent that the outlay or expense was reasonable in the circumstances.” As held by Justice Cattanach, a business expense would be unreasonable if it is shown that no other reasonable business person, acting only with the taxpayer’s business interests in mind, would incur such an expense.

Note that while Justice Cattanach’s statement describes the relevant standard, it does not inform us of the method(s) by which courts can, or must, determine whether an expense was (un)reasonable. In Petro-Canada v. R.,[163] which was referred to by Nadon in the Glaxo case, Justice Sharlow of the FCA cited Cattanach’s statement in Gabco and then moved on to also cite the FCA in Mohammad v. Canada (C.A.). In that case, Justice Robertson shed valuable light on the methods by which courts ought to determine whether an expense was (un)reasonable. In the words of Justice Robertson, “[w]hen evaluating the reasonableness of an expense, one is measuring its reasonableness in terms of its magnitude or quantum. Although such a determination may involve an element of subjective appreciation on the part of the trier of fact, there should always be a search for an objective component.”[164]

Justice Bowman also cautioned against this risk of subjective appreciation on the part of the trier of fact. In Podlesny v. The Queen, he stated that “[a] determination of reasonableness does not justify arbitrariness,”[165] and went on to cite the following cautionary words in 2831422 Canada Inc. et al v. The Queen:[166]

What is reasonable in any circumstance is a matter of fact, judgment, and common sense. In Words and Phrases Legally Defined there are eight pages of two columns dealing with the words reasonable or reasonably, yet no court of which I am aware has ever had the temerity to try to formulate a comprehensive definition of the word, nor do I. Any attempts to assign a meaning to it usually end up using the word itself. It is said to imply the application of objective criteria but it is a word of such fluidity and elasticity that a judge must resist the temptation to let some element of subjectivity creep into his or her determination. What may seem reasonable to one judge may not to another. Attempts to define the "reasonable person" usually end up deferring to some hypothetical passenger on the

165. Podlesny v. The Queen, 2005 TCC 97 (CanLII); 59 DTC 344, para. 16.
Clapham omnibus. One can ask "What would an impartial observer possessing a somewhat (but not excessively) above average intelligence, knowing all the relevant facts, having no preconceived notions, biases or hidden agendas consider to be reasonable?" In short, one draws the line between reasonable and unreasonable where one's good sense tells one to draw it.

How can the risk of arbitrariness be minimized when using this standard of reasonableness? In Mohammad v. Canada, Justice Robertson suggested as follows:[167]

When dealing with interest expenses, the task can be objectified readily. For example, it would have been open to the Minister to challenge the amount of interest being paid on the $25,000 loan had the taxpayer agreed to pay interest in excess of market rates. The reasonableness of an interest expense can thus be measured objectively, namely, by reference to market rates. [...]

More recently, Justice Paris of the TCC explained that for the purposes of section 67:[168]

The burden was therefore on the appellant to establish, upon objective standards, that the research expenses were reasonable. Krishna, in his treatise The Fundamentals of Income Tax Law, states that one determines the reasonableness of an expense “by comparing the expense in question with amounts paid in similar circumstances in comparable businesses.”

Also notable is a recent decision dealing with section 68 in which the FCA acknowledged that the standard of reasonableness ought to also be informed by valuation theory, among other things. In the words of Justice Mainville:[169]

[75] The concept of reasonableness under section 68 of the Act is similar to that used for the purpose of section 67 of the Act. Consequently, for the purpose of section 68 of the Act, I conclude that an amount can reasonably be regarded as being the consideration for the disposition of a particular property if a reasonable business person, with business considerations in mind, would have allocated that amount to that particular property. In this context, long-standing regulatory and industry practices, as well as auditing and valuation standards and practices, are relevant. [...]

[82] Had the Tax Court judge applied the correct test, and considered whether a reasonable business person, with business considerations in mind, would have allocated the amount of $190,824,476 to goodwill, he would have been compelled to consider industry and regulatory standards, as well as accounting and valuation theory, which all point in the direction of the agreed allocation. That agreed allocation was reasonable precisely because of its compliance with industry and regulatory norms and its consistency with standard valuation theory for regulated businesses and standard accounting principles applied in such industries.

