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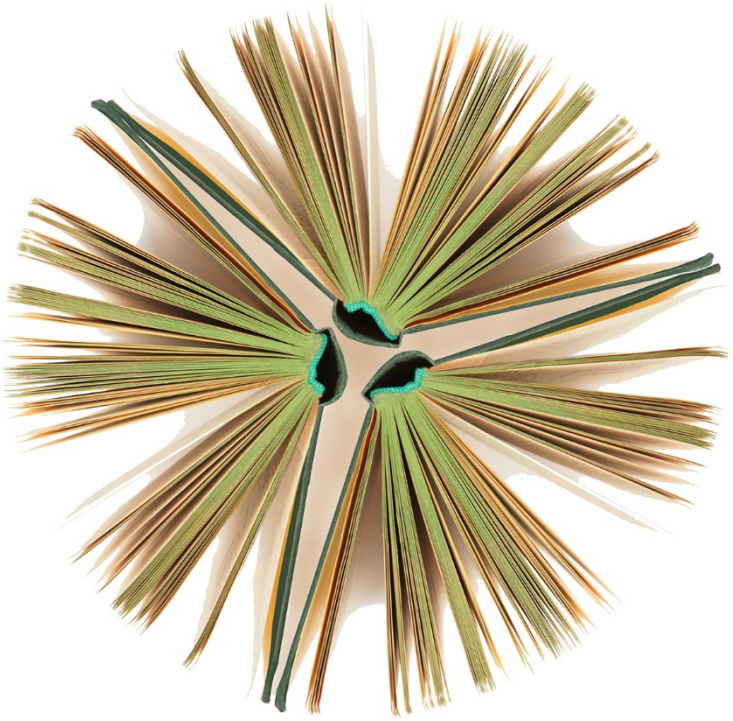

Canadian Tax & Legal Alert

Tax Court rules in favour of taxpayer in a transfer pricing case

December 1, 2020

On August 27, 2020, the Tax Court of Canada (TCC or the Court or the Tax Court) ruled in favour of the taxpayer and against the Crown's sham, recharacterization and transfer pricing arguments in *AgraCity Ltd. v. The Queen*[1].

The litigation involved corporations that are part of the Farmers of North America group of companies (FNA or FNA group) which are ultimately controlled by James Mann and/or his brother Jason Mann and have operations in Canada, the US and Barbados.

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[1] 2020 TCC 91 (August 27, 2020).

The transfer pricing arrangement at issue was the service arrangement between AgraCity Ltd. (AgraCity Canada or AgraCity) and NewAgco Inc., a Barbados international business corporation (NewAgco Barbados), in connection with the sale by NewAgco Barbados, directly to Canadian farmer-users, of a glyphosate-based herbicide (ClearOut), a generic version of Bayer-Monsanto's RoundUp.

The Canada Revenue Agency (CRA) reassessed AgraCity Canada relying on the transfer pricing rules in paragraphs 247(2)(a) and (c) of the Income Tax Act (ITA) and reallocated all of NewAgco Barbados' profits back to AgraCity. AgraCity Canada was also reassessed transfer pricing penalties under subsection 247(3) of the ITA on the basis it did not satisfy the contemporaneous documentation requirements.

At trial, the Crown's case was based on the following assessing positions:

- Firstly, the transactions were a sham or window dressing designed to deceive the CRA into concluding that NewAgco Barbados, and not AgraCity, was undertaking the sales business and incurring real risks.

- Secondly, the arrangements are not commercially rational and the transactions should be recharacterized. The Crown argued that arm's length parties, unlike AgraCity Canada, would not have allowed NewAgco Barbados to be part of the transactions or to make any of the profits.

- Thirdly, the arrangement should be subject to a price adjustment given that the value created by the parties to the transactions did not align with what was credited to AgraCity Canada and NewAgco Barbados. Hence, the Crown argued that all sales profits realized from the ClearOut sales by NewAgco Barbados should be reallocated to AgraCity, as none of those profits would have been NewAgco Barbados's had they been dealing at arm's length.

