2018 Issue No. 33
2 October 2018

Tax Alert — Canada

Tax Court of Canada finds for the taxpayer in Cameco transfer pricing case

Cameco Corporation v The Queen, 2018 TCC 195

On 26 September 2018, the Tax Court of Canada (TCC or the Court) released its decision in *Cameco Corporation v The Queen*, 2018 TCC 195. The Court allowed the taxpayer's appeal, concluding that none of the transactions, arrangements or events in issue was a sham, and reversed the Minister of National Revenue (the Minister)'s transfer pricing adjustments under section 247 of the *Income Tax Act* (Canada) (the Act) for each of the taxation years in question.

In so concluding, the Court found that there was no evidence to suggest that the contracts entered into by the parties did not represent the parties' true intentions. In reversing the transfer pricing adjustments under section 247(2), the Court concluded that the series of transactions was not commercially irrational such that the criteria in subparagraph 247(2)(b)(i) had not been met and the recharacterization rule in paragraph 247(2)(d) did not apply. The Court also found that the prices the taxpayer charged 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). The Crown has 30 days to appeal this decision.

Building a better working world

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.

Uranium is commonly sold in two types: U_3O_8 and UF_6. Cameco has conversion facilities such that it could purchase and sell either type of uranium. Typically, before either type of uranium can be sold it must first be mined and then processed into fuel assemblies. However, during the early 1990s the Russian Government began a program to sell the uranium supply it formerly used in its nuclear weapons and concluded an agreement with the US Government for the sale of its highly enriched uranium. To be useable in nuclear reactors, the highly enriched uranium had to be blended with natural UF_6 uranium to create low-enriched uranium, or enriched UF_6. In addition, the US Government put into place legislation whereby it would purchase this uranium and withhold certain amounts from the market over a number of years.

During the late 1990s, Cameco considered the opportunities and issues that might flow from these international agreements and legislation. Due to concerns about a supply of highly enriched uranium flooding the market, 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).

Over the same period, Cameco decided to reorganize itself, forming a Swiss subsidiary and a Barbadian 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 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, CESA/CEL had two employees to perform duties that included the conclusion of new uranium contracts — approximately 20 to 25 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 the base-escalated pricing model (the BPC transactions). In addition, from 1999 to 2006, CESA/CEL and Cameco entered into 22 agreements to deliver uranium to Cameco on a specific date or short-term delivery period that used a fixed or market-based price (the CC transactions and, collectively, the transactions).

Uranium is not listed on an exchange but is bought and sold under private contracts — spot or long-term. There are, however, two companies that publish price indicators. Uranium contracts follow four types of pricing mechanisms: fixed pricing, base-escalated pricing, market-related pricing and hybrid pricing.

The Minister reassessed the appellant's 2003, 2005 and 2006 taxation years to increase its income to include all of the profits from CESA/CEL, relying firstly on the legal doctrine of sham, secondly on paragraphs 247(2)(b) and (d) of the Act to recharacterize the transactions, and lastly on paragraphs 247(2)(a) and (c) of the Act to reprice the transactions.

The decision

Sham

For the doctrine of sham to apply, the Crown had to show that the parties to the transaction presented their legal rights and obligations differently from what they knew those legal rights, if any, to be. If a transaction is a sham, extrinsic evidence will be used to determine the true nature of the transaction. If a transaction is not a sham, the document(s) papering the transaction will determine the transaction's legal characterization.

The Court found that there was no sham in this case and that the appellant, Cameco US and CESA/CEL entered into numerous contracts to create the legal relationships described in those contracts, and that there was no evidence to suggest that those contracts (between 1999 and the end of 2006) did not reflect the parties' true intentions to those contracts. While those arrangements may have been tax related, a tax motivation does not transform the arrangements into a sham. In particular, the Court found that "de minimis examples" raised by the Crown did not support a finding of a sham or support the argument that the appellant routinely concluded contracts on behalf of CESA/CEL and treated CESA/CEL's inventory as its own. The Court also refused to draw adverse inferences or findings of deceit from certain failures or deficiencies raised by the Crown, including the failure of some witnesses to keep notes in sales meetings or to document the express agreement of CESA/CEL on each of the back-to-back sales to Cameco US; the execution of contracts a few days after the effective date or other minor irregularities in concluding contracts; and a few backdated notices that certain witnesses attempted to rectify.

