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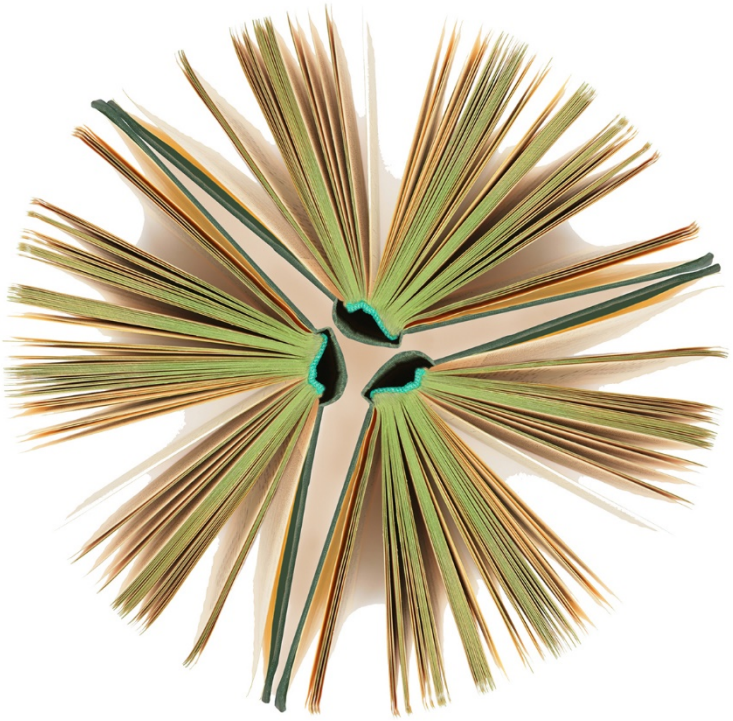

Transfer pricing alert

Cameco wins landmark transfer pricing case

October 30, 2018

Overview

On September 26, 2018, the Tax Court of Canada ruled in favour of Cameco Corporation (Cameco) in a landmark transfer pricing case. The case involved Cameco's 2003, 2005 and 2006 taxation years.

Cameco is the world's largest publicly traded uranium company and is based in Canada. The transfer pricing arrangement at issue involved Cameco Europe (CEL), a subsidiary of Cameco based in Switzerland. CEL purchased uranium from Cameco and third parties pursuant to a number of long-term contracts. In general terms, intercompany purchases from Cameco were priced based on the

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published long-term price for uranium at the time the contracts were concluded (as is common in the industry). CEL subsequently entered into sales contract for the uranium purchased from Cameco and the third parties. Due to increases in uranium prices, CEL generated significant profits.

The Canada Revenue Agency (CRA) reassessed Cameco on the basis that CEL's profits should have been realized by Cameco. The CRA's case was based on three key arguments:

- First, CRA asserted that transfer pricing arrangement was a sham. CRA argued that Cameco transferred its uranium trading business to CEL on paper, but in reality, all important functions and strategic decisions for the uranium trading business continued to be performed by Cameco.
- Second, CRA asserted that the arrangement was not commercially rational and should be recharacterized. CRA argued that Cameco negotiated valuable uranium contracts and allowed CEL to enter into those contracts even though Cameco knew the contracts would give rise to an economic windfall.
- Third, CRA argued that the arrangement should be subject to a price adjustment given that an arm's length party would not agree to terms or conditions that result in any income being earned by CEL.

The Court held that the element of deceit required for a sham was not present. Further, a parent entity providing a subsidiary a business opportunity is not commercially irrational. Lastly, the Court held that the third party uranium purchase contracts negotiated by Cameco and entered into by CEL did not have intrinsic economic value at the time they were entered into, and that the prices charged by Cameco to CEL for uranium delivered were well within the arm's length range of prices.

Background

The decision describes the following key facts:

- CEL[1] is a wholly-owned Swiss subsidiary of Cameco.
- Cameco Inc. (Cameco US) is a wholly owned US subsidiary of Cameco.
- In 1999, the Cameco group was restructured, with Cameco as a miner and producer of uranium, CEL as a uranium trader, and Cameco US as a distributor of uranium to end customers.

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[1] Cameco originally established a Luxembourg entity that had a branch in Switzerland. This Swiss branch was subsequently transferred to CEL. In this document the Luxembourg entity and CEL are collectively referred to as CEL.

- Over a number of years, Cameco pursued negotiations in order to secure certain uranium purchase arrangements.[2] Starting in 1999, CEL entered into uranium purchase agreements (UPAs) with arm's length third parties (Third Party UPAs) and CEL also entered into long-term UPAs with Cameco (Cameco UPA).
- Thereafter, Cameco US purchased uranium from CEL and sold it to third party customers. Cameco US did not hold inventory and only took flash title to the uranium it sold to third party customers. The terms of the sale of uranium from CEL to Cameco US mirrored the terms of the sale of uranium from Cameco US to the customers, except that the price was 2% lower such that Cameco US earned a 2% resale margin.
- CEL entered into an intercompany services agreement with Cameco whereby Cameco agreed to provide various services including uranium contract administration, legal, accounting and other functions.
- CEL had one senior employee up to 2006, with extensive experience in the uranium industry, and hired a second employee at that time. CEL's employee(s) regularly attended sales meetings held by Cameco US.
- After 2002, there was a significant increase in the market price of uranium. The pricing of the Third Party UPAs and Cameco UPA allowed CEL to benefit from the increasing market price of uranium.

