AIRD BERLIS

Cameco Corporation v. The Queen: A Lesson in Sham and Canadian Transfer Pricing Adjustments

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Introduction

On September 26, 2018, the Tax Court of Canada released its decision in *Cameco Corporation v. The Queen*. The case addressed the transfer pricing provisions contained in subsection 247(2) of the *Income Tax Act* (Canada) (the "**Act**") and whether the transactions in question were a sham. In a win for the taxpayer, the Court found that the prices used by Cameco Corporation ("**Cameco**") were within an arm's length range of prices and that there was no sham.

Background

Cameco was incorporated in Canada in 1987 for the purpose of acquiring assets in the mining and nuclear energy sectors. Cameco successfully completed the asset acquisitions in 1988 and had uranium mines in Saskatchewan and uranium refining and processing facilities in Ontario. U.S. subsidiaries of Cameco owned uranium mined in the United States. Cameco had focused primarily on Canadian business operations until the mid-1990s.

In 1993, following the collapse of the Soviet Union, the United States and Russian governments signed a denuclearization agreement known as the Megatons to Megawatts Agreement (the "**MTMA**"). The general aim of the MTMA was to provide Russia with a means to sell the uranium formerly contained in its nuclear weapons. This laid the groundwork for a large amount of uranium to flow into the market through what the Court called the "HEU feed." In February 1993, Cameco began pursuing contracts for the purchase of uranium from the HEU feed in an effort to control excess uranium from being dumped in the market.

After several years of negotiation by Cameco, a Luxembourg subsidiary of Cameco, Cameco Europe S.A. ("**CESA**"), secured a contract for the purchase of uranium from the HEU feed (the "**HEU Feed Agreement**" [1]) on March 24, 1999. The HEU Feed Agreement provided CESA and the other parties to the agreement[2] with exclusive options to purchase the majority of the HEU feed from 1999 until the end of Russia's commitment under the MTMA.

Additionally, on September 9, 1999, CESA entered into an agreement with Urenco Limited to purchase additional uranium supply derived from the HEU Feed Agreement (the "**Urenco Agreement**," together with the HEU Feed Agreement, the "**Agreements**").

Both the HEU Feed Agreement and the Urenco Agreement were amended several times throughout the relevant period.

Cameco provided guarantees relating to CESA's and CEL's (as hereinafter defined) obligations under both the HEU Feed Agreement and the Urenco Agreement.

The Restructuring

Before entering into the Agreements, Cameco undertook an international restructuring (the "**Restructuring**"). The Restructuring included the following:

- On March 16, 1999, CESA was incorporated by Cameco as a wholly-owned Luxembourg subsidiary

with an operating branch in Switzerland. Shortly thereafter, as mentioned above, on March 24, 1999, CESA entered into the HEU Feed Agreement negotiated by Cameco.

- On September 1, 1999, Cameco entered into a services agreement with CESA to provide administrative and back-office services to CESA, including contract administration, assistance in market forecasting, legal services, human resources services and accounting services.
- On September 9, 1999, CESA entered into the Urenco Agreement.
- On September 15, 1999, Cameco Europe AG (SA, Ltd.) ("**CEL**") was incorporated in Switzerland. Effective October 1, 2002, CEL acquired the Swiss branch of CESA. For the purposes of the case, there was little distinction between CESA and CEL; therefore, CESA and CEL will hereafter be referred to as "**CESA/CEL**."
- Starting November 1999, Cameco Inc. ("**Cameco US**") began purchasing uranium from CESA/CEL to fulfil its obligations to customers outside Canada. CESA/CEL supplied the uranium at a 2% discount to the contract price negotiated between Cameco US and the customer.
- Additionally, starting March 27, 2001, Cameco US and CESA/CEL began entering into conversion services contracts.
- From 1999 to 2002, Cameco entered into spot sale contracts to sell its existing inventory of uranium to CESA/CEL.
- From 1999 to 2004, Cameco entered into long-term contracts to sell its uncommitted uranium production to CESA/CEL (the "**BPC Contracts**"). The BPC Contracts contained different terms and conditions, including fixed pricing, base-escalated pricing mechanisms, market-based pricing mechanisms and a combination of base-escalated and market-based pricing mechanisms. Additionally, the BPC Contracts contained different "flex options," which provided CESA/CEL with the power to adjust the volume of uranium that was ultimately deliverable under the contract.
- Starting December 7, 1999, Cameco began purchasing uranium inventory back from CESA/CEL under various contracts (the "**CC Contracts**").
- Between August 2001 and June 2006, CESA/CEL entered into various other agreements with Cameco for the exchange and loan of uranium, as well as for conversion services.

