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The 'Cameco' Transfer Pricing Sequel: Government's Appeal on Interpretation of Transaction Substitution Rule Rejected

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OVERVIEW

An analysis of the September 2018 transfer pricing decision by the Tax Court of Canada (TCC) in *Cameco Corporation v. The Queen,*[1] in this journal in November of that year, was titled *'Cameco': Canadian Counterpart of 'E.I. Du Pont de Nemours'*[2] in recognition of the role that Swiss-based marketing and distribution subsidiaries played in both *Cameco* and the U.S. transfer pricing case of *E.I. Du Pont de Nemours and Co. v. United States*[3] some 40 years earlier. But the report went on to note the quite different result: the Canadian taxpayer won in *Cameco* (with the TCC rejecting three different government legal theories, only one of which was based on conventional arm's-length transfer pricing principles), while the U.S. taxpayer lost in *Du Pont.* This report continues our discussion of the *Cameco* saga with an analysis of the June 2020 decision of Canada's Federal Court of Appeal (FCA), which rejected the government's appeal of the TCC decision.[4]

While the government advanced a variety of legal theories at trial, ranging from its assertion of sham doctrine to invalidate the taxpayer's entire foreign subsidiary structure at issue to standard arm's-length transfer pricing considerations, the appeal was restricted to the interpretation of a specific transfer pricing transaction substitution rule in the *Income Tax Act (Canada)*[5] invoked by the government in an attempt to recast the series of intercompany transactions and arrangements between Cameco and its overseas subsidiaries. More specifically, the primary dispute on appeal centered on whether that rule, which permits the tax authorities to recast a transaction between non-arm's-length parties that is otherwise commercially irrational and entered into primarily to enjoy a tax benefit, should be interpreted on a subjective or objective basis. This was the first case to deal with the interpretation of this transaction substitution rule and it will likely be significant going forward in Canada's growing body of transfer pricing jurisprudence.

Finally, by way of overview, the magnitude of the taxes in dispute and the legal costs awarded for the proceedings at trial are worth noting. The case arose from the Canada Revenue Agency's (CRA) reassessment of Cameco to include Can $483 million in its income for its 2003, 2005, and 2006 tax years. However, the overall dispute for all tax years up to 2017 was estimated by Cameco to involve more than Can $2.5 billion in taxes, interest and penalties. Following Cameco's success at trial, it was awarded Can $10.25 million in costs for legal fees. This cost award, as well as the courts' rejection of the government's remaining legal theory, will now stand barring both a successful application by the government for leave to appeal to the Supreme Court of Canada (SCC) and a favourable verdict on any such appeal.

THE FACTS AND THE DECISION SET OUT IN THE TCC JUDGMENT

The Facts

Prior to 1999, Cameco — a publicly listed Canadian corporation that produces uranium from mines in Canada and the United States — sold its output directly to foreign related and unrelated customers and also directly bought uranium from foreign suppliers for resale to foreign customers. Then, in 1999, it formed a Swiss subsidiary, Cameco Europe AG (CEL), and a Luxembourg subsidiary (with a Swiss branch, which was subsequently transferred to and consolidated with the Swiss subsidiary), Cameco Europe S.A. (CESA), collectively referred to in the trial judgment as CEL or CESA or CESA/CEL, to act as marketing and distributing subsidiaries that would take over the international transactions. They would assume and deal with existing or new buy and sale ar-

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[1] 2018 TCC 195.

[2] Nathan Boidman, *'Cameco': Canadian Counterpart of 'E.I. Du Pont de Nemours'*, 47 Tax Mgmt. Int'l J. 704 (Nov. 9, 2018).

[3] 221 Ct. Cl. 333 (1979).

[4] *The Queen v. Cameco Corp.*, 2020 FCA 112.

[5] Paragraphs 247(2)(b) and (d) of the *Income Tax Act* (Canada) (the Act or the ITA). All statutory references herein are to the Act unless otherwise noted.

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rangements or contracts with foreign parties and would buy uranium from Cameco for resale to foreign customers.

