Delineating the Terms of a Single Composite Transaction in Transfer Pricing: The Role of Step-Transaction Analysis in the Aggregation of Interrelated (Linked) Contracts

This article provides guidance on the task of aggregation and disaggregation of contract terms in transfer pricing. It explains that: (1) aggregation involves giving expression to the parties' single composite transaction; (2) aggregation requires applying a step-transaction analysis, which makes it possible to delineate the true substance of the composite transaction, and then apply the relevant tax rule(s) based on the combined effect of the interrelated contracts; and (3) disaggregation may be used as an anti-avoidance measure. The article also identifies notable implications of aggregation.

1. Aggregation of Contracts in Transfer Pricing: The Need for Clarity

For the purpose of conducting a transfer pricing arm's length comparability analysis, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) recognize the possible need to aggregate separately executed but interrelated (linked) transactions. Following the OECD's recommendations, in the GlaxoSmithKline Inc. case the Supreme Court of Canada held that a linked transaction may need to be "taken into account" as a relevant circumstance. Unfortunately, the Court failed to elaborate on, or clarify as to how, linked transactions are to be taken into account. What does the task of aggregation require? Arguably, the OECD guidance on this issue is also insufficient. Considering the significant role and potential implications of aggregation, this need for clarity ought to be addressed.

This article aims to fill this gap by explaining the role of aggregation in the comparability analysis; identifying notable implications of aggregation; and providing further necessary guidance and clarification on this task of aggregation.

2. Delineating the Terms of the Actual Controlled Transaction

2.1. Arm's length comparability analysis: An overview

According to the OECD Guidelines and the US Treasury Regulations (US Regulations) under section 482 of the Internal Revenue Code, a transfer pricing comparability analysis begins by delineating the actual controlled transaction. It is necessary to determine whether these commercial or financial relations were carried out under conditions (i.e. special non-arm's length conditions) which are different from those that would have been agreed to in a comparable uncontrolled transaction under comparable circumstances. If a comparable reveals that the special non-arm's length conditions would not have been agreed, it is necessary to determine the contracting parties' income allocation based on the conditions that would have been agreed by arm's length parties – namely the income allocation that would have resulted in the comparable uncontrolled transaction. Income allocation in the uncontrolled transaction would be determined by applying an appropriate valuation method, which may be one of the transactional or non-transactional methods specified in the OECD Guidelines or US Regulations, or some other unspecified method, so long as it is consistent with the arm's length standard. The methodology ought to reveal...
a price or ‘profit margin’, within an acceptable range of figures, which represents an arm’s length income allocation result.

Having identified the arm’s length result, it then becomes possible to compare it to the income allocation in the controlled transaction. Tax authorities ought to respect the transfer price if the arm’s length result is consistent with the income allocation chosen by the associated enterprises in the controlled transaction. If the result is inconsistent, however, tax authorities may adjust the amount of allocation in the controlled transaction to reflect the arm’s length result.

When a tax authority increases a taxpayer’s taxable profits as a result of applying the arm’s length principle to the taxpayer’s transactions with its related party in another jurisdiction, double taxation arises if the same profits have been or will be included in the tax base of the related party. To eliminate the double taxation, the tax authority in the other jurisdiction may agree to reduce the taxable profits of that related party. Such a downward adjustment to the related party’s taxable profit is known as corresponding adjustment.10

However, there is risk that “if the other jurisdiction does not agree to make a corresponding adjustment the multinational enterprise (MNE) group will be taxed twice on this part of its profits”.11 To prevent double taxation, the taxpayer could challenge the transfer pricing adjustment by taking legal action within the jurisdiction where the adjustment was made. Additionally, it could request the tax authorities to resolve double taxation through a mutual agreement procedure (a procedure used to resolve disputes involving the application of tax treaties).12

2.2. The need to delineate the actual controlled transaction as it was structured by the parities

Tax is applied on the effects produced by (a) contract(s).13 A determination of the effect(s) of a contract ought to be based on the true (actual) nature of the contract being assessed.14 Accordingly, similar to courts in other countries, the BEPS Actions 8-10 Final Reports recognize a tax administration should not disregard 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 [of the OECD Guidelines] apply”.18 The US Regulations likewise state that, in determining the true taxable income of a controlled taxpayer, the “Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance”.19

How should the actual controlled transaction be delineated? According to the BEPS Actions 8-10 Final Reports:

[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

The BEPS Actions 8-10 Final Reports go on to state:

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 a judgment of its true nature” (US: DC (E.D. La.), 29 Jun. 1976, Universal Drilling Co. v. United States, 412 F. Supp. 1231, 1234 (E.D. La. 1976)).

15. US: SC, 28 May 1974, Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 US 134, 148 (1974); US: CA (8th Cir.), 3 May 2004, Armstrong v. United States, 366 F.3d 622, 626 (8th Cir. 2004). Similarly, the Canadian Supreme Court has stated that “[u]nless the Act provides otherwise, a taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done, and certainly not based on what a less sophisticated taxpayer might have done” (CA: SC, 15 Oct. 1999, Shell Canada Ltd. v. Canada), 1999 3 SCR 622). As Bullen points out, this principle can also be found in other OECD Member and non-Member countries, which suggests a widespread recognition of this “as-structured principle” (A. Bullen, Arm’s Length Transaction Structures Recognizing and Restructuring Controlled Transactions in Transfer Pricing (IBFD 2011), ch. 6, sec. 6.2.4., Online Books IBFD).

Bullen, supra n. 15, at ch. 4, sec. 4.2 & Ch. 6, sec. 6.11.7.

17. OECD Guidelines (2010), supra n. 2, at para. 1.64 (emphasis added). See also OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project (OECD 5 Oct. 2015), paras. 1.121, 1.33, International Organizations’ Documentation IBFD. As Bullen points out, both the OECD Guidelines and the US Regulations require taking “into account the structure and valuation of the controlled transaction, but also the facts and circumstances surrounding it” (Bullen, supra n. 15, at ch. 14, sec. 14.1). Furthermore, “[t]he pertinent issue under the arm’s length principle is which conditions unrelated enterprises would have made in ‘comparable transactions and comparable circumstances’” (Bullen, supra n. 15, at ch. 14, sec. 14.1; OECD Guidelines (2010), supra n. 2, at para. 1.6; US Treas. Reg. sec. 1.482-1(b)(1)).

18. OECD, Actions 8-10 Final Reports, supra n. 17, at para. 1.121.


20. OECD, Actions 8-10 Final Reports, supra n. 17, at para. 1.42.
The Canadian Tax Court was following the courts’ comments in Alberta to be exhaustive, as consideration of all relevant factors is Notably, this list of comparability factors “is not intended because they may influence the arm’s length party’s decisions as to what terms and conditions to agree to. Notably, this list of comparability factors “is not intended to be exhaustive, as consideration of all relevant factors is mandated.” The Canadian Tax Court has explained that relevant factors are not limited to those which would arise in arm’s length relations, but rather also include “those that arise from, derive from or are rooted in the non-arm’s length relationship.” i.e. comparability factors that exist only because of the non-arm’s length relationship. It is also notable that, as Justice Hogan cautioned in the General Electric Capital Canada case, the “Crown cannot pick and choose among the economically relevant characteristics of the transaction and use only those facts that are favourable to its position.”

The BEPS Actions 8-10 Final Reports go on to state as follows:

If the contract neither explicitly nor implicitly […] addresses characteristics of the transaction that are economically relevant, then any information provided by the contract should be supplemented for purposes of the transfer pricing analysis by the evidence provided by identifying those characteristics. The OECD approach to identifying the contractual terms appears to be in line with ordinary contract law principles. In Canada, for example, “[f]or a contract to be binding, the parties must come to the same determination, which must be disclosed by written or spoken words, or by some other signification of intention from which an implication of law, or an inference of fact, or both, may arise” The Canadian Encyclopedic Digest explains as follows:

In determining whether the parties have reached agreement for legal purposes, the starting point must be the alleged contract larger parent company, stood in the position of having an implicit guarantee by its parent’s bank debts” (paras. 160, 162). This evidence forms the basis for comparing the controlled transaction to uncontrolled transaction(s), unless the law allows recharacterization of the actual controlled transaction. These characteristics are therefore also referred to as comparability factors. They form the basis for comparison because they may influence the arm’s length party’s decisions as to what terms and conditions to agree to. Notably, this list of comparability factors “is not intended to be exhaustive, as consideration of all relevant factors is mandated.” The Canadian Tax Court has explained that relevant factors are not limited to those which would arise in arm’s length relations, but rather also include “those that arise from, derive from or are rooted in the non-arm’s length relationship.” i.e. comparability factors that exist only because of the non-arm’s length relationship. It is also notable that, as Justice Hogan cautioned in the General Electric Capital Canada case, the “Crown cannot pick and choose among the economically relevant characteristics of the transaction and use only those facts that are favourable to its position.”

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21. Id., at para. 1.43 (emphasis added). See also para. 1.36.
27. OECD, Actions 8-10 Final Reports, supra n. 17, at para. 1.43 (emphasis added). See also para. 1.36.
29. US Treas. Reg. sec. 1.482-1(d)(3)(ii)(A) (“In general. Determining the degree of comparability between the controlled and uncontrolled transactions requires a comparison of the significant contractual terms that could affect the results of the two transactions”). OECD Guidelines (2010), supra n. 2, at para. 1.36 (“In order to establish the degree of actual comparability and then to make appropriate adjustments to establish arm’s length conditions (or a range thereof), it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm’s length transactions”). See also paras. 1.33, 1.35; CA: TC, 4 Dec. 2009, General Electric Capital Canada Inc., v. The Queen, 2009 TCC 563, para. 198.
31. The Canadian Tax Court was following the courts’ comments in Alberta Printed Circuits, where Justice Pizzitelli noted as follows: “factors or circumstances that exist solely because of the non-arm’s length relationship of the parties should not be ignored, otherwise the reasonable businessman would not be standing entirely in the Appellant’s shoes… In General Electric, the Federal Court of Appeal confirmed that no error of law was made in taking into consideration the Appellant in that case, as a sub of its

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itself. If there is a written contract whose wording reveals a plain and unambiguous intention, that will ordinarily be the end of the matter. But where it is unclear whether or not the parties made a contract, the court may resort to evidence beyond the contractual language, including the factual matrix in existence at the relevant time and the genesis and aim of the transaction. The conduct of the parties during and subsequent to the purported making of a contract is also admissible to determine whether they did in fact make a binding contract, and, if they did, what the contractual terms were.  