The Restructuring effectively transferred all of the risk of uranium market price fluctuations to CESA/CEL. This was admittedly done for the purpose of reducing Cameco's overall tax burden, since CESA/CEL was situated in a low-tax jurisdiction. While Cameco and Cameco US focused on production and marketing, CESA/CEL were primarily responsible for the trading of uranium held by the Cameco group of companies.

After the Restructuring, the market price of uranium increased and CESA/CEL realized significant gains under the Agreements, the BPC Contracts and the CC Contracts. Conversely, Cameco realized significant losses for its 2003, 2005 and 2006 tax years. It was this imbalance in income allocation that caused the Minister concern and led to the reassessments at issue in this case.

<u>The Minister's Position</u>

At the outset, the Minister argued that Cameco's business was never substantially transferred to CESA/CEL, and that all of the transactions undertaken by CESA/CEL were a sham. The Minister argued that all of the important functions and strategic decisions for the uranium-trading business continued to be performed by Cameco in Saskatoon, and that CESA/CEL did little more than rubberstamp the paperwork.

Additionally, the Minister argued that the transactions between Cameco and CESA/CEL were not commercially rational and that the transfer pricing re-characterization rules contained in paragraphs 247(2)(b) and (d) of the Act should apply. These rules would allow the Minister to assess tax based on what would have been commercially rational transactions (ie. that Cameco should have realized all of the profits of CESA/CEL).

In the alternative, the Minister argued that the traditional transfer pricing adjustment rules contained in paragraphs 247(2)(a) and (c) should apply. These rules would allow the Minister to adjust the terms and

conditions of the transactions between Cameco and CESA/CEL to properly reflect those terms to which arm's length parties would have agreed.

The Court's Finding

Sham

The Court first addressed the issue of sham and found that the Minister fundamentally misunderstood the concept of a sham. The Court found that a sham only exists where parties to a transaction present their legal rights and obligations in a manner that does not reflect the legal rights and obligations that they intended to create. In other words, a sham involves a deceit by a taxpayer by factually representing the existence of legal rights when the taxpayer knows those legal rights either do not exist or are different from the representation.

In this case, the Court found that all of the contracts that Cameco entered into properly reflected the legal rights that they intended to create. Under the numerous purchase and sale contracts, CESA/CEL agreed to buy or sell uranium, and they did in fact buy and sell uranium. The Court found that the arrangements made under the Restructuring were not a façade in any way and that the evidence did not support such a finding, but the Restructuring was in fact the legal foundation for implementing Cameco's tax plan. The Court noted that a tax motivation does not transform the arrangements into a sham.

Transfer Pricing Adjustment

The Court then addressed the alternative issue of transfer pricing adjustments. The Court considered four transactions or series of transactions involving Cameco, which were at issue:

1. The series of transactions comprised of the incorporation of CESA, the decision by Cameco to designate CESA as the signatory to the HEU Feed Agreement, CESA's execution of the HEU Feed Agreement and Cameco's guarantee with respect to CESA's obligations under the HEU Feed Agreement;
2. The series of transactions comprised of the incorporation of CESA, the decision by Cameco to designate CESA as the signatory to the Urenco Agreement, CESA's execution of the Urenco Agreement and Cameco's guarantee with respect to CESA's obligations under the Urenco Agreement;
3. The transactions consisting of Cameco and CESA/CEL entering into the BPC Contracts and Cameco delivering uranium to CESA/CEL under the BPC Contracts; and
4. The transactions consisting of Cameco and CESA/CEL entering into the CC Contracts and CESA/CEL delivering uranium to Cameco under the CC Contracts.