Key points of judgement

Sham

The Court resoundingly rejected CRA's argument that the arrangements involving CEL were a sham, stating that CRA's position "reflects a fundamental misunderstanding of the concept of sham." In reaching this decision, the Court reviewed the jurisprudence on the concept of sham as originally formulated in *Snook v. London & West Riding Investments Ltd.*, [1967] 1 All E.R. 518, as well as Canadian cases dealing with the sham doctrine. From this, the Court concludes that for a transaction to be a sham the facts (assumed or proven) must establish that the parties to the transaction presented their legal rights and obligations differently from what they know to be true. On the basis of the facts, the Court concluded that there was "… no evidence to suggest that the written terms and conditions of the many contracts … do not reflect the true intentions of the parties to those transactions, or that the contracts presented the resulting transactions in a manner different from what the parties knew the transactions to be."

Notably, the Court also concluded, "The arrangements created by the contracts were not a façade but were the legal foundation of the implementation of the Appellants tax plan." The Court then stated, "… a tax motivation does not transform the arrangements among [the parties] into a sham."

In arguing sham, CRA had asserted that Cameco employees were performing various services for Cameco's account, and that the control and essential functions of the uranium trading business were undertaken by Cameco rather than CEL. In support of its position, CRA had argued that some of the contracts that CEL entered into were actually concluded by employees of Cameco rather than employees of CEL. The Court found that there was no evidence to support a conclusion that Cameco was performing services for its own account rather than for the benefit of CEL. The Court stated that a corporation may undertake activities through its own employees or through independent contractors acting

[2] These negotiations had commenced before CEL was established.

on its behalf. The Court held that the examples provided by CRA on this point were insignificant and did not support a conclusion that Cameco routinely concluded contracts on behalf of CEL (or the conclusion that the overall arrangement was a sham and that the business of CEL should be considered to be the business of Cameco).

CRA also argued that the overall arrangement was a deliberate deception of CRA "because the Appellant was doing everything." In making this argument, CRA relied on the fact that Cameco continued to play an important role in various activities and the decision making process among the parties was collaborative rather than adversarial. On this point, Court held that there was "nothing unusual about the way in which the Cameco Group operated", noting that it is common for administrative functions to be centralized and shared, for there to be commercial integration across the enterprise, and for the parent to provide cooperation and coordination among the entities.

Consequently, the Court found that the element of deceit required for a sham was not present.

Recharacterization

The Cameco case is the first case that involves judicial interpretation of the recharacterization provisions of the Income Tax Act (ITA).

The transfer pricing recharacterization rule in paragraphs 247(2)(b) and (d) of the ITA may apply where a two-prong test is satisfied:

1. The transaction or series would not have been entered into by arm's length parties; and
2. The transaction or series can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit.

The Court stated that the assumption underlying the recharacterization provision is that arm's length parties would not have entered into the transaction or series on any terms or conditions, but that there is an alternative transaction that arm's length parties would enter into. While the court determined that the recharacterization provision was not applicable, it is notable that the Court stated that CRA can assume the existence of an alternative transaction and the taxpayer must then demolish the assumption. It is also notable that the court stated that in evaluating the "purpose" where there is a series of transactions, one must consider the purpose of the overall series, and not each individual transaction in the series (unlike the approach that is used in evaluating purpose under the general anti-avoidance rule).

In evaluating the applicability of the recharacterization provision, the court also stated that while the purpose of section 247 of the ITA is to implement the arm's length principle, "Parliament has chosen text that is quite different from the text … of the Model Convention." As a result, the Court directs that the evaluation must be based on the text chosen by Parliament, and reiterates the principle established by the Supreme Court of Canada in *Canada v. GlaxoSmithKline Inc.*, 2012 SCC 52, [2012] 3 S.C.R. 3 that the Organisation of Economic Co-operation and Development (OECD) Transfer Pricing Guidelines are not controlling as if a Canadian statute.

In applying the first test, the Court instructs that the question to address is whether the transaction or series would have been entered into by arm's length persons acting in a commercially rational manner. If a transaction is commercially rational, then it is reasonable to assume that arm's length parties would enter into it. The Court considered whether it was commercially rational for Cameco to allow CEL to enter into the Third Party UPAs. The Court accepted the view of Cameco's expert that "Any entity would be willing to give up a business opportunity as long as they are fairly compensated… ". The Court also stated that "There is nothing exceptional, unusual or inappropriate about the Appellant's decision to incorporate [CEL] and have [CEL] execute the [Third Party UPAs]", and suggested that such behavior is a core function of a parent of a multinational enterprise. As such, the Third Party UPAs entered into by CEL did not meet the first test. The Court similarly found that the Cameco's sale of uranium to CEL did not meet the first test, citing that the terms and conditions of the Cameco UPA were generally consistent with practices in the uranium industry.