In particular, the Cameco group was involved in several significant international transactions during and after the years in which it formed CESA/CEL. First, CESA/CEL entered into a long-term purchase agreement alongside two competitors to buy significant quantities of Russian uranium from AO Techsnabexport (Tenex), a Russian state-owned enterprise. Next, Cameco negotiated a related long-term purchase agreement for CESA/CEL to buy significant quantities of Russian uranium from Urenco Limited (Urenco), another Russian entity, which had itself contracted with Tenex to purchase a portion of its uranium output. Cameco guaranteed CESA/CEL's performance under the contracts with Tenex and Urenco. Separately, CESA/CEL bought from Cameco the uranium it produced under long-term bulk purchase contracts (BPCs). Consistent with its contemplated function, CESA/CEL then sold the uranium that it acquired from Cameco, Tenex, and Urenco under short-term contracts to a U.S. subsidiary of Cameco (Cameco US), which acted as a distributor and resold the uranium to arm's-length customers.

The TCC categorized all of these transactions as follows, at paragraphs 709-10:

> Consistent with my interpretation of subsection 247(2), I have identified the following transactions or series of transactions:
>
> 1. The series of transactions comprised of the incorporation of CESA, the decision by the Appellant to designate CESA as the Cameco Group signatory to the HEU Feed Agreement, CESA's execution of the HEU Feed Agreement and the Appellant's guarantee with respect to CESA's obligations under the HEU Feed Agreement (the "Tenex Series").[6]
>
> 2. The series of transactions comprised of the incorporation of CESA, the decision by the Appellant to designate CESA as the Cameco Group signatory to the Urenco Agreement, CESA's execution of the Urenco Agreement and the Appellant's guarantee with respect to CESA's obligations under the Urenco Agreement (the "Urenco Series").[7]
>
> 3. The transactions consisting of the Appellant and CESA/CEL entering into the BPCs and the Appellant delivering uranium to CESA/CEL under the BPCs (the "BPC Transactions"). In identifying each sale under the BPCs as a separate transaction, I am cognizant of the fact that I could classify the Appellant's deliveries of uranium under each BPC as a series of transactions. However, I have concluded that the most effective way to test these deliveries against the arm's length principle is to address each delivery separately. In my view, identifying each delivery as a separate transaction does not preclude an analysis of the terms and conditions of the BPCs having regard to all deliveries contemplated by those contracts since, in conducting any transfer pricing analysis, all the relevant circumstances must be considered.
>
> 4. The transactions consisting of the Appellant and CESA/CEL entering into the CC Contracts and CESA/CEL delivering uranium to the Appellant under the CC Contracts (the "CC Transactions").
>
> I will refer to the Tenex Series and the Urenco Series, collectively, as the "Series" and to the BPC Transactions and the CC Transactions collectively as the "Transactions."[8]

The TCC judgment indicates that the following facts related to the foregoing agreements were at the heart of the dispute between the parties:

- First, a significant aspect of the wide range of transactions undertaken involved a clear element of tax-motivated planning. Mr. Justice Owen found that Cameco was primarily motivated by tax considerations in establishing and using the Swiss subsidiary structure in order to relocate its existing foreign trading and distribution operations outside Canada and using those entities to enter into the Series.[9] By contrast, he concluded that the Transactions were entered into primarily for the purpose of earning a profit from the underlying commercial activity, rather than being motivated by tax considerations, although the Cameco group derived tax benefits from the corporate reorganization which led to the incorporation of CESA/CEL.
- Second, CESA/CEL were properly constituted with fully functioning boards and were expressly authorized by both the Swiss and Euro-

[6] This saw CESA/CEL buy uranium from third parties and resell to other third parties.

[7] Same as the Tenex Series.

[8] The taxpayer contended (see TCC ¶711) the first category were "events without tax attributes and therefore cannot be subject to the transfer pricing rules." The TCC rejected that in ¶712 and found the rules could apply to the Tenex Series and the Urenco Series.

[9] TCC ¶741.