The Court found that the evidence presented did not establish the existence of any sham transactions, nor any deceptive window dressing. As per the Court, the service agreement between AgraCity Canada and NewAgco Barbados appeared to be a valid contractual agreement setting out in a very large measure what the parties intended, agreed to, and reported to the CRA. The Court also found nothing in the expert reports or testimony that could provide material support to CRA's position that the transactions in question were not transactions that arm's length parties would have entered into.

Background

The decision describes the following facts:

- James Mann established the FNA group as a membership and service-based organization for farmers across the US and Canada.

- In Canada, ClearOut was subject to the Pest Management Control Act and, for the period of the audit, was not offered for sale as a Canadian registered product. The US FDA registration allowed FNA to apply as a sponsor for ClearOut's acceptance, pursuant to the Own User Import (OUI) program, to be eligible for Canadian farmers to purchase it from the US.

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- In 2005, James Mann established a procurement entity in the US (NewAgco US) to facilitate the purchase and sales to farmer-users. NewAgco US used AgraCity to attend to the logistics and related activities of sales and delivery to the Canadian buyers.

- In December 2005, the third-party manufacturer of ClearOut in the US sold its rights and inventory to Albaugh (unrelated supplier).

- The Mann brothers negotiated and arranged with Albaugh to sell ClearOut to NewAgco Barbados under an exclusive third-party supply agreement in order to be able to sell to Canadian farmers. NewAgco Barbados asset acquisition of NewAgco US included spring 2006 sales orders, ClearOut inventory, and rights.

- During 2006 and 2007, Jason Mann continued to purchase ClearOut for NewAgco Barbados and set the selling price.

- Pursuant to a service agreement entered into between AgraCity and NewAgco Barbados, AgraCity arranged for logistical and related activities of NewAgco Barbados' sales and deliveries to their Canadian customers. NewAgco Barbados paid AgraCity an amount per litre of ClearOut sold to perform these services. AgraCity and NewAgco Barbados adjusted the amount per litre periodically to ensure that AgraCity earned a reasonable profit above its costs.

The CRA reassessed AgraCity's 2007 and 2008 taxation year relying on the transfer pricing rules in paragraphs 247(2)(a) and (c) of the ITA and reallocated all of NewAgco Barbados' profits back to AgraCity Canada.

CRA's argument was based on the premise that NewAgco Barbados did not perform any functions in the context of the transactions (and so provided no value to which profits should be attributed). CRA's expert witness performed a "functional analysis" and argued that "the value created by the parties to the transactions did not align with what was credited to AgraCity and NewAgco Barbados".[2]

Accordingly, before the Tax Court, the Crown had the following positions in support of the reassessments:

a) primary assessing position – the transactions were a sham or window dressing;
b) alternative position – recharacterization of the transactions under paragraphs 247(2)(b) and (d) of the ITA; and
c) a further alternative position – transfer pricing adjustment under paragraphs 247(a) and (c) of the ITA.

Crown's primary assessing position – sham

The Crown argued sham on the basis that the series of transactions entered by AgraCity Canada were designed to deceive and mislead the CRA and others into concluding that NewAgco Barbados, not AgraCity, was undertaking a business and incurring real risk.

Specifically, the Crown argued that AgraCity Canada, entered into the service agreement to give the illusion that NewAgco Barbados was selling ClearOut to Canadian farmers "when the evidence shows that the activities were those of

[2] 2020 TCC 91, par. 87.

AgraCity*".*[3] Some of the key arguments/assumptions made by the Crown in support of its position were:

- NewAgco Barbados was an empty shell and had no employees;
- NewAgco Barbados had no assets and performed no economic activities and provided no value-added functions;
- AgraCity Canada undertook all functions and therefore assumed all the risks;
- NewAgco Barbados was not a party to the sale of the ClearOut;
- Suppliers sold the ClearOut to AgraCity and not NewAgco Barbados;
- Jason Mann negotiated prices for ClearOut with suppliers and not NewAgco Barbados; and,
- The Board of Directors of NewAgco Barbados was for appearance and only rubberstamped decisions previously made in Canada by Jason Mann and his brother.