The parties may present evidence to establish the terms they agreed to. They could also present evidence “for the purpose of showing that no contract in fact exists, or that the contract does not correctly set out the agreement between the parties.”

2.3.2. Step 2: Interpreting the terms to ascertain and give effect to the intentions of the parties

2.3.2.1. The need to ascertain the contractual intentions of the parties

A common thread in the law of contracts, in both civil law and common law jurisdictions, is that the true nature of a contract is based on the parties’ agreed intentions. As the Canadian Federal Court of Appeal explained, the essence of a contractual relationship is the intention of the parties, and thus “in determining the legal nature of a contract, it is a search for the common intention of the parties that is the object of the exercise.”

Considering the primacy attributed to the common intentions of the parties, it is generally recognized that the function of courts is to “trive to give effect to what the parties reasonably intended to agree to when the contract was made.” This applies in any type of dispute involving contracts – be it a dispute between the parties (e.g. over the formation or enforcement of the contract) or a dispute with tax authorities over the correctness of tax liability based on the effects of the contract, for example. Accordingly, Justice Campbell of the Canadian Tax Court recently held that “[a] determination of the intent of the parties and the scope of their understanding should be the court’s overriding concern and the present-day approach that should be applied.” Similarly, the US Court of Appeals for the Fourth Circuit has stated that “in applying federal law to determine the tax consequences of a transaction […] we look to the intention of the parties.”

Hence, after having identified the terms of the contract, it is necessary to interpret the terms in order to ascertain and give effect to the contractual intentions of the parties. This has been firmly established by domestic courts around the world. As the Canadian Supreme Court explained, “[t]he cardinal interpretative rule of contracts is that the court should give effect to the intentions of parties as expressed in their written document.” Similarly, the UK Supreme Court stated that “the ultimate aim of interpretative analysis?”

40. Canadian Encyclopaedic Digest, Contracts, supra n. 39, at 1.2, sec. 5.
41. Where the contract consists of oral terms, the parties may present written evidence of those oral terms. Such evidence is a memorandum of the oral terms, rather than a written agreement unless, as a matter of fact, the court finds that the written document itself constitutes a written agreement (I. Goldsmith & T. Heintzman, Goldsmith on Canadian Building Contracts, 4th ed. (Carswell 1995), quoted in CA: NSC, 19 Jan. 2010, Busch Mac Developments Ltd. v. Harris, 2009 NSC 381, paras. 22-24).
42. Goldsmith & Heintzman, supra n. 41, at para. 20.
52. US: CA (4th Cir.), 9 July 2009, Volvo Cars of North America, LLC v. US, 571 F3d 373, at 379. Similarly, the US Tax Court has stated that its function is to give contractual agreements “a construction that is reasonable, capable of being carried into effect and in accord with the parties’ intentions” (US: TC, 25 Aug. 1994, Fisher v. Commissioner, TC Memo, 1994-434, at 6).
53. Yet, it should not be assumed that courts necessarily adhere to this cardinal rule of interpretation. On the contrary, as the Canadian Federal Court of Appeal acknowledged, courts “in their propensity to create artificial legal categories, have sometimes overlooked the very factor which is the essence of a contractual relationship, i.e. the intention of the parties” (CA: Wolf (2002), para. 117).
Accordingly, the OECD recommends that:

[where 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.]

The Guidelines go on to caution that if the parties were to change their terms over time, it would be necessary to determine whether the change reveals an alternation of the intentions of the parties, in which case the transaction would have been transformed from the time of that change. Moreover, considering the cardinal importance of ascertaining and giving effect to the intentions of the parties, the OECD Guidelines also recommend as follows:

It is, therefore, good practice for associated enterprises to document their decisions and intentions regarding the allocation of significant rights in intangibles. Documentation of such decisions and intentions, including written agreements, should generally be in place at or before the time that associated enterprises enter into transactions leading to the development, enhancement, maintenance, protection, or exploitation of intangibles.

2.3.2.2. The need to delineate the intentions of the parties in accordance with the applicable law of contractual interpretation

Any and every type of legal text requires legal interpretation in order to ascertain its legal meaning based on the intentions of the parties. In his treatise, Wigmore stated that “[i]nterpretation is a process that always occurs when a court applies a contract, even if the text is so clear that only one outcome seems to be possible.” Wigmore went on to explain that “the process of interpretation, then, though it is commonly simple and often unobserved, is always present, being inherently indispensable.”

Where a party in litigation is seeking to have a contract interpreted in a particular manner, it “bears the burden of establishing with reasonable clarity the correctness of such an interpretation.” But, while the parties in a dispute may offer their own interpretation, it is ultimately the task of the courts to determine the proper interpretation of the terms. In carrying out this task, “[i]t is the duty of the courts to give effect to contracts and testamentary dispositions according to the settled rules and principles of law, since we are under a reign of law […]” In other words, courts are not free to determine the meaning of contractual terms haphazardly or based on any random source of
In accordance with the law of interpretation that governs the contract in question. Only then can a court proceed to determine the issue in dispute with regard to the contract, such as the correctness of a tax assessment that is based on the contract in question. As Lord Greene of the UK Court of Appeal explained:

In considering tax matters a document is not to have placed on it a strained or forced construction in order to attract tax, nor is a strained or forced construction to be placed on it in order to avoid tax. The document must be construed in the ordinary way and the provisions of the relevant tax legislation then applied to it. If, on its true construction, it falls within a certain taxing category, then it is taxed. If, on its true construction, it falls outside the taxing category, then it escapes tax.71

In his comments to the OECD on the Discussion Draft on BEPS Actions 8, 9 and 10, the author alerted the OECD as to the need to have the OECD Guidelines explicitly acknowledge the necessary role of contract interpretation law in a transfer pricing arm’s length comparability analysis.72 Subsequently, the author further elaborated on this issue in articles that were published in the World Tax Journal73 and the International Transfer Pricing Journal.74 Fortunately, in its BEPS Actions 8-10 Final Reports, the OECD responded by correcting this oversight. Paragraph 1.43 of the revised OECD Guidelines now explicitly requires “taking into account applicable principles of contract interpretation” when delineating the contractual terms of a controlled transaction.75

2.3.3. Step 3: Verifying the formalized terms based on the substance of the agreement

Once the contract terms have been identified and interpreted, it is then necessary to verify whether the parties’ conveyed intentions (as they were formally expressed by the terms) are in line with the intentions demonstrated by the agreement that they actually executed.76 Verification is necessary because, as the OECD explains, it may be that ‘the parties’ actual conduct indicates that the contractual terms have not been followed, do not reflect a complete picture of the transactions, have been incorrectly characterised or labelled by the taxpayer, or are a sham’.77 This risk is particularly acute in non-arm’s length transactions, but it can also arise in other types of circumstances, such as employment contracts.78

The transaction that the parties actually executed in reality, as evidenced by their conduct, is treated as representing the best evidence of the actual true nature of the agreement.79 As the substance of the agreement is evidenced by the agreement actually executed by the parties, the agreement which they formally purported to undertake (as conveyed by their terms) will be given effect only if it is consistent with the agreement they actually executed.80 If it is found that the formally conveyed intentions of the parties do not reflect the substance of their agreement, the expressed terms would need to be adjusted by the tax authorities to reflect the transaction that they actually executed.81 Here, the adjustment is applied in order to accurately delineate the controlled transaction “actually"
undertaken, rather than to recharacterize the transaction “actually” undertaken.85

In In re DeCoro USA, Ltd., for example, the US Bankruptcy Court had to consider whether an intercompany distribution agreement (IDA) should be adjusted under section 482. Justice Stocks held that “[w]hile the IDA may provide some indication of the functions of the Debtor and the nature of the controlled transactions, the court should respect only those terms that are consistent with the economic substance of the underlying transactions, i.e., consistent with how the Debtor actually operated.”86

The judge went on to conclude as follows:

The provisions of the IDA are not consistent with the economic substance of the transactions at issue. The relationship between the Debtor and LTD and the manner in which the Debtor actually conducted business were vastly different than portrayed in the IDA. According to the evidence, the economic substance of the Debtor’s relationship with LTD and the Debtor’s actual operations, the Debtor was neither independent nor a distributor that bought and sold furniture. Instead, the evidence showed that the Debtor existed and functioned to facilitate sales that were made within the United States by LTD directly to end customers. That reality, and not the fictitious business model described in the IDA is the proper basis for evaluating whether the Debtor’s income should be adjusted under section 482.87

This task of verification is necessary even where the intentions of the parties have not been contested. As the Canadian Federal Court of Appeal explained, “if the intention of the parties is uncontested […] the common law judge has nevertheless the responsibility to ‘look to see’ if the terms used and the surrounding circumstances are compatible with what the parties say their contract is.”88

Notably, this approach reflects the substance-over-form principle which permeates domestic tax laws around the world. In the United States, for example, the Tax Court recently explained that:

[[The incidence of taxation depends upon the substance of a transaction […] Before recharacterizing a transaction’s form to align with its substance, we conduct ‘a searching analysis of the facts to see whether the true substance of the transaction is different from its form or whether the form reflects what actually happened’.