The Court also found that the fact that the boards of CESA and CEL approved of transactions in the best interests of the Cameco Group as a whole did not detract from the legitimacy of their role in directing the affairs of CESA/CEL, and that "[n]o reasonable person would expect a wholly owned subsidiary to act in a manner that is at odds with the interests of the ultimate parent corporation or of the broader corporate group." The Crown took issue with the manner of administration of various contracts entered into by CESA/CEL, because the decision-making by CESA/CEL, the appellant and Cameco US was collaborative and not adversarial, and argued that the overall arrangement was a deliberate deception, because the appellant was doing everything. The Court rejected this argument and found that the way that the Cameco Group operated was reasonable and that "there was nothing unusual about the way the Cameco Group operated."

Transfer pricing

The Court highlighted that this was the first decision where the transfer pricing recharacterization rule (TPRR) in paragraphs 247(2)(b) and (d) was being considered. Prior to interpreting the TPRR, the Court noted that section 247 does not apply to a transaction or a series between a taxpayer and one or more arm's-length persons, or to a transaction or a series between two nonresidents where neither is a taxpayer. However, the existence of such a transaction or series, and the terms and conditions of that transaction or series, may be relevant facts when applying the TPRR to a transaction or series between a taxpayer and a non-arm's-length nonresident.

Paragraph 247(2)(b) applies where i) the transaction or series would not have been entered into by arm's-length parties and ii) 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. In determining whether subparagraph 247(2)(b)(i) is met, the Court held that the focus is on whether the transaction or series would have been entered into by arm's-length persons acting in a commercially rational manner. Therefore, the test will be satisfied if it is found that the transaction or series is not commercially rational, and such an objective assessment of the transaction or series may be aided by expert opinion. In determining whether subparagraph 247(2)(b)(ii) has been satisfied, the Court stated that it will be met where, upon an objective assessment of the driving forces behind the transaction or series, it is reasonable to consider that the transaction or series was not entered into primarily for bona fide purposes other than to obtain a tax benefit.

The Court indicated that if the two-pronged test in paragraph 247(2)(b) is satisfied, then the Minister may apply paragraph 247(2)(d). While this is referred to as a recharacterization rule, in the Court's view, it does not permit the Minister to recharacterize the transaction or series identified, nor does it allow the Minister to simply disregard the transactions as if nothing in fact occurred. Rather, subsection 247(2) permits the Minister to identify an alternative transaction or series that in the same circumstances would be entered into by arm's-length parties in place of those entered into and then to make an adjustment that reflects arm's-length terms and conditions for that alternative transaction or series. This adjustment, being based on arm's-length terms and conditions, may alter the quantum or the nature of an amount.

The Court found that the conditions in the preamble of subsection 247(2) were satisfied. Cameco is a taxpayer, and CESA/CEL and Cameco US are non-arm's-length nonresidents that were the participants in a series of transactions. While the Court rejected the Crown's assertion that all of the transactions undertaken by Cameco and/or CESA/CEL since the reorganization in 1999 are part of a single set of transactions that must be tested against the transfer pricing rules, the Court identified four series of transactions. In essence, these consisted of the incorporation of CESA/CEL, the designation of CESA/CEL as the signatory to the Tenex Agreement and Urenco Agreement, Cameco's guarantee of the obligations of CESA/CEL under those agreements (collectively, the series) and the entering into by CESA/CEL to receive uranium from Cameco (the BPC transactions) and to deliver uranium to Cameco (the CC transactions and, collectively, the transactions).

In determining whether the first prong of the test in paragraph 247(2)(b) was met for the series, the Court concluded that it would be commercially rational for a party to give up a business opportunity, so long as it received the appropriate compensation for such an opportunity (such an analysis is governed by paragraphs 247(2)(a) and (c)). Here, for Cameco to conclude the Tenex Agreement and Urenco Agreement, it was necessary to involve the participation of two competitors, since each party gave up a business opportunity to achieve other objectives.

Further, the Court noted that the foreign affiliate regime in the Act contemplates Canadian corporations establishing subsidiaries abroad to carry on active businesses in those jurisdictions, and the purpose of the regime is to allow Canadian multinationals to compete in international markets through foreign subsidiaries without attracting Canadian income tax. Accordingly, the Court found that there was nothing exceptional, unusual or inappropriate about Cameco's decision to incorporate CESA/CEL and to have CESA/CEL execute the Tenex Agreement or Urenco Agreement. As a result, the application of the extraordinary remedy in paragraph 247(2)(d) was not warranted or appropriate in the circumstances.