The above summary provides us with additional insight, beyond Cattanach’s statement in Gabco, necessary for understanding how the “reasonableness” standard ought to be applied. Applying this standard to section 69(2), as the FCA did, the transfer price paid by Glaxo Canada would be unreasonable if no reasonable business person, acting only with Glaxo Canada’s business consideration in mind, would have agreed to the terms of the Supply Agreement. Regrettably, the FCA failed to also note that, considering the risk of subjective appreciation on the part of the trier of fact, care should be taken by the courts to rely on objective measures of reasonableness, such as the comparability analysis that is required by the market approach to valuation.

4.2.2. The role of objective measures in the TP Guidelines

Recall that the TP Guidelines require recharacterization of the actual controlled transaction if it is found not to be commercially rational. While it would appear that the OECD has adopted the standard of the reasonable business person, the application of this standard is curtailed by and is subject to the application of the market approach (which provides an objective measure of reasonableness). As was already noted, the guidelines state that “[w]here reliable data show that comparable uncontrolled transactions exist, it cannot be argued that such transactions between associated enterprises would lack commercial rationality. The existence of comparables data evidencing arm’s length pricing for an associated enterprise arrangement demonstrates that it is commercially rational for independent enterprises in comparable circumstances.

4.2.3. Judicial prioritization of actual comparables as a source of objective measures, if and where comparables exist

In addition to revealing an apprehension about the use of a ‘reasonableness’ standard, foreign case law also reveals judicial preference for using actual comparables, when such comparables exist. As Professor Richard Ainsworth and Andrew Shact noted based on their study of cases in multiple jurisdictions:

All transfer pricing regimes give priority to the comparable uncontrolled price (CUP) method. Despite declarations that transfer pricing is a search for the “best method” or “most appropriate method,” all systems concede that the search is over when an exact comparable is found because a CUP is preferred over all methods.

Since Mr. Meghji’s comment focused on the judicial approaches in the United States and Australia, the examples below focus on those jurisdictions. Admittedly, a wider survey of case law from other jurisdictions could have also been explored, but in this author’s view doing so is not necessary in order to establish this article’s argument.

In Lufkin Foundry & Machine Co. v. Commissioner, the US Court of Appeals for the Fifth Circuit emphasized the importance of basing the comparability analysis on external evidence from uncontrolled transactions that actually took place; rather than merely relying on internal data from the controlled transaction, as would be the case when using a hypothetical uncontrolled transaction. As Justice Cudahy explained:

No amount of self-examination of the taxpayer’s internal transactions alone could make it possible to know what prices or terms unrelated parties would have charged or demanded. We think it palpable that, if the standard set by these unquestioned regulations is to be met, evidence of transactions between uncontrolled corporations unrelated to Lufkin must be adduced in order to determine what charge would have been negotiated for the performance of such marketing services.

Finally, the Supreme Court has recently said that the “purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer...”. CIR v. First Security Bank of Utah, 405 U.S. 394, 400, 92 S. Ct. 1085, 1093, 31 L.Ed.2d 318 (1972) [quoting 26 C.F.R. § 1.482-1(b)(1) (1971)]. Under this latest authority it remains obvious that a court cannot discern whether a disparity in tax treatment exists if it has only evidence of what has occurred in controlled situations. Therefore, some evidence of similar business activities between uncontrolled taxpayers must be adduced.

The court’s approach in the Lufkin case has since been reaffirmed in numerous subsequent cases. Notably, in Central Bank of The South v. US, the US Court of Appeals for the Eleventh Circuit held as follows:

170. Supra n. 3, para 1.65
171. Supra n. 3, para. 9.172
173. 468 F.2d 805 (1972).
175. Id., at 808.
When a taxpayer challenges the Commissioner’s allocation under section 482, he satisfies this burden by demonstrating that the transaction would not have varied had uncontrolled parties been dealing at arm’s length. See 26 C.F.R. § 1.482-1(b). As pointed out earlier, this proof necessarily requires “evidence of the transactions of uncontrolled companies unrelated to the taxpayer,” see Lufkin, 468 F.2d at 808, and includes both the amounts and the terms of such independent transactions. Engineering Sales, 510 F.2d at 569.

