APPENDIX 63 (RE MERCK AND PARAGRAPH 247(2)(b))

Material:

Dale C. Hill, Santino Di Libero, and Jamal Hejazi, "Moving Intellectual Property Offshore in a Transfer Pricing Setting", *Tax Notes International*, Volume 48, Number 7, November 12, 2007, p. 683

Nathan Boidman, "Is Canada Misusing Recharacterization Rule in Merck Transfer Pricing Dispute?", *Tax Notes International*, Volume 48, Number 8, November 19, 2007, p. 783

Brian Bloom, "Paragraph 247(2)*(b)* Demystified", *Tax Topics*, CCH, May 11, 2006, Number 1783

Merck & Co., Inc., Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, For the Fiscal Year Ended December 31, 2007, United States Securities and Exchange Commission, Form 10-K (brief extract)

Merck & Co., Inc., Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, For the quarterly period ended September 30, 2008, United States Securities and Exchange Commission, Form 10-Q (brief extract)

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Moving Intellectual Property Offshore in a Transfer Pricing Setting

by Dale C. Hill, Santino Di Libero, and Jamal Hejazi

Reprinted from *Tax Notes Int'l*, November 12, 2007, p. 683

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Practitioners' Corner

Moving Intellectual Property Offshore in a Transfer Pricing Setting

by Dale C. Hill, Santino Di Libero, and Jamal Hejazi

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If a multinational corporation had the luxury of perfect hindsight, it would optimize its global positioning and operational efficiencies by migrating intangible assets before those assets proved valuable. Most companies, however, do not have that luxury, and the decision to migrate assets often comes well after their value is realized. In light of this, it comes as little surprise that governments are increasingly considering crackdowns on tax havens as more and more multinational organizations move profits offshore to low-tax jurisdictions.

The Canada Revenue Agency and other tax authorities have stepped up enforcement activities related to various industries, including the pharmaceutical sector, that employ valuable intellectual property (IP). The CRA announced in 2005 that it had set up 11 centers of expertise to deal with aggressive international tax planning. These centers, located in regional tax services offices across Canada, bring together international tax auditors and tax avoidance officers. One of the priorities of the centers is to develop new ways to address aggressive international transactions. A major target in the CRA's audit compliance reviews is transfer pricing transactions, specifically the migration of IP.

With increased resources available to it, the CRA is combining its rapidly improving knowledge of transfer pricing disciplines with improved legislative powers to raise transfer pricing adjustments within the pharmaceutical industry.

From a tax perspective, any financial planning that involves multinational corporations moving profits offshore can be justified if the corresponding functions, assets, and risks borne to earn these profits are also shifted offshore and if the appropriate buy-in payments have been made. The world economy has become increasingly globalized, and the need to maximize after-tax profits is not only advantageous to improving corporate profits, it is also necessary to remain competitive. Although implementing such a framework is a long and complex process, it can result in material tax savings.

The Merck Case

Although there are many clear benefits to migrating intangibles, the strategy poses risks, including the potential for significant transfer pricing adjustments. Ideally, intangibles should be migrated when they do not possess considerable economic value.

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However, as stated earlier, companies do not have the benefit of hindsight and often decide to migrate after the intangibles prove valuable.

During transfer pricing audits, tax authorities have used existing legislation (for example, section 247(2)(b) of the Canada Income Tax Act) to recharacterize related-party transactions after settlement negotiations have broken down, resulting in transfer pricing adjustments.

The power of governments to recharacterize a particular transaction was seen in the recent transfer pricing dispute between the CRA and Merck Frosst Canada (Merck). The CRA examined Merck's tax returns from 1998 through 2004 and reassessed Merck for "adjustments related to certain intercompany pricing matters." On October 10, 2006, the CRA issued a notice of reassessment related to various intercompany transactions totaling US $1.4 billion plus US $360 million in interest. Although all details of the case are not known, Montreal's *La Presse* reported in October 2006 that the adjustments relate to Merck's patent for its asthma drug Singulair. The drug, developed in Quebec, generated sales of US $950 million in the second quarter of 2006. The patent was later transferred to Barbados. Given the considerable size of the adjustment, it can be surmised that the negotiations between the CRA and Merck have not resulted in an acceptable resolution. Consequently, the CRA has used its ability to apply existing legislation to recharacterize the transaction as if the transaction did not occur, thus raising the corresponding adjustment.

Although the dispute with Merck has yet to be resolved, the financial resources required to handle such a dispute can be daunting. Merck could be required to post a deposit of up to half of the tax and interest assessed.