With respect to the transactions, the Court found that the BPC transactions were long-term contracts, the duration of which was within the range of the long-term contracts for that period, that were for volumes of uranium that were reasonable when compared to arm's-length wholesale contracts made during the same period, and that provided Cameco with an appropriate level of compensation. Given that commodity producers will sell production under a base-escalated contract to secure a guaranteed revenue stream for that production even if the price is expected to move higher, the Court found that the transactions were not the type described in subparagraph 247(2)(b)(i) of the Act. Similarly, with respect to the CC transactions, the Court found that there was nothing commercially irrational about the contracts since they were for a single delivery of uranium or deliveries over a short period of time and were based on a fixed price or a market-based price.

While the Court concluded that the first prong of the test in paragraph 247(2)(b) had not been met, the Court went on to consider the application of subparagraph 247(2)(b)(ii). The Court stated that the appellant admitted that tax was a motivation of the reorganization undertaken, and found that the appellant would not have implemented the series were it not for the tax savings. Accordingly, the Court held that the primary purpose of the series was to save the tax that would have been payable in Canada had Cameco entered into those agreements directly. However, the Court distinguished between the primary purpose of the series and that of the transactions, indicating that the purpose of the transactions simply did not follow the primary purpose of the series. The transactions entered into between CESA/CEL and Cameco were for the bona fide purpose of earning a profit. Consequently, the transactions did not meet the second prong of the test in paragraph 247(2)(b).

Finally, the Court considered the application of paragraphs 247(2)(a) and (c) (referred to as the "traditional transfer pricing rules") to the series and transactions — the price that would have been paid in the same circumstances had the parties been dealing at arm's length. With respect to the Tenex Agreement, the Court found based on the evidence (such as the conclusion of an agreement with two competitors and the purpose of the agreement to prevent the market being flooded with uranium) that the economic benefit of participating in the agreement at the time of execution was negligible and that any economic benefit would depend on uncertain future events. Consequently, the Court rejected any adjustment with regard to the appellant on the basis of the series of transactions leading to the Tenex Agreement.

With respect to the Urenco Agreement, the Court found that the objective of the agreement was to avoid Urenco dumping uranium onto the market, depressing its price, and to provide a trading opportunity to CESA/CEL. While Cameco US led the negotiation of the agreement on behalf of CESA/CEL, this did not automatically lead to a transfer pricing adjustment. Such an adjustment would depend on the compensation to Cameco US. Given that Cameco US also benefited from the agreement with Urenco because of its 2% commission, the Court held that it was unlikely such a transfer pricing issue exists. Similar to the Tenex Agreement, the Court concluded that there was no evidence to support a different view regarding the value of the Urenco Agreement, given that it was negotiated by arm's-length parties and since it represented the possibility that CESA/CEL could earn a profit by purchasing Urenco's uranium.

The Court held that for both transactions the comparable uncontrolled price (CUP) methodology was the most reliable transfer pricing methodology to test the price charged under those contracts. With respect to the sales of uranium by Cameco to CESA/CEL under the BPC transactions, the Court rejected the Minister's submission that the value of the administrative services provided by Cameco in the functions of forecasting and research justified shifting the price risk inherent in the core purchase and sales function of CESA/CEL to Cameco such that the profit earned by CESA/CEL from the purchases and sales of uranium should be shifted to Cameco. Using hindsight, the Crown argued that the arrangement created a windfall that should have accrued to Cameco Canada by virtue of its involvement. However, under the CUP methodology, the Court held that the terms and conditions of the transactions were those that arm's-length parties would have entered into given the circumstances. Based on Cameco's experts' analyses, it found that the transaction pricing, absent hindsight, was well within the arm's-length range.

Importantly, the Court also held that price risk associated with the commodity transactions (and commensurate remuneration for such risk — which, according to the Crown, should have represented the majority of CESA/CEL's profit from the purchase and sale of uranium) cannot be shifted simply because a related party provided support and other services under a contract for services. The Court noted that the traditional transfer pricing rules must not be used to recast the arrangements actually made among the participants in the transaction or series, except to the limited extent necessary to properly price the transaction or series by reference to objective benchmarks. The Court referred approvingly to the following statement in one of the expert reports: "The key point is that it is the owners of the asset who bear the asset's risk, not the managers of that risk."

