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Tax Alert – Canada

Federal Court of Appeal rejects Crown appeal of Tax Court of Canada decision in Cameco transfer pricing case

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 26 June 2020, the Federal Court of Appeal (FCA) released its decision in the case of *The Queen v. Cameco Corporation*, 2020 FCA 112, an appeal of the September 2018 Tax Court of Canada (TCC) decision in *Cameco Corporation v. The Queen*, 2018 TCC 195. The FCA upheld the TCC's decision in favour of the taxpayer, and in doing so set out a succinct interpretation of the transfer pricing recharacterization provisions in the *Income Tax Act* (the Act).

For additional detail regarding the TCC decision, see EY 2018 Tax Alert No. 33.

Facts

During the taxation years in issue (2003, 2005 and 2006), Cameco Corporation (Cameco) was one of the world's largest uranium producers and suppliers of conversion services. Prior to a reorganization, Cameco had uranium mines in Saskatchewan and uranium refinery and conversion facilities in Ontario. Cameco's US subsidiary owned uranium mines in the US.

In the late 1990s, Cameco's European subsidiary Cameco Europe S.A (CESA/CEL), Cogema (a French state-owned uranium producer and competitor), Nukem Inc . (a US trader in uranium), and Tenex (a Russian uranium company) entered into an agreement with the Russian government to purchase certain amounts of highly enriched uranium (the Tenex Agreement). Following the Tenex Agreement, Cameco's European subsidiary concluded an agreement with Urenco Limited to purchase a certain amount of natural uranium (the Urenco Agreement).

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During the same period, Cameco reorganized itself, including the formation of a Swiss subsidiary. Following the reorganization, the Cameco group had three main entities: the Canadian entity, which continued to operate uranium mines and conversion facilities in Canada along with providing administrative support services to other Cameco entities; CESA/CEL, a Swiss entity that was the trader for the group, purchasing and selling uranium from Russia and from the Canadian and US affiliates; and Cameco US, which was the marketing arm responsible for selling the uranium to third parties for use in nuclear reactors.

During the period in question, CESA/CEL had two employees to perform duties that included the conclusion of approximately 20 to 25 new uranium contracts per year. Cameco provided administrative services to CESA/CEL, including the administration of CESA/CEL's uranium contracts, assistance in market forecasting, legal services, human-resources-related services, and financial, bookkeeping and accounting services. In addition, Cameco and CESA/CEL entered into various contracts with respect to the delivery of uranium. From 1999 to 2001, CESA/CEL entered into nine long-term agreements with Cameco. Under the agreements, CESA/CEL was to receive uranium from Cameco, most of which used a base escalated pricing model. In addition, from 1999 to 2006, CESA/CEL and Cameco entered into twenty-two agreements to deliver uranium to Cameco on a specific date or short-term delivery period that used a fixed or market-based price.

The Minister reassessed the Appellant's 2003, 2005, and 2006 taxation years to increase Cameco's income to include all of the profits from CESA/CEL, relying firstly on the legal doctrine of sham, and secondly on paragraphs 247(2)(b) and (d) of the Act to recharacterize the transactions on the premise that Cameco, as an arm's length person, would not have entered into the transactions with CESA/CEL. Lastly, the Minister relied on paragraphs 247(2)(a) and (c) of the Act to re-price the transactions. The reassessments increased Cameco's income by approximately $483 million for the three years in dispute.

Tax Court of Canada decision

The TCC's September 2018 decision found in favour of Cameco, allowing the taxpayer's appeal. In so doing, the TCC concluded that none of the transactions, arrangements or events in issue was a sham, finding that there was no evidence to suggest that the contracts entered into by the parties did not represent the parties' true intentions. The decision also reversed the Minister's transfer pricing adjustments under section 247 of the Act for each of the taxation years in question, concluding that the series of transactions was not commercially irrational such that the criteria in subparagraph 247(2)(b)(i) had not been met and therefore recharacterization rule in paragraph 247(2)(d) did not apply. The TCC also found that the prices charged by the taxpayer for uranium delivered in the relevant taxation years were well within an arm's length range of prices and that consequently no transfer pricing adjustment was warranted under paragraphs 247(2)(a) and (c).

Federal Court of Appeal decision

The FCA dismissed the Crown's appeal of the TCC decision.

In its appeal, the Crown did not appeal the TCC dismissal of the sham argument and did not directly challenge the TCC's findings of fact on the pricing of the transactions. Rather, the Crown largely restricted itself to challenging the TCC's findings regarding the recharacterization provisions in paragraphs 247(2)(b) and (d) of the Act.