Migrating Intangibles

Tax authorities around the world have begun to target structures that migrate profits offshore. As a result, multinational companies need to ensure that their documentation is sufficient to support the migration of valuable intangibles and the profits they drive.

Three methods commonly used to migrate these intangibles assets are:

- cost-sharing agreements (CSAs);
- buy-in payments; and
- sale of intangibles.

Cost-Sharing Agreements

CSAs are one of the most effective ways to migrate intangibles. A CSA is an agreement between two parties that defines the contributions each party will make in terms of costs expended and the associated benefits that will be returned to the parties for such an investment. For a CSA to be effective, the following are necessary:

- the CSA must make business and economic sense;
- it must include upfront and well-documented terms;
- it must indicate costs incurred by each party relative to the reasonability of expected profits; and
- if providing entry, exit, or termination of a CSA, provisions must involve arm's-length prices.

Failure on the part of companies to draft effective CSAs serves only to increase audit risk. In this respect, great care must be taken to ensure that CSAs make both economic and business sense.

CSAs are often found in industries that require substantial research and development activities, such as the pharmaceutical industry. In such an industry, some of the costs associated with performing the R&D activities are incurred in low-tax jurisdictions. Given these related parties pay for a portion of the R&D, they are entitled to exploit an interest in the intellectual property that was developed. As a result, no royalty on the CSA must be paid.

Buy-In/Buy-Out

Buy-in/buy-out payments are another way to migrate intangible income offshore. Buy-in payments require a party in a related-party setting to buy into a CSA or buy out of one. To do so, the buy-in/buy-out payments must be payments that represent arm's-length prices. Buy-in options are valuable given they provide many opportunities considering associated risks, and must be reflected in the price. Subsidiaries must pay fair market value to buy in. Failure to do so will increase the firm's audit risk for an unfavorable audit.

Sale of Intangibles

The final approach regarding the migration of intangibles is through the sale of intangibles. Intangibles are a large source of profits, and selling them to offshore affiliates will help build support for the argument that profits generated from these assets should be taxed in these offshore jurisdictions. It is important, as in the other two cases above, to ensure that this is done at arm's length. Determining the arm's-length sale of intangibles is complicated. The most common way of determining the price at which this should be transacted involves the comparable uncontrolled price method. The CUP method requires finding external comparables that involve the sale of similar intangibles, which is often difficult to achieve.

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Conclusion

The migration of intangibles is an acceptable tool in an effort to maximize after-tax profits. However, doing so normally requires the migration of functions, assets, and risks. One should be cautioned that for intangibles that have proven valuable and subsequently migrated, tax authorities will certainly be on the alert to scrutinize the transactions, as the Merck case has shown. It is imperative that any strategic decision to transfer intangibles be supported by comprehensive transfer pricing documentation that incorporates as much evidence as possible supporting an arm's-length price. ◆

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Is Canada Misusing Recharacterization Rule in Merck Transfer Pricing Dispute?

by Nathan Boidman

Reprinted from *Tax Notes Int'l*, November 19, 2007, p. 783

Letters to the Editor

Is Canada Misusing Recharacterization Rule in Merck Transfer Pricing Dispute?

To the Editor:

In their November 12 article (Dale C. Hill, Santino Di Libero, and Jamal Hejazi, "Moving Intellectual Property Offshore in a Transfer Pricing Setting," *Tax Notes Int'l*, Nov. 12, 2007, p. 683) concerning Canada's US $1.760 billion (tax and interest) reassessment of Merck's Canadian subsidiary (Merck Canada), apparently related to Merck Canada's transfer of its patent for its asthma drug, Singulair, to a Barbados affiliate, the authors state that " . . . CRA has use its ability to apply existing legislation to recharacterize the transaction as if the transaction did not occur, thus raising the corresponding adjustment" (at page 684).

Although, as the authors note, the full facts about the Merck Canada dispute are not known at this juncture, a word is in order concerning the notion that the CRA initiative apparently has been based on a recharacterization rule (section 247(2)(b) of the *Canadian Income Tax Act*), which has been described in an article by my partner, Brian Bloom (one of the principal drafters, in 1998, of Canada's current transfer pricing rules, of which 247(2)(b) is a part), as follows:

> Tucked away in the deep recesses of the *Income Tax Act* (the "Act"), obscured by the long shadows cast by the neighbouring general anti-avoidance rule in section 245 of the Act (the "GAAR"), is paragraph 247(2)(b), an arcane recharacterization rule whose genesis, purposes and ambit are shrouded in mystery. The purpose of this article is to demystify paragraph 247(2)(b) and thereby (hopefully) provide some much needed guidance to practitioners and the Canada Revenue Agency (the "CRA") alike in terms of that provision's intended application. (See Brian Bloom, "Paragraph 247(2)(b) Demystified," *Tax Topics*, CCH [Canada], May 11, 2006, Number 1783, at page 1).