Evidence of Wellington’s business justifications for the failure to pay resembles the “self-examination” that the court in Lufkin found insufficient to satisfy the taxpayers’ evidentiary burden in a tax refund suit. See 468 F.2d at 808. To meet the evidentiary standard under section 482 and its regulations, taxpayers must present evidence to show what unrelated parties would do in the same or similar circumstances, not why taxpayers did what they did in these circumstances. See id. This record does not contain such evidence.

Most recently, in Altera Corporation and Subsidiaries v. CIR,[178] the Commissioner challenged the taxpayer’s income allocation in a qualified cost-sharing agreement (QCSA) because it did not comply with the cost sharing rule in Treasury Regulations §1.482-7(d)(2) (“2003 Regulations”). Commenting on these Regulations, the US Tax Court explained that:[179]

The regulations relating to QCSAs have as their focus reaching results consistent with what parties at arm’s length generally would do if they entered into cost sharing arrangements for the development of high-profit intangibles. These final regulations reflect that at arm’s length the parties to an arrangement that is based on the sharing of costs to develop intangibles in order to obtain the benefit of an independent right to exploit such intangibles would ensure through bargaining that the arrangement reflected all relevant costs, including all costs of compensating employees for providing services related to the arrangement. Parties dealing at arm’s length in such an arrangement based on the sharing of costs and benefits generally would not distinguish between stock-based compensation and other forms of compensation.

Note that these Regulations did not base the arm’s length result on empirical evidence of what arm’s length parties actually did/do (i.e. whether they in fact share these stock-based compensation costs).[180] Instead, the arm’s length result was based on the Commissioner’s own hypothetical (theoretical) construct of what they believed uncontrolled parties would do (i.e. a hypothetical arm’s length comparable). Moreover, the Commissioner took the view that it did not even need to consider and rely on any empirical evidence (i.e. factual investigation) to support its position about what uncontrolled parties would do,[181] even though relevant empirical data was presented to it for consideration.[182] That data suggested that parties operating at arm’s length would not have shared these costs.[183]

In a unanimous decision, the US Tax Court held that the final cost-sharing rule in these Regulations was invalid, and consequently it could not support the Commissioner’s income allocation under section 482. The rule was invalid because it was based on a belief (that unrelated parties would share stock-based compensation costs in the context of a QCSA) held by the Commissioner, which was not supported “with any evidence in the record. Accordingly, the final rule lacks a basis in fact.”[184] The court reminded that, as was held in Xilinx Inc. v. Commissioner,[185] “the arm’s-length standard always requires an analysis of what unrelated entities do under comparable circumstances.”[186]

The Commissioner attempted to defend its failure (to provide a reasoned basis for its conclusion based on evidence in the administrative record) by relying “on the notion that ‘[t]here are some propositions for which scant empirical evidence can be marshaled’.”[187] While the court recognized that “this may be true regarding certain propositions,” it refused to accept this argument in this case because[188]

178. 145 T.C. no. 3.  
179. Ibid. at p. 11.  
180. Ibid. at pp. 12, 21.  
181. Ibid. at p. 21.  
182. Ibid. at p. 23.  
183. Ibid. at p. 21.  
184. Ibid. at p. 23.  
185. 125 T.C., at pp. 53-55.  
187. Ibid. at p. 22.  
188. Id.
First, commentators submitted significant evidence regarding this proposition. See infra part IV.C. Second, we were able to reach a definitive factual determination on the basis of significant evidence regarding this very proposition in Xilinx. See Xilinx Inc. v. Commissioner, 125 T.C. at 58-62. Third, Treasury could not have rationally concluded that this is a proposition "for which scant empirical evidence can be marshaled", see Fox Television, 556 U.S. at 519, without attempting to marshal empirical evidence in the first instance, which respondent concedes it did not do.