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pean Union nuclear regulatory authorities to engage in the uranium industry, and each established offices in Switzerland with at least one senior, well-qualified industry officer. Although they did turn to their parent, Cameco, for a variety of support services and to third-party service providers, the TCC found that these were standard collaborative practices for multinational enterprises. As Mr. Justice Owen stated in reviewing the testimony of a Cameco expert witness:

> However, there was nothing unusual about the way in which the Cameco Group operated. Carol Hansell [the taxpayer's expert witness on corporate governance] opined that it is common in an MNE [multinational enterprise] such as the Cameco Group for administrative functions to be centralized and shared across the enterprise and that commercial integration across the MNE and the accountability of the parent company to investors and regulators requires cooperation and coordination across the entities forming the MNE.[10]

- Third, CESA/CEL did not compensate Cameco for assigning to them whatever rights and interests it had in the Series it had developed before CESA/CEL were formed and which were then used by CESA/CEL to carry on their businesses. This involved the parent of a multinational group designating and assigning to a particular subsidiary a business opportunity. After citing,[11] with apparent approval, the U.S. Court of Claims decision in *Merck & Co. v. United States*[12] — that "a U.S. parent of a corporate group is free to establish subsidiaries and to decide which among its subsidiaries will earn income and that the mere power to do so cannot justify reallocating the income earned by that subsidiary" — and indicating the implication in that view, that the behavior of the parent corporation in establishing overseas subsidiaries and placing business opportunities in those subsidiaries is not commercially irrational, and then stating "I would go so far as to suggest that such behavior is a core function of the parent of a multinational enterprise," Mr. Justice Owen infers a relationship thereof to the role of Canada's foreign affiliate system in allowing "Canadian multinationals to compete in international markets through foreign subsidiaries without attracting Canadian income tax."[13]
- Fourth, the uranium produced in Canada and purchased by CESA/CEL from Cameco pursuant to long-term contracts at fixed prices turned out to be unusually profitable to CESA/CEL because they resold it at uncommitted spot prices in the market, which rose much quicker than industry experts had projected. Also, subsidiaries sold Cameco third-country-supplied uranium that was subject to a rule eliminating any tax benefit.[14]

The TCC Decision

Against that factual background, the government assessed Cameco as earning all the profit of CESA/CEL on the alternate grounds that the structure was a sham or was commercially irrational (under the special transfer pricing transaction substitution rule) or did not reflect arm's-length pricing under basic transfer pricing principles. As discussed next, the TCC rejected each of the government's arguments.

Sham

The TCC concluded, after reviewing all of the case law on the doctrine of sham under Canadian law, that a sham transaction was one which contained an element of deceit in factually presenting the rights and obligations of transactions differently from what the parties know those rights and obligations, if any, to be. On that basis, and after examining how the Series and Transactions were implemented and carried out, the TCC concluded as follows:

> In summary I find as a fact that the appellant, Cameco US and CESA/CEL did not factually represent the numerous legal arrangements that they entered into in a manner different from what they knew those arrangements to be nor did they factually represent the transactions created by those arrangements in a manner different from what they knew those transactions to be, consequently the element of deceit required to find sham is simply not present.[15]

[10] TCC ¶625.
[11] TCC ¶722.
[12] 24 Cl. Ct. 73 (1991).
[13] TCC ¶725. Under Canada's "foreign affiliate" system, Canadian MNEs are not taxed on earning business profits through foreign subsidiaries, nor on their distribution where tax treaty or Tax Information Exchange Agreements (TIEA) jurisdictions are involved.
[14] ITA §95(2)(a.1).
[15] TCC ¶670.

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Commercially Irrational Transactions

Paragraphs 247(2)(b) and (d) allow the CRA to substitute all or part of an intercompany transaction if both (1) the transaction would not have been entered into by parties acting at arm's length and (2) the primary purpose of the transaction was to reduce tax. The TCC concluded that the first test requires a finding that the transaction was commercially irrational. That was based on examining the OECD background to the rule.

The TCC then concluded that none of the arrangements (including the Series) were commercially irrational and therefore the rule did not apply, notwithstanding its finding that the transfer of the rights under the Series by Cameco to CESA/CEL was tax motivated.

Arm's-Length Pricing

The final element of the TCC decision in favour of the taxpayer was its conclusion that the prices at which Cameco sold uranium to CESA/CEL met the conventional arm's-length requirements of paragraphs 247(2)(a) and (c) of the Act and that there was no expectation of super profit in the Series as would warrant and require that Cameco charge anything to its subsidiaries upon the transfers of the Series. This entailed the usual duel of competing transfer pricing methods, facts and witnesses, with the taxpayer winning the duel.