Brian went on to write that this rule [which requires according to the Act, a transaction that "*(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*"], was added to the transfer pricing rules only because it was considered to be *authorized* by paragraphs 1.36 and 1.37 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 1995, and was intended to be governed by the extremely narrow ambit thereof that was established in those guidelines.

What is germane here in that context and in light of the plain language of section 247(2)(b) are three aspects of the OECD guidelines. First, the guidelines state: "[I]n other than exceptional cases, the tax administration should not disregard the actual transactions or substitute transactions for them." Second, as Brian wrote in his CCH article, the Canadian rule requires two components:

> First, the transaction must be one that, when viewed as a whole, would not have been one that would have been entered into by independent enterprises behaving in a commercially

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rational manner. In other words, the transaction must be one that is manifestly contrary to the commercial interests of the tested party. Second, the transaction must have been structured in this commercially irrational manner in order to impede the tax authorities' ability to determine an arm's length price under 'normal' transfer pricing rules or to achieve some other tax benefit for the tested party. The application of normal transfer pricing rules is impeded because there are no arm's length comparables upon which to base a transfer pricing assessment.

The third element, which seemingly would have a direct relevance to the Merck dispute, is that in Brian's words, "[T]he example, given in the Revised Guidelines is that of the current sale by a taxpayer for a lump sum amount of all future intellectual property (*in contradistinction to existing intellectual property*) developed by the taxpayer in a subsequent period." (Emphasis added).

It is obvious from the foregoing, that it is not *the mere absence of comparable prices* that makes applicable this recharacterization rule, but rather *the absence of a comparable type of transaction.*

Therefore, if it turns out that in the Merck Canada dispute there was merely a full outright transfer, for a particular price, of existing and perfected intangibles, *and not a sale of future intangibles to be developed by the Canadian company*, there should in fact, be no role for the recharacterization rule of paragraph 247(2)(b), a rule which, in Brian's words, was enacted:

> . . . to ensure that the revised Canadian transfer pricing rules in section 247 of the Act can be applied in an effective manner to irrational transactions for which no arm's length comparables exist, where the particular form of the transaction was selected by the parties to thwart the effective application of such rules to the tested party.

Finally (a point also noted in Brian's article) a disconnect appears to have developed between the current assessing practices of CRA (if it is correct that (1) the Merck transaction saw a mere outright assignment of an intangible, and (2) CRA has reassessed based on section 247(2)(b)) and CRA's own views about the very limited ambit of section 247(2)(b) set out in Information Circular 87-2R, which was released in September 1999, just after the enactment of the revisions to Canada's transfer pricing rules. It is for this very reason that Brian in his CCH piece sought to "demystify" this "arcane rule" for both practitioners and CRA, with the hope that the latter would restrict its use of the rule to the narrow circumstances intended if unnecessary litigation is to be avoided. The Merck Canada dispute indicates that CRA has yet to read Brian's article.

This Canadian dispute reflects, of course, perhaps the most controversial aspect of international transfer pricing, one which was the object of one of the two principal subjects studied at the recently concluded annual congress of the International Fiscal Association in Kyoto [*Cahiers de droit fiscal international*, IFA, Volume 92a, Transfer Pricing and Intangibles, General Report by Toshio Miyatake, (Japan)]. Not surprisingly, a summary of the panel discussions of the subject matter (Giammarco Cottani, "IFA, 61st Congress in Kyoto, Subject I: Plenary Session — Transfer Pricing and Intangibles" IBFD, Tax News Services, 22 October 2007, Volume 41, Issues 43, page 457) focused on the role of paragraphs 1.36 and 1.37 of the OECD guidelines and, particularly, the tax authorities' inability to make the *critical distinction* between the issue of whether a transaction does not comport with an arm's-length-type transaction (which can attract recharacterization) and an issue of whether an intercompany transaction has not been priced on an arm's-length basis (which does not attract recharacterization). ◆

Yours sincerely,

Nathan Boidman
Davies Ward Phillips & Vineberg LLP
Montreal, Canada
November 14, 2007

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Paragraph 247(2)(*b*) Demystified[1]

Tucked away in the deep recesses of the *Income Tax Act* (the "Act"),[2] obscured by the long shadows cast by the neighbouring general anti-avoidance rule in section 245 of the Act (the "GAAR"), is paragraph 247(2)(*b*),[3] an arcane recharacterization rule whose genesis, purpose and ambit are shrouded in mystery. The purpose of this article is to demystify paragraph 247(2)(*b*) and thereby (hopefully) provide some much needed guidance to practitioners and the Canada Revenue Agency (the "CRA") alike in terms of that provision's intended application.

The OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* were extensively revised in 1995 (the "Revised Guidelines"). The Revised Guidelines provide that, in exceptional circumstances, it is permissible for tax administrators to recharacterize or reconstitute transactions themselves, rather than merely adjust the terms of such transactions:

> In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute transactions for them ... However, there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction.[4]

These statements in the Revised Guidelines served as the Department of Finance's "authority" for enacting the recharacterization rule in paragraph 247(2)(*b*). In other words, but for these statements, paragraph 247(2)(*b*) would not have been enacted. Accordingly, paragraph 247(2)(*b*) is not intended to apply in circumstances other than those identified in the Revised Guidelines.[5]

As noted, the Revised Guidelines set forth two circumstances where it is permissible for tax authorities to proceed in this exceptional manner.

Inside

2006 Federal Budget ... 5
Technical News No. 34 5
Revised Guides 5
Revised Forms 5
Commentary Revisions 5
Recent Cases........... 5
Twelve recent cases on a variety of issues including SR&ED activities, the application of GAAR to a tax-free return of capital, criteria used to determine an "eligible individual" for GST credits and the Canada Child Tax Benefit, and the definition of "eligible relocation" for purposes of a deduction for moving expenses

The first circumstance is where the form of the transaction belies its substance. The example provided in the Revised Guidelines is the making of a loan by a taxpayer to a non-arm's length person, where, having regard to the economic situation of the borrower, the investment appears to be an economic substitute for share capital. The Revised Guidelines are thus alluding to a thin capitalization type situation.[6] Another example of this first circumstance (albeit outside of the transfer pricing context) is provided by the *Imperial Oil* case.[7] In that case, the taxpayer lent money to a non-bank subsidiary of a bank, on the strength of the bank's loan guarantee. The taxpayer lent the money in this manner, rather than directly to the bank, because a loan to a bank would not have given rise to an investment allowance for capital tax purposes. Therefore, while the transaction's legal form was a loan to a subsidiary of a bank, its economic substance was, arguably, a loan to a bank.

The Department of Finance and the CRA considered whether the new transfer pricing rules should apply to these types of transactions, i.e., transactions where the form belies the substance, and concluded that they should not, as such transactions were more appropriately dealt with by specific anti-avoidance rules or the GAAR. In arriving at this conclusion, consideration was given to the relationship between transfer pricing rules, on the one hand, and specific anti-avoidance rules and the GAAR, on the other hand. It was determined that transfer pricing rules were not intended to bolster or supplement specific anti-avoidance rules,[8] since this would create uncertainty as to the application of those rules and would effectively permit the CRA to bypass or supplant the protections afforded taxpayers by subsection 245(4). More specifically, it was felt that the types of transactions described by the first circumstance should *not* be recharacterized, unless they constituted a misuse of the provisions of the Act or an abuse of the Act when read as a whole within the meaning of subsection 245(4) (the "misuse or abuse" tests).[9] Indeed, to apply the transfer pricing rules in this "substance versus form" context would usurp the role of the GAAR and render subsection 245(4) virtually meaningless in those situations (but only those situations) where the transaction or series involves a non-arm's length non-resident. Plainly, this was not the result sought by Finance in enacting paragraph 247(2)(*b*).

That paragraph 247(2)(*b*) is not intended to apply in this context is confirmed by the wording of the provision itself, which, as explained more fully below, does not seek to ascertain if a particular transaction or series is a substitute for a different, arm's length transaction or series, but rather whether the particular transaction or series has no such arm's length substitutes. That wording is as follows:[10]

> (*b*) the transaction or series
>
> (i) would not have been entered into between persons dealing at arm's length ...

Consequently, transactions contemplated by the first circumstance are not intended to come within the ambit of paragraph 247(2)(*b*). This means, for example, that, even if the Act did not contain any thin capitalization rules, paragraph 247(2)(*b*) would not serve as a basis to recharacterize loans made by non-arm's length non-residents to resident corporations or trusts.

