

Transfer Pricing e-Alert

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Arbitrary Transfer Pricing Adjustment Set Aside

The Tax Court of Canada (**Tax Court**) recently released its long-awaited transfer pricing decision in *Cameco Corporation v Her Majesty the Queen* [2018 TCC 195](#). This case involved a landmark transfer pricing dispute in which the Tax Court addressed the transfer pricing provisions contained in subsection 247(2) of the Canadian Income Tax Act (**Act**). In allowing the taxpayer's appeal, the Tax Court found that the prices used by Cameco Corporation (**Cameco**) were within an arm's length range of prices and reversed the transfer pricing adjustments made by the Minister of National Revenue (**Minister**).

Background Facts

In 2003, 2005 and 2006, Cameco constituted one of the world's largest uranium producers and suppliers of conversion services. It had uranium mines in Saskatchewan and uranium refining and processing facilities in Ontario. In the US, uranium mines were owned by local subsidiaries of Cameco.

In the early 1990s, Russia concluded an agreement with the US to sell its weapons-grade uranium. In order to be usable in nuclear reactors, the highly enriched uranium had to be converted to UF₆. Cameco saw this as an opportunity to reorganise its business affairs in order to address issues that might flow from the agreement.

In 1999, Cameco reorganised itself into three main entities:

- Cameco in Canada, which remained the miner and producer and which provided administrative support services to other Cameco entities;
- Cameco Europe SA, a Luxembourg subsidiary of Cameco (**CESA**), and Cameco Europe AG, a Swiss subsidiary of Cameco (**CEL**) (collectively, **CESA/CEL**), were to be the traders and the price speculators on the sale and purchase of uranium; and
- Cameco Inc, the US subsidiary, was to be the broker.

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Due to concerns that a supply of highly enriched uranium would flood the market, CESA/CEL, Cogema (a French state-owned uranium producer and competitor) and Nukem Inc (a privately owned US trader in uranium) agreed to buy the Russian uranium (**Tenex agreement**). CESA/CEL also entered into an agreement to purchase natural uranium from Urenco Limited (**Urenco agreement**).

In addition, Cameco and CESA/CEL entered into numerous contracts for the delivery of uranium. Under nine long-term agreements entered into between CESA/CEL and Cameco, most of which used the base-escalated pricing model (**BPC transactions**), CESA/CEL was to receive uranium from Cameco. Further, CESA/CEL entered into 22 agreements with Cameco to deliver uranium to Cameco on a specific date or short-term delivery period. These used fixed or market-based prices (**CC transactions**).

During the years in question, CESA/CEL earned substantial profits whereas Cameco incurred significant losses. This discrepancy led the Minister to reassess Cameco under the Act to attribute all the profits of CESA/CEL to Cameco for the 2003, 2005 and 2006 taxation years. In a transfer pricing context, the Minister firstly relied on subsections 247(2)(b) and (d) of the Act, and, secondly, on subsections 247(2)(a) and (c) of the Act to make the transfer pricing adjustments.

Decision

Re-characterisation — subsections 247(2)(b) and (d)

The Tax Court noted that subsection 247(2)(b) applies where:

- (i) the transaction or series would not have been entered into between persons dealing at arm's length; 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 deciding whether or not subsection 247(2)(b)(i) is met, the focus is on the commercial rationality of the transaction or series, taking into consideration all of the relevant circumstances. In other words, it is only where the transaction or series is commercially irrational that subparagraph 247(2)(b)(ii) becomes relevant. If the two-pronged test in subsection 247(2)(b) is

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satisfied, then subsection 247(2)(d) allows 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 the actual transaction or series, and then to make an adjustment that reflects the arm's length terms and conditions for that alternative transaction or series.

The Tax Court concluded that in allowing CESA/CEL to enter into the Tenex agreement and the Urenco agreement, Cameco effectively gave up a business opportunity. However, it would be commercially rational for a party to give up a business opportunity as long as it was fairly compensated for such an opportunity. Further, the Tax Court noted that the foreign affiliate regime in the Act permits Canadian corporations to be competitive by establishing subsidiaries abroad to carry on active businesses without attracting Canadian income tax. Therefore, there was nothing exceptional, unusual or inappropriate about Cameco's decision to incorporate CESA/CEL and to have CESA/CEL execute the Tenex agreement and the Urenco agreement.

With respect to the BPC transactions, the duration of the contracts was within the range for long-term contracts during that period, and the volumes of uranium were not excessive when compared to arm's length wholesale contracts made during the same period. Given that a commodity producer may sell production under a base-escalated contract to secure a guaranteed revenue stream for that production even if prices are expected to move higher, the Tax Court found that the transactions were not commercially irrational. Similarly, for the CC transactions, the contracts were not commercially irrational since they were for a single delivery of uranium or deliveries over a short period of time and were based on fixed or market-based prices.