Implications

Takeaways from this decision for taxpayers include:

- The transaction or series of transactions (which are to be tested against the transfer pricing rules) should not be defined overly broadly, as that would make it difficult if not impossible to find comparables. Rather, the transaction or series identified must allow for a meaningful, predictable and practical application of the arm's-length principle.

- The recharacterization provisions of paragraphs 247(2)(b) and (d) will not apply where the taxpayer's arrangements are commercially rational, even if there exists a tax-oriented purpose to the overall arrangements.
- Tax authorities should avoid the use of hindsight in their analysis of taxpayers' transactions.
- Performance of administrative functions, including in this case the management of risk, will not in and of itself result in a transfer of risk from an asset owner to a service provider.
- A transfer pricing adjustment under paragraphs 247(2)(a) and (c) is not warranted where the prices charged are within an arm's-length range supported by a rigorous CUP analysis based on the relevant circumstances. Tax motivation does not undermine pricing established through appropriate benchmarking.

Context of this case in the global environment

Cameco Corporation v The Queen is illustrative of two megatrends in the global transfer pricing environment: the need to clearly and narrowly define the intercompany transaction and the court's continued reliance on third-party transactions as evidence of arm's-length pricing.

While the Crown considered the aggregate series of transactions, the Court disaggregated the series into narrowly and well-defined transactions for purposes of analyzing the characterization. Once the transactions were clearly defined, the Court relied on third-party transactions, including a CUP, to determine pricing.

Both trends continue to be addressed in courts and tax audits globally and should be given proper consideration when entering into and pricing intercompany transactions.

Learn more

For more information, please contact your EY or EY Law advisor or one of the following professionals:

Toronto

Marlon Alfred
+1 416 932 5151
marlon.alfred@ca.ey.com

Andrew Clarkson
+1 416 943 2146
andrew.clarkson@ca.ey.com

Tara Di Rosa
+1 416 943 2671
tara.dirosa@ca.ey.com

Sean Kruger
+1 416 941 1761
sean.kruger@ca.ey.com

Ken Kyriacou
+1 416 943 2703
ken.kyriacou@ca.ey.com

Quebec and Atlantic Canada

Angelo Nikolakakis
+1 514 879 2862
angelo.nikolakakis@ca.ey.com

Rachel Spencer
+1 514 879 8214
rachel.spencer@ca.ey.com

Wael Tfaily
+ 514 879 6695
wael.tfaily@ca.ey.com

Alfred Zorzi
+1 514 874 4365
alfred.zorzi@ca.ey.com

Prairies

Lawrence Greer
+1 403 206 5031
lawrence.a.greer@ca.ey.com

Ottawa

Rene Fleming
+1 613 598 4406
rene.fleming@ca.ey.com

Paul Mulvihill
+1 613 598 4339
paul.f.mulvihill@ca.ey.com

Tony Wark
+1 613 598 4322
tony.wark@ca.ey.com

Vancouver

Tina Berthaudin
+ 604 891 8207
tina.berthaudin@ca.ey.com

Greg Noble
+1 604 891 8221
greg.noble@ca.ey.com

Adrian Tan
+ 604 891 8318
adrian.tan@ca.ey.com

EY Law

Daniel Sandler
+1 416 943 4434
daniel.sandler@ca.ey.com

Louis Tassé
+1 514 879 8070
louis.tasse@ca.ey.com

David Robertson
+1 403 206 5474
david.d.robertson@ca.ey.com

Roger Taylor
+1 613 598 4315
roger.taylor@ca.ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization and may refer to one or more of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

About EY's Tax Services
EY's tax professionals across Canada provide you with deep technical knowledge, both global and local, combined with practical, commercial and industry experience. We offer a range of tax-saving services backed by in-depth industry knowledge. Our talented people, consistent methodologies and unwavering commitment to quality service help you build the strong compliance and reporting foundations and sustainable tax strategies that help your business achieve its potential. It's how we make a difference.

For more information, visit ey.com/ca/tax.

About EY Law LLP
EY Law LLP is a national law firm affiliated with EY in Canada, specializing in tax law services, business immigration services and business law services.

For more information, visit eylaw.ca.

About EY Law's Tax Law Services
EY Law has one of the largest practices dedicated to tax planning and tax controversy in the country. EY Law has experience in all areas of tax, including corporate tax, human capital, international tax, transaction tax, sales tax, customs and excise.

For more information, visit http://www.eylaw.ca/taxlaw

ey.com/ca