Transfer Pricing Re-Characterization Rules – Paragraphs 247(2)(b) and (d)

The Court first considered whether the transfer pricing re-characterization rules under paragraphs 247(2)(b) and (d) of the Act were applicable. Paragraph 247(2)(b) applies where a transaction or series of transactions (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 found that the focus of the test in subparagraph 247(2)(b)(i) is whether the transaction or series is "commercially rational," taking into consideration all of the relevant circumstances. Where the transaction or series is commercially irrational, then subparagraph 247(2)(b)(ii) becomes relevant. As non-arm's length persons may enter into transactions or series that arm's length persons would not, subparagraph 247(2)(b)(ii) ensures that that fact alone does not trigger the Minister's right to substitute an alternative arm's length transaction or series. If subparagraph 247(2)(b)(ii) is also found to apply, paragraph 247(2)(d) would be available to permit the Minister to re-characterize the transaction as an alternative arm's length transaction for the purposes of the Act. This re-characterization allows the Minister to then determine what the terms and conditions of an alternative transaction would have been had the parties been dealing at arm's length. Without the ability to re-characterize an irrational transaction where

subparagraph 247(2)(b)(ii) applies, it would be impossible for the Minister to determine what the arm's length terms and conditions would be, since arm's length parties would never have entered into such a transaction in the first place.

In this case, the Court relied on expert evidence to find that when Cameco allowed CESA/CEL to enter into the HEU Feed Agreement and the Urenco Agreement, it effectively gave up a business opportunity. The Court found that any entity would be willing to give up a business opportunity as long as it was fairly compensated for giving up the opportunity. Further, the Court found that there was nothing unusual or inappropriate about Cameco's decision to incorporate CESA/CEL and have it execute the agreements. The Court noted that the foreign affiliate regime is in place to allow Canadian multinationals to be competitive by structuring their business affairs conducted outside of Canada through foreign subsidiaries. Canada does not tax active business income earned in a foreign subsidiary in a jurisdiction with which Canada has a treaty or tax information exchange agreement. The Court looked to U.S. case law to conclude that it is a "core function" of a parent of a multinational enterprise to establish foreign subsidiaries and to place business opportunities in those subsidiaries.[3] Therefore, the transactions were commercially rational and subparagraph 247(2)(b)(i) did not apply. Instead, the Court found that the focus should be on whether the correct amount of compensation was received by Cameco (i.e., an analysis of paragraphs 247(2)(a) and (c)).

Similarly, the Court had little trouble determining that the sale of uncommitted uranium under the BPC Contracts and the sale of uranium inventory under the CC Contracts at various fixed and market-based prices were commercially rational and, therefore, subparagraph 247(2)(b)(i) did not apply.

Additionally, although not relevant to the outcome of the case because of the Court's finding that subparagraph 247(2)(b)(i) did not apply to any of the transactions, the Court also commented on the application of subparagraph 247(2)(b)(ii). First, the Court found that the primary purpose of the series of transactions described in paragraphs 1 and 2, above, was to save the tax that would have been payable in Canada had Cameco entered into the agreements directly. In other words, there was no other *bona fide* purpose for these series of transactions other than to obtain a tax benefit. However, instead of condemning Cameco's behaviour, the Court recognized that this was simply a case of Cameco utilizing a tax planning tool provided by Parliament. Conversely, with respect to the series of transactions involving the BPC Contracts and CC Contracts, the Court found that Cameco had a *bona fide* purpose of earning a profit in each case such that subparagraph 247(2)(b)(ii) would not have applied to these transactions.

Traditional Transfer Pricing Rules – Paragraphs 247(2)(a) and (c)

After dispensing with the arguments for sham and re-characterization of the transactions under paragraphs 247(2)(b) and (d) of the Act, the Court turned to the traditional transfer pricing rules under paragraphs 247(2)(a) and (c) of the Act. The traditional transfer pricing rules allow the Minister to adjust the quantum of the amounts in question so that the transactions or series of transactions between a Canadian taxpayer and a non-arm's length non-resident reflect arm's length terms and conditions. The Court heard extensive expert evidence on what would constitute arm's length terms and conditions for the transactions in question, and ultimately found that the prices used by Cameco were within a reasonable range of outcomes and there was no evidence warranting any adjustment.