Under the second test, the Court found that the primary purpose of the Third Party UPAs was to save tax, whereas there was a bona fide profit-earning primary purpose in respect of the Cameco UPA.

Ultimately, the recharacterization rules did not apply to the transactions and series at issue, given that the first test was not satisfied.

Price Adjustment

Having concluded that the arrangements between Cameco and CEL were neither a sham nor subject to recharacterization, the court evaluated whether the pricing of such arrangement was arm's length.

A price adjustment under paragraph 247(2)(a) and (c) of the ITA will apply to a transfer price where the price that would have been paid in the same circumstances between persons dealing at arm's length differs from the price actually applied to the transaction or series. A price adjustment does not permit for the recasting of the arrangements made between the participants (e.g., as in the case of a recharacterization), except to the limited extent necessary to properly price the transaction or series by reference to objective benchmarks.

CRA argued that Cameco knew the Third Party UPAs it allowed CEL to enter into were valuable business opportunities and that Cameco should not have allowed CEL to earn any more than a routine distributor's return. However, the Court found that the Third Party UPAs were entered into with third parties and reflected "a market determined value". While there was no doubt the Third Party UPAs afforded CEL an opportunity, the Court accepted the view of Cameco's expert that the economic benefit of participating in the Third Party UPAs was negligible at the time the parties executed the contracts – whether the opportunity had positive or negative value depended on uncertain future events. On this basis, the Court said that there was no evidence to warrant a transfer pricing adjustment with respect to the Third Party UPAs.

CRA took the position that the profit earned by CEL from the Third Party UPAs and Cameco UPA should be attributed to Cameco because it performed all the critical functions that earned the profit, including market forecasting and research services. CRA's expert reports suggested that CEL's income should be

based on a cost plus or resale minus approach, shifting all of the income attributable to uranium price movement to Cameco.

The Court held that the evidence established that the services provided by Cameco to CEL in support of its purchase and sale activities were routine commercially available services utilizing non-proprietary information. Further, CEL contracted Cameco to perform certain services and, under Canadian law, there is no distinction between a corporation carrying on activities using its own employees versus using independent contractors. The Court also rejected the contention that Cameco unilaterally made all decision regarding the purchase and sale of CEL's uranium. CEL's workforce had sufficient expertise and was involved in making key decisions regarding such purchases and sales.

Finally, the Court considered the consistency between the legal contracts and economic substance of the arrangement. The Court found that CEL had contractually assumed price risk by entering into the Third Party UPAs and Cameco UPA.

In respect of the Cameco UPA, the Court accepted an application of the comparable uncontrolled price method in determining that the prices charged by Cameco to CEL for uranium delivered were well within the arm's length range of prices.

Consequently, the Court held that there was no evidence warranting a price adjustment for the Third Party UPAs or the Cameco UPA.

Appeal

On October 26, 2018, the CRA filed an appeal with the Federal Court of Appeal regarding the Tax Court of Canada decision. The CRA did not appeal the Tax Court of Canada's decision that sham does not apply.

Takeaways

The issues decided in the Cameco case are not confined to any specific area of transfer pricing and have broad implications. The key principles affirmed by the Court in the Cameco decision include:

- The traditional principles of what constitutes a sham continue to apply. If the contractual arrangements reflect the underlying transactions and the intention of the parties, the arrangement should not be considered a sham.
- A transaction should not be subject to recharacterization if it is commercially rational. If it is commercially rational, the transfer pricing issue is simply the determination of the correct price.
- If a series of transactions is undertaken primarily for business purposes, it should not be subject to recharacterization. Unlike the test applied pursuant to the general anti-avoidance rule, the entire series should not be tainted if one aspect is undertaken primarily for tax purposes, provided the overall series is undertaken to achieve a business purpose.

Further, in evaluating transfer prices:

- Absent a recharacterization, the transfer pricing analysis must focus on the actual transactions and respect the contractual arrangements.
- A parent of a multinational group is allowed to provide a business opportunity to a subsidiary.
- Corporations bearing contractual risk will be subject to the resulting profit or loss – it is not critical that the corporation directly employ the individuals that manage the risk.
- There is a strong preference for traditional transaction transfer pricing methods that directly test the price of the transactions actually undertaken. Use of methods that effectively re-write the transaction or determine the income that would be realized if the taxpayer had entered into different contractual arrangements, are to be avoided.
- Transfer pricing analyses should, to the extent possible, be based on objective evidence. Speculation about what parties might have known should be avoided.

In light of the strong focus on contractual arrangements (which might not align with the approach in other jurisdictions), multinationals should review their transfer pricing positions and consider whether all significant intercompany transactions are covered by appropriate legal documentation and whether the relevant parties to such transactions are acting in accordance with the legal arrangements.

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