Cameco decision addresses transfer pricing recharacterization rules in Canada

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In brief

The Tax Court of Canada (the TCC or the Court) published on September 26 its decision in *Cameco Corporation* (2018 TCC 195), resolving a long-running dispute between Cameco Corporation (Cameco, the Appellant) and the Minister of National Revenue (the Minister or the Crown) involving reassessments to Cameco's 2003, 2005, and 2006 taxation years.

The adjustments made in the reassessments related to the prices used in the purchase and sale of uranium contracts involving Cameco, Cameco Europe (CESA, a Swiss branch of Cameco's Luxembourg subsidiary) and, later, its Swiss subsidiary (CEL), as well as its US-based subsidiary (Cameco US) and third parties. The Minister's reassessments were based on arguments that Cameco's structure, specifically the reorganization that took place in 1999, was a sham. The Minister further argued that CESA/CEL performed few if any valuable functions during the years under consideration and, accordingly, reassessments were warranted pursuant to either paragraphs 247(2)(b) and (d) or paragraphs 247(2)(a) and (c) of the Income Tax Act (the Act), the latter being the transfer pricing provisions more typically employed (and referred to by the TCC as the traditional transfer pricing rules).

The Court ruled that the Appellant and related entities did not factually represent the legal agreements that they entered into, or the transactions created by those arrangements, in a manner different from what they knew those arrangement to be and that consequently the element of deceit required to find sham was not present. In addition, the Court found that neither paragraph 247(2)(a) nor 247(2)(b) of the Act applied.

This Tax Insight will focus on the findings of the Court in respect of the application of paragraphs 247(2)(b) and (d). See our previous Tax Insights for details on the Court's findings in respect of the application of paragraphs 247(2)(a) and (c) and the sham doctrine.

Note: The Canada Revenue Agency (CRA) has appealed the TCC's judgment and specifically its determination that the Appellant's transfer prices were arm's length within the meaning of paragraphs 247(2)(a) to (d) of the Act. The Crown has not advanced sham in its appeal.

In detail

Transfer pricing recharacterization rules

Paragraph 247(2)(b) delineates the conditions in which an alternate transaction or series may be considered in determining a transfer pricing adjustment where parties have not dealt at arm's length. That paragraph provides that where a transaction or series is one that (i) would not have been entered into by arm's-length parties **and** (ii) was not entered into (primarily for *bona fide* purposes) other than to obtain a tax benefit, an adjustment (in quantum or nature) may be made to reflect the transaction or series under the terms and conditions that would have transpired at arm's length.

Background

Cameco is a uranium producer with mines in Saskatchewan and a refinery and conversion facilities in Ontario. Its foreign affiliate in the United States also owned uranium mines in the United States.

In the 1990s, following demilitarization, the Russian government began a program to sell its supply of uranium that was previously used in nuclear weapons. This additional supply of stocks of uranium on the market created significant concerns of a flooded market and depressed uranium prices. In response, a number of industry participants coordinated to purchase the additional supply from the Russian government (the Tenex Agreement). This agreement included Cameco, Cogema, Nukem Inc., and Tenex. A second agreement to purchase the additional supply was entered into by Urenco Limited (the Urenco Agreement).

At or about the same time, Cameco undertook a reorganization to focus its efforts on three distinct areas: the operation of the mines and conversion facilities, brokerage activities (i.e., the purchase and sale of uranium), and the marketing of uranium to consumers. Under the reorganization, Cameco would be responsible for the mines and conversion facilities as well as for providing certain administrative services, including services related to the administration of uranium contracts, and market forecasting, legal, human resources, financial, and accounting services. CESA was responsible for trading activities, which subsequently were transferred to CEL. Cameco US was responsible for the marketing of uranium to third parties for use in nuclear reactors. In addition, a Barbadian entity, Cameco Services Inc. (CSI), was responsible for coordination and monitoring of administrative, operational, and marketing activities for CESA.