It is sufficient for this review to note three points in relation to the pricing. First, the introductory portion of our prior report provides a sense of the TCC's overall view. That read as follows:

> Were the prices Arm's Length?
>
> Finally we come to the place where transfer pricing cases usually start (and end). Were the prices charged by Cameco to Swiss subsidiary under the long-term contracts (BPCs) for Cameco's uncommitted uranium production arm's length prices? (There was also pricing of the service contracts) and whether a fee should have been charged for providing the Tenex and Urenco contracts — pricing for the inbound sales was irrelevant because of the deemed passive income rule).
>
> The short answer is that Justice Owen found that all the prices and all the other terms and conditions met the requirement of §247(2)(a) of being ''those that would have been made between persons dealing at arm's length.'' How he arrived at that conclusion can only be seen my considering more closely the law, a maze of facts, conflicting expert witness testimony, and intricate and nuanced analysis and findings by the court. The following deals with only some of the highlights of those elements.

Second, the TCC flatly rejected the government's attempts to treat monitoring of risk (by Cameco) undertaken by the subsidiaries in entering into the uranium trading business as equivalent to bearing the risk (which the court found was borne by CESA/CEL).

Third, not disassociated from the latter point, was the TCC's criticism of the transparent government attempt to insinuate into its more conventional transfer pricing arguments the arguments founded on the transaction substitution rule in paragraphs 247(2)(b) and (d) which were so thoroughly separately rejected by the TCC. This did not win any brownie points with the judge, Mr. Justice Owen.

We are now ready to move on to review the FCA judgment.

THE FCA DECISION

What Was the Ambit of the Government's Appeal?

On appeal, the government did not directly challenge any of the TCC's conclusions of law or findings of fact except for its conclusion in respect of the transaction substitution rule of paragraphs 247(2)(b) and (d) — although it complained that the TCC should have preferred the testimony of its expert witnesses to those of Cameco. But the FCA did note at several points in its judgment that the way in which the government argued the transaction substitution rule issue could be seen as an indirect attack on the TCC's findings of fact.

The principal issue in the appeal was the interpretation of paragraphs 247(2)(b) and (d). These provisions provide the CRA with exceptional powers to recast and then reprice transactions when a taxpayer engages with a foreign related party in a transaction that is both tax-motivated and commercially irrational. Paragraph 247(2)(b) provides the CRA with the authority to make a special transfer pricing adjustment where the transaction actually entered into between the parties satisfies the following two conditions, namely (i) that it not be a transaction that would have been entered into between persons dealing at arm's length and (ii) that it be a transaction that cannot be reasonably considered to have been entered into primarily for *bona fide* purposes other than to obtain a tax benefit. When paragraph 247(2)(b) applies, the adjustment is determined under paragraph 247(2)(d) by invalidating the actual transaction and substituting it with the transaction that ''would have been entered into between persons dealing at arm's length.'' The CRA is then authorized to reprice the transaction to reflect the transaction that would have been entered into between persons dealing at arm's length. *Cameco*

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was the first case to deal with the interpretation of these rules, although the bulk of the parties' submissions on appeal and the FCA's judgment were directed at the interpretation of subparagraph 247(2)(b)(i).

The government argued that the inquiry under subparagraph 247(2)(b)(i) is a subjective one and is satisfied if the particular taxpayer would not have entered into the transaction in question with the other participant had they been dealing at arm's length. The FCA instead held that the condition set out in subparagraph 247(2)(b)(i) is an objective test which considers whether hypothetical persons dealing at arm's length would have entered into the transaction at issue. In reaching this conclusion, the FCA decisively rejected the government's subjective interpretation of subparagraph 247(2)(b)(i).

There are two oddities in the judgment — one relating to the fashion in which Canadian courts deal with the OECD transfer pricing guidelines and one relating to the ambit of the government's assertion that the TCC erred in not deciding that all of the Swiss subsidiaries' profit should be allocated to Cameco under paragraphs 247(2)(b) and (d). The latter (which, as discussed above, was interpreted — rightly in the view of these writers — as requiring a commercially irrational transaction) is dealt with immediately below and the former is addressed thereafter.