The second circumstance contemplated in the Revised Guidelines has two components. Firstly, the transaction must be one that, when viewed as a whole, would not have been one that would have been entered into by independent enterprises behaving in a commercially rational manner. In other words, the transaction must be one that is manifestly contrary to the commercial interests of the tested party. Secondly, the transaction must have been structured in this commercially irrational manner in order to impede the tax authorities' ability to determine an arm's length price under "normal" transfer pricing rules or to achieve some other tax benefit for the tested party. The application of normal transfer pricing rules is impeded because there are no arm's length comparables upon which to base a transfer pricing assessment.[11]

The two-part test in paragraph 247(2)(*b*) is intended to parallel the above-described two-part test in the Revised Guidelines.[12]

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The example given in the Revised Guidelines is that of the current sale by a taxpayer for a lump sum amount of all future intellectual property (in contradistinction to existing intellectual property) developed by the taxpayer in a subsequent period. This same example is discussed at paragraphs 150 and 151 of Information Circular 87-2R, which deals with international transfer pricing:

> 150. As outlined in paragraph 43 of this circular, the Department generally accepts business transactions as they are structured by the parties. However, the OECD Guidelines identify two types of situations where the recharacterization of a transaction would be considered. One situation identified by the OECD is a sale under a long-term contract, for a lump-sum payment, of unlimited entitlement to intangible property arising as result of future research.
>
> 151. The Department will review any long-term agreements between non-arm's length parties for the right to use intangibles to ensure that they are consistent with the arm's length principle. Paragraph 247(2)(*b*) provides for an adjustment where the Department determines that:
>
> - a long-term sale of intangible property would not have been entered into between persons dealing at arm's length; and
> - the sale was not entered into primarily for *bona fide* purposes other than to obtain a tax benefit.
>
> For example, it may be appropriate in such a situation for the Department to modify the amounts for purposes of the Act on the basis of an alternative transaction whose form, nature, terms, and conditions correspond to what arm's length parties would have agreed to – to reflect an ongoing research agreement.

The specific reason this particular transaction may be recharacterized is touched on at paragraph 1.10 of the Revised Guidelines: "For example, an independent enterprise may not be willing to sell an intangible (e.g. the right to exploit the fruits of all future research) for a fixed price if the profit potential of the intangible cannot be adequately estimated and there are other means of exploiting the intangible". More specifically, absent parameters as to (i) the type of research to be conducted, (ii) the nature of the technology expected to result from the research, and (iii) the potential market for such technology, it is virtually impossible to set a price for the future technology currently agreed to be sold. Therefore, absent the above-listed parameters, this may be an irrational transaction in which arm's length parties, in particular the transferor, would not participate. Conversely, if those parameters are present, the transaction should not be recharacterized, as it would be possible to adequately or rationally estimate the future technology's profit potential.

Both the Information Circular and the Revised Guidelines state that, if recharacterization of this transaction is appropriate, then it may be appropriate to treat the transaction as a continuing or ongoing research agreement. The Revised Guidelines shed some light on what this means by noting that, notwithstanding such recharacterization, it may be proper to respect the transaction as a transfer of commercial property.[13] If the transfer of (rights to such future) property is to be respected, but it is not rational to set a fixed price therefor currently, absent the parameters listed above, then it follows that arm's length parties would probably have agreed to the payment of a royalty by the transferee based on future revenues generated by the transferee from the resulting future property's exploitation.

The Department of Finance and the CRA considered how the GAAR's misuse or abuse tests would apply to this particular transaction. They concluded that the misuse test was probably irrelevant, since no specific provision of the Act was being misused. Although the abuse test was thought to be relevant, it probably did not apply either, since, based on the *Stubart* case,[14] the Act did not contain a general scheme against tax-motivated transactions.[15] Neither could it be said that the Act contained a general scheme against commercially irrational transactions.[16] Nevertheless, it was decided that, as a matter of tax policy, the CRA should not need to rely on the GAAR in this case, as it should be able to recharacterize such a transaction, if structured in this manner to specifically thwart the application of the normal transfer pricing rules.[17] Accordingly, it is this type of transaction, and only this type of transaction, that is intended to come within the ambit of paragraph 247(2)(*b*).

