‘Cameco’ decision analyzes arm’s-length principle in Canada

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In brief

The Tax Court of Canada (the TCC or the Court) on September 26 published 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 Respondent) 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 a 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, that 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 arrangements 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 paragraph 247(2)(b) applied.

This Tax Insight focuses on the Court’s findings in respect of the application of paragraphs 247(2)(a) and (c) of the Act. Later Tax Insights will cover the Court’s findings in respect of the sham doctrine and the application of paragraphs 247(2)(b) and (d) of the Act.

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.

In detail

Traditional transfer pricing rules

Paragraph 247(2)(a) of the Act delineates the conditions for a transfer pricing adjustment and specifically the circumstances in which the terms and conditions in respect of a transaction or series of transactions between a taxpayer and non-resident related party differ from those that would have occurred between parties dealing at arm’s length. Where the conditions in paragraph 247(2)(a) are met, paragraph 247(2)(c) provides that an adjustment (in quantum or nature) may be made to reflect the terms and conditions that would have been agreed to had the parties been dealing at arm's length.

Crown's position

The Crown's position was that Cameco performed essentially all the functions in the corporate group and therefore should earn all the profit. The Crown considered the services performed by Cameco for CESA/CEL under a services agreement as well as the initial negotiation (prior to assignment) of the third-party contracts giving rise to the intercompany transactions. In forming its position, the Crown asserted that these functions were performed by Cameco on its own account and that CESA/CEL therefore should be considered limited-risk entities.

As a result, the Crown concluded that transfer prices were best determined using the transactional net margin method (TNMM) treating CESA/CEL as the tested party, a company-wide test that in effect treats all the transactions as a single series.

TCC explains transfer pricing rules

The TCC found that the Crown's position — i.e., that the transactions undertaken by Cameco following its restructuring in 1999 were part of a single series that can be tested together for purposes of paragraphs 247(2)(a) and (c) — "completely disregards the purpose and focus of the transfer pricing rules" and does not represent an appropriate interpretation of paragraphs 247(2)(a) and (c) as it does not consider all relevant circumstances.

The TCC further concluded that the "clear focus of the transfer pricing rules" applies to transactions between a taxpayer and a non-arm's length non-resident, and that paragraphs 247(2)(a) and (c) do not apply to a transaction between a taxpayer and one or more arm's-length persons, or between a non-resident and another non-resident where neither is a taxpayer. However, the TCC stated the existence of such a transaction may be of relevance when applying the transfer pricing rules to a transaction between a taxpayer and a non-arm's length non-resident.

As a result, the TCC determined that the transactions and series of transactions at issue included purchase and sale of uranium transactions between Cameco and CESA/CEL (the Transactions) and a series of transactions involving non-resident persons dealing at arm's length (the Tenex series and Urenco series, collectively the "Series"). The issue with respect to the Transactions was whether they reflected arm's-length prices, and with respect to the Series was whether arm's-length parties under similar circumstances would have attributed value to the business opportunities assigned by Cameco to CESA/CEL at no cost.

Fact-based analysis

In its decision, the TCC followed prior Canadian jurisprudence including the Supreme Court of Canada's decision in *Canada v. GlaxoSmithKline Inc.,* which held that a transfer pricing analysis is a fact-driven exercise. It thus placed significant weight on the nature of the activities performed by the Appellant and its related parties in respect of the Transactions and the Series.

The TCC took issue with the overall functional analysis relied on by the CRA, finding that it failed to recognize the economic significance of certain core functions performed by CESA/CEL and Cameco US, namely, purchasing, marketing, and selling a commodity. The TCC also noted that although the transportation, financing, and management functions ("administrative services") performed by the Appellant may have played an overall role in the purchase and sale of uranium, they were not economically significant relative to the core functions.

The TCC held that since Canadian tax law does not distinguish between a company that carries on an activity using its own employees and one that carries on an activity using independent contractors, the administrative services cannot be viewed as functions performed by the Appellant for its own account. The TCC did not agree with the CRA's position that the Appellant unilaterally made all decisions regarding the purchase and sale of CESA/CEL's uranium, in particular finding that "the fact that decisions may have been collaborative rather than adversarial does not support the shift of substantive contractual price risk... to the Appellant."

The TCC also found that when CESA/CEL entered into contracts for the purchase of uranium, they took on the inherent price risk (and effectively the profits due to the sharp unexpected rise in uranium prices) associated with these contracts. The TCC also found that the terms of the uranium contracts entered into by CESA/CEL were similar to terms found in arm's-length contracts.

The TCC agreed with Cameco's assertion that "it is the owners of the asset who bear the asset's risk, not the managers of the risk." It found that price risk is inherent in uranium as a fungible commodity with a market-driven price, and that the legal purchaser of uranium takes on this risk.

As a result, the TCC found that paragraph 247(2)(c) does not permit the price risk associated with the purchase and sale of uranium to be shifted to the Appellant simply because it provided support services to CESA/CEL. Although the evidence indicated that the Appellant and Cameco US performed core functions, the TCC did not give much weight to these, preferring to rely on evidence that collaboration is required in multinational groups.