Similarly in Canada, the Tax Court explained that “the law requires the Court to look at the substance of the arrangement between the parties and not just the title. If the substance of the arrangement is not in accord with the label put upon it by the parties, it is the substance which must prevail.”90 Yet, “attitude towards form and substance in tax law generally and tax avoidance in particular varies greatly from country to country both with regard to the way they approach the issues and how far they are prepared to let substance prevail over form.”91 For example, while some countries, such as the United States,92 give effect to the ‘economic substance’ of the transaction, other countries, such as Canada, give effect to its ‘legal substance.’93

When looking at the agreement that the parties executed in reality, what aspect of that agreement, according to the OECD, ought to be taken into account and given effect? In the BEPS Actions 8-10 Final Reports, section D of Chapter I of the revised OECD Guidelines uses the term “factual substance.”94 In its summary of the revisions to Section D, the Final Reports explain that an objective of the OECD Guidelines is to ensure “that actual business transactions undertaken by associated enterprises are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality.”95 Further insight can also be found in Chapter IX of the OECD Guidelines, which deals with the transfer pricing aspects of business restructuring. This chapter still uses the terminology ‘economic substance,’ which is found in Section D of Chapter I of the previous version of the OECD Guidelines (2010).96 Hence, for the purpose of ascertaining the substance of the transaction, the OECD Guidelines remain focused on the economic substance of the transaction that was actually executed by the associated enterprises.97 Notably, the US Regulations similarly focus on the economic substance of the transaction(s).98

The OECD Guidelines explain as follows:

The economic substance of a transaction or arrangement is determined by examining all of the facts and circumstances, such as the economic and commercial context of the transaction or arrangement, its object and effect from a practical and business point of view, and the conduct of the parties, including the functions performed, assets used and risks assumed by them.99

3. Delineating the Terms Where Contracts Are Interrelated (Linked)

A transaction could be executed using either (i) a single contract or (ii) a series of separate but closely interrelated (linked) contracts which together make possible a “single composite transaction” (i.e. one ‘whole deal’, ‘plan’). The possibility of these alternative scenarios was at issue in, for example, GlaxoSmithKline Inc.

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85. Bullen, supra n. 15, at ch. 8, sec. 8.4.2.4.
94. OECD, Actions 8-10 Final Reports, supra n. 17, at paras. 1.46, 1.120.
95. Id., at 13 (emphasis added).
97. R. Wittendorff, Transfer Pricing and the Arm’s Length Principle in Interna-
Glaxo Canada is a subsidiary of Glaxo Group, a UK company which itself is a subsidiary of Glaxo Holding Plc. This multinational enterprise is engaged in discovering, developing, manufacturing and distributing pharmaceutical products throughout the world. Glaxo Canada is the distributor of Glaxo pharmaceutical products in Canada.

This case involved Zantac, a patented and trademarked drug used to treat stomach ulcers. Glaxo Group owned the Zantac trademark and the patent for its active ingredient, ranitidine. Glaxo Group sold to distributors around the world the rights to sell the drug, while also providing them with other related services, benefits and products. According to Glaxo Canada’s witness at trial, Glaxo Group’s policy was that distributors would retain approximately 60% of their gross profit from the sale of the drug, while the remainder would be remitted back to Glaxo Group in the form of transfer price, royalties, or both. Where the distributor was to pay both transfer prices and royalties, they would be considered together to determine the distributor’s gross profit margin after payment of the royalty.

Different types of contractual arrangements where used to execute these transactions. In most countries, Glaxo Group entered into a single contract with its distributors. This package deal provided the rights to sell the drug and related services, as well as the raw material necessary to assemble the drug for sale (i.e. the Zantac ranitidine, a primary active pharmaceutical ingredient of Zantac).

In contrast, Glaxo Canada was required to enter into two separate contracts. It had to enter into a licence agreement with Glaxo Group. This licence agreement gave Glaxo Canada numerous rights and benefits/services, such as: the right under the patents to manufacture, use and sell Glaxo Group products […] the exclusive right to the use of the trademarks owned by Glaxo Group, including Zantac […] the right to receive technical assistance for its secondary manufacturing requirements […]”.

The licence agreement required Glaxo Canada to (i) pay “a six percent royalty to Glaxo Group on its net sales of Zantac” and (ii) enter into a supply agreement to purchase the Zantac ranitidine from a Glaxo Group approved source, which happened to be Adechsa (a Swiss affiliate of Glaxo Group).

The Canadian Minister of National Revenue (the Minister) reassessed Glaxo Canada’s income tax for the years 1990-1993. At issue was the supply agreement. The Minister argued that the price paid to Adechsa (i.e. the “transfer price”) was not “reasonable in the circumstances” within the meaning of section 69(2) of the Income Tax Act. As 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). Glaxo Canada appealed the Minister’s assessment to the Canadian Tax Court, where the trial judge was then Associate Chief Justice Gerald J. Rip.

As Justice Rip explained:

[In transfer pricing cases, the goal of the MNE is to divert profits to a low tax jurisdiction. The amounts will be included in calculating the income of the recipient to whom they were diverted (in this case Adechsa), with the result being a lower rate of tax and more profits left for distribution to the parent company.]

Justice Rip described as follows the alleged income shifting scheme in this case:

13 Adechsa had an agreement with the Swiss tax authorities under which it agreed to pay tax on the basis that it earned a minimum profit of four percent. Few taxes were paid by the Singapore manufacturer because it qualified for a ten-year pioneer relief tax holiday that began in 1982. After the expiry of the ten-year period, the tax rate was ten percent. Under the pioneer relief program, Glaxo World benefited from “tax sparing” between Singapore and the United Kingdom. Glaxo World’s Singapore company did not pay any tax on the profits earned in Singapore; income apparently was deemed by the United Kingdom tax authority to have been fully taxed at the current Singapore tax rate. When the profits were brought into the United Kingdom in the form of dividends, United Kingdom tax was payable only on any excess in terms of the United Kingdom tax rate over the Singapore tax rate. Glaxo World’s transfer pricing arrangements allowed Singapore to earn gross profits of around ninety percent in Singapore on the sale of ranitidine to Adechsa during the period 1990 to 1993. During the same period, Glaxo Canada was earning gross profits of around 57 percent. According to a memorandum by Lionel Halpern, the “Group” taxation controller of Glaxo Holdings, Glaxo World’s strategy to minimize its taxes worldwide was:

1. to make as much profit as possible in Singapore;
2. to make as much of the remainder of the Group’s profit as possible in the U.K.; and

100. Glaxo (TCC), para. 10.
102. Glaxo (TCC), para. 10.
103. Glaxo (SCC), para. 6.
104. Glaxo (TCC), para. 76.
105. Glaxo (SCC), para. 8. As the trial judge explained, “to use a very simple example, if the ranitidine product was sold for $10 in Italy, the transfer price would be $4; if the ranitidine product was sold for $20 in France, the transfer price would be $8” (Glaxo (TCC), para. 47, cited in Glaxo (SCC), para. 8).
106. Glaxo (TCC), para. 3. See also Factum of the Appellant (The Queen) submitted to Supreme Court in Glaxo, para. 9.
107. Glaxo (TCC), para. 50.
108. Id., para. 10.
109. Id., para. 7.
111. Id., para. 50. Under the licence agreement, Glaxo Canada was not given the freedom to purchase the raw material from sources other than a Glaxo approved source (Glaxo (TCC), para. 80). For this reason, the Supreme Court 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).
112. 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). Adechsa was Glaxo Group’s clearing company, located in Switzerland (Glaxo (SCC), para. 6). Adechsa’s role in this process was, essentially, “to administer the transfer prices” (Glaxo (TCC), para. 15).
113. Glaxo (TCC), para. 1. At the time of this assessment, section 69(2) contained Canada’s transfer pricing rule. See Appendix 3 (section 9.3.) for the text of section 69(2).
3. to ensure the Group does not pay tax on the same profit twice. [...] 

166 [...] As set out in paragraph 13 of these reasons, Glaxo Group’s taxation strategy was to minimize tax by shifting its profits to Singapore via Switzerland. Part of the strategy included using Adechsa as a distributor and funneling the excess amounts through it. The corporate structure of Glaxo World was, in part, designed to minimize income in high tax jurisdictions by diverting income to low tax jurisdictions.115

In addition to shifting profits to Singapore via Switzerland, the scheme would also make it possible for Glaxo Canada to avoid Canadian withholding taxes. Justice Rip noted as follows:

Royalty payments in Canada are subject to withholding tax and the profit will accrue to Glaxo Group and be taxed in the United Kingdom. The purchase price for ranitidine is not subject to any withholding tax and the profit accrues in Switzerland, and ultimately in Singapore. To suggest that Glaxo Group does not care whether its profits are in the form of royalty payments or purchase price belittles the issue in these appeals.116

For the purpose of conducting the arm’s length comparability analysis under section 69(2), it was necessary to delineate the actual controlled transaction. The parties disputed the true nature of the transaction. More specifically, they disputed what Glaxo Canada was paying for.

The Minister suggested that the contractual terms were confined to those within the four corners of the supply agreement. Based on those terms, it was suggested that Glaxo Canada was essentially paying for the raw material (i.e. goods) and nothing more. This view of the actual nature of the agreement would make it possible for the Minister to suggest that the proper arm’s length comparables were purchases of the generic ranitidine – which is chemically equivalent and bioequivalent to the Zantac ranitidine117 – by Apotex and Novopharm from arm’s length manufacturers. In these transactions, Apotex and Novopharm were similarly paying for the raw material and nothing more.

Glaxo Canada’s witness, Dr. J. Gregory Ballentine, characterized the issue as “what would be the cost of selling ranitidine products in Canada?”118 As the trial judge explained, “in doing so, he combined the royalty paid pursuant to the licence agreement with the purchase price for ranitidine hydrochloride paid to Adechsa to arrive at a bundle of goods and benefits received from the Glaxo World as a whole.”119 In other words, Glaxo Canada asserted that the transfer price was actually intended to be a bundled payment for the goods (i.e. the raw materials) received from Adechsa under the supply agreement, as well as for rights and services received from Glaxo Group under the licence agreement, and that this bundled payment was considered for one “whole deal”: to enable Glaxo Canada to manufacture and sell the Zantac drug in Canada.120

This alternative view of the actual nature of the controlled transaction made it possible for Glaxo Canada to argue that the arm’s length transactions proposed by the Minister were not comparable. It also made it possible to suggest that alternative arm’s length transactions should be used. These were purchases of Zantac ranitidine by Glaxo Group’s European arm’s length distributors.121 According to Glaxo Canada, these were comparable because “they purchased the same ranitidine under the same set of business circumstances as the appellant”.122

Justice Rip accepted the Minister’s view that the Supply Agreement with Adechsa and the Licence Agreement with Glaxo Group cover separate matters and that they are to be considered independently123 – in other words, that “the arm’s length principle should be applied on a transaction-by-transaction basis”.124 With this focus on the contractual terms of the supply agreement, Justice Rip agreed with the Minister’s assertion that Glaxo Canada was essentially paying for the raw material (i.e. goods) and nothing more.125 Accordingly, he accepted that the arm’s length purchases of the generic ranitidine were comparable to the supply agreement.