The specific purpose of paragraph 247(2)(*b*), therefore, is to ensure that the revised Canadian transfer pricing rules in section 247 of the Act can be applied in an effective manner to irrational transactions for which no arm's length comparables exist, where the particular form of the transaction was selected by the parties to thwart the effective application of such rules to the tested party. While it was felt that the "primary" transfer pricing rule in paragraph 247(2)(*a*) could, in theory, apply in those types of situations, it was recognized that the resulting adjustments would be too arbitrary to serve as the basis for a transfer pricing assessment, and that such an approach would effectively be playing into the hands of the taxpayer. That being said, it was also recognized that the recharacterization of a real transaction into a notional arm's length transaction would lead to equally arbitrary results, and thus that it would be improper to use the recharacterization power in circumstances other than the one, exceptional circumstance identified above. This sentiment is evident in paragraphs 43 and 44 of the Information Circular:

> 43. The Department generally accepts business transactions as they are structured by the parties. The fact that a taxpayer has entered into a transaction with a non-arm's length non-resident party in a form that would not exist between arm's length parties does not necessarily imply that the transaction is inconsistent with the arm's length principle. This may reflect the fact that parties not

dealing at arm's length operate under different commercial circumstances than do parties transacting at arm's length.

44. There are instances where it is necessary to recharacterize a transaction for tax purposes; however, as indicated in the OECD Guidelines, those instances are limited. The OECD Guidelines identify two exceptional situations when the recharacterization of a transaction would be considered (see paragraph 1.37 of the OECD Guidelines).[18]

and is echoed in the OECD's admonition to overzealous tax administrators in this regard:

> In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured.[19]

Hopefully, the Transfer Pricing Review Committee, which is the CRA body entrusted with ensuring the fair and consistent application of paragraph 247(2)(*b*) and the body to which all proposed assessments under this provision must be referred, will heed these cautionary words.

– Brian Bloom, Davies Ward Phillips & Vineberg LLP

Notes:

[1] Although the author was a member of the Tax Legislation Division of the Department of Finance at the time the new Canadian transfer pricing rules were formulated, the views expressed in this article are entirely his own and may or may not represent the views of the Department of Finance or the Canada Revenue Agency on the matters discussed. The author would like to thank Nathan Boidman for his valuable suggestions, but is solely responsible for any errors that may have crept into this article despite the author's best efforts.

[2] R.S.C. 1985 (5th supp.), c. 1.

[3] The relevant portion of subsection 247(2) is as follows:

"Where a taxpayer (. . .) and a non-resident person with whom the taxpayer (. . .) does not deal at arm's length are participants in a transaction or a series of transactions and (. . .)

(*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 *bone 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 (. . .) for a taxation year (. . .) shall be adjusted (in this section referred to as an "adjustment") to the quantum or nature of the amounts that would have been determined if, (. . .)

(*d*) where paragraph (*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".

[4] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, 1995, at paragraphs 1.36 and 1.37.

[5] Indeed, the explicit use of the arm's length principle in subsection 247(2), the penalty provision in subsection 247(3) and the documentation requirements in subsection 247(4) were all things that Finance believed were "authorized" by the Revised Guidelines.

[6] One can infer from the Revised Guidelines that where thin capitalization rules exist, they would apply to the exclusion of any recharacterization rules.

[7] *Her Majesty the Queen v. Imperial Oil Limited*, 2004 DTC 6044.

[8] See paragraph 21 of Information Circular 87-2R in this regard.

[9] Paragraph 20 of Information Circular 87-2R states the following:

"20. In addition to affecting the cross-border movement of property and services, section 247 could be applied to financial transactions. In theory, section 247 could be applied to a wide variety of arrangements resulting in foreign accrual property income to Canadian shareholders. In general, the Department considers that subsection 247(2) does not change the existing law as it relates to inter-corporate debt and equity investments. *The Department will usually use subsection 245(2) if the arrangement is part of an aggressive tax plan or is potentially abusive (e.g. loss importation), but could also use subsection 247(2) to challenge such an arrangement.*" (my emphasis)

In my view, the reference to subsection 247(2) at the end of this paragraph is boilerplate.

[10] See footnote 12 *infra* for a discussion of the "tax benefit" language in subparagraph 247(2)(*b*)(ii).

[11] Note that there is an important distinction to be made between, on the one hand, transactions that are commercially irrational and, on the other hand, transactions that are commercially rational but high-risk. For example, arm's length parties routinely make unsecured loans to thinly capitalized companies, as attested to by the existence of so-called junk bonds. The second circumstance is not intended to capture transactions that, from the point of view of arm's length parties, are merely high-risk.