Paragraph 247(2)(b) of the Act sets out two required conditions in order for the recharacterization provision in paragraph 247(2)(d) to apply:

(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 bona fide purposes other than to obtain a tax benefit.

If those conditions apply, then paragraph 247(2)(d) allows the Minister to adjust amounts determined for the transactions in question to make an adjustment "to the quantum or nature of the amounts that would have been determined if … 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."

The parties and the FCA focused on the first condition of paragraph 247(2)(b)(i). The court framed the operative question as being "whether the transaction or series of transactions would have been entered into between persons dealing with each other at arm's length (an objective test based on hypothetical persons) — not whether the particular taxpayer would have entered into the transaction or series of transactions in issue with an arm's length party (a subjective test)." In answering that question at an interpretive level, the FCA succinctly found that "Subparagraph 247(2)(b)(i) of the Act applies when no arm's length persons would have entered into the transaction or the series of transactions in question, under any terms and conditions. If persons dealing at arm's length would have entered into the particular transaction or series of transactions in question, but on different terms and conditions, then paragraphs 247(2)(a) and (c) of the Act would be applicable."

Answering the question with respect to Cameco, the FCA reaffirmed the TCC decision, finding that "There is no basis to find that parties dealing with each other at arm's length would not have bought and sold uranium or transferred between them the rights to buy uranium from Tenex or Urenco." In reaching its conclusion, the FCA referenced and found support in the OECD's 2010 *Transfer Pricing Guidelines*. No reference was made by the FCA to changes to the OECD *Transfer Pricing Guidelines* since 2010.

Notwithstanding its conclusion that the conditions of paragraph 247(2)(b)(i) were not met, the FCA also considered the application of paragraph 247(2)(d) as advanced by the Crown. It determined that where the pre-conditions of paragraph 247(2)(b) are met:

> "Paragraph 247(2)(d) of the Act requires the Court to replace the transaction or series of transactions that was entered into between the participants with the transaction or series of transactions that would have been entered into between persons dealing with each other at arm's length. It contemplates replacing the existing transaction or series of transactions with some other transaction or series of transactions. It does not contemplate replacing the existing transaction or series of transactions with nothing, which is the result proposed by the Crown in paragraph 4 of its memorandum: "Cameco Canada would not have entered into any transactions with its Swiss subsidiary if they had had been dealing at arm's length". Treating Cameco as if it had not entered into any transactions with CEL would, in effect, result in the separate existence of CEL being ignored or effectively CEL being amalgamated with Cameco."

The FCA observed "If the Crown's interpretation is correct, then whenever a corporation in Canada wants to carry on business in a foreign country through a foreign subsidiary, the condition in subparagraph 247(2)(b)(i) of the Act would be satisfied. Because the company wants to carry on business in that foreign country either on its own or through its own subsidiary, it would not sell its rights to carry on such business to an arm's length party." The breadth of this interpretation by the Crown led the FCA to further opine that this was not what Parliament intended.

In summarizing the recharacterization issue, the FCA noted "the rules in paragraph 247(2)(b) and (d) of the Act are not as broad as the Crown suggests. They do not allow the Minister to simply reallocate all of the profit of a foreign subsidiary to its Canadian parent company on the basis that the Canadian corporation would not have entered any transactions with its foreign subsidiary if they had been dealing with each other at arm's length."

Lastly, the FCA summarily dismissed the Crown's alternative argument with respect to pricing the transactions under paragraphs 247(2)(a) and (c), finding that this approach was a challenge to the TCC's findings of fact, against which the Crown had not appealed.

The Crown has until 25 September 2020 to seek leave to appeal the decision to the Supreme Court of Canada (although this date may be extended under proposed legislation related to COVID-19 pandemic measures).

Implications

Takeaways from this decision for Canadian taxpayers include:

- Canada's foreign affiliate regime has a legitimate purpose to allow Canadian companies to conduct business outside of Canada on a tax-effective basis, and taxpayers are entitled to structure their affairs within this regime without triggering adverse consequences.
- The recharacterization provisions of paragraphs 247(2)(b) and (d) will not apply where the taxpayer's arrangements are commercially rational and especially where

nothing impedes the determination of a transfer price, even if there exists a tax-oriented purpose to the particular structure utilized.

- In determining under paragraph 247(2)(b) whether arm's length parties would have entered into a transaction, reference should be made to arm's length persons in general rather than to the particular participants to a transaction.
- Where paragraph 247(2)(d) does apply, it is incumbent upon the Minister to substitute arm's length terms and conditions for the transaction it has determined would have been entered into between arm's length persons, rather than substituting the terms and conditions with nothing on the presumption that the no transaction would have occurred.

Learn more

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