In light of this, Justice Rip found it appropriate to determine the arm’s length price using the CUP method, and to use the cost-plus method to verify this CUP method.126 Based on this analysis, 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 of the generic ranitidine ranged between CAD 193 to CAD 304 per kilogram. For this reason, it was appropriate for the Minister to adjust the price paid by Glaxo Canada, and to disallow deductions of its payments (to Adechsa) to the extent that they were “in excess of the highest monthly

115. Id., paras. 13, 166.
116. Id., para. 77 (emphasis added).
117. Both parties agreed that the generic ranitidine is chemically equivalent and bioequivalent to the Zantac ranitidine (Glaxo (TCC), para. 118).
118. Glaxo (TCC), para. 75.
119. Id.
120. Id.
121. Yet, surprisingly and perplexingly, in its appeal to the Federal Court of Appeal and the Canadian Supreme Court, Glaxo Canada ended up abandoning its call to have the income allocation result in the supply agreement compared to the arm’s length result in the transactions involving the European distributors. Instead, Glaxo Canada managed to convince the FCA that section 69(2) requires comparing the supply agreement to a hypothetical uncontrolled transaction. The Federal Court of Appeal accepted this approach, irrespective of whether actual comparables existed, and even though both the Minister and Glaxo Canada asserted at trial that actual comparables did exist. For a detailed critique of the approach of the Federal Court of Appeal, see A. Pichhadze, The Arm’s Length Comparable in Transfer Pricing: A Search for an “Actual” or a “Hypothetical” Transaction?, 7 World Tax J. 3 (2015), at 383, Journals IBFD.
122. Glaxo (TCC), para. 69. As Glaxo Canada explained in its factum to the Canadian Supreme Court, the European arm’s length distributors “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 sources” (Factum of the Respondent (GlaxoSmithKline Inc.), submitted on appeal to the Supreme Court, para. 26).
123. Glaxo (TCC), para. 78.
124. OECD Guidelines (2010), supra n. 2, at para. 3.9; Glaxo (SCC), para. 32.
125. Rip explained that “the Supply Agreement also provided protection against foreign currency exchange, indemnity insurance and the provision of intellectual property to the extent that [the appellant] shall not previously have received it or shall not otherwise receive it directly from [Glaxo Group]” (Glaxo (TCC), para. 15). Yet, he accepted the Minister’s view that this was essentially a supply of goods, as the raw materials were the only item of value received by Glaxo Canada (Glaxo (TCC), para. 16).
price per kilogram of ranitidine paid by Apotex and Novo-pharm to their arm's length manufacturers. On final appeal to the Canadian Supreme Court, the Minister again submitted that "each transfer is to be treated as a separate transaction". Al Meghji, Counsel for Glaxo Canada, alerted the Supreme Court as to the need for clarity on this issue. In his submission at the hearing before the Court, he stated as follows:

"Madam Chief Justice, my submission to you is that question about when you have a particular good that is priced with different elements and it is a transaction that has different things in it, and when do you unbundle it? When do you separate it? Do you say that if it is essentially the good with some elements, it is okay, but there is more to it, then you don't? That question is this whole debate about unbundling, which I don't think can be answered in this context. And it really is the subject matter of some PhD thesis, because it is a troubling issue the OECD has talked about."

The Supreme Court qualified the application of a transaction-by-transaction approach. In reaching its unanimous decision, it referred to the OECD Guidelines. Justice Rothstein noted that, according to paragraph 1.42 of the Guidelines (1995), "while a transaction-by-transaction approach may be ideal, the 1995 Guidelines themselves recognize that it is not appropriate in all cases." He also noted that paragraph 1.42 provides that "[...] there are often situations where separate transactions are so closely linked that they cannot be evaluated adequately on a separate basis." He went on to explain as follows:

"According to the 1995 Guidelines, a proper application of the arm's length principle requires that regard be had for the "economically relevant characteristics" of the arm's length and non-arm's length circumstances to ensure they are "sufficiently comparable." When there are no related transactions or where related transactions are not relevant to the determination of the reasonableness of the price in issue, a transaction-by-transaction approach may be appropriate. However, "economically relevant characteristics of the situations being compared" may make it necessary to consider other transactions that impact the transfer price under consideration. In each case it is necessary to address this question by considering the relevant circumstances.

Applying the OECD's recommendations to the transaction(s) in question, Justice Rothstein explained that the terms of the licence agreement would be linked to the transfer price in the supply agreement if they would "impact the transfer price under consideration." He suggested that such link may have existed because "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. Furthermore, "[t]he effect of the link between the Licence and Supply agreements was that an entity that wished to market Zantac was subject to contractual terms affecting the price of ranitidine that generic marketers of ranitidine products were not." Finally, Justice Rothstein stated as follows:

"This requirement was not the product of the non-arm's length relationship between Glaxo Canada and Glaxo Group or Adechsa. Rather, it arose because Glaxo Group controlled the trademark and patent of the brand-name pharmaceutical product Glaxo Canada wished to market. An arm's length distributor wishing to market Zantac might well be faced with the same requirement."

Justice Rothstein refrained, however, from concluding that the agreement was in fact linked to the supply agreement. Instead, he left the Canadian Tax Court to make that determination in a retrial. However, that retrial never took place because the taxpayer and the Minister ended up settling their dispute.

4. A Closer Look into the Task of Aggregation

Justice Rothstein held that "[i]f the circumstances require, transactions other than the purchasing transactions must be taken into account to determine whether the actual price was or was not greater than the amount that would have been reasonable had the parties been dealing at arm's length." But what precisely is involved in carrying out this task? Justice Rothstein merely directed that the trial judge examine the terms of the licence agreement. Unfortunately, the Canadian Supreme Court missed the opportunity to clarify how a linked transaction ought to be taken into account.

The OECD Guidelines provide examples of linked transactions and explain as follows how to deal with them:

"Examples may include, 1. some long-term contracts for the supply of commodities or services, 2. rights to use intangible property, and 3. pricing a range of closely-linked products (e.g. in a product line) when it is impractical to determine pricing for each individual product or transaction. Another example would be the licensing of manufacturing know-how and the supply of vital components to an associated manufacturer; it may be more reasonable to assess the arm's length terms for the two items together rather than individually. A further example would be the routing of a transaction through another associated enterprise; it may be more appropriate to consider the transaction of which the routing is a part in its entirety, rather than consider the individual transactions on a separate basis."

In the BEPS Actions 8-10 Final Reports, the recently revised OECD Guidelines state that "[i]n situations where services and transfers of intangibles are intertwined, deter-

127. Factum of the Appellant (The Queen) submitted to the Supreme Court in Canada v. Glaxo SmithKline Inc., para. 20.
128. Glaxo (SCC), para. 32.
129. Transcript of The Queen v. GlaxoSmithKline Inc. (33874), at 17 (emphasis added). Reproduced with the permission of the Supreme Court of Canada, 2012, at 41, lines 7-14.
130. Glaxo (SCC), paras. 33-42.
133. Id.
134. Id., para. 42 (emphasis added).
135. Id., para. 42 (emphasis added).
136. Id., para. 49. See also para. 46.
137. Id., para. 48.
138. Id., para. 47.
139. Id., paras. 54, 57.
140. Id., para. 57.
141. Id., para. 38. See also para. 53.
142. In the words of Justice Rothstein: "I agree with Justice Nadon that 'the amount that would have been reasonable in the circumstances' if Glaxo Canada and Adechsa had been dealing at arm's length has yet to be determined. This will require a close examination of the terms of the Licence Agreement and the rights and benefits granted to Glaxo Canada under that Agreement" (Glaxo (SCC), para. 54).
mining arm’s length prices on an aggregate basis may be necessary. Unfortunately, this guidance fails to provide sufficiently specific and detailed guidance about this task of aggregation, which leaves open the risk of misconceptions of the task at hand.

Fortunately, shortly after the Canadian Supreme Court’s decision, an Indian Income Tax Appellate Tribunal took the opportunity to elaborate on this issue. In the Demag Cranes case, the Tribunal explained that ‘the proposition that a number of individual transactions can be aggregated and construed as a composite transaction in order to compute [the arm’s length price] also finds an echo in the OECD guidelines under Chapter III […]’. In more recent cases, the Tribunal followed the rationale laid down in Demag Cranes. It again held that closely linked transactions ‘can be aggregated and construed as a single transaction for the purpose of determining the arm’s length price’.

In other words, aggregation gives expression to the parties’ single composite transaction. Their composite transaction is delineated by applying a step-transaction analysis, which ‘treats a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result’. This makes it possible to identify the true nature of the transaction (i.e. the commercial or financial relations) between the parties. As Lord Wilberforce reminded in the W T Ramsay Ltd case, ‘[i]t is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded’.

What are the tax implications of aggregating separate contracts into a single composite transaction? As the US Tax Court explained, ‘where an interrelated series of steps is taken pursuant to a plan to achieve an intended result, the tax consequences are to be determined not by viewing each step in isolation, but by considering all of them as an integrated whole’. Similarly, the US Court of Appeals for the Fifth Circuit explained:

Under the step transaction doctrine, ‘the tax consequences of an interrelated series of transactions are not to be determined by viewing each of them in isolation but by considering them together as component parts of an overall plan’ […] When considered individually, each step in the series may well escape taxation. The individual tax significance of each step is irrelevant, however, if the steps when viewed as a whole amount to a single taxable transaction […] [Taxpayers] cannot compel a court to characterize the transaction solely upon the basis of a concentration on one facet of it when the totality of circumstances determines its tax status.

