The McKesson Case – A Holiday Gift from Justice Boyle of the Tax Court of Canada: Ask and You Shall Receive(able) – Canada's Latest Transfer Pricing Decision

By: Jules Lewy

On Friday, December 20th, the Tax Court of Canada released the long-awaited and lengthy decision of Justice Patrick Boyle in *McKesson Canada Corporation v. The Queen,* a case involving transfer pricing adjustments under section 247 of the *Income Tax Act* (the "Act") and the limitation period in Article 9(3) of the *Canada-Luxembourg Tax Convention*.

McKesson Canada is the principal Canadian operating company in the McKesson Group. The core business of the McKesson Group and of McKesson Canada is the wholesale distribution of "over the counter" and prescription pharmaceutical medicine products. Effective December 16, 2002 McKesson Canada and its Luxembourg parent company, MIH, entered into a Receivables Sales Agreement (the "RSA") and a Servicing Agreement. Under the RSA, MIH agreed to purchase all of McKesson Canada's eligible receivables as of that date (about $460,000,000) and committed to purchase all eligible receivables daily as they arose for the next five years unless earlier terminated as provided for in the RSA and subject to a $900,000,000 cap. The price to be paid for the receivables was at a 2.206% discount to their face amount (if one takes into account that historically receivables were paid on average within 30 days, this rate equates to an annual financing rate of approximately 27%). The Canada Revenue Agency reassessed McKesson Canada's 2003 taxation year on the basis that if the RSA had been made between arm's length parties the Discount Rate would have been 1.013% and made a transfer pricing adjustment under section 247 of the Act of $26,610,000 (the taxation year of McKesson Canada under appeal ended March 29, 2003 and was approximately three and a half months long – the annualized transfer pricing adjustment was therefore approximately $80,000,000).

The Tax Court trial lasted 32 days over a period of five months from October, 2011 to February, 2012 and following the Supreme Court of Canada's decision in *Canada v. GlaxoSmithKline Inc.* in October, 2012, both parties made further written submissions.

Under the RSA, eligible receivables were trade receivables owing by arm's length customers not in default and whose receivables would not represent in the aggregate more than 2% of McKesson Canada's then outstanding receivable pool. However, the 2% concentration limit on eligibility did not apply to McKesson Canada's largest customers who accounted for about one-third of the sales. MIH had the right to put non-performing receivables back to McKesson Canada for a price equal to 75% of the face amount to be later re-adjusted to the amount actually collected and MIH did not otherwise have recourse against McKesson Canada for unpaid purchased receivables. The receivables under the RSA were expected to be collected in a short period of time (historically, payment was made by customers in 30 days) and the historical bad debt experience was .043%.

Under the Servicing Agreement, McKesson Canada agreed to service the accounts receivable and received a servicing fee of $9,600,000 annually regardless of the amount outstanding. The amount paid under the Servicing Agreement was not challenged by the CRA.

The amount payable for a purchased receivable under the RSA was determined by multiplying the face amount of the receivable by one minus the Discount Rate. The Discount Rate was defined to be the sum of (a) the Yield Rate which was equal to the 30 day Canadian dollar banker's acceptance (BA) rate or the Canadian dealer offered rate (CDOR) on the first business day of the relevant settlement plus (b) the Loss Discount which was intended to reflect the credit risk of the McKesson Canada customers whose receivables were covered by the RSA and was set at 0.23 for the year under appeal. For the remaining term of the RSA commencing January 1, 2004, the Loss Discount was to be recalculated as often as MIH considered necessary based on the credit risk of certain customers plus (c) the Discount Spread which was set at the fixed rate of 1.7305% and related to the risk that (i) McKesson Canada's credit worthiness deteriorated significantly and receivable debtors might set off their rebate entitlements in such event, (ii) the risk that McKesson Canada's customers might increase their take-up of available prompt payment discounts, (iii) the risk that MIH might decide to appoint a new service provider who would require a greater servicing fee, and (iv) the need for the Discount Rate to fully cover MIH's cost of funds.

Toronto Dominion Securities Inc. ("TDSI") was retained by counsel for McKesson Canada to provide advice on the arm's lengths aspects of certain terms and conditions of the RSA and certain components of the Discount Rate calculation at the time the RSA was entered into. The TDSI reports were relied on by McKesson Canada as contemporaneous documentation and, therefore, a transfer pricing penalty under subsection 247(3) of the Act was not assessed by the CRA (had there been no contemporaneous documentation, McKesson Canada would have been automatically subject to a penalty of 10% of the transfer pricing adjustment). Interestingly, Justice Boyle states in a footnote that the CRA may need to review its threshold criteria in respect of contemporaneous documentation under subsection 247(4) of the Act and that he would not "have expected last minute, rushed, not fully informed, paid advocacy that was not made available to the Canadian taxpayer and not read by its parent would satisfy the contemporaneous documentation requirements."

Justice Boyle stated that the CRA reassessment was made under paragraphs 247(2)(a) and (c) of the Act and that the task of the Court was to determine whether the terms and conditions of the transactions carried out by the parties resulted in a Discount Rate that was within the range of what McKesson Canada and MIH would have agreed to, had their transaction applied terms and conditions which persons dealing at arm's length would have used. Interestingly, in light of recent OECD discussion papers, he noted that the CRA did not directly or indirectly raise "any fair share or fiscal morality arguments that are currently trendy in international tax circles" and that "it wisely stuck strictly to the tax fundamentals: the relevant provisions of the legislation and the evidence relevant thereto". He noted that issues of fiscal morality and fair share are within the realm of Parliament.