Turning to Australia, Glaxo Canada’s table of authorities, in its Factum to the SCC,[189] included the SNF case. Glaxo Canada’s reliance on this case as an authority that supports its position is puzzling. This is so because the Australian Federal Court in this case actually reaffirmed the relevance and importance of the market approach in the arm’s length analysis. In the words of the Australian Federal Court: "... so long as appropriate comparable transactions were available, an analysis of relevant comparables was appropriate."[190] The Australian court acknowledged that this approach is consistent with the TP Guidelines, though it also held that it was not legally bound to follow the guidelines.[191]

4.3. Conclusion

The FCA interpreted Canada’s transfer pricing rule as requiring the use of a hypothetical uncontrolled transaction as a comparable. This approach is similar to the Commissioner’s analysis in the Altera case, which was based on the rule in the 2003 Regulations. By this analysis, the arm’s length result is based on a hypothetical construction (belief) of what reasonable arm’s length parties would have done in comparable circumstances, rather than relying on what arm’s length parties actually did in comparable circumstances. Importantly, the FCA, similar to the Commissioner in Altera, relied on this hypothetical comparable irrespective of whether actual comparables existed, and notwithstanding that both parties (at trial) suggested that actual comparables did exist (though the parties disagreed as to which transactions were properly comparable).

Regrettably, unlike the US Tax Court, the SCC failed to correct this approach. This approach is at odds with the coordinated approach taken by the OECD as well as the approach taken by courts in other jurisdictions (as exemplified in this article by the jurisprudence in Germany and the United States). The internationally accepted approach, as conveyed in the TP Guidelines and as established in the case law, appears to require relying on actual comparables as objective benchmarks of reasonableness; if and where actual comparables exist. It appears inconceivable that the FCA’s interpretation of section 69(2) properly reveals parliament’s intentions, since that interpretation would: (i) belittle Canada’s role within the OECD; and (ii) it would undermine and frustrate the objective of avoiding double taxation through a coordinated application of the ALS.

5. The Existing Uncertainty Created by the SCC’s Analysis

Recall that the Minister, in its appeal to the SCC, questioned whether the FCA erred in its interpretation of section 69(2).[192] Immediately after quoting the text of section 69(2), Justice Rothstein of the SCC stated that “[t]he challenge is to find an arm’s length proxy that replicates the circumstances of Glaxo Canada as closely as possible in respect of its acquisition of ranitidine”. [193] This comment clearly alludes to the market approach to valuation, which involves comparing the controlled transaction to an uncontrolled transaction that actually took place in the market, if an actual comparable is available. As the FCA recently explained in Cameco Corporation v. Canada:[194]

The Supreme Court in Canada v. GlaxoSmithKline Inc., 2012 SCC 52 (CanLII) [Glaxo] confirmed that former subsection 69(2) – the predecessor to paragraph 247(2)(a) – contemplates the existence of objective benchmarks compiled by reference to arm’s length data capable of being used as a proxy for testing the terms and conditions of the transaction in issue. Where possible, this is done by way of comparable transactions or adjusted comparable transactions. If not, reliance must be placed on a constructed price based on a recognized pricing methodology involving arm’s length data as construed by experts.

189. Supra n. 101, p. 40.
190. SNF, para. 71.
191. SNF, para. 122.
192. Supra n. 96, p. 9.
194. 2015 FCA 143, para. 47.
Accordingly, the SCC moved on to compare the supply agreement to the purchases of the generic ranitidine. It concluded that these transactions were not comparable because the purchases of the generic ranitidine “do not reflect the economic and business reality of Glaxo Canada and, at least without adjustment, do not indicate the price that would be reasonable in the circumstances, had Glaxo Canada and Adechsa been dealing at arm’s length”. Surprisingly, the Court did not continue to also consider whether the purchases by the European independent distributors were comparable. This is odd because at trial Glaxo Canada itself urged the Court to compare its controlled transaction to the purchases of the Zantac ranitidine by the European independent distributors.