Accordingly, a transfer pricing adjustment would be based on the combined effect of the series of linked contracts that made possible a single composite transaction, rather than making an adjustment based on the effects of each contract (step) separately (i.e. a transaction-by-transaction approach). The central purpose of this step-transaction analysis is to ensure ‘that the tax consequences of a particular transaction turn on substance rather than form’.

This understanding has also been expressed in domestic administrative guidance on transfer pricing. The Australian Taxation Office, for example, recognizes the possibility that the substance of the parties’ commercial or financial relations could be found in a single composite transaction. In the United States, for the purpose of determining the true taxable income of a controlled taxpayer, the US Regulations require taking into account the possible need to “aggregate” transactions. It states as follows:

[the combined effect of two or more separate transactions (whether before, during, or after the taxable year under review) may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm’s length consideration for the controlled transactions.]

In its discussion of how to coordinate between interest adjustment requirements under different sections of the Internal Revenue Code, the US Regulations go on to state that it is first necessary to determine the substance of the transaction, and “for this purpose, all the relevant facts and circumstances shall be considered and any law or rule of law (assignment of income, step transaction, etc.) may apply.” The need for a step-transaction analysis is also alluded to in the recent IRS Notice 2014/58:

For purposes of determining whether the codified economic substance doctrine applies, ‘transaction’ generally includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement; and any or all of the steps that are carried out as part of a plan. Facts and circumstances determine whether a plan’s steps are aggregated or disaggregated when defining a transaction.

Generally, when a plan that generated a tax benefit involves a series of interconnected steps with a common objective, the ‘transaction’ includes all of the steps taken together – an aggregation approach. This means that every step in the series will be considered when analyzing whether the ‘transaction’ as a whole lacks economic substance.

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144. OECD, Actions 8-10 Final Reports, supra n. 17, at paras. 6.101 (emphasis added). See also para. 6.135.
150. Id., at 1245.
155. US: IRS, Notice 2014-58, Additional Guidance under the Codified Economic Substance Doctrine and Related Penalties, IRB 2014-44, at 746 (emphasis added). This IRS Notice is relevant to the analysis in section 482 because the US Regulations require verification that the contractual terms are consistent with the economic substance of the underlying transactions. US Treas. Reg. sec. 1.482-1(d)(3)(ii)(B).
5. The Authority To Aggregate

Notwithstanding the guidance provided by the OECD and by tax administrations, it is also pertinent and necessary to inquire as to whether article 9(1) would apply to a single composite transaction that has been executed using separate but interrelated contracts (steps). As Wittendorff explains, for Article 9(1) to apply, conditions must be made or imposed ‘between’ associated enterprises concerning their ‘commercial or financial relations’. According to its wording, Article 9(1) applies to direct relations between associated enterprises.165 He goes on to note that ‘domestic law may provide that step transactions are to be treated as direct transactions between associated enterprises’;163 “[i]f, under domestic law, it is possible to treat a step transaction as a direct transaction between associated enterprises, Article 9(1) will apply”.158

Under domestic law, it may be possible to find references to the step-transaction analysis in statutory transfer pricing rules. This is typically achieved by having the legislature apply the rules to “a transaction or a series of transactions”, as exemplified by the current rules in the United Kingdom and Canada.159 The purpose of this notion of series is to identify situations where a particular transaction and one or more, usually tax-motivated, other transaction(s) are sufficiently integrated and related to be considered together, rather than on a transaction-by-transaction basis, in ascertaining the tax consequences of the transactions.160

In OSFC Holdings Ltd., the Canadian Federal Court of Appeal accepted the inference that Parliament’s statutory reference to a ‘series of transactions’ is intended to apply the step-transaction doctrine.161

Section 69(2) of the Income Tax Act, under which Glaxo Canada was assessed in the Glaxo case, did not explicitly mention this notion of a ‘series of transactions’. As Tobin opined, “on its face” section 69(2) was focused “on specific payments for specific transactions and not transactions as a whole”.166 Yet, neither did section 69(2) explicitly exclude its application to a series of transactions. Therefore, it was arguably open for the Canadian Supreme Court to apply (or at least consider the option and/or need to apply) a step-transaction analysis as a judicial doctrine. This well-established doctrine has been applied to situations where separate transactions were “intended to have effect as part of a nexus or series of transactions”.165 A UK court explained that where a scheme (i.e. a series of transactions) “amounted in practice to a single transaction, the court should look at the scheme as a whole”.164 Another UK court further stated that “the fiscal consequences of a pre-ordained series of transactions, intended to operate as such, are generally to be ascertained by considering the result of the series as a whole, and not by dissecting the scheme and considering each individual transaction separately”.168 In other words, “where one finds transactions with a commercial unity, they are to be taxed by reference to their combined effect”.166

This judicial doctrine has been applied in different contexts for the purpose of aggregating transactions. The US Tax Court has, for example, “applied the step transaction doctrine to aggregate a taxpayer’s two separate same-day transfers in land to reflect the economic substance of the transaction”.167

Notably, the form and usage of this judicial doctrine varies around the world. For example, while it has been described as ‘well-established’ and ‘expressly sanctioned’ in the United States,166 it “did not gain much popularity” in Canada,169 although it has been applied in some Canadian cases.170 Also, as explained in Appendix 2, there are different ways (tests) by which a step-transaction analysis could be applied — although each of these tests is said to be “faithful to the central purpose of the step transaction doctrine: ensuring that the tax consequences of a particular transaction turn on substance rather than form”.171 Moreover, some countries have developed alternative concepts that may apply to step transactions, such as the concept of “unnatural transactions” in some civil law countries.172

6. Using Disaggregation as an Anti-Avoidance Measure

In some countries, such as Canada, the judicial step-transaction doctrine is used solely to delineate a single composite transaction so that tax can be based on the combined effect of the series of interrelated transactions, while in other countries, such as the United States and the United Kingdom, the doctrine is also used as an anti-avoidance measure against tax-motivated steps (i.e. contracts within the series). This anti-avoidance measure is achieved by applying a disaggregation approach.

Recall that, as the IRS recently explained in its Notice 2014–58, in the United States the general rule is that all the interconnected steps within a series would be aggregated in order to determine their intended combined effect as

156. Wittendorff, supra n. 97, at 233.
157. Id.
158. Id.
163. UK: W T Ramsey Ltd.
a single composite transaction. Yet, as the IRS goes on to explain: when a series of steps includes a tax-motivated step that is not necessary to achieve a non-tax objective, an aggregation approach may not be appropriate. In that case, the “transaction” may include only the tax-motivated steps that are not necessary to accomplish the non-tax goals – a disaggregation approach.

Whether the economic substance doctrine is relevant and whether a transaction should be disaggregated will be considered on a case-by-case basis, depending on the facts and circumstances of each individual case. For example, if transfers of multiple assets and liabilities occur and the transfer of a specific asset or assumption of a specific liability was tax-motivated and unnecessary to accomplish a non-tax objective, then the economic substance doctrine may be applied solely to the transfer or assumption of that specific asset or liability. Separable activities may take many forms including, for example, the use of an intermediary employed for tax benefits and whose actions or involvement was unnecessary to accomplish an overarching non-tax objective. These situations are merely examples intended to illustrate the potential application of the disaggregation approach and are not exhaustive or comprehensive.

This disaggregation approach has also been expressed and applied by the courts in the United States. In the Smith case, for example, the US Tax Court explained that a step-transaction analysis “generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced.” The Court went on to explain that, in dealing with such schemes, “courts are not bound by the twisted path taken by the taxpayer, and the intervening steps may be disregarded or rearranged.”

Turning to the United Kingdom, there the courts have set out a four-pronged test. As the House of Lords explained in Craven v. White:

As the law currently stands, the essentials emerging from Furniss v. Dawson, [1984] A.C. 474 appear to me to be four in number:
(1) that the series of transactions was, at the time when the intermediate transaction was entered into, pre-ordained in order to produce a given result;
(2) that the transaction had no other purpose than tax mitigation;
(3) that there was at that time no practical likelihood that the pre-planned events would not take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life, and
(4) that the pre-ordained events did in fact take place.

In Canadian Utilities Ltd., Justice Rothstein, of the Federal Court of Appeal, noted that the second and third factors in this test move beyond merely defining what constitutes a series of transactions. They also incorporate anti-avoidance measures. In his words:

[52] [... The four factors listed in Craven v. White do more than define a series.]

[53] In England, the courts have created judicial anti-avoidance measures whereby they ignore the legal effects of otherwise valid transactions in certain circumstances. The Craven v. White factors are a common law code for determining not only whether a series exists, but also when the legal effect of an intermediate transaction in the series, which has no other purpose than tax avoidance and which is not intended to have any independent life, may be ignored.

[54] In articulating his four-part test in Craven v. White, Lord Oliver explained at 513-14 that the court in Furniss v. Dawson sought not only to treat a series of transactions as one composite transaction, but also to ignore an intermediate transaction that would otherwise have to be given legal effect:
...the court was able to look at the overall transaction and to assess its legal result as a composite whole. But it was able to do this because it was in fact not only conceived but carried out as one indivisible transaction. However, that in itself was not enough, because if you merely did that you still ended up with the statutory fiscal results of an actual disposition by the Dawsons via Greenjacket to Wood Bastow and the price firmly locked in Greenjacket. You have to go one stage further and nullify the immediate transfer to Greenjacket which has its own permanent fiscal consequences unless it can be totally disregarded, for Ramsay merely ‘enables the courts to arrive at a conclusion which corresponds with the parties’ intentions’: In Furniss v. Dawson the parties’ intention was to produce a sale by Greenjacket instead of a sale by the Dawsons. So a further ingredient had to be supplied, and this is found in Barmah. This establishes the further proposition that if you find in what, ex hypothesi, is an integrated and interdependent series of transactions a step inserted which has no other purpose than that of avoiding or minimising a liability to tax which, without that step, would be attracted by the transactions, you are entitled for fiscal purposes to ignore that step in assessing what is the true legal result of the series taken as a whole [emphasis in original].

[55] Thus, the second and third parts of the test articulated by Lord Oliver are not concerned with when individual transactions are sufficiently connected that the court may consider them as having the composite legal effect they were intended to have. Rather, they are concerned with whether one transaction in that series was inserted solely for tax purposes, and, as a matter of judicial anti-avoidance, should not be given what would otherwise be its legal effect.