The arrangement between CSI and CESA/CEL was the subject of a Swiss tax ruling. The Appellant acknowledged that the overall restructuring considered, among other things, the reduction of costs (including tax costs) as a means of improving profitability in a depressed uranium price environment.

The reorganization later was expanded to include the purchase and sale of uranium to Cameco. These transactions were referred to by the Court as the CC transactions for Cameco's purchase of uranium, and the BPC transactions for Cameco's sale of uranium (collectively, the Transactions).

Crown's position

The Crown took the position that the series involved all of the bulk sales agreements between Cameco and CESA/CEL as well as the agreements to purchase uranium from third parties. In considering the series, the Crown concluded that CESA/CEL would not have been participants to the arrangement at arm's length, and as such an adjustment should be made pursuant to paragraph 247(2)(d) to include in Cameco's income all of the profit earned by CESA/CEL from uranium trading.

In forming its view, the Crown relied on certain facts and subjective assertions, as follows:

- CESA/CEL did not perform the functions and activities relating to the uranium brokerage business, and while Cameco no longer was a signatory to third-party contracts, it continued to perform important related functions and make all related strategic decisions.
- These decisions were presented to CESA/CEL in the form of recommendations and CESA/CEL did little more than rubber-stamp the paperwork. In addition, CESA/CEL did not perform the core functions of a distributor and, further, those functions were not covered by their services agreement.
- Cameco was actively pursuing an arrangement to acquire the Russian stock well in advance of the establishment of CESA, and the assignment of the third party contracts to CESA/CEL was not done on an arm's-length basis.
- Cameco had preexisting relationships with most of the nuclear power utilities and the Canadian, US, and Russian government agencies involved in the uranium industry (and could have entered into the arrangements themselves), and the involvement of CESA/CEL did not improve the arrangement. In fact, the market recognized Cameco (and not CESA/CEL) as the

effective purchaser and required financial and performance guarantees from Cameco.

- The pricing arrangements entered into by CESA/CEL and Cameco were too narrow and did not take into account historical values or that prices were expected to rise once existing stocks were depleted.
- Cameco's terms with CESA/CEL were not consistent with the normal terms of contracts with third parties. For example, contracts in the uranium industry are subject to renegotiation, and no effort was made to renegotiate terms and conditions as economic circumstances changed.
- There was a lack of contemporaneous documents and a failure to keep records that otherwise would serve as reliable indicators of CESA's/CEL's active involvement in important decisions and involvement in the purchasing/selling activities.
- CESA/CEL did not exercise any independent decision making or perform functions that an arm's-length party would agree to compensate.

Cameco's position

Cameco took the position that the recharacterization transfer pricing rules are intended to be applied sparingly and only in circumstances where the transactions are commercially irrational and cannot be priced under arm's-length terms and conditions. Cameco argued that as CESA/CEL's profits were the result of commercially normal transactions for the purchase and sale of a fungible commodity, its profits could not simply be shifted back to Canada.

The Transactions and the Series

In considering the Transactions and the Series (the Series comprises the Tenex and Urenco Series as described below), the TCC held that a series ought not to be so broadly defined as to obscure the application of a comparability analysis that underpins the application of the arm's-length principle.

The TCC identified four transactions or series involving Cameco and its related parties:

1. The Tenex Series. The series of transactions comprising the incorporation of CESA, the assignment of the HEU feed agreement to CESA, the execution of the Tenex Agreement by CESA (i.e., purchase of uranium from Tenex), and Cameco's guarantee with respect to CESA's obligations under the feed agreement.
2. The Urenco Series. The series of transactions comprising the incorporation of CESA, the assignment of the Urenco Agreement to CESA, CESA's execution of the Urenco Agreement, and Cameco's guarantee with respect to CESA's obligations under the Urenco Agreement.
3. The BPC transactions. Those transactions in which Cameco sold and delivered uranium to CESA/CEL. While the Court recognized that these transactions could have been considered a series, it considered each delivery separately.
4. The CC transactions. Those transactions in which Cameco purchased and received uranium from CESA/CEL.