Traditional Transfer Pricing Rules — Sections 247(2)(a) and (c)

The Tax Court noted that the task under the traditional transfer pricing rules is to ascertain the price that would have been paid in the same circumstances if the parties had been dealing at arm's length. In the present instance, the prices used by Cameco were within a reasonable range of outcomes and therefore did not warrant any adjustment by the Minister.

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The Tax Court concluded that no compensation was payable to Cameco for giving up the opportunity to enter into the Tenex agreement and the Urenco agreement. As regards the Tenex agreement, the Tax Court found that the terms of the agreements were negotiated between equally self-interested parties dealing at arm's length for the purpose of preventing the market from being flooded with uranium. The agreements had no intrinsic value at the time of execution and any benefit realised by CESA/CEL was due to the market price of uranium, which happened to rise in the years subsequent to execution.

With respect to the Urenco agreement, the Tax Court found that the purpose was to prevent Urenco from dumping uranium onto the market and depressing its price. The fact that Cameco Inc led the negotiation on behalf of CESA/CEL did not, in itself, lead to a transfer pricing adjustment as this would depend on whether or not Cameco Inc was adequately compensated.

In relation to the BPC and the CC transactions, the Tax Court held that the comparable uncontrolled price method was the most reliable transfer pricing method to test the price charged in these circumstances. More importantly, the Tax Court agreed that the profit arising to CESA/CEL was as a result of CESA/CEL taking on the price risk associated with the ownership of uranium. The provision of administrative services by Cameco did not justify shifting the price risk associated with the commodity transactions from CESA/CEL to Cameco such that the profit earned by CESA/CEL should be shifted to Cameco.

Our Comments

Cameco is a precedent-setting case for multinational enterprise groups with Canadian subsidiaries or a Canadian parent corporation as this is the first decision to provide an extensive discussion of the scope of the transfer pricing provisions in the Act that allow the Minister to re-characterise the taxpayer's transactions. In this respect, it is noteworthy that a narrow interpretation of these provisions was adopted such that re-characterisation would not apply where the taxpayer's arrangements are commercially rational. Further, the case reaffirms the principle that a transfer pricing adjustment is not warranted where the prices used are within an arm's length range of prices supported by rigorous analysis based on all of the relevant circumstances.

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Similar principles were applied by the Special Commissioners of Income Tax (**SCIT**) in *MM Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* (2013) MSTC 10-046, which was the first transfer pricing case to be litigated and reported in Malaysia. The Inland Revenue Board (**IRB**) performed the transfer pricing audit relying on the Transfer Pricing Guidelines 2003 (**TPG**). The SCIT held that:

- the general anti-avoidance provision under Section 140(1) of the Income Tax Act 1967 (**ITA**) is not applicable in making transfer pricing adjustment;
- transfer pricing legislation was only enacted by Parliament as Section 140A of the ITA, which came into effect on 1.1.2009; and
- the TPG has no legal effect as they are not an instrument prescribed by statute.

The landmark decision in *the MM Sdn Bhd*, which was affirmed by the High Court, has drawn attention to the legality of the IRB's actions and the various transfer pricing guidelines introduced. It is undeniable that transfer pricing by changing the value of cross-border transactions could have a huge impact on the distribution of profits of a multinational corporation (**MNC**).

In a global economy where MNCs play a prominent role, governments need to ensure that the taxable profits of MNCs are not artificially shifted out of their jurisdiction and that the tax base reported in their country of origin reflects the economic activity undertaken therein. Meanwhile, for taxpayers, it is essential to limit the risks of economic double taxation that may result from a dispute between two countries on the determination of the arm's length remuneration for their cross-border transactions with associated enterprises.

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Transfer pricing is not an exact science, and there will be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable. It is hoped that these cases impress upon taxpayers the need for proper consideration when entering into and pricing intercompany transactions. The cases serve as a reminder to ensure that commercial reality is reflected in formulating transfer pricing policies. In this regard, it is essential that taxpayers put in place proper intercompany agreements that reflect commercial terms and conditions and properly document all intercompany transactions as they would arm's length transactions.

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If you have any queries in relation to the above or require assistance in matters pertaining to transfer pricing, please contact our tax partners **Datuk D P Naban** or **S Saravana Kumar** at tax@lh-ag.com

Datuk Naban and Saravana successfully represented the taxpayer in *MM Sdn Bhd* and are currently engaged in another 15 transfer pricing disputes before the courts.

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