Turning to Canada, the Supreme Court affirmed that the starting point is the English common law test for determining whether there is a series (i.e. a single composite transaction), although this common law test is expanded by the definition of a “series of transactions” in section 248(10) of the Income Tax Act. However, that Canadian law has not adopted the anti-avoidance elements from the English series test. As Justice Rothstein explained in the Canadian Utilities Ltd. case:

[56] The Canadian approach is one of statutory rather than judicial anti-avoidance measures. Thus, it would be inappropriate to import in its entirety a common law test which involves when the legal effect of a transaction may be ignored into the definition of series for Canadian tax purposes.

[57] Adoption of the House of Lords’ approach as described in OSFC means adoption of the pre-ordination test for determining whether a series of transactions exists at common law. It is only necessary to determine whether each of the transactions in the alleged series was preordained

174. Id. This IRS notice is relevant to the analysis under section 482 because it requires verification that the contractual terms are consistent with the economic substance of the underlying transactions. US Treas. Reg. sec. 1.482-1(d)(3)(ii)(B).
7. Implications of Aggregation and/or Disaggregation

7.1. Whether aggregated or not, identifying the terms is a precondition for contractual interpretation

The starting point of contractual interpretation is the plain meaning of the words used by the parties within their terms, unless their terms need to be deduced from their conduct. This is true in both civil and common law systems, as well as at the international level. It is therefore not possible to properly interpret the terms—in order to identify the intentions of the parties and the true nature of their agreement—without first identifying the full scope of their terms. In the Glaxo case, for example, to determine whether Glaxo Canada intended to bundle payments, it was necessary to first identify the terms they agreed to, which may have been laid out in a single written contract (i.e. the supply agreement) or in a series of linked contracts (i.e. the supply and licence agreements) that together made possible a single composite transaction.

Recall that the Canadian Supreme Court left it to the Tax Court to determine whether the licence agreement was linked to the supply agreement. If it was, aggregation of terms could have been required. Yet, a retrial never took place, and therefore the scope of the terms was not determined by the courts.

Nevertheless, in its analysis the Supreme Court concluded that Glaxo Canada appears to have intended to bundle payments for the raw materials received from Adechsa and “at least some of the rights and benefits under the Licence Agreement.” Respectively, in the author’s opinion, without having established the scope of the terms which had to be construed, the Court was not in a proper position to draw this conclusion about the intentions of Glaxo Canada.

7.2. The contents of the terms could affect the outcome of contractual interpretation

The scope and contents of the terms could have a pivotal role in the outcome of interpretation. In the Glaxo case, for example, if the terms of the licence agreement were indeed a part of a single composite transaction, they could have been determinative in delineating the intentions of the parties. Yet, this is not explicitly revealed by the Canadian Supreme Court’s reasons for judgment. This is not surprising, considering that the Court did not even mention if and how it construed the terms of the transaction.

Nevertheless, to explain how the scope and contents of the terms could have affected the outcome of interpretation in this case, it is possible to apply contractual interpretation principles to two hypothetical scenarios. The first scenario requires assuming that the terms were confined to those expressed within the four corners of the supply agreement. The second scenario requires assuming that the terms of the supply and licence agreement needed to be aggregated to reflect the parties’ single composite transaction.

Considering that the courts in this case did not indicate which source of law governed the contractual interpretation of the supply and licence agreements, for both scenarios it is also assumed that Canadian common law governed the interpretation of these contracts. The pertinent principles of interpretation are summarized below, and are then applied to the transaction in both scenarios.

7.2.1. Canadian common law principles of contractual interpretation: A summary

Recall that tax is based on the effects of contract(s), and the effects of contracts ought to be based on the true nature of the agreement of the parties, as it was intended by the parties. Contractual intentions ought to be delineated objectively from the terms the parties agreed to, as they were expressed (in writing or orally) and/or as they could be implied from their words and/or conduct.

[58] For these reasons, the trial judge should not have considered the second and third parts of the test set out in Craven v. White in determining whether the ATCOR/Forest series of transactions and the normal course dividends together constituted a common law series.


183. The Canadian Supreme Court appeared to suggest that aggregation was indeed justified and required in this case in order to determine the arm’s length result based on the combined effect of the two contracts. For example, it stated that “[t]he combined effect of the Licence and Supply agreements enabled Glaxo Canada, among other things, to purchase ranitidine, put it in a delivery mechanism, and market it under the trade-mark Zantac” (Glaxo (SCC), para. 8). “The result of the price paid was to allocate to Glaxo Canada what Glaxo Group considered to be appropriate compensation for its secondary manufacturing and marketing function in respect of ranitidine and Zantac” (Glaxo (SCC), para. 49).


Regardless of whether the relevant terms are ambiguous, \({188}\) their meaning \({189}\) ought to be ascertained in light of their total context, which includes all the terms in the agreement (i.e. the contract’s internal context), \({190}\) as well as relevant surrounding circumstances (i.e. the contract’s external context). \({191}\) If the terms are ambiguous, a court should apply a commercially sensible interpretation. \({192}\) Extrinsic evidence of subjective intentions, which were not conveyed by the parties in their terms, must not be relied on as evidence of the intentions of the parties, \({193}\) unless doing so is necessary to resolve latent ambiguity in the terms. \({194}\)

### 7.2.2. Scenario 1: Interpretation of a “single transaction”

In this scenario, it is necessary to distil Glaxo Canada’s intentions from within the terms in the four corners of the supply agreement, as understood in light of its total context (i.e. the agreement as a whole as well as the agreement’s surrounding circumstances). In such a case, Glaxo Canada’s commercial purpose and the licence agreement would expectedly be relevant circumstances that ought to have been admissible for the purpose of shedding light on the meaning of the terms. However, that extrinsic evidence could not be relied on to reveal Glaxo Canada’s intention to bundle payments, unless the terms were latently ambiguous. If the terms of the supply agreement clearly and unambiguously conveyed an intention to pay for only the goods/services provided under the terms of the supply agreement, it is that intention that should have been given effect, even if the result would appear to be commercially unreasonable.

Presumably, the expressed terms of the supply agreement did not convey an intention to bundle payments. \({195}\) Moreover, as pointed out elsewhere, it is doubtful whether Glaxo Canada would have been able to establish the need to imply an intention to bundle payments. \({196}\) Neither party in this dispute, nor the courts, suggested that the terms of the supply agreement were ambiguous. Therefore, the commercial reasonableness of bundling payments should not have been determinative, and effect would have to be given to the intentions of the parties as objectively delineated from their terms.

If indeed the terms were unambiguous, extrinsic evidence, for the purpose of revealing the subjective intention of the parties to bundle payments, should not have been admissible. Nevertheless, based on the extrinsic evidence of Glaxo Canada’s commercial purpose and business reality (which, again, included the commercial purpose to manufacture and sell the Zantac brand, as well as the need to enter into both the licence and supply agreements in order to achieve that purpose), \({197}\) the Supreme Court concluded that, as it appears, Glaxo Canada intended to bundle payments for the goods/services/rights received under both the licence and supply agreements. There is real risk that this conclusion amounted to an error of law. \({198}\) It is therefore suggested that the Court should consider overruling its decision in this case. \({199}\)

### 7.2.3. Scenario 2: Interpretation of a “single composite transaction”

In this scenario, the terms of the licence agreement would not be mere surrounding circumstances. Rather, these terms, in their aggregated form, would provide admissible evidence of the subjective intentions of the parties. This could have revealed an intention to bundle payments. Thus, had the Canadian Supreme Court actually reached a conclusion that the terms were so closely linked (so closely intertwined) that they had to be aggregated to form a single composite transaction, an interpretation of the terms in that composite transaction could then possibly reveal Glaxo Canada’s intention to bundle payments.

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\(^{191}\) CA: Sattva Capital Corp. (2014), para. 47. The Canadian Supreme Court went on to explain that “the nature of the evidence that can be relied upon under the rubric of surrounding circumstances will necessarily vary from case to case. It does, however, have its limits. It should consist only of objective evidence of the background facts at the time of the execution of the contract (Kings v. Operating Engineers Training Institute of Manitoba Inc., 2011 MBCA 80, paras. 66, 70), that is, knowledge that was or reasonably ought to have been within the knowledge of both parties at or before the date of contracting” (CA: Sattva Capital Corp. (2014), para. 58).


\(^{195}\) If an intention was explicitly expressed, the issue should not have been contentious in this case.

\(^{196}\) Pichhadze, supra n. 45, at 162-163.

\(^{197}\) Glaxo (SCC), paras. 15, 45.

\(^{198}\) See e.g. CA: FCA, 21 Apr. 2008, General Motors of Canada Ltd. v. The Queen, 2008 FCA 142, para. 42.

\(^{199}\) In Craig v. The Queen (CA: SC, 1 Aug. 2012, 2012 SCC 43), the Canadian Supreme Court was faced with the delicate question as to whether to overrule its prior decision. Not surprisingly, the Court stated that such a move should not be undertaken lightly (para. 24), and that such a decision has been carried out in only a limited number of cases. Nevertheless, the Court’s power and willingness to overrule its prior decision is firmly established. For example in The Queen v. Salturo (CA: SC, 28 Nov. 1991, (1991) 3 SCR 654, para. 29), the Court stated that “[t]his court is now willing, where there are compelling reasons for doing so, to over turn its own previous decisions [...] Stuart v. Bank of Montreal (1909), 41 SCR 516”. Similarly, in Ranville, the Court stated that “[t]he traditional justification for the stare decisis principle is certainty in the law. This of course remains an important consideration even though this Court has announced its willingness, for compelling reasons, to overturn a prior decision” (CA: SC, 28 Sept. 1982, Canada (Minister of Indian Affairs & Northern Development) v. Ranville (1982) 2 SCR 518, para. 15 (emphasis added)). Turning back to Craig, the Court explained that when considering whether to overrule its prior decision, the Supreme Court “must ask whether it is preferable to adhere to an incorrect precedent to maintain certainty, or to correct the error” (CA: Craig (2012), para. 27). It was emphasized that “the Court must be satisfied based on compelling reasons that the precedent was wrongly decided and should be overruled” (para. 25).
7.3. The outcome of interpretation affects the search for arm's length comparables

The search for an arm's length comparable is based on the delineated transaction, be it a single or a composite transaction. In the Glaxo case, for example, if the terms were confined to those within the supply agreement, and an interpretation of those terms revealed an intention to pay for the ranitidine and nothing more, then the arm's length comparable would need to reflect the same intention. In such a case, arguably the Minister's proposed arm's length purchases of the generic ranitidine may have been comparable, as Apotex and Novopharm were similarly paying for the equivalent raw material and nothing more. Conversely, if the terms had to be aggregated in order to reflect a single composite transaction, and an interpretation of the aggregated terms revealed and intention to bundle payments, then the arm's length comparable would need to reflect the same intention.

