FCA refuses to pierce the corporate veil in Cameco transfer pricing case

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On June 26, 2020, the Federal Court of Appeal (FCA) issued a unanimous decision[1] upholding the decision of the Tax Court of Canada in *Cameco Corporation v The Queen*.[2] The case provides additional clarity with respect to the application of Canada's transfer pricing rules found in section 247 of the *Income Tax Act* (Canada) (the Tax Act),[3] which govern transactions between Canadian residents and non-arm's length non-residents of Canada.[4]

What you need to know

The FCA unanimously rejected an attempt by the Canada Revenue Agency (CRA) to use the transfer pricing rules to pierce the corporate veil and disregard taxpayers' true legal relationships.

The purpose of Canada's transfer pricing rules is to ensure that transactions between non-arm's length parties are conducted on arm's length terms and conditions.

Whether transactions are carried out under arm's length terms and conditions is a question of fact.

The "re-characterization" rule at paragraph 247(2)(b) and (d) of the Tax Act imposes an objective test: would hypothetical arm's length parties have entered into the transaction or series of transactions?

Background

Cameco Corporation (Cameco), a Canadian taxpayer, is one of the world's largest producers of uranium. In 1999, Cameco decided to pursue foreign business opportunities to acquire Russian uranium and resell it to third parties. Cameco entered into contracts to sell a substantial portion of its uranium to its Swiss subsidiary, and also guaranteed long-term contracts entered into by the Swiss subsidiary to purchase uranium from third parties. In subsequent years, the price of uranium unexpectedly spiked. The result was profits from sales by the Swiss subsidiary to foreign customers were realized largely in Switzerland as opposed to Canada.

Reassessment and appeal to the Tax Court of Canada

The CRA reassessed Cameco to reallocate all of the Swiss subsidiary's profits to Cameco in Canada on the basis that the purchase and sales contracts involving the Swiss subsidiary:

Were a sham and should be disregarded; and

Did not meet the arm's length standard contained in Canada's transfer pricing rules, and accordingly, CRA could ignore the contracts or revise their terms in accordance with the agreement that arm's length parties would have made.

The Tax Court of Canada (TCC) dismissed the Crown's primary argument that Cameco's transactions were a sham.

Further, the TCC concluded the transactions carried out by Cameco were commercially rational and undertaken on terms and conditions that would be acceptable to arm's length parties. Accordingly, neither branch[5] of Canada's transfer pricing provisions supported the CRA's reassessments.

For our analysis of the September 2018 decision of the TCC in *Cameco Corporation v The Queen*, see *Taxpayer Wins Convincing Decision in Landmark Canadian Transfer Pricing Case*.

The Crown appealed to the FCA on the issue of transfer pricing. The Crown did not challenge the TCC's findings with respect to the sham. In the event that it was successful in the main appeal, the Crown submitted it was appealing the TCC's April 29, 2019 decision awarding Cameco costs in the amount of $10,250,000.[6]

Decision of the Federal Court of Appeal

In a unanimous decision, the FCA dismissed the Crown's appeal, and held that the Crown's interpretation of the re-characterization rule departed from the text of paragraphs 247(2)(b)(i) of the Tax Act.

The FCA conducted a textual, contextual and purposive analysis of subparagraph 247(2)(b)(i) and noted, rather than asking whether a particular taxpayer (in this case, Cameco) would have entered into the particular transaction or series of transactions with an arm's length person, this provision poses an objective question: would hypothetical arm's length parties have entered into the transaction or series of transactions?

According to the FCA, the text of the provision (*i.e.* "the transaction […] would not have been entered into between *persons* dealing at arm's length") made clear Parliament intended to create an objective test. Had Parliament intended to create a subjective test, as suggested by the Crown, the provision would have been worded differently (*i.e.* "the transaction […] would not have been entered into between *the participants* if they had been dealing at arm's length"[7]). This was supported by the text of paragraph 247(2)(d), which also includes the phrase "*persons* dealing at arm's length", but does not clearly refer to the actual parties to a transaction.

The FCA noted the Crown's interpretation of subparagraph 247(2)(b)(i) was overbroad, and if correct, would result in the application of the re-characterization rule any time a Canadian corporation wanted to carry on business in a foreign country through a foreign subsidiary.

Further, the FCA held that the Crown's interpretation effectively ignored the separate existence of the Swiss subsidiary. Rather, the FCA found that if the conditions in paragraph 247(2)(b) were satisfied, paragraph 247(2)(d) allows the existing transactions to be replaced by another transaction, not ignored altogether. Accordingly, the CRA could not simply ignore the transfer by Cameco of its sales function to its Swiss subsidiary.