Tax Court's decision – sham

The Court followed the concept of sham as most recently set out by the Court in *Cameco Corporation v. The Queen*[4] (*Cameco*) and *Palletta v. The Queen*[5] and concluded that the evidence presented did not establish the existence of any sham transactions, nor any deceptive window dressing. The transactions that occurred and were documented were the transactions the parties intended, agreed to, and that the parties reported to others including the CRA.

Some of the key reasons for this conclusion were as follows:

- The basic structure involving a non-Canadian company to source and sell ClearOut was done for *bona fide* non-tax reasons with no reason or intention to deceive anyone.
- It was understood that under Health Canada Regulations a Canadian company would not be permitted to be responsible for selling or distributing ClearOut in Canada. Hence, it supported the business decision of using NewAgco Barbados.
- There was no attempt to mislead or deceive others about the adopted structure, the participants involved or its purpose and objectives.
- It was NewAgco Barbados that purchased the ClearOut and the third-party supplier and others within AgraCity were fully aware of this and the fact that Jason Mann was acting on behalf of NewAgco Barbados in negotiating the purchases and exclusive supply contract.
- The accounting records reflected the structure of the transactions and cash moved into and out of NewAgco Barbados bank accounts.

[3] 2020 TCC 91, par. 73.
[4] 2018 TCC 195 aff'd 2020 FCA 112.
[5] 2019 TCC 205.

- NewAgco Barbados received orders from customers for prices set by Jason Mann, duly authorized by the Board of NewAgco Barbados to do so on its behalf.

- NewAgco Barbados paid for the ClearOut which it had shipped to its warehouse in the US and it arranged and paid for the ClearOut to be delivered to Canadian customers.

- AgraCity collected the amount from the customers and remitted the amounts to NewAgco Barbados, and the amounts were recorded as revenue by NewAgco Barbados.

- NewAgco Barbados bore material risk, including foreign exchange risk, which it incurred and recorded in its books.

- NewAgco Barbados owned inventory including the original inventory it purchased when it was set up.

- NewAgco Barbados acquired valuable assets (i.e., the exclusive supply agreement).

- NewAgco Barbados complied with all corporate and commercial law.

- The Services Agreement between AgraCity and NewAgco Barbados was a valid contractual agreement setting out what AgraCity was responsible for and what it actually did.

Crown's alternate assessing position – recharacterization

While the Crown presented recharacterization as its alternate assessing position, it did not make any factual assumptions to support its position that arm's length parties would not have entered into transactions other than those made to support the sham or transfer pricing adjustments under paragraphs 247(2)(a) and (c) of the ITA.

Tax Court's decision –recharacterization

The Court referenced *Cameco Corporation v. The Queen*[6] stating that it must be proved that the very transactions agreed to and completed by the parties "would not have been entered into between persons dealing at arm's length".[7]

Furthermore, the Crown's expert witness testimony and report did not include anything specific to support or prove that the transactions would not have been entered into between arm's length parties.

In the absence of evidence, the Court dismissed this recharacterization argument.

Crown's other alternate assessing position – transfer pricing adjustment

The Crown's expert witness acknowledged that ClearOut had to be sold to Canadian farmer-users by a non-Canadian entity and that NewAgco Barbados contractually purchased and sold ClearOut and made payments for ClearOut and the transportation of ClearOut. The Crown also acknowledged that NewAgco Barbados was the entity that had the exclusive buy-sell contract and

[6] 2018 TCC 195 aff'd 2020 FCA 112.
[7] 2020 TCC 91, par. 79.

that in 2006 AgraCity entered into the services agreement with NewAgco Barbados to carry out the activities which were largely, though not exclusively, logistical in nature, for the purpose of selling ClearOut to FNA members.