8. Conclusion: Necessary Next Steps

Both the OECD Guidelines and domestic administrative guidance on transfer pricing ought to clarify, more explicitly, that the task of aggregation requires applying a step-transaction analysis in order to delineate the terms of the parties' single composite transaction, and to then apply the relevant tax rule(s) based on the combined effect of the interrelated contracts. As for domestic courts, if domestic legislation has not already adopted the notion of a series of transactions, they should consider applying the step-transaction analysis as a judicial doctrine when aggregating interrelated transactions.
This competition gets problematic once the practices used by states become harmful. As the G7 countries declared in 1996:

globalisation is creating new challenges in the field of tax policy. Tax schemes aimed at attracting financial and other geographically mobile activities can create harmful tax competition between States, thereby increasing the costs of distortions of trade and investment and could lead to the erosion of national tax bases.209

In this competitive environment, tax rates are not the only tool used by states. States also compete by offering attractive legal conditions, particularly through their domestic tax rules. Perhaps inevitably, this leads to gaps and divergences between domestic tax laws.

The taxation of cross-border transactions is further complicated by the use of additional layers of legal and non-legal instruments. These include other sources of binding “hard law”, such as bilateral and multilateral tax treaties;210 customary international laws;211 and non-binding “soft law” instruments, such as internationally coordinated guidelines. It has thus been said that “legal pluralism is intrinsic to cross-border taxation”.212

Having cross-border taxation governed by a pluralistic legal system can have significant implications. As Tamanaha explains:

What makes this pluralism noteworthy is not merely the fact that there are multiple uncoordinated, coexisting or overlapping bodies of law, but that there is diversity amongst them. They may make competing claims of authority; they may impose conflicting demands or norms; they may have different styles and orientations. This potential conflict can generate uncertainty or jeopardise for individuals and groups in society who cannot be sure


210. As Pistone explains, “unlike other international treaties, tax treaties face legal pluralism as a natural condition for their application, since Art. 3.2 of the OECD Model allows characterization based on the domestic law of either contracting state for terms not defined by the treaty, unless the context otherwise requires. This is possible a necessary consequence of the absence of an international tax court and need to secure effective application of limits on the exercise of taxing powers in the national jurisdiction of each contracting state” (P. Pistone, Soft Tax Law: Steering Legal Pluralism towards International Tax Coordination, in Traditional and Alternative Routes to European Tax Integration: Primary Law, Secondary Law, Soft Law, Coordination, Comitology and Their Relationship (D. Weber ed., IBFD 2010), at 100, Online Books IBFD).

211. As Christians explains, “unlike treaty law, customary law emerges not from formal documentation but from state practice, pronouncements made by international bodies, and other informal processes” (A. Christians, Hard Law, Soft Law, and International Taxation, 25 Wisc. Intl. L. J. 2 (2007), footnote 18). She goes on to explain that “customary law is characterized by two fundamental elements: states uniformly comply with […] and they do so out of a sense of legal obligation […]” (Christians, at 329). It has been argued, for example, that the arm’s length standard, which is used internationally as the basis for conducting the transfer pricing analysis, is a form of customary international law. See R. Avi-Yonah, Tax Competition, Tax Arbitrage, and the International Tax Regime, 61 Bull. Intl. Taxn. 4 (2007), at 130, Journals IBFD. B. Lepard, Is the United States Obligated to Drive on the Right? A Multidisciplinary Inquiry into the Normative Authority of Contemporary International Law Using the Arm’s Length Standard as a Case Study, 10 Duke J. Comp. & Intl. L. 43 (1999-2000), at 167-175.


The competition between states to establish attractive fiscal and legal environments has created ripe conditions for legal arbitrage. That is, differences between the domestic tax laws among countries have created the incentives and opportunities for tax arbitrage.214

9.1.1.2. The other side of the coin: Multinational enterprises take advantage of legal arbitrage through aggressive tax planning schemes

Perhaps not surprisingly, multinational enterprises have been exploiting this opportunity of tax arbitrage by devising aggressive tax planning schemes. Two key factors make these enterprises particularly well suited to devise and implement such schemes. First, they operate under conditions of common control, which gives them greater flexibility in how they structure intra-firm transactions (i.e. the “commercial or financial relations” between members of the same multinational enterprise), as compared to businesses that trade at arm’s length.215 As the OECD explains:

Associated enterprises are able to make a much greater variety of contracts and arrangements than can independent enterprises because the normal conflict of interest which would exist between independent parties is often absent. Associated enterprises may and do conclude arrangements of a specific nature that are not or are very rarely encountered between independent parties. This may be done for various economic, legal, or fiscal reasons dependent on the circumstances in a particular case. Moreover, contracts within an MNE could be quite easily altered, suspended, extended, or terminated according to the overall strategies of the MNE as a whole, and such alterations may even be made retroactively.216


210. As Pistone explains, “unlike other international treaties, tax treaties face legal pluralism as a natural condition for their application, since Art. 3.2 of the OECD Model allows characterization based on the domestic law of either contracting state for terms not defined by the treaty, unless the context otherwise requires. This is possible a necessary consequence of the absence of an international tax court and need to secure effective application of limits on the exercise of taxing powers in the national jurisdiction of each contracting state” (P. Pistone, Soft Tax Law: Steering Legal Pluralism towards International Tax Coordination, in Traditional and Alternative Routes to European Tax Integration: Primary Law, Secondary Law, Soft Law, Coordination, Comitology and Their Relationship (D. Weber ed., IBFD 2010), at 100, Online Books IBFD).

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213. B.Z. Tamanaha, Understanding Legal Pluralism: Past to Present, Local to Global, 30 Sydney L. Rev. (2008), at 375 (emphasis added).

214. Tax arbitrage refers to “transactions that are designed to take advantage of differences between national tax systems to achieve double non-taxation” (Avi-Yonah, supra n. 211, at 137).

215. As the OECD explains, “when independent enterprises transact with each other the conditions of their commercial and financial relations (e.g. the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces” (OECD Guidelines (2010), supra n. 2, para. 1.2). Presumably, in such arm’s length transactions neither party controls the decision making of the other and each party negotiates the price of the transaction with its self-interests in mind. According to an affidavit submitted to the Federal Court of Australia, “the buyer attempts to pay as little as possible and the seller attempts to extract as high a price as possible – with the ultimate price largely determined by the positions/bargaining power of the two parties” (AU: Affidavit of Brian C. Becker, submitted for SNF (Australia) PTY Ltd v. Commissioner of Taxation, Federal Court of Australia, (Mar. 2009), at 19). The OECD goes on to explain that, in contrast, “[w]hen associated enterprises transact with each other their commercial and financial relations may not be directly affected by external market forces in the same way […]” (OECD Guidelines (2010), supra n. 2, para. 1.2). This is due to their conditions of control. That is, either one party to the transaction controls the other (e.g. a parent company controls its subsidiary), or both parties are controlled by the same entity (e.g. two subsidiaries with a common parent company). This control makes it possible for the parties in a contract to pursue common objectives, as opposed to dealing as separate entities, each with its own interests in mind.

Second, unlike businesses that trade mainly within their national market, multinational enterprises have a presence in multiple jurisdictions which makes possible cross-border, intra-firm transactions.

The differences in domestic tax rules may create the conditions and incentives for planning intra-firm, cross-border transactions in ways that exploit ‘legal arbitrage opportunities and the boundaries of acceptable tax planning [...]’218 For example, a multinational enterprise can flexibly structure the conditions of its intra-firm transactions in ways that ultimately result in shifting its income to jurisdictions that have more favourable tax rates, thereby avoiding taxes either partially or completely. As Baistrucchi explains:

[I]f the effective tax rate of the manufacturer’s jurisdiction is higher than that of its subsidiary, then the manufacturer can charge the lowest possible transfer price to its subsidiary in order to channel the profits of the MNE to the lowest tax jurisdiction. Conversely, if the manufacturer’s effective tax rate is lower than that of its subsidiary, the manufacturer can charge the highest possible price to its subsidiary. The net effect of this transfer pricing strategy is to increase the after-tax profit of the MNE.219

9.1.3. The risk of tax base erosion

The OECD Guidelines state that “[t]ransfer prices [...] determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions.”220 For example:

New Zealand taxes all persons on their income sourced in New Zealand, which means exercising its jurisdiction to tax foreign-based multinationals on profits attributable to their New Zealand operations. These profits, in theory, are expected to be commensurate with the economic contribution made (including commercial risk borne) by those New Zealand operations.221

As the New Zealand Internal Revenue Department explains, “[t]he transfer price [as] adopted by a multinational determines where the profits of that multinational are sourced. Consequently, it also determines whether tax is imposed on the amount of income truly attributable to each jurisdiction in which the multinational operates.”222

The Internal Revenue Department further explains:

If a non-market value (inadequate or excessive consideration) is paid for the transfer of goods, services, intangible property or loans between those members, the income calculated for each of those members will be inconsistent with their relative economic contributions. This distortion will flow through to the tax revenues of their host countries.223

Considering the risk of tax base erosion, New Zealand, similar to other states, shares an interest of ensuring “that the proper amount of income is attributed to its jurisdiction”224. The New Zealand’s transfer pricing rules, similar to the equivalent rules in other states, “are intended to measure the amount of income and expenditure of a multinational properly attributable to its New Zealand operation.”225 As was explained by the Canadian Tax Court:

[i]t the underlying policy concern behind the transfer pricing rules is, of course, leakage from the Federal Treasury due to profits being shifted from one country to another or, expressed in more conventional terms, the object is to ensure that parties not at arm’s length report substantially the same amount of income in the jurisdiction in which they are located as would parties dealing at arm’s length.226

This risk of tax base erosion is particularly significant considering that “MNEs are responsible for two-thirds of global trade and 80% of investment”,227 and consequently transfer pricing schemes can result in a substantial loss (for states) of otherwise taxable revenue. It has been found that multinational enterprises can reduce their tax burden by anywhere from 3% to 22%.228

9.1.4. An internationally coordinated response

9.1.4.1. The arm’s length principle: A coordinated standard for income allocation

It is commonplace for states to use domestic rules to combat aggressive transfer pricing schemes. Yet, if each state that is affected by the same cross-border transaction were to apply different and inconsistent approaches to determining income allocation and deductions, the risk could arise that the parties will be subject to double taxation (i.e. the same income will be included in the tax base of the different jurisdictions involved).