Justice Boyle sets out in detail the evidence from the two material witnesses and the five expert witnesses who testified and criticizes much of the expert evidence. In respect of the transfer pricing report prepared by a major accounting firm in 2005 in response to the CRA's review of the RSA transaction, he states that the report was primarily a piece of advocacy work, "perhaps largely made as instructed" and that the examples used by the accounting firm resulted in

"picking and choosing" and mixing and matching the performance of the receivable pools which resulted in "transparently poor advocacy and even more questionable valuation opinions".

Mr. Justice Boyle also criticized the taxpayer in respect of the manner in which the appeal was undertaken "Overall I can say that never have I seen so much time and effort by an Appellant to put forward such an untenable position so strongly and seriously. This had all the appearances of alchemy in reverse."

In determining the appropriate methodology to determine the Discount Rate, Justice Boyle did not accept the conclusions of any of the experts or their reports in their entirety although he acknowledged that the Court's analysis was informed by the testimony and information provided by the witnesses. He notes that the purpose of the RSA transaction was to reduce McKesson Canada's Canadian tax liability by paying the maximum under the RSA that was justifiable (interestingly, McKesson Canada had been profitable for the years prior to the RSA but after the RSA was executed, McKesson Canada operated at a loss) and that there is nothing wrong with taxpayers engaging in "tax-oriented transactions, tax planning, and making decisions based entirely upon tax consequences (subject only to GAAR which is not relevant to this appeal)". However, Justice Boyle also notes that the reasons for, and predominant purposes of, non-arm's length transactions form a relevant part of the factual context being considered.

He then reviewed the various elements of the Discount Rate. In respect of the Yield Rate, he accepted that the 30 day CDOR rate is appropriate. However, for the period in question, he stated that it was necessary to review the historical evidence in respect of when payment would be made and that the parties should have taken into account the fact that the first period had a "missing" fifteen days because the agreement was entered into in the middle of the month. In respect to the Loss Discount which was fixed by the RSA at 0.23% Justice Boyle stated that this should be based on historical data which showed write-offs of approximately 0.04% and even if the parties provided a buffer of 50% to 100% increase in write-offs, the Loss Discount would be in the range of 0.6% to 0.8%. In respect of the Discount Spread, Justice Boyle looked at the various elements which were included in this number and based on the historical data and the facts provided, stated that the servicing discount risk would be in the range of 0.17% to 0.25%, the prompt payment dilution discount would be 0.5% to 0.53%, the accrued rebate dilutions discount (which involves a customer paying a lesser amount in respect of its accounts taking into account an expected rebate) was not justified and that the interest discount which was intended to provide MIH with a return from a discounted purchase of receivables would be between 0.0% and 0.08% for a total Discount Rate range of 0.959% to 1.17%. Accordingly, because the taxpayer did not rebut the CRA's assumptions in respect of a reasonable Discount Rate, the taxpayer's appeal in respect of the CRA's transfer pricing adjustment was rejected.

The second issue reviewed by the Court involves the shareholder benefit and withholding tax on the deemed dividend which resulted from the excess amount paid by McKesson Canada to its Luxembourg parent MIH under paragraph 214(3)(a) and subsection 15(1) of the Act. By utilising a Discount Rate which was greater than an arm's length rate, McKesson Canada provided a benefit to MIH which is to be treated as a deemed dividend and is subject to non-resident withholding tax and McKesson Canada was jointly liable with MIH for the withholding tax under subsection 215(6) of the Act. The taxpayer did not deny this liability but stated that it was statute-barred because the *Canada-Luxembourg Tax Convention* specifically provided for a five-year limitation period (Article 9 (3)) and the reassessment of McKesson Canada in respect of withholding tax was issued after this period. Justice Boyle held that because Article 9(3) of the Convention only deals with Article 9(1) of the Convention in respect of transfer pricing

adjustments and not deemed dividends and because there was no evidence that MIH was subject to any “extra tax” in Luxembourg because of the deemed dividend, the five-year time limit in Article 9(3) does not apply and, therefore, the withholding tax assessed against McKesson Canada was not subject to the limitation period in the Convention. Therefore the taxpayer’s appeal in respect of withholding tax was also dismissed.

As noted above, the decision is a lengthy one (probably one of the lengthiest Tax Court decisions). In his final footnote, Justice Boyle apologizes for the length of the decision and quoting Lord Neuberger of Abbotsbury from a 2013 address, states:

“we seem to feel the need to deal with every aspect of every point that is argued, that makes the judgement often difficult and unrewarding to follow. Reading some judgements one rather loses the will to live – and that is particularly disconcerting when it’s your own judgment that you are reading”.

It will be interesting to see whether McKesson Canada decides to appeal this decision and if it does so, how Justice Boyle’s decision will be dealt with by the Federal Court of Appeal.

This article originally appeared in: http://www.canadiantaxlitigation.com/the-mckesson-case-a-holiday-gift-from-justice-boyle-of-the-tax-court-of-canada-ask-and-you-shall-receiveable-canadas-latest-transfer-pricing-decision