Specifically, the Court found that no compensation was payable to Cameco for giving up the opportunity to enter into the HEU Feed Agreement and Urenco Agreement because the terms of the agreements were negotiated between equally self-interested arm's length parties. As such, at the time of signing, the agreements had no intrinsic value. CESA/CEL only realized a benefit under the Agreements because the market price of uranium happened to rise in the years subsequent to signing.

Similarly, the Court was satisfied with Cameco's expert evidence regarding the pricing of the BPC Contracts and the CC Contracts. The Court found that the Minister's experts failed to provide appropriate estimates of comparable arm's length transactions, and instead provided pricing based on alternative transactions. Perhaps this related to the fact that the Minister's arguments were focused primarily on sham and re-characterization under paragraphs 247(2)(b) and (d) of the Act. Additionally, the Court agreed that profit arose to CESA/CEL from taking on the price risk associated with ownership of uranium, and that the profit earned by each of CESA/CEL, Cameco and Cameco US was consistent with their functions. While CESA/CEL bore all of the price risk associated with the purchase and sale of uranium, Cameco was found to have provided administrative and back-office services and Cameco US performed sales and marketing

functions. Lastly, the Court rejected the Minister's argument that Cameco's losses were indicative of non-arm's length terms. The Court noted that losses in and of themselves are not indicative of a transfer pricing issue, especially when the property being sold is a commodity with a market-driven price that is independent of the costs of its production.

Conclusion

Since there was no sham and no transfer pricing adjustment, the Court ultimately found in favour of Cameco and ordered that the Minister unwind the transfer pricing adjustments made on reassessment. Consequently, Cameco's income was ordered to be reduced by approximately $483 million from 2003 to 2006 ($43 million in 2003, $197 million in 2005 and $243 million in 2006).

At first blush, the facts of this case did not appear to favour the taxpayer. The facts may have suggested that the mind and management of CESA/CEL remained with Cameco in Canada and that Cameco's guarantees of the Agreements initially kept the economic risk of the business in Canada. CESA/CEL became extremely profitable despite having only one employee from the time of the Restructuring until August 2006. Additionally, Cameco continued to play an important role in the gathering of market intelligence and the administration of various contracts entered into by CESA/CEL, and collaborated with CESA/CEL following the Restructuring.

The Minister argued that the Restructuring only resulted in the uranium-trading business being transferred to CESA/CEL on paper and that CESA/CEL were merely rubberstamping decisions that were made by Cameco in Canada. On the basis of those arguments, the Minister focused on arguing that the arrangements were a sham or that the transfer pricing re-characterization rules should apply rather than arguing, for example, that there was not sufficient substance in CESA/CEL and, therefore, the central management and control of CESA/CEL remained in Canada. Perhaps the Minister's decision to argue sham and its focus on the paragraph 247(2)(b) and (d) transfer pricing re-characterization rules hurt its chances of prevailing in this case.

This case is the first decision to undertake an extensive discussion of the application of paragraphs 247(2)(b) and (d) and the Court provided a narrow interpretation of these provisions. While the Court's interpretation of the transfer pricing re-characterization rules seems reasonable, it remains to be seen whether the narrow interpretation makes it less likely for the Minister to attempt to apply these rules rather than the traditional transfer pricing rules in paragraphs 247(2)(a) and (c).

The Court's judgment in this case is quite long and, in ultimately agreeing with the expert evidence provided by Cameco, goes to great lengths to establish the findings of fact on which the decision is based. The extensive findings of fact may make it difficult for this decision to be overturned on appeal.

On October 25, 2018, the Minister filed a notice of appeal with the Federal Court of Appeal. The Minister has appealed on the basis that the Court erred in fact and in law in concluding that paragraphs 247(2)(b) and (d) and that paragraphs 247(2)(a) and (c) did not apply. The Minister did not appeal the Court's decision with respect to whether there was a sham.

[1] The HEU Feed Agreement was formally known as the UF6 Feed Component Implementing Contract.

[2] Cameco entered into the HEU Feed agreement with Cogema, Nukem Inc. and Nukem Nuklear GH.

[3] The Court cited *Merck & Co. v. U.S.*, 24 C1 Ct 73 at page 88, which was cited in *Amazon.com, Inc. & Subsidiaries v. Commissioner of Internal Revenue*, 148 T.C. No. 8 at pages 152 and 153.

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