[12] When first released on September 11, 1997, paragraph 247(2)(*b*) did not explicitly contain the wording now found in subparagraph (ii) thereof (the "tax benefit" test). This was because Finance initially thought that the tax benefit test was implicit in the language now contained in subparagraph (i). However, in meetings with taxpayer representatives, the point was made, with some force, that multinationals enter into all manner of transactions that have no arm's length comparables and that a tax benefit test was needed to winnow out the ones that were acceptable from a tax policy point of view from the ones that were not. Finance agreed and paragraph 247(2)(*b*) was re-drafted accordingly. See, in this regard, paragraph 43 of Information Circular 87-2R and footnote 16 *infra*. Note that the effective circumvention of the normal transfer pricing rules in paragraph 247(2)(*a*) was the only "tax benefit" identified by Finance and CRA at the time the new transfer pricing rules were introduced.

[13] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, 1995, at paragraph 1.37.

[14] *Stubart Investments Ltd. v. The Queen*, 84 DTC 6305.

[15] Different from the approach of the Supreme Court of Canada in *Canada Trustco Mortgage Co. v. R.*, 2005 DTC 5523, Finance approached the misuse or abuse tests in subsection 245(4) on the assumption that they were two distinct tests. A detailed discussion of subsection 245(4) is beyond the scope of this article.

[16] As described in Interpretation Bulletin IT-96R6, dated October 23, 1996, the CRA employs a commercial rationality standard when assessing the appropriateness of applying section 69 of the Act (in contradistinction to section 245 of the Act) to a disposition of securities pursuant to the exercise of a call option granted to a non-arm's length person:

"Anti-avoidance provisions

17. When a taxpayer grants an option to a person with whom it does not deal at arm's length on capital account to acquire securities of another entity, section 69 may be applied to the disposition of the securities if the price of the option and the exercise price are materially less than the fair market value of the securities otherwise determined at the time of the exercise of the option. *The application of section 69 will most often apply when the taxpayer has granted a non-arm's length "non-commercial option". A "non-commercial option" is one into which arm's length parties would not consider entering.* For example, this type of option may involve an unrealistically long option period, a low option price, or an exercise price that

does not fully recognize expected future events (e.g., inflation, zoning change, market trends) that affect the value of assets owned by the corporation whose securities are being optioned and thus which affect the price of the optioned securities over the option period." (my emphasis)

Significantly, the CRA does not seek to apply the GAAR in these (perceived) non-commercial circumstances. The CRA's explanation of the changes made to the prior version of paragraph 17 (*viz.*, former paragraph 11) of the Interpretation Bulletin states that this paragraph was specifically revised to reflect the CRA's (new) position that section 69, rather than subsection 245(2), is the relevant provision in the circumstances. Note also the similarity between the CRA's administrative commercial rationality standard, as emphasized above, and the wording of subparagraph 247(2)(*b*)(i).

[17] Whether or not the sham doctrine could be successfully invoked by the CRA in these circumstances would depend on whether the parties' course of conduct corresponded with their contractual arrangements. See footnote 14 in this regard.

[18] M.N.R., Information Circular 87-2R, "International Transfer Pricing" (September 27, 1999) at paragraphs 43 and 44.

[19] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, 1995, at paragraph 1.36.

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Table of Contents

As filed with the Securities and Exchange Commission on February 28, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-K

(MARK ONE)

☑ **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the Fiscal Year Ended December 31, 2007

or

☐ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from ________ to ________

Commission File No. 1-3305

Merck & Co., Inc.

One Merck Drive
Whitehouse Station, N. J. 08889-0100
(908) 423-1000

Incorporated in New Jersey

I.R.S. Employer Identification No. 22-1109110

Securities Registered pursuant to Section 12(b) of the Act:

Title of Each Class	*Name of Each Exchange on which Registered*
Common Stock ($0.01 par value)	New York and Philadelphia Stock Exchanges

Number of shares of Common Stock ($0.01 par value) outstanding as of January 31, 2008: 2,165,289,746.