The FCA's analysis was supported by a number of contextual factors, including the OECD's[8] Transfer Pricing Guidelines (the OECD Guidelines), which state that "except in exceptional circumstances, transfer pricing arrangements should be examined based on the transactions undertaken by the parties." According to the FCA, there were no exceptional circumstances preventing either the CRA or the TCC from determining the appropriate transfer price for transactions between Cameco and its Swiss subsidiary. Indeed, the TCC determined the prices at which uranium was sold by Cameco to its subsidiary "were well within an arm's length range of prices".[9]

As part of the context, the FCA noted that the headings to Part XVI.1 and section 247 of the Tax Act as well as the corresponding Technical Notes did not support the Crown's position. According to the FCA, the headings "Transfer Pricing" and "Transfer Pricing Adjustment" help demonstrate that the purpose of the provisions are to adjust the pricing in a particular transaction or series, not to allow the CRA to pierce the corporate veil and reallocate profits between members of a corporate group.[10]

The FCA dismissed the Crown's arguments with respect to paragraphs 247(2)(b) and (d) and determined that the re-characterization rules only apply where a Canadian taxpayer and a non-arm's length non-resident have entered into a transaction that would not have been entered into by hypothetical arm's length parties, under any terms or conditions. The determination must be made based on the facts and circumstances in existence at the time of the transaction without the advantage of hindsight. In the event the conditions of paragraph 247(2)(b) are met, the particular transaction is replaced by another transaction that would have been acceptable between hypothetical arm's length parties.

Finally, the FCA dismissed the Crown's alternative arguments with respect to the proper interpretation of paragraph 247(2)(a) and (c) as an indirect attempt to challenge the TCC's findings of fact, none of which were challenged by the Crown. The FCA confirmed that without a palpable and overriding error, the TCC is entitled to deference as to its weighing of the evidence presented at trial.

Takeaways

In this appeal, the Crown argued the proper interpretation of paragraph 247(2)(b) was that the re-characterization rule could be applied unless the taxpayer was able to establish it would have entered into the same transaction with the actual counterparty, had they been dealing at arm's length. This interpretation was unanimously rejected by the FCA.

In dismissing the appeal, the FCA confirmed that the transfer pricing rules cannot be used to pierce the corporate veil to tax Cameco on its Swiss subsidiary's profits. On the facts, the TCC was able to conclude there was no basis to find arm's length parties would not have bought and sold uranium, or transferred between them the right to buy uranium from third parties, and that the prices charged by Cameco to the Swiss subsidiary "were well within an arm's length range of prices". These findings of fact were unchallenged on appeal, and in any event, the trial judge's findings on these issues were entitled to deference. This result confirms the importance of leading reliable evidence at trial to permit the TCC to find the necessary facts upon which factual findings on arm's length pricing can be made.

The decision in *Cameco* is also significant as it firmly rejects the CRA's attempt to disregard the true legal relationships between Cameco and its Swiss subsidiary to tax the profits of the Swiss subsidiary's uranium sales in Canada. At trial, the Crown unsuccessfully relied on the sham doctrine to justify the reallocation of the Swiss subsidiary's profits to Cameco. The Crown's reliance on the re-characterization rule in paragraphs 247(2)(b) and (d) essentially sought to indirectly achieve the same result.

In rejecting the Crown's arguments, the FCA confirmed the actual objective of the transfer pricing rules is ensuring that transactions between non-arm's length parties are conducted on arm's lengths terms and conditions.

[1] *The Queen v Cameco Corporation*, 2020 FCA 112 [*Cameco* (FCA)]

[2] 2018 TCC 195 [*Cameco* (TCC)]

[3] RSC 1985 c. 1 (5th Supp.) [*Income Tax Act*].

[4] The Crown has 60 days from the date of the FCA decision to seek leave to appeal to the Supreme Court of Canada. It is not known whether leave will be sought.

[5] Being the general transfer pricing rule found at paragraphs 247(2)(a) and (c), and the re-characterization rule found at paragraphs 247(2)(b) and (d).

[6] Because the main appeal was unsuccessful, the April 29, 2019 costs award stands.

[7] *Cameco* (FCA) at para. 45.

[8] Organization for Economic Co-Operation and Development.

[9] *Cameco* (TCC) at para. 856.

[10] *Cameco* (FCA) at para. 60.

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