

Canada: McKesson decision issued regarding transfer pricing adjustment and non-resident withholding tax liability

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In brief

On December 13, 2013 the Tax Court of Canada (TCC) made its decision in *McKesson Canada Corporation v Her Majesty the Queen*. The primary issue was a transfer pricing adjustment made by the Canada Revenue Agency (CRA) to McKesson Canada Corporation's (MCC's) income under paragraphs 247(2)(a) and (c) of the Income Tax Act (the Act). The adjustment was related to trade receivables factoring transactions involving MCC and its immediate parent company MIH, a company resident in Luxembourg, during the 2003 tax year. The secondary issue was MCC's liability under the Act for its failure to withhold and remit to CRA an amount equal to the Part XIII non-resident withholding tax resulting from the disallowed amounts paid by MCC to MIH.

The Court dismissed the appeal with respect to both issues and made a number of comments related to transfer pricing that are of general interest to taxpayers. MCC has 90 days to appeal the decision.

The facts of the case and the Court's judgment on the primary and secondary issues are summarized below, along with a summary of PwC's observations. A more detailed PwC analysis of the general observations will follow.

In detail

The case

MCC's core business is the wholesale distribution of over-the-counter and prescription pharmaceutical products. The ultimate parent of MCC is McKesson Corporation, a public company resident in the US and

on the Fortune 20 list of companies.

On December 16, 2002, MCC entered into a Receivables Sales Agreement (RSA) and a Servicing Agreement with MIH. Under the terms of the RSA, MIH agreed to purchase all of MCC's eligible receivables as at

the date of the facility (approximately \$460 million), with a commitment to continue to purchase these receivables daily for the next five years subject to a cap of \$900 million unless the RSA was terminated.¹

¹ Eligible receivables were generally receivables of a third party customer that was not in default and whose receivables typically represented less than 2% of the outstanding receivables pool.

Under the RSA, MIH purchased these receivables at a discount of 2.206% from the face amount. The CRA's transfer pricing adjustment was approximately \$26,610,000, which is consistent with a discount of 1.013% on the purchased receivables.

The sole question considered by the Court was the amount that an arm's length party would have been willing to pay for the rights and benefits obtained

The decision

The Court determined that its decision should be based on the legal structure of the RSA and whether the terms and conditions that affect the discount rate were different from arm's length terms and conditions. All alternative methodologies proposed were rejected.

Specifically, the Court considered each component of the discount rate included in the RSA, i.e., the yield rate, the loss discount, and the discount spread (the sum of which equal the discount rate).

The Court did not dispute the yield rate, which represented the cost of financing, but stated it was necessary to make an adjustment to reflect that the RSA was entered into in the middle of a month and therefore the yield rate used to calculate the initial payment should be adjusted accordingly.

The Court did not accept the loss discount rate, which represented compensation for credit risk related to the receivables, stating that it should be based on actual write-offs taken. The Court did permit an increase to the historical default rate to allow for potential future increases in defaults.

The discount spread was the sum of four components: a servicing discount, a prompt payment dilutions discount, an accrued rebate dilutions

discount, and an interest discount. The servicing discount and prompt payment dilutions discount were adjusted downward by the Court based on historical data related to the receivables. The Court rejected the inclusion of an accrued rebate dilutions discount on the basis that a seller of receivables would not agree to provide an arm's length purchaser with a discount that reflects the possibility of a rebate being claimed by a third party customer. The Court also adjusted the interest discount, rejecting the claim that it was appropriate for MIH to receive a discount related to MIH's cost of capital.

The Court concluded that the arm's length discount rate was between 0.959% and 1.17%. As the taxpayer's rate of 2.206% was outside this range, and the CRA's rate of 1.013% was in the range, the Court rejected the taxpayer's appeal. The Court did not feel the need to reassess MCC's tax obligation based on the higher end of its discount rate range (1.17%) rather than the discount rate of 1.013% used by CRA.

Part XIII Assessment

On April 15, 2008, MCC was issued a Part XIII reassessment related to the shareholder benefit it provided to MIH resulting from the non-arm's length discount rate provided for in the RCA. The amount of this benefit is deemed to have been a dividend paid by MCC to MIH and is subject to non-resident withholding tax under paragraph 214(3)(a) and subsection 15(1) of the Act. MCC was jointly liable for the withholding tax under subsection 215(6) of the Act.

MCC did not contest that there was a requirement to withhold at the rate set out in the Canada-Luxembourg treaty (the "Treaty") but submitted that it was not liable for payments related to the 2003 taxation year, as

Article 9(3) of the Treaty includes a five calendar year limitation on assessing tax on certain transfer pricing adjustment income (i.e., the Part XIII assessment was issued outside of the five-year period).

The Court dismissed the taxpayer's appeal on this issue on the basis that the deemed dividend was not an amount of income that would have accrued to MIH had an arm's length discount rate been used and therefore the five-year limitation did not apply.

The takeaway

PwC observes

There are several important observations that can be made from the 100-page judgment. The Court (i.e., Justice Boyle) made several transfer pricing related comments that, while relevant to the case, were not all required to support the judgment. The issues raised include the following:

- The relevance of the OECD Guidelines in a court proceeding.
- The relevance of the series of transactions that relate to the transaction.
- The scope of transfer pricing adjustments under subparagraphs 247(2)(a) and (c) and whether the adjustments are limited to quantum versus terms.
- The requirement of the Court to consider factors that exist only because of a non-arm's length relationship.
- The requirement of the Court to consider alternative options available to the taxpayers.
- The requirement of the Court to consider the purpose of the transaction and issues related to the "fair share of tax" debate.

- Contemporaneous documentation and “reasonable efforts” under subparagraph 247(4). A more detailed PwC analysis of these observations will follow.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Transfer Pricing and Tax Controversy

Charles Thériault, *Toronto*
+1 416 687 8262
charles.theriault@ca.pwc.com

Jeff Rogers, *Toronto*
+1 416 815-5271
jeff.rogers@ca.pwc.com

Andrew Paton, *Toronto*
+1 416 687 8529
andrew.paton@ca.pwc.com

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