Aggregate market value of Common Stock ($0.01 par value) held by non-affiliates on June 30, 2007 based on closing price on June 30, 2007: $107,919,000,000.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. **Yes** ☑ **No** ☐

Table of Contents

Notes to Consolidated Financial Statements (unaudited) (continued)

As previously disclosed, Merck's Canadian tax returns for the years 1998 through 2004 are being examined by the Canada Revenue Agency ("CRA"). In October 2006, the CRA issued the Company a notice of reassessment containing adjustments related to certain intercompany pricing matters, which result in additional Canadian and provincial tax due of approximately $1.5 billion (U.S. dollars) plus interest of approximately $1.0 billion (U.S. dollars). In addition, in July 2007, the CRA proposed additional adjustments for 1999 relating to another intercompany pricing matter. The adjustments would increase Canadian tax due by approximately $21 million (U.S. dollars) plus $22 million (U.S. dollars) of interest. It is possible that the CRA will propose similar adjustments for later years. The Company disagrees with the positions taken by the CRA and believes they are without merit. The Company intends to contest the assessments through the CRA appeals process and the courts if necessary. In connection with the appeals process, during 2007, the Company pledged collateral to two financial institutions, one of which provided a guarantee to the CRA and the other to the Quebec Ministry of Revenue representing a portion of the tax and interest assessed. The collateral is included in Other Assets in the Consolidated Balance Sheet and totaled approximately $1.3 billion at September 30, 2008. During the first nine months of 2008, approximately $400 million of cash and cash equivalents in the collateral account was transferred out and a corresponding amount of investments was transferred in. The Company has previously established reserves for these matters. While the resolution of these matters may result in liabilities higher or lower than the reserves, management believes that resolution of these matters will not have a material effect on the Company's financial position or liquidity. However, an unfavorable resolution could have a material adverse effect on the Company's results of operations or cash flows in the quarter in which an adjustment is recorded or tax is due.

In July 2007, the CRA notified the Company that it is in the process of proposing a penalty of $160 million (U.S. dollars) in connection with the 2006 notice. The penalty is for failing to provide information on a timely basis. The Company vigorously disagrees with the penalty and feels it is inapplicable and that appropriate information was provided on a timely basis. The Company is pursuing all appropriate remedies to avoid having the penalty assessed and was notified in early August 2007 that the CRA is holding the imposition of a penalty in abeyance pending a review of the Company's submissions as to the inapplicability of a penalty.

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

☑ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2008

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________

Commission File No. 1-3305

MERCK & CO., INC.

One Merck Drive
Whitehouse Station, N.J. 08889-0100
(908) 423-1000

Incorporated in New Jersey

I.R.S. Employer Identification No. 22-1109110

The number of shares of common stock outstanding as of the close of business on September 30, 2008:

Class	Number of Shares Outstanding
Common Stock	2,114,186,139

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes ☑ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

As previously disclosed, Merck's Canadian tax returns for the years 1998 through 2004 are being examined by the Canada Revenue Agency ("CRA"). In October 2006, the CRA issued the Company a notice of

http://www.sec.gov/Archives/edgar/data/64978/000095012308002272/y44547e10vk.htm (255 of 308) [23/12/2008 5:55:33 PM]

reassessment containing adjustments related to certain intercompany pricing matters, which result in additional Canadian and provincial tax due of approximately $1.6 billion (U.S. dollars) plus interest of approximately $810 million (U.S. dollars). In addition, in July 2007, the CRA proposed additional adjustments for 1999 relating to another intercompany pricing matter. The adjustments would increase Canadian tax due by approximately $22 million (U.S. dollars) plus $21 million (U.S. dollars) of interest. It is possible that the CRA will propose similar adjustments for later years. The Company disagrees with the positions taken by the CRA and believes they are without merit. The Company intends to contest the assessment through the CRA appeals process and the courts if necessary. In connection with the appeals process, during 2007, the Company pledged collateral to two financial institutions, one of which provided a guarantee to the CRA and the other to the Quebec Ministry of Revenue representing a portion of the tax and interest assessed. The collateral is included in Other Assets in the Consolidated Balance Sheet and totaled approximately $1.4 billion at December 31, 2007. The Company has previously established reserves for these matters. While the resolution of these matters may result in liabilities higher or lower than the reserves, management believes that resolution of these matters will not have a material effect on the Company's financial position or liquidity. However, an unfavorable resolution could have a material effect on the Company's results of operations or cash flows in the quarter in which an adjustment is recorded or tax is due.

In July 2007, the CRA notified the Company that it is in the process of proposing a penalty of $160 million (U.S. dollars) in connection with the 2006 notice. The penalty is for failing to provide information on a timely basis. The Company vigorously disagrees with the penalty and feels it is inapplicable and that appropriate information was provided on a timely basis. The Company is pursuing all appropriate remedies to avoid having the penalty assessed and was notified in early August 2007 that the CRA is holding the imposition of a penalty in abeyance pending a review of the Company's submissions as to the inapplicability of a penalty.