To reduce this risk of double taxation, states have been relying on an internationally coordinated common standard for determining income allocation in controlled transactions.229 The US Regulations under section 482 of the Internal Revenue Code refer to this as the arm’s length standard,230 while the OECD Guidelines refer to this as the arm’s length principle.231 Coordination of this standard has been achieved by incorporating it into bilateral tax treaties.232

217. As Love explains, “[s]mall businesses, businesses working mainly in one national market and new firms can’t compete with MNEs who shift profits across borders to avoid or reduce tax” (P. Love, What is BEPS and How Can You Stop It?, OECD Insights (19 July 2013)).


221. NZ: Inland Revenue Dept., supra n. 221, at 10.

222. NZ: Inland Revenue Dept., supra n. 221, at 10.

223. Id., at 9.

224. Id., at 10.

225. Id., at 9.


227. OECD, Globalisation and Regional Economies, supra n. 201, at 63.


232. It has been estimated that there are more than 2,500 bilateral tax treaties worldwide (Z.D. Altman, Dispute Resolution Under Tax Treaties (IBFD 2005), at 1, Online Books IBFD).
Treaties typically adopt the standard as it is formulated in article 9 of the model tax treaties. Under article 9(1) of the OECD Model, for example, if the conditions in the actual controlled transaction differ to those which would be agreed in an uncontrolled transaction under comparable circumstances, the profits (i.e., income allocation) in the actual controlled transaction could be adjusted to reflect the allocation that would have resulted in the comparable uncontrolled transaction.

This analysis aims to identify uncontrolled transactions(s) which, while being comparable in character and circumstances, were (in fact) not (or hypothetically are presumed not to have been) subject to the special (non-arm’s length) conditions that may have affected income allocation in the controlled transaction. The aim is to eliminate the effect of these special conditions on income allocation in the controlled transaction.

The OECD Guidelines further state that “OECD member countries consider that an appropriate adjustment is achieved by establishing the conditions of the commercial and financial relations that they would expect to find between independent enterprises in comparable transactions under comparable circumstances.” As explained in the United Nations Practical Manual on Transfer Pricing (the UN Manual):

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.

233. Model tax treaties include the OECD Model Convention on Income and on Capital, which focuses on treaties between developed countries; the UN Model Double Taxation Convention between Developed and Developing Countries; and the US Model Income Tax Convention. Each of these models contains an article 9, which deals with associated enterprises and sets out the arm’s length standard. As the US Internal Revenue Service noted in its Notice 88-123, the OECD, UN, and US Models are essentially the same with regard to article 9 (US: Treasury Department and Internal Revenue Service, Notice 88-123: A Study of Intercompany Pricing under Section 482 of the Code, 1988-2 CB 458, 475).

234. OECD, Model Tax Convention, supra n. 12, at 29-30. The text of article 9(1) is set out in Appendix 3 (section 9.3.) of this article.

235. Conditions could be, for example, “the price of goods transferred or services provided and the conditions of the transfer or provision” (OECD Guidelines (2010), supra n. 2, at para. 1.2). Additional examples of conditions may be “payment terms” or “allocation of risks” (OECD Guidelines (2010), supra n. 2, at para. 9.165). According to the OECD Guidelines, “where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm’s length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises” (OECD Guidelines (2010), supra n. 2, at para. 1.11).

236. Conditions might differ because, for example, while they might be affected by market forces when the parties deal with one another at arm’s length, “when associated enterprises transact with each other, their commercial and financial relations may not be directly affected by external market forces in the same way [...]. When transfer pricing does not reflect market forces and the arm’s length principle, the tax liabilities of the associated enterprises and the tax revenues of the host countries could be distorted” (OECD Guidelines (2010), supra n. 2, at paras. 1.2-1.3).

237. This could “be either a comparable transaction between one party to the controlled transaction and an independent party (‘internal comparable’) or between two independent enterprises, neither of which is a party to the controlled transaction (‘external comparable’)” (OECD Guidelines (2010), supra n. 2, para. 3.24).


239. Id., at para. 1.3.

Thus, the arm’s length standard is given domestic effect by having legislatures incorporate it into their domestic tax law, although there are variations in how countries have gone about doing so. In Canada, for example, “[p]aragraphs 247(2)(a) and (c), like former subsection 69(2), is analogous to Article 9(1) of the OECD Model [...].” As the Canadian Federal Court of Appeal explained, the statutory objective: is to prevent the avoidance of tax resulting from price distortions which can arise in the context of non arm’s length relationships by reason of the community of interest shared by related parties. The elimination of these distortions by reference to objective benchmarks is all that is required to achieve the statutory objective. Otherwise all the factors which an arm’s length person in the same circumstances as the respondent would consider relevant should be taken into account.

The text of sections 69(2) and 247(2) of the Canadian Income Tax Act is set out in Appendix 3 of this article.

9.1.2.2. The OECD Guidelines: Coordinated guidance for applying the standard

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.” Similarly, the arm’s length standard under domestic law may not provide such information.

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 that are set out in the US Regulations under section 482. As for other countries, by and large they follow the OECD Guidelines, as well as domestic administrative guidance issued by tax authorities. Notably, attempts are made to coordinate the approaches taken by the US Regulations and the OECD Guidelines.
9.2. Appendix 2: Step-transaction tests
There are different ways (tests) by which a step-transaction analysis could be applied, as exemplified below by contrasting the US and Canadian approaches.

In the United States, the courts developed three different tests, any of which could be applied. According to the US Tax Court in the Superior Trading case, “[t]hese tests, in increasing degrees of permissiveness are: The binding commitment test, the end-result test, and the interdependence test.”252 The end-result test ‘focuses on the parties’ subjective intent at the time of structuring the transaction [...]. The test examines whether the formally separate steps are prearranged components of a composite transaction intended from the outset to arrive at a specific end result.”250 As for the interdependence test, it: analyzes whether the intervening steps are so interdependent that the legal relations created by one step would have been fruitless without completion of the later series of steps. If, however, intermediate steps accomplished valid and independent economic or business purposes, courts respect their independent significance.251

For an example of how these tests are applied, see the Buyuk case as adjudicated by the US Tax Court.252

The Canadian Supreme Court explained that “where [...] the Minister assumes that the tax benefit resulted from a series of transactions rather than a single transaction, it is necessary to determine if there was a series, which transactions make up the series, and whether the tax benefit resulted from the series.”255 Rather than adopting the US mutual-interdependence or end-results test,254 Canada has adopted the English common law “preordination test” for determining whether there exists a series of transactions.255 Where a statutory provision applies to a series of transactions, such as transactions affected by Canada’s GAAR in section 245 of the Income Tax Act, it is also the English common law approach that applies, although this is subject to section 248(10). Section 248(10) has broadened the common law definition of a series by ‘providing that related transactions’ completed ‘in contemplation of’ or because of the series shall be deemed to form part of the series.”256 As the Canadian Tax Court recently pointed out, ‘the Supreme Court of Canada in Copthorne Holdings Ltd. [...] mandates an expansive approach to the issue of series, given the inclusive nature of the meaning to be given to series of transactions’ in subsection 248(10).”257

9.3. Appendix 3: Extracts of sources of law

9.3.1. Article 9(1) of the OECD Model
Where
a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly [emphasis added].

9.3.2. Section 69(2) of the Canadian Income Tax Act
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 payable therefor.

9.3.3. Section 247(2) of the Canadian Income Tax Act
Transfer pricing adjustment
Where a taxpayer or a partnership and a non-resident person with whom the taxpayer or the partnership, or a member of the partnership, does not deal at arm’s length (or a partnership of which the non-resident person is a member) are participants in a transaction or a series of transactions and (a) the terms or conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm’s length, or (b) the transaction or series (i) would not have been entered into between persons dealing at arm’s length, and (ii) can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit, any amounts that, but for this section and section 245, would be determined for the purposes of this Act in respect of the taxpayer or the partnership for a taxation year or fiscal period shall be adjusted (in this section referred to as an “adjustment”) to the

250. Id., at 89.
251. Id., at 90 (internal citations omitted).
255. The test is derived from the first factor in the four prong test which was set out in Furniss v. Dawson (UK: HL, 9 Feb. 1983) (1983) UKHL 4) and adopted in Craven v. White (1989). In Craven, Lord Oliver restated these factors as follows: “(1) that the series of transactions was, at the time when the intermediate transaction was entered into, pre-ordained in order to produce a given result; (2) that that transaction had no other purpose than tax mitigation; (3) that there was at that time no practical likelihood that the preplanned events would not take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life, and (4) that the pre-ordained events did in fact take place” (sura n. 177, at 514).
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quantum or nature of the amounts that would have been determined if,
(c) where only paragraph 247(2)(a) applies, the terms and conditions made or imposed, in respect of the transaction or series, between the participants in the transaction or series had been those that would have been made between persons dealing at arm’s length, or
(d) where paragraph 247(2)(b) applies, the transaction or series entered into between the participants had been the transaction or series that would have been entered into between persons dealing at arm’s length, under terms and conditions that would have been made between persons dealing at arm’s length.258

258. Emphasis added.