It is odd that the basis for the alleged error of law by the TCC does not seem to appear in the latter's written judgment. That (claimed) basis is set out by the FCA in paragraphs 31 and 39, as follows:

> [31] In this case, the focus will be on the interpretation of one of the conditions in paragraphs 247(2)(b) of the Act (the condition in subparagraph 247(2)(b)(i) of the Act). In general, the interpretive issue for this condition relates to the subtle distinction between the competing interpretations proposed by the parties. Is this condition satisfied if the particular taxpayer (Cameco in this case) would not have entered into the transaction or series of transactions in issue with an arm's length person? Or, alternatively, is this condition only satisfied if no persons dealing at arm's length with each other would have entered into this transaction or this series of transactions?
>
> [. . .]
>
> [39] It is the Crown's submission that the first condition [in paragraph 247(2)(b)] is satisfied if the particular taxpayer (Cameco) would not have entered into the transactions in question with the other participant (CESA or CEL) if they were dealing at arm's length. In paragraphs 3 and 4 of its memorandum, the Crown stated:
>
> > 3. . . .Section 247, properly interpreted, required the trial judged to determine what Cameco Canada and its Swiss subsidiary would have done in the same circumstances if they had been dealing at arm's length.. . .
> >
> > 4. A proper analysis of all relevant facts and circumstances leads to the inevitable conclusion that Cameco Canada would not have entered into any transactions with its Swiss subsidiary if they had been dealing at arm's length. This Court should allow the appeal to include the profits of the Swiss subsidiary in Cameco Canada's income for tax purposes under s. 247(2)(d) of the *Income Tax Act.*

While this raises the question of whether a party to tax litigation can properly ask an appeals court to redress an error if the lower court did not expressly decide the point alleged to be the object of the error, it is implicit in the reasons for judgment that Mr. Justice Owen viewed subparagraph 247(2)(b)(i) as an objective standard. The FCA used a textual, contextual, and purposive interpretation of subparagraph 247(2)(b)(i).

Textual Interpretation Subparagraph 247(2)(b)(i)

The FCA first undertook a textual analysis of subparagraph 247(2)(b)(i), which asks whether "the transaction or series. . .would not have been entered into between persons dealing at arm's length." The court noted that the plain statutory language does not refer to whether the particular taxpayer and its counterparty would not have entered into the particular transaction if they had been dealing at arm's length. It further noted that if Parliament had intended that subparagraph 247(2)(b)(i) would apply if the particular taxpayer and its counterparty would not have entered into the particular transaction if they were dealing at arm's length, it could have said so using clear language to that effect.

The FCA then elaborated, in a fashion which is not entirely clear, on a hypothetical which demonstrated its view that the government's interpretation would lead to an unreasonable result. According to the court, if the government's interpretation was correct, then whenever a Canadian corporation wished to carry on business in a foreign country through a foreign subsidiary, the condition in subparagraph 247(2)(b)(i) would automatically be satisfied because the company would have demonstrated that it would not sell its rights to carry on such business to an arm's-length foreign party.

Finally, the FCA noted that the words "persons dealing at arm's length" in subparagraph 247(2)(b)(i) cannot be read in isolation but must be read within the context of subsection 247(2) as a whole and in con-

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nection with paragraph 247(2)(d) in particular. Under this paragraph, any amount that would otherwise be determined for the purposes of the Act is to be adjusted 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 court found that this unequivocally mandated an objective standard and that the text of the Act suggested the same standard should apply to both provisions.

Taken together, the FCA found that these textual factors strongly suggested an objective reading of the phrase ''persons dealing at arm's length'' in subparagraph 247(2)(b)(i). It should be noted, however, that even if the FCA had accepted the government's position that the rule involved a subjective test rather than an objective one, it is not apparent how that would have advanced the government's ultimate purpose of recasting the transactions between Cameco and CESA/CEL.

Contextual and Purposive Interpretation of Paragraph 247(2)(b)

Although it found that the text of paragraphs 247(2)(b) and (d) was clear, the FCA sought to reinforce its textual interpretation by examining several contextual factors, in particular the 1995 Transfer Pricing Guidelines published by the OECD,[16] as well as the rationale for the enactment of the transaction substitution rule. While the reasons for judgment do not clearly distinguish the role of context and purpose in the court's analysis, the court held that factors such as the ''Transfer Pricing'' and ''Transfer Pricing Adjustment'' headings in section 247 and subsection 247(2), respectively, and the explanation of the overall purpose of section 247 in the Department of Finance's Technical Notes issued when the section was enacted suggest the transfer pricing rules are intended to allow for adjustments in transaction prices, not to permit the tax authorities to disregard the existence of a taxpayer's foreign subsidiary and reallocate its profits entirely.

