Canada Revenue Agency successful in significant transfer pricing case

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In a judgment that gave an unusually harsh critique of the evidence provided by a taxpayer's expert witnesses, the Tax Court of Canada recently handed the Canada Revenue Agency a decisive win in a C $26 million transfer pricing case involving a related-party debt factoring arrangement.

The court made its long-awaited decision in *McKesson Canada Corp. v. The Queen (2013 TCC 404)* on 13 December 2013 and publicly released it on 27 December 2013, nearly two years after the conclusion of a 32-day trial that was heard over a five-month period from October 2011 to February 2012. The court had permitted the parties to make further submissions after the Supreme Court of Canada's October 2012 decision in *The Queen v. GlaxoSmithKline Inc. (2012 SCC 52)*, in which the Court affirmed a Federal Court of Appeal ruling that GlaxoSmithKline was justified in taking licensing and pricing arrangements into account to determine the intercompany pricing of the pharmaceutical drug Zantac.

The case focused on a receivables sales agreement entered into in December 2002 by McKesson Canada Corp. (McKesson Canada) and its immediate parent company, Luxembourg-based McKesson International Holdings III SARL (MIH). McKesson Canada is the principal Canadian operating company in the McKesson group owned by McKesson Corp., a US-based healthcare services and information technology company.

MIH agreed under the receivables sales agreement to purchase all of McKesson Canada's eligible receivables as of 16 December 2002 (about C $460 million) and committed to purchasing all eligible receivables daily as they arose for the following five years, unless the agreement were terminated earlier as provided, and subject to a C $900 million cap. Under a related servicing agreement, MIH paid McKesson Canada a fixed annual fee of C $9.6 million to service the transferred receivables regardless of the amount outstanding; the CRA did not challenge the amounts paid under the servicing agreement.

Under the receivables sales agreement, MIH and McKesson Canada agreed to a discount rate that would be applied to the face amount of each accounts receivable purchased by MIH. The discount rate was intended to compensate MIH for assuming the risk that some of the accounts receivable may not be collected and would have to be written off. The rate was calculated using a formula that resulted in a discount rate of 2.206%.

McKesson Canada's outside tax adviser on the deal, Blake, Cassels & Graydon LLP, in early December 2002 retained Toronto Dominion Securities Inc. (TDSI) to provide advice on the arm's-length aspects of some of the terms and conditions of the receivables sales agreement and of some components of the discount calculation. By the time TDSI was consulted, the pricing approach and formula were largely settled, and no significant changes were made to reflect any advice or information given by TDSI. McKesson Canada relied on the opinions prepared by TDSI as contemporaneous documentation to successfully contest the CRA's pre-reassessment proposal to impose a 10% transfer pricing penalty under subsection 247(3) of Canada's Income Tax Act.

As a result of the debt factoring arrangement, McKesson Canada in 2003 ceased to be profitable and reported a tax loss for that year. McKesson Canada's profits in later years similarly were significantly reduced.

The CRA objected to the parties' agreed-upon discount rate and in March 2008 reassessed tax against McKesson Canada for the 2003 tax year on the grounds that if the receivables sales agreement had been entered into by parties dealing at arm's length, the discount rate would have been 1.013%. The CRA therefore made a transfer pricing adjustment of C $26 million under subsection 247(2)(a) and (c) of the ITA.

The CRA in April 2008 imposed a separate assessment for McKesson Canada's failure to withhold and remit the tax on the shareholder benefit that McKesson Canada paid to its parent (and sole shareholder), MIH, via the transfer of receivables at an overstated discount rate, which resulted in McKesson Canada giving away some of its assets to its parent/shareholder. The CRA treated that shareholder benefit as a deemed dividend under subsections 15(1) and 214(3)(a) of the ITA and subjected it to non-resident withholding tax. McKesson Canada was jointly liable with MIH for the withholding tax under subsection 215(6) of the ITA.

In an appeal filed with the Tax Court in September 2008, McKesson Canada contended that the agreed-upon discount rate was consistent with the rate that would have been set by parties dealing with each other at arm's length.

McKesson Canada also argued that the withholding tax assessment was time-barred under article 9(3) of the Canada-Luxembourg income tax treaty, which imposes a five-year limitations period for assessing tax on some transfer pricing adjustment income, because the assessment was issued after the five-year period had ended.

The judgment

In a 397-paragraph judgment, Justice Patrick Boyle said his task was to determine whether the terms and conditions of the transactions carried out by McKesson Canada and MIH resulted in a discount rate that was within the range of what parties dealing with each other at arm's length would have used.

Noting that the transfer pricing reassessment was made under subsection 247(2)(a) and (c) of the ITA, Boyle discussed the scope of adjustments permitted by those provisions and the extent to which the court can revise a transaction's terms and conditions. He also noted that a transaction can be recharacterised only under the conditions set out in subsection 247(2)(b) and (d) of the ITA and that the CRA was not relying on those provisions in this case.

Boyle said that a transaction's terms and conditions can nevertheless be adjusted under subsection 247(2)(a) and (c), if necessary, in order to properly adjust the quantum of an amount that is based on those terms and conditions. He suggested that the quantum of an amount can be adjusted under subsection 247(2)(a) and (c) based on the terms and conditions that would have been agreed to by arm's-length parties, and that adjustments to the terms and conditions can be made to conform to the arm's-length standard without giving rise to a recharacterisation of the transaction itself.