Preferred transfer pricing method and application of the method

The parties also had different views about the fungible nature of uranium and how to price it. Cameco selected the comparable uncontrolled price (CUP) method as the most reliable and the TCC agreed, noting that the amendments to the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued by the Organisation for Economic Co-operation and Development (OECD Guidelines) following its base erosion and profit shifting (BEPS) project recognize the appropriateness of this methodology to price commodities.

The TCC also found that the transfer pricing analyses/expert evidence provided by the Crown was based on a significant degree of hindsight as well as assumptions regarding the subjective views of the Appellant and Tenex at the time the relevant transactions occurred, remarking that "the CRA is falling in a classic economic trap. It is looking not at the transaction as it was designed at the point in time that it was arranged. It is looking at what was the outcome of the transaction."

The parties also disagreed about the evolution of the price of uranium as of the time of the Cameco restructuring. The Appellant argued that after a decade-long price stagnation, "no one anticipated that prices would rise to unprecedented levels beginning in 2004," while the Respondent referred to a high of US$43 per pound in 1973 to advance its position that "no one predicted prices would remain below US$10 after 2003."

The TCC found that Cameco's expectations as reflected in the intercompany agreements were reasonable based on the information it had at its disposal at the time of entering the Transactions, and that the CRA's position was based substantially on hindsight, speculation, and subjective views rather than on "objective benchmarks" as required by the transfer pricing rules. Consequently, the TCC found that, absent hindsight, the pricing of the Transactions was within the arm's-length range.

Should value be attributed to the business opportunities provided to CESA?

The TCC did not agree with Cameco that the decision to allow CESA to sign certain feed agreements was without tax attributes and thus concluded that the transfer pricing rules could be appropriately applied to such transactions to determine whether an adjustment was warranted to the Series. Nonetheless, the TCC did not find that an adjustment was warranted in the circumstances.

The TCC noted that the Appellant started negotiating with Tenex in 1993 and in 1996 agreed with two third parties to jointly negotiate an agreement with Tenex for the HEU (highly enriched uranium) feed. It found that the lack of remuneration flowing in either direction reflects the rational expectation of the third parties that any agreement reached with Tenex would have no economic intrinsic value. While the feed agreements became very valuable for CESA/CEL after 2002 as a result of the significant rise in the market price of uranium, the TCC found that no transfer pricing adjustment was warranted in relation to either the Tenex or Urenco agreements because the parties did not expect this (nor did anyone else).

Did the transactions reflect arm's-length pricing?

As noted, the TCC rejected the CRA's argument that Cameco's performance of some functions for CESA/CEL entitled it to all the profits realized by CESA/CEL. It also rejected the Crown's submission that Cameco's comparables were not comparable because this position was based on speculation as to the motivations of Tenex to enter into the agreement. The TCC considered that there were reasonable price benchmarks to allow for the application of a CUP methodology, and found no evidence of significant differences in bargaining power between the parties to the Transactions and the Series.

It further rejected the argument that losses on the Canadian side and the long-term nature of the intercompany contracts raised suspicion and somehow supported a transfer price adjustment. Consequently, the TCC found that no transfer pricing adjustments were warranted for the years under dispute.

The takeaway

This decision can be viewed as providing several important considerations for the analysis and documentation of intercompany transactions in a Canadian context:

- Once again, the OECD Guidelines were considered to be informative but not controlling given the differences between section 247 of the Act and Article 9, Associated Enterprises, of the OECD Model Convention on Income and on Capital.
- In order to achieve certainty, predictability, and fairness when interpreting section 247 of the Act, there is a strong preference for

fact-based analysis over subjective analysis.

- Paragraphs (a) and (c) of subsection 247(2) can be used only in limited scope to vary terms and conditions of a transaction to the extent necessary to determine arm's-length prices and not to restate a transaction in its entirety.
- Paragraph 247(2)(c) can be used to give effect to an adjustment only to the extent paragraph 247(2)(a) applies.
- The TCC decision did not distinguish between activities performed by CESA/CEL on its own account and those contracted for under the services agreement. Thus, the decision indicates activities performed under a properly defined agreement that would be outsourced at arm's length cannot be used to reallocate risks and returns under a transfer pricing analysis. This may have implications for the CRA's application of the updated OECD Guidelines and BEPS initiatives.
- Comparability is viewed as paramount in a transfer pricing analysis. Evidence of similar behavior by third parties in comparable circumstances provides significant support for the pricing used.
- The decision makes clear that hindsight is not appropriate in evaluating transfer pricing, placing significant emphasis on the information that would have been reasonably available to the parties at the time of the transaction and disregarding ex-post analysis of profitability.
- Accordingly, comprehensive documentation that substantiates the intent and expectations of the parties at the time of the transaction and provides relevant context, including key economic, industry, and regulatory factors, should continue to be important in substantiating transfer prices and defending against an audit.
- In addition, robust intercompany agreements that define roles, responsibilities, and obligations and align with the actual conduct of the parties should play an important role in defending against an inappropriate allocation of risks and/or returns.

Due to the CRA's appeal of the decision and the complexity of the fact pattern, several more years may elapse 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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