# Canadian Appeals Court Upholds Taxpayer Win in *Cameco*

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**Executive Summary**

- the Federal Court of Appeal (FCA) has upheld Cameco Corporation's transfer pricing, rejecting an appeal by the Canada Revenue Agency (CRA) from the taxpayer's win in the Tax Court of Canada in September 2018;
- *Cameco* is the first court case to consider the portion of Canada's transfer pricing rules that potentially allow the CRA to go beyond merely repricing the taxpayer's transactions and instead replace them with the terms and conditions of different transactions;
- the FCA's unanimous judgment decisively rejected the CRA's expansive interpretation of this "recharacterization" rule, concluding that it may apply "only where a taxpayer and non-arm's length non-resident have entered into a transaction or a series of transactions that would not have been entered into between any two (or more) persons dealing at arm's length, under any terms or conditions", i.e., a "commercial irrationality" standard;
- this case demonstrates that the CRA can ignore the actual legal relationships created by the parties only in very exceptional circumstances, and not merely because the taxpayer would not have entered into the same transaction that it in fact entered into with a related non-resident, had that non-resident been arm's length; and
- Canada's transfer pricing rules accept the commercial reality that multinational groups are structured and operate differently from stand-alone entities, and do not seek to force them to do otherwise – rather, they simply require that arm's-length pricing be used to ensure that Canadian group members do not pay too much for goods and services they obtain from, or receive too little for goods and services they sell to, non-arm's-length non-residents. If the taxpayer's transfer pricing meets the arm's-length standard based on the actual legal rights and obligations its transactions create, there is no basis for the CRA to challenge it unless those transactions are commercially irrational.

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In September 2018, the Tax Court of Canada issued its decision in *Cameco Corp. v. The Queen*, 2018 TCC 195, in which the taxpayer was completely successful in reversing the CRA's re-assessments regarding its transfer pricing. Specifically, in *Cameco* the Canadian taxpayer (one of the world's largest uranium producers) entered into long-term contracts to sell uranium to a European subsidiary and guaranteed long-term contracts that its European subsidiary entered into to purchase uranium from two non-Canadian third parties. After the parties entered into these supply contracts, the price of uranium rose significantly. The result was that profits from sales by the European subsidiary outside of Canada were realized largely in Switzerland rather than Canada.

The Canada Revenue Agency (CRA) reassessed Cameco to attribute to it all of the profits that its European subsidiary had earned. The CRA argued that the purchase and sales contracts involving the European subsidiary:

- were a "sham" that the court should simply look through; and
- did not meet the arm's-length standard in Canada's transfer pricing rules, thus allowing the CRA to either completely ignore the actual contracts or revise their terms to reflect what arm's-length parties would have agreed to.

The Tax Court rejected the Crown's arguments in full, concluding that the relevant transactions were exactly what they appeared to be, and could not be said to be commercially irrational or priced outside the range of what arm's-length persons would have agreed to under similar circumstances.[1]

The CRA appealed to the Federal Court of Appeal, which issued its judgment on June 26, 2020 upholding the Tax Court's decision in full.[2] The CRA's primary argument on appeal related to the transfer pricing recharacterization rule (TPRR) in section 247(2)(b) of the *Income Tax Act* (Canada), which applies when a Canadian taxpayer (here, Cameco) and a non-arm's-length nonresident (its European subsidiary) participate in a transaction or a series of transactions that:

"(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".

The Court succinctly framed the legal question before it as one of competing interpretations of the first condition for applying the TPRR:

> [31] In this case, the focus will be on the interpretation of one of the conditions in paragraph 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?

Essentially the Crown sought to frame s. 247(2)(b)(i) as requiring the taxpayer to show that it would have entered into the same transaction with its European subsidiary had it been a completely arm's-length party. The Court rejected this interpretation (at para. 43):

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[1] For analysis of the Tax Court decision, see Steve Suarez, "The Cameco Transfer Pricing Decision: A Victory for the Rule of Law and the Canadian Taxpayer," *Tax Notes Int'l*, Nov. 26, 2018, p. 877, available at www.blg.com .

[2] See *Canada v. Cameco Corporation*, 2020 FCA 112, available at https://decisions.fca-caf.gc.ca/fca-caf/decisions/en/item/481730/index.do

> [43] However, subparagraph 247(2)(b)(i) of the Act does not refer to whether the particular taxpayer would not have entered into the particular transaction with the non-resident if that taxpayer had been dealing with the non-resident at arm's length or what other options may have been available to that particular taxpayer. Rather, this subparagraph raises the issue of 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). . . .
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> [44] 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.
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> [45] If Parliament had intended that subparagraph 247(2)(b)(i) of the Act would apply if the particular taxpayer would not have entered into the particular transaction with any arm's length person, this subparagraph could have provided:
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> > (b) the transaction or series
> >
> > (i) would not have been entered between the participants if they had been dealing at arm's length
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> [46] 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.

This passage highlights the fundamental flaw in the CRA's argument, both at trial and before the FCA, in that it advances an interpretation of Canada's transfer pricing rules that is at odds with both the scheme of the ITA as a whole and basic common sense as to how a transfer pricing regime can and should work.