Boyle said there may be a point at which the extent of changes to a transaction's terms and conditions could constitute an effective recharacterisation that is permitted only under the circumstances described in subsection 247(2)(b) and (d). However, he concluded that the court did not need to venture anywhere close to that line in disposing of McKesson Canada's appeal and that such a debate could be left for another day.

Turning to the "reams and reams" of documentation and evidence provided in the case, Boyle gave a detailed overview of the trial testimony of McKesson Canada's two material witnesses (one from TDSI and another from McKesson's US parent company) and two expert witnesses, and the CRA's three expert witnesses. Boyle also discussed a transfer pricing report that was prepared by PricewaterhouseCoopers LLP for McKesson Canada in 2005 in response to the CRA's review of the receivables sales agreement. (No one from PwC testified at the trial.)

Boyle was unusually critical of McKesson Canada's expert witnesses and the company's handling of the case. He pointed to the testimony of Daniel J. Frisch, a well-known transfer pricing expert who said he didn't think any of the four methods outlined in the OECD transfer pricing guidelines could be applied in a reliable manner to the receivables sales agreement transactions and that another method needed to be developed, as contemplated by paragraph 2.9 of the 2010 OECD guidelines. Frisch told the court that he did not have the expertise to develop that "other" method.

Boyle agreed that another transfer pricing method was appropriate in this case but said he was surprised that Frisch "thought that developing or opining on an 'other method' was outside the expertise of expert transfer pricing economists."

Boyle also criticised McKesson Canada's other expert witness, Jeremy Reifsnyder, as "a partisan advocate quick to point out the specks in the respondent's expert reports, and downplaying, if not refusing to acknowledge, the weak points in his own."

In assessing the value of the 2005 PwC transfer pricing report, Boyle noted that it did not develop the concept of arm's-length factoring and pricing as a comparable transaction to the receivables sales agreement, nor did it address why that would not be possible or appropriate. "This is a significant shortcoming and causes one to think that the PwC report was primarily a piece of advocacy work, perhaps largely made as instructed," Boyle wrote.

He further criticised the report's analysis of the credit loss risk associated with McKesson Canada's receivables pool. He faulted PwC's failure to reconcile its chosen approach with the actual, known performance of the receivables pool and its decision to analyse the pool's historic performance only when determining the non-designated obligors' credit risk. "This picking and choosing, 'mix and match as it suits' approach to the relevance of the actual performance of the receivables pool makes for transparently poor advocacy, and even more questionable valuation opinions," he wrote.

Boyle was also critical of McKesson Canada's approach to its appeal. "Overall I can say that never have I seen so much time and effort by an appellant to put forward such an untenable position so strongly and seriously," he wrote. "This had all the appearances of alchemy in reverse. One could only assume that the appellant knew full well the weaknesses of the TDSI report, and this was the best method it could use to support the discount rate used by the McKesson Group in the" receivables sales agreement.

Although he did not agree with the findings of the CRA's expert witnesses, Boyle's criticism of their analyses was not nearly as biting as his assessment of McKesson Canada's expert witnesses.

In his own analysis of the appropriate method for determining an arm's-length discount rate, Boyle said that while he did not accept the conclusions of any of the parties' expert witnesses or their reports in their entirety, their testimony and the information they provided had informed his assessment of the issues. After reviewing the various components that McKesson Canada and MIH used to calculate the discount rate, Boyle concluded that the discount rate range to which parties dealing with each other at arm's length would have agreed was 0.959% to 1.17%.

Boyle said it would be inappropriate to order the minister of national revenue to reassess McKesson Canada's tax using the high end of the court's range of arm's-length discount rates (1.17%), rather than the 1.013% rate used by the CRA. "That would reward overreaching taxpayers who would then count on the court process to ensure they enjoyed the highest permissible transfer price," he wrote. "This would encourage the poor use of public resources and expenditures."

In rejecting McKesson Canada's argument that the withholding tax assessment was time-barred by the Canada-Luxembourg treaty, Boyle noted that article 9(3) of the treaty provides a maximum five-year period for either country to make a transfer pricing adjustment to the taxable income of a related company residing in the other country under the circumstances described in article 9(1). For transactions between McKesson Canada and MIH, article 9(1) would permit Canada, under some circumstances, to make a transfer pricing adjustment to MIH's income that is subject to tax in Canada.

Boyle said that for McKesson Canada's article 9(3) argument to prevail, the company had to demonstrate that the adjustment was made to income that would have accrued to MIH – not McKesson Canada – if not for the related-party conditions of the receivables sales agreement, and that Canada had sought to add the adjustment to MIH's income and taxed it accordingly. Boyle said the argument fails because a tax assessment against McKesson Canada for its failure to withhold and remit does not constitute Canada adding the transfer pricing adjustment to MIH's income and then taxing it accordingly. Boyle added that while the amount of MIH's taxable benefit and deemed dividend may be the same as McKesson Canada's transfer pricing adjustment, it is not an amount of income that would have accrued to MIH if the receivables sales agreement had had an arm's-length discount rate.

"On the contrary, the transfer pricing adjustment is income that, but for the non-arm's-length terms and conditions, would have accrued to McKesson Canada," he wrote.

An appeal?

It's not yet known whether McKesson Canada will appeal the decision.

(This is an edited version of the full Tax Analyst's article.)