Bloomberg BNA

Tax Management
Transfer Pricing Report™

Lessons from Canada's Silver Wheaton Case: When Corporate Directors Are Sued for Transfer Pricing Transgressions

The authors examine the lawsuit filed by shareholders of Silver Wheaton Corp., which highlights the complexities of value determination in the mining industry as well as the inherent conflicts between shareholders and directors given their distinct incentives. The fiduciary duties and possible liabilities of directors as they relate to tax compliance and obligations, including transfer pricing, also are reviewed.

BY DAVID HOGAN AND ANDRE OLIVEIRA, RICHTER, TORONTO

On July 8, 2015 shareholders of Silver Wheaton Corp. filed a securities class action lawsuit against Silver Wheaton's executives and the company itself. This lawsuit raises key considerations that executives of public and private corporations should take into account when discussing their own strategies for achieving shareholders' goals—especially their tax strategies for enhancing profit maximization.

The lawsuit

Silver Wheaton shares plunged in the beginning of July, 2015, following the news that Canada Revenue Agency was seeking more than $220 million in taxes and penalties as a result of transfer pricing adjustments.[1] Investors currently fear that the ultimate tax bill could surpass $600 million, given that the CRA's reassessment proposal reflected only tax years 2005-10. Upon the news of the proposal, the company's shares fell $2.08 per share, approximately 12 percent, damaging investors and, of course, the company's reputation. Some stock analysts estimate that the company's valuation could take a $900 million hit as a result. The lawsuit alleges that Silver Wheaton and some of its senior executives:

- failed to disclose that the company's financial statements contained errors concerning income tax owed from the income generated by its foreign subsidiaries;
- issued annual reports, Securities and Exchange Commission filings and other statements that failed to disclose material adverse information and misrepresented the truth about the company's finances;

David Hogan and Andre Oliveira are transfer pricing experts in the cross-border tax group of Richter in Toronto, Canada. *The authors would like to acknowledge the contributions of Yves Nadeau and Terry McInally of Richter's Risk Management advisory practice.*

[1] The company subsequently challenged the adjustment. See 24 Transfer Pricing Report 665, 10/1/15.

 ISSN 1063-2069

■ issued reports and filings that allegedly were designed to influence the market for Silver Wheaton's securities, and as a result, artificially inflated the market price of its securities; and

■ managed a company that lacked adequate internal controls over its financial reporting.

The shareholders' lawsuit also lists three senior executives of Silver Wheaton as individual defendants: the company's current president and chief executive officer, its current chief financial officer and its former chief executive officer. The lawsuit alleges that the current and former executives were able to control the content of Silver Wheaton's statements given their positions of control and authority, and that as officers and directors of a publicly held company they had a duty to disseminate timely, accurate and truthful information about the company's businesses, operations, future financial condition and future prospects.

Transfer pricing at the center

This case is particularly interesting and unique because transfer pricing tax positions in Canada are at the root of the judicial claims. It is well known that transfer pricing is not an exact science, and very often more than one approach is possible, leaving company officers with decisions to make regarding how to allocate profits among the affiliates of the group.

In the Silver Wheaton case, the CRA argued that approximately $570 million of income earned by some non-Canadian subsidiaries of the company should have been allocated to the Canadian entity and subject to income tax in Canada from 2005-10. Details of the business model adopted by Silver Wheaton are not publicly available; however it is likely that the CRA's position includes the view that too much income was allocated to entities in the Cayman Islands and Barbados. In its 2014 annual report, Silver Wheaton's management stated that a ''significant portion of the Company's operating profit is derived from its subsidiaries, Silver Wheaton Caymans which is incorporated and operated in the Cayman Islands and historically, Silverstone Resources (Barbados) Corp., which was incorporated and operated in Barbados, such that the Company's profits are subject to low income tax.''

The CRA typically challenges structures involving low-tax jurisdictions, usually arguing that the amount of income in these locations is not justifiable given the limited functions, risks and assets of these entities. The proposed transfer pricing adjustments also may involve some affiliates in Luxembourg, the Netherlands or mining operating entities in South America, Mexico or Europe.

The case serves as a useful starting point for reflecting on two topics:

■ the complexities and conflicting interests involved in allocating income in the mining industry; and

■ the potential conflicts between shareholders' and directors' incentives and goals, especially taking into account the shareholders' goal of value maximization versus the directors' desire to mitigate any risks relating to their fiduciary duties, including possible personal liabilities.

Value creation, allocation in the mining industry: An exemplar case of conflicting interests

The exercise of setting intercompany prices is not a simple one in the mining industry, and naturally, transfer pricing is a key area of focus for company directors and local tax authorities. As in other industries, the transfer pricing policies determine the allocation of global taxable income among entities and jurisdictions within the group. The mining industry, however, is an exemplar case where, very often, alternative policies and methods are possible, as are distinct interpretations of the functions performed, risks assumed and assets employed by the participant entities in the intercompany transactions.

Here, the latent conflicting interests are heightened in that directors may view the setting of intercompany pricing as an opportunity for tax planning, while local tax authorities of the jurisdictions where the related parties of the group operate, often bringing opposing positions and interests, may view this as an opportunity to argue that more taxable income should be allocated to their own jurisdictions and not to a counterpart jurisdiction.