In defining the Series, the TCC concluded that the decision to allow the signing of the agreement(s) by CESA (rather than Cameco), while itself an event without tax attributes, does not prevent the application of section 247 of the Act. The TCC concluded that while the assignment of the contract to CESA/CEL did not involve a specific transaction subject to adjustment, this did not preclude that the Series in its entirety (which could include a transaction not itself subject to adjustment) may be subject to the transfer pricing rules and result in a transfer pricing adjustment.

The TCC further concluded that a transfer pricing adjustment could be raised in the taxation years before the Court notwithstanding that the assignment and actions leading up to the assignment took place in prior years. Again, the critical years for an adjustment were those under appeal, even though prior years may be reviewed to determine the appropriateness of those adjustments.

The Series

In its decision, the TCC first considered the condition set out in subparagraph 247(2)(b)(i) of the Act that the transaction or series would not have been entered into between persons dealing at arm's length. The TCC concluded that if a transaction is "commercially rational" it would be entered into by arm's-length parties and the condition would not be met. In the converse, the TCC concluded that where a transaction is commercially irrational, it can be said that arm's-length parties would not have entered into it.

The TCC also makes clear that the evaluation of subparagraph 247(2)(b)(i) does not require speculation as to what arm's-length parties otherwise would have done in the circumstances, but simply whether the transaction would have been entered into by arm's length-parties acting in a commercially rational manner. One can presuppose that the set of rational transactions is a broad one, and it is not to determine what an arm's-length party would have done but to determine whether the act done fits within that set of possibilities. The Court recognized that expert evidence might assist in this regard. Further, the fact that an act is uncommon or unique does not preclude the possibility of a commercially rational transaction, although it may well require further explanation on the part of the taxpayer.

In determining whether the Series was commercially rational, the TCC accepted the opinion of the experts Shapiro and Sarin who in their report stated that "any entity would be willing to give up a business opportunity as long as they are fairly compensated for giving up that opportunity." The Court further noted that neither expert Wright nor Barbera contested the commercial rationality of the assignment.

The TCC also found that this conclusion was supported by the actions of Cameco, which, after initially attempting to conclude the Tenex arrangement on its own, ceded a portion of the opportunity first to Cogema and then Nukem, both arm's-length corporations.

With reference to the Canadian foreign affiliate regime and recent decisions in the United States (in which the courts have concluded that a US parent corporation's ability to organize structure does not in and of itself justify the reallocation of that income by the Internal Revenue Service), the Court affirmed such allocations as both commercially rational and forming part of the core functions of the parent of a multinational enterprise. More specifically, the Court affirmed the US Tax Court's view "that the behavior of the parent corporation in establishing subsidiaries and placing business opportunities in those subsidiaries is not commercially irrational," and went further to suggest "that such behaviour is a core function of the parent of a multinational enterprise."

Observation: Certainly such behavior must not be carried out in a manner offensive to the transfer pricing rules, and it may well be that the Crown would regard "offensive" in a manner more expansive than would the Court.

The TCC concluded that as the first test in subparagraph 247(2)(b)(i) was not met, paragraph 247(2)(b) did not apply and transfer pricing adjustments were not warranted pursuant to paragraph 247(2)(d).

The transactions

Unsurprisingly, the TCC did not find anything extraordinary about the purchase or sale of uranium by an operator and did not find the terms and conditions regarding its related-party transactions to be sufficiently different from third-party arrangements. As a result, it did not find the Transactions to be commercially irrational.

Once again, the Court found that as the first test in subparagraph 247(2)(b)(i) was not met, paragraph 247(2)(b) did not apply and transfer pricing adjustments were not warranted pursuant to paragraph 247(2)(d).