Multinational enterprises (MNEs) are organized differently and operate differently than stand-alone entities. They rarely operate on the basis that each entity in each jurisdiction should perform all of the business functions that a stand-alone single entity does. For example, for reasons of efficiency and expertise, various back-office services are often centralized and provided to group members from a single group service provider. Production and/or distribution functions may be centralized within the group (or within particular geographic regions). Business opportunities are similarly organized and allocated to specific entities within the MNE. Strategic direction is provided by the MNE parent entity. All of this makes good business sense, and there is absolutely nothing within the ITA that suggests any of this could or should be open to challenge so long as arm's-length pricing is employed.

Indeed, the scheme of the ITA as a whole is diametrically opposed to the interpretation of the TPRR the CRA's assessment was based on. Canada's rules governing foreign affiliates of Canadian residents describe in great detail the circumstances in which business income earned by a Canadian taxpayer's foreign subsidiaries is attributed back to the Canadian taxpayer (for example, profits from sales to Canadian customers). Outside of those limited situations, it is clear that Parliament does not consider the use of a foreign subsidiary to earn income that the Canadian taxpayer could otherwise earn directly to be objectionable – to the contrary, these rules clearly allow foreign sales corporations selling outside of Canada such as Cameco used. Instead, such intra-group arrangements are to be governed by Canada's transfer pricing rules, which are based on arm's-length pricing. It is therefore not surprising that the FCA rejected an interpretation of s. 247 ITA intended to achieve a result (ignoring the European sales subsidiary and attributing all of its income back to the Canadian parent company) contrary to the explicit tax policy choices Parliament has made elsewhere in the ITA.

The logical endpoint of the Crown's interpretation is that whenever a business decision within an MNE results in lower taxes payable in Canada relative to some plausible theoretical alternative, the Canadian taxpayer is in danger of being re-assessed under the TPRR. Since under Canada's foreign affiliate rules earning business income outside of Canada directly almost always results in more Canadian tax payable than doing so through a foreign subsidiary, the Crown simply had no answer to the Court's question as to why using a foreign subsidiary would not routinely trigger the TPRR under the Crown's reasoning.

The Crown's interpretation of s. 247 rejected by the FCA is also inconsistent with "one of the fundamental principles of [the Canadian] tax system: that tax consequences flow from the legal relationships or transactions established by taxpayers."[3] In *Cameco*, the Tax Court judge reviewed the taxpayer's legal documentation and actual business practices in great detail, and concluded that there was no valid reason for challenging their legal efficacy – they indeed created the legal rights and obligations that they purported to create. In applying the TPRR, the CRA sought to ignore those very same legal relationships and treat Cameco as if it had earned the profits in fact earned by another legal entity under business contracts validly entered into. This was clearly a result the Court could not countenance in the absence of clear and explicit language in the statute authorizing such, which was not the case here:

> [81] Parliament has chosen to indirectly address the issue of a Canadian taxpayer shifting profits to a non-arm's length person located in another jurisdiction by implementing the transfer pricing rules found in Part XVI.1 of the Act. These rules will adjust prices paid for goods purchased and sold and for services provided in transactions between a taxpayer and a non-resident person with whom that taxpayer is not dealing at arm's length, if such prices differ from the amount that would be paid in an arm's length transaction. By adjusting prices for goods and services, the profit realized by the Canadian taxpayer will be adjusted. However, 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

[3] *Jean Coutu Group Inc. v. Canada*, 2016 SCC 65, para. 41.

> 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.
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> [82] Paragraphs 247(2)(b) and (d) of the Act apply only where a taxpayer and non-arm's length non-resident have entered into a transaction or a series of transactions that would not have been entered into between any two (or more) persons dealing at arm's length, under any terms or conditions. In such a situation, the transaction or series of transactions that would have been entered into between arm's length persons is substituted for the transaction or series of transactions in question, with the appropriate terms and conditions. In particular, paragraphs 247(2)(b) and (d) of the Act cannot be used to simply reallocate all of the profits earned by CEL to Cameco, its Canadian parent corporation, in the circumstances of this case.

Various other arguments put forward by the Crown were dismissed by the Court as being effectively challenges to the detailed findings of fact made by the trial judge (which the CRA ostensibly claimed not to be challenging).[4] Fundamentally the Crown's approach to this case never accepted the correct starting point or demonstrated an understanding of what it is that Canada's transfer pricing rules are trying to achieve. Canada's transfer pricing rules accept the commercial reality that multinational groups are structured and operate differently from stand-alone entities, and do not seek to force them to do otherwise. Indeed, forcing Canadian members of MNEs to operate commercially as stand-alone entities would be itself commercially irrational (as well as contradictory to the foreign affiliate rules in the ITA itself).

The policy objective of Canada's transfer pricing rules is limited to ensuring that Canadians use arm's-length pricing in transactions with non-arm's-length non-residents, for the purpose of ensuring that they do not pay too much for goods and services they obtain from, or receive too little for goods and services they sell to, such non-arm's-length non-residents. Unless a taxpayer has engaged in commercially irrational behaviour, transfer prices that comply with the arm's-length standard leave no basis for challenge under s. 247 ITA, a message that the FCA's decision in *Cameco* makes very clear.

[4] An appeals court in Canada will entertain challenges to findings of fact (as opposed to questions of legal interpretation) only in cases of "palpable and overriding error" by the trial judge.