Elements that generate potential conflicts in this area are abundant. Some examples are:

■ *Complex supply and value chains*, where extraction, processing, refining, logistics and sales and marketing are performed by entities located in different jurisdictions.

■ *Intercompany transactions of significant size and variety*, including the sale of minerals (processed or unprocessed, refined or unrefined) from producing entities located in developing countries (for example, Brazil, Argentina, Chile, Peru and Mexico) to sales and marketing entities typically located in lower tax jurisdictions. Canada is unique in that in this value chain it can host both a producing entity (a Canadian mine) or a sales and marketing or strategic management function. Headquarters or hubs are likely to provide a variety of services such as strategic management, operational and administrative support to the producing entities, and the mining operations also may be funded by intercompany loans.

■ *Difficulties in assessing and determining the value of specific functions, risks and assets along the value chain*. This is likely to include the value of some sales and marketing activities performed by traders. Commodity producing versus capital jurisdictions has been an area of conflict, in particular with respect to how much value or profit should be allocated to the lower-tax jurisdiction for the sales and marketing functions.

■ *Difficulties in applying the comparable uncontrolled price (CUP) method*. The availability of public information on market prices from transparent markets like metal exchanges makes the CUP method usually the first to be considered. However, the actual intercompany transaction within a group often cannot be compared to the market price without adjustments. For example, if a market price (for example, London Bullion) is representative of the value of the commodity to an end-user at the end of the supply chain, then adjustments should be made to this price when the intercompany transaction under review occurs at a prior step in the value chain. This is the case, for instance, of the sale of unrefined metals that still require refining and sales

  TMTR ISSN 1063-2069

& marketing activities before it turns into a sale of a refined metal at the end of the chain (to banks and dealers).

■ *Difficulties in finding comparable transactions for more complex transactions*, such as metal streaming, offtake agreements and take-or-pay or other long-term contracts.

■ *Possible application of alternative methods for the same intercompany transaction*. For instance, CUP, the resale price method and the transactional net margin method all can be applied for the sale of minerals from commodity-producing countries to sales and marketing entities.

■ *Possible controversy regarding the relative importance of intangible assets*, including mineral extraction rights in the producing country and customer relationships in headquarters or sales and marketing entities.

The OECD in releasing specific guidance on commodity transactions in December 2014[2] outlined the concerns of developing and producing countries, suggesting CUP as the appropriate method and discussing how adjustments to the method may be required.

With uncertainties remaining, controversies between taxpayers and tax authorities will continue. Another mining company, Cameco Corp., also has a transfer pricing dispute in Canadian court.[3]

Shareholders vs. directors

While striving to reduce global consolidated tax and increase shareholder returns, the directors at Silver Wheaton allegedly implemented a tax structure that involved a significant potential liability in Canada. As a result, some shareholders are now alleging that Silver Wheaton's directors breached their fiduciary duty to communicate those risks and that they did not reveal the company's correct financial position. The irony is that the directors, in the name of maximizing value for their shareholders, are now being sued by these same shareholders. Moreover, depending on the actual organizational structure of the group, the transfer pricing adjustment might be deemed a dividend, which would be subject to withholding tax. Should Silver Wheaton not remit the withholding tax and given the personal liability provisions in Canada, that amount would become a personal liability of those same Silver Wheaton directors.

Fiduciary duties of directors related to tax planning, compliance

Shareholders may favor strategies or positions that would put directors at risk of personal liabilities, including personal financial costs and reputational damages. Conflicts may arise when corporate decisions are made regarding critical matters, such as:

■ *Capital structure*. In seeking high returns on equity, shareholders may favor a very high debt-to-equity ratio, which may lead to bankruptcy risks. In this situation, the director may be left in a risky position in which he or she may end up being personally liable for payroll and other corporate debts including withholding and goods and services tax or harmonized sales tax.

■ *Tax planning strategies*. Shareholders' focus on after-tax profits is signaling the need for executives to implement tax saving strategies to reduce the global and consolidated tax expenses.

Directors need to be aware that there can be severe personal consequences associated with these decisions. There are a number of acts of legislation in Canada that hold directors accountable and personally liable, such as the Income Tax Act, the Employment Insurance Act and the Excise Tax Act.[4] Similar personal liabilities exist for directors under provincial legislation (Ontario) in the Employee Health Tax Act, Corporations Tax Act and the Retail Sales Tax Act.

For public companies, directors also may be liable for transgressions under the legislation governing securities trading, such as the U.S. Securities Exchange Act used by Silver Wheaton's shareholders to sue its directors. At the time of publication, no charges have yet been laid under the Canadian securities regulations.

Transfer pricing in a complex industry: Protections for directors

Overall, when performing duties for a company, directors should bear in mind the potential for legal repercussions that accompany their roles and take steps to minimize risks. These include personal responsibility for appropriate financial statements and internal controls, as well as personal liability, penalties and fines for specific tax liabilities of the companies they serve. When legal risks are involved, adopting practices to mitigate these risks is paramount. When possible, independent parties should conduct reviews of a company's tax compliance procedures and planning structures, transfer pricing and internal controls, to avoid situations similar to Silver Wheaton's.

---

[2] See 23 Transfer Pricing Report 1170, 1/8/15. This discussion draft was incorporated into final guidelines released in October, available at http://src.bna.com/tx.

[3] Cameco, a Canadian resident corporation and one of the world's largest publicly traded uranium producers, established a Swiss subsidiary in 1999 to