The Crown's expert report treated NewAgco Barbados as the tested party for the transfer pricing analysis, looked at the value of the functions performed by and the contributions of NewAgco Barbados, and concluded that NewAgco Barbados was not entitled to a return for any functions performed because it performed no functions, used no assets and took no risks. Therefore, 100% of the profit earned by NewAgco Barbados should have been Agra City's revenue and none of the profits would be NewAgco Barbados, if they were dealing at arm's length.

The Crown's expert witness testified that he would not allocate any value in an Organisation for Economic Co-operation and Development (OECD) transfer pricing functional analysis to any actual foreign exchange, product liability or any other risk actually borne by NewAgco Barbados as a buyer, owner, or seller of ClearOut because NewAgco Barbados performed no functions. However, he did acknowledge during the trial that he understood why the Court would have trouble thinking that an arm's length party would agree to be paid nothing when they legally assumed real risk.

Tax Court's decision – transfer pricing adjustment

The Court followed the line of jurisprudence of the Supreme Court of Canada in *Hickman Motors Ltd. v. Canada*[8] and the Federal Court of Appeal in *House v. Canada*[9] on the issue of burden of proof and concluded that the findings and all evidence presented clearly made a *prima facia* case that the reassessments were incorrect and demolished the Crown's assumptions of fact that supported the transfer pricing adjustments.

The Court noted the following:

- A non-Canadian entity was required in order to sell ClearOut to Canadian customers;
- NewAgco Barbados was the purchaser and beneficial owner of the ClearOut acting on its own account upon purchasing it until it sold the ClearOut to Canadian farmers;
- NewAgco Barbados paid for its purchases and received the sales proceeds for its own account;
- NewAgco Barbados sourced the ClearOut with Jason Mann, doing it on behalf of NewAgco Barbados as duly authorized by NewAgco Barbados;
- NewAgco Barbados had Jason Mann negotiate an exclusive supply agreement;
- NewAgco Barbados took real foreign exchange risk and took real risk as the owner of large volumes of a chemical based regulated herbicide; and,
- The services agreement is the proper transaction whose terms, rights and obligations need to be reviewed for purposes of the transfer pricing rules.

[8] [1997] 2 S.C.R. 336 (Hickman).
[9] 2011 FCA 234.

The Court was left to determine what amount of NewAgco Barbados net sales profits would have been payable by NewAgco Barbados to AgraCity Canada under the service agreement if they were dealing at arm's length. The Crown and its expert witness did not provide any evidence in support of how to determine any such amount as their view was that all of the net profits of NewAgco Barbados should be with AgraCity Canada.

AgraCity's expert witness provided evidence and testimony that indicated that the amount paid to AgraCity generated a return on costs for AgraCity that was in the range of what somewhat comparable arm's length service providers earn. Being the only evidence presented it was by definition the best evidence, notwithstanding it had limitations.

The Crown failed to produce satisfactory evidence to prove on a balance of probabilities that its relevant assumptions, or its further allegations or positions, were correct. Consequentially, the Court ruled that AgraCity succeeded in the appeal.

Key takeaways

The key principles affirmed by the Court in *AgraCity* are similar to those affirmed in *Cameco*[10] and 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, with no reason to attempt to deceive anyone, the arrangement should not be considered a sham.

- To successfully recharacterize a transaction, the CRA will need to provide some evidence to support its assertion that the transaction would not be entered into between arm's length parties.

- A transaction should not be subject to recharacterization if it is commercially rational. If it is commercially rational, the transfer pricing analysis must focus on the actual transaction and the terms, rights and obligations regarding that transaction.

- The Court held that based on the actual transactions that occurred, NewAgco Barbados owned assets and bore risks, and it was entitled to a return in respect of the assets and risks notwithstanding the fact that it did not have its own employees. While this is at odds with the 2017 OECD Transfer Pricing Guidelines, it is clear that the court was of the view that the arm's length parties would conduct business in this manner.

- This case continues to show how difficult it may be for the CRA to apply the recharacterization provisions in the ITA.

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.

[10] 2018 TCC 195 aff'd 2020 FCA 112.

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