Observation: The TCC's decision to consider each as an independent transaction could have yielded an outcome in which certain transactions were subject to a transfer pricing adjustment while others were not; such approach clearly would place an emphasis on a thorough examination of the terms and conditions of each of the Transactions.

Primarily to obtain a tax benefit

While not required for the purposes of determining a transfer pricing adjustment pursuant to paragraphs 247(2)(b) and (d), the TCC also considered the applicability of subparagraph 247(2)(b)(ii).

In considering the Series, the TCC found, as confirmed by the Appellant, that the Series (and the reorganization) was entered to achieve tax savings and improve profits, and that this in itself was not sufficient to satisfy the condition set out in subparagraph 247(2)(b)(ii). More specifically, the TCC concluded that the determination as to whether the purpose of the Series was primarily to save tax must be made with regard to all of the relevant transactions, including the extent to which the Series simply took advantage of planning tools already provided by Parliament.

The TCC found that while the primary purpose of the Series was to obtain a benefit, such benefit was not beyond that which was provided within the broader context of the Act and, as a result, subparagraph 247(2)(b)(ii) would not have applied. Put another way, the reorganization and the steps that were included in that reorganization could not be said to be outside the scope of accepted planning, namely the foreign affiliate regime as provided under the Act.

In considering the Transactions, the TCC distinguished the Transactions from the Series of which they formed a part and found that the contracts for the purchase and sale of uranium, while giving rise to tax savings because CESA/CEL were subject to a lower tax rate, were primarily entered for purposes of earning profit (income). As such, they do not meet the test in subparagraph 247(2)(b)(ii).

Recharacterization

Although the TCC did not find that a transfer pricing adjustment was appropriate, it clarified that the application of paragraph 247(2)(d) only supports the computation of a transfer pricing adjustment with reference to an alternate transaction (that would have been entered by arm's-length parties). In other words, paragraph 247(2)(d) does not actually recharacterize the transaction(s) or series itself.

The takeaway

This decision provides several important considerations for the analysis and documentation of intercompany transactions in a Canadian context:

- The creation by a parent of subsidiaries to carry on particular activities is not untoward; what must follow, however, is that the income realized by these entities is supported by the functions undertaken, either by themselves or on their behalf, and the risks incurred.
- Transfer pricing adjustments pursuant to paragraphs 247(2)(b) and (d) may serve only to alter the quantum and nature of the amount and do not serve to recharacterize the transactions themselves. This may have implications under Canada's bilateral tax treaties where the transaction or series involves one or more entities in multiple jurisdictions and may require an allocation among the entities.
- The transfer of a business opportunity, whether at the onset of an arrangement or as part of a restructuring, is compensable. To the extent remuneration is warranted, the amount may be considered as part of the series and not only at the time of transfer.
- The determination of whether a transaction is undertaken "primarily for purposes of obtaining a tax benefit" should be considered in the broader context of the Act and not include otherwise permissible tax planning strategies. The mere fact that a transaction or series gives rise to tax savings does not in itself fulfill the condition that the transaction or series was entered into primarily to obtain a tax benefit. Consideration must be given to the overall business purpose.
- The TCC did not distinguish between activities performed by CESA/CEL on their own account and those contracted for by CESA/CEL under the services agreement. Thus, activities performed under a properly defined agreement and certainly those that would be outsourced at arm's length may not be used to recharacterize risks and returns under a transfer pricing analysis where the facts support the allocation of profits. This may have implications for the CRA's application of the updated Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued by the Organisation for Economic Co-operation and Development and base erosion and profit shifting (BEPS) initiatives.
- The determination of commercially rational and *bona fide* purpose are highly fact-specific and depend heavily on the alignment of the conduct of the parties with the contractual arrangements. Where an alternate transaction is considered under paragraphs 247(2)(b) and (d), the Minister may assume such a transaction and the onus is on the taxpayer to demonstrate otherwise.
- Due to the CRA's appeal of the decision and the complexity of the fact pattern, it may take several more years before these matters are finally resolved.

Let's talk

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

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