The FCA appeared to place the greatest reliance on the OECD Guidelines, which provide guidance on the application of the arm's-length principle functioning as the international consensus on transfer pricing. As noted by the FCA, the Guidelines advocate adhering to the actual transactions undertaken by the parties and resorting to recasting or substituting transactions only in exceptional circumstances, such as where the transactions practically impede the tax authorities from determining an appropriate transfer price. The court held that there was nothing to indicate Cameco's transfer pricing structure impeded the ability of the CRA or the TCC to determine whether the transactions had arm's-length prices.[17]

The second oddity referred to above relates to the manner in which Canadian courts deal with the OECD Guidelines, as discussed in paragraph 65 of the judgment, which reads as follows:

> [65] In *Canada v. Glaxo Smith Kline Inc.*, 2012 SCC 52 [2012] 3 S.C.R. 3 (*Glaxo*), the Supreme Court of Canada described the role that the OECD Guidelines could play in interpreting the transfer pricing legislation:
>
>> 20 In the Courts below and in this Court, there has been reference to the 1979 *Guidelines* and the 1995 *Guidelines* (the *Guidelines*). The *Guidelines* contain commentary and methodology pertaining to the issue of transfer pricing. However, the *Guidelines* are not controlling as if they were a Canadian statute and the test of any set of transactions or prices ultimately must be determined according to s. 69(2) rather than any particular methodology or commentary set out in the *Guidelines.*
>>
>> 21 Section 69(2) does not, itself, offer guidance as to how to determine the ''reasonable amount'' that would have been payable had the parties been dealing at arm's length. However, the *Guidelines* suggest a number of methods for determining whether transfer prices are consistent with prices determined between parties dealing at arm's length.

Paragraph 20 in *Glaxo* clearly states that the OECD Guidelines are not law in Canada. But paragraph 21 clearly invites a Canadian court to consider them. The problem from a pure law standpoint is that Canadian

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[16] Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995).

[17] The conclusions expressed by the FCA with respect to the Guidelines are consistent with those of the TCC. As noted in our November 2018 report, this view is also consistent with the thinking of the principal draftsman of these rules, Brian Bloom, as reflected in a 2006 article (some eight years after their enactment). Bloom explained in that article that the objective — derived from ¶¶1.36 and 1.37 of the 1995 OECD Transfer Pricing Guidelines — was to reconstitute or substitute transactions that are both commercially irrational and ''have been structured in this commercially irrational manner in order to impede tax authorities' ability to determine an arm's length price under 'normal' transfer pricing rules or to achieve some other tax benefit for the tested party.'' *See* Brian Bloom, *Paragraph 247(2)(b) Demystified*, 1783 Tax Topics (CCH) I-5 (May 11, 2006).

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courts seem to forget paragraph 20 and work the Guidelines into their judgments as though they do have the status of law.[18] In this case, however, the fact that legislative draftsmen had their eye on the Guidelines in drafting paragraph 247(2)(b) is a strong rationale for treating them as tantamount to law in Canada.

CONCLUSION

Given the variety of legal theories deployed to challenge the taxpayer's arrangements, the result at trial initially left open several avenues of appeal to the government in *Cameco*. However, the narrow grounds relied on by the government in its appeal to the FCA and the latter's tightly reasoned rejection of those grounds seemingly leaves little basis for the government to successfully apply for leave to appeal to the SCC, let alone to prevail if leave were granted. Furthermore, the highly esoteric nature and limited scope of the paragraph 247(2)(b) rule likely would not be seen as meeting a key criteria for leave, namely an issue of broad national importance. However, the government does have until August 25, 2020 to file a request for leave and nothing can be ruled out, given the amount of tax at stake as well as the multi-million-dollar legal costs award upheld against the government.

[18] See, for example, the discussion by the TCC in this case of OECD pricing methods for §247(2)(a).

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