Unfortunately, the SCC did not, as was asked by the Minister, specifically and directly determine whether section 69(2) allowed for, or required, using a hypothetical uncontrolled transaction as a comparable based on the standard of the reasonable business person, as was suggested by Glaxo Canada and applied by Nadon. However, by noting Nadon’s application of this test without question, the SCC appeared to affirm the FCA’s approach. Recently, in McKesson Canada Corporation v. The Queen, Justice Boyle referred to the comparable uncontrolled transaction as the “notional” arm’s length transaction. This is synonymous with the idea of a “hypothetical” arm’s length transaction, as used in the Glaxo case.

The Canadian approach is consequently in a state of uncertainty and inconsistency. On the one hand, the SCC appears to have acknowledged the relevance and role of a market approach to the comparability analysis. On the other hand, it also appears to have accepted the FCA’s approach, which relied exclusively on the construction of a hypothetical comparable irrespective of whether actual comparables existed in the marketplace, and even though both the Minister and Glaxo Canada suggested at trial that actual comparables existed (though they disagreed over which transactions were in fact comparable).


As argued in this article, the Minister was correct in alleging that the FCA’s approach in the Glaxo case has left “Canadian jurisprudence at odds with the approach adopted by its partners in the OECD”. The coordinated approach of the OECD in the TP Guidelines, the US Regulations, and the jurisprudence from other countries (such as Australia, Germany and the United States) all point to international consensus that a market approach ought to be used if and when actual comparables exist, rather than using a hypothetical uncontrolled transaction as a comparable irrespective of whether actual comparables exist. Actual comparables are essential for achieving the transfer pricing regime’s aim of ascertaining the arm’s length result based on objective (market based) measures.

As for the use of commercial rationality (of arm’s length parties) as a standard, where possible the application of this standard ought to be curtailed by objective measures. This is clearly established in Canadian jurisprudence, although the FCA failed to acknowledge the relevant case law on this requirement. This is also clearly stated by the OECD, which requires treating the existence of comparable data as evidence of commercial rationality, and cautions that “tax administrations should not ordinarily interfere with the business decisions of a taxpayer as to how to structure its business arrangements”. Moreover, the judicial approach of other jurisdictions, such as in the United States, similarly reveals a judicial preference to rely on comparables as the benchmark of reasonableness in order to avoid the risk of having to reach arbitrary subjective results.

It is hoped that Canada’s courts will, based on this article’s critique, reconsider their use of “hypothetical” (“notional”) arm’s length comparables. Yet, this article’s objective and relevance extends beyond Canada’s borders. The article is driven by a realization of the potential that courts in other jurisdictions may transplant this Canadian approach, and thereby risk repeating the same mistake(s). The potential of such transplantation is real. It is plausible, in particularly, in those jurisdictions where the jurisprudence on this topic is limited, as exemplified by the United Kingdom. As Beeton, Clayson and Sangster, from the law firm Freshfields Bruckhaus Deringer LLP, commented:

197. McKesson Canada Corporation v. The Queen, 2013 TCC 404 (CanLii), paras. 128-129.
198. Supra n. 96, para. 1.
199. Supra n. 3, paras. 9.171-172.
Major transfer pricing disputes that proceeded all the way to a final court decision have been rare in the UK... In light of the relative dearth of transfer pricing case law, it is highly likely that a UK court or tribunal would look to any relevant authorities emerging out of Commonwealth countries or other jurisdictions with a common law tradition in order to inform its decision. For example, recent Canadian cases such as General Electric Capital Canada Inc. v. Her Majesty The Queen and GlaxoSmithKline Inc. v. Her Majesty The Queen might well be persuasive in arriving at conclusions in the UK.

It is therefore hoped that courts in other jurisdictions will learn from the lessons distilled from this Canadian experience, and will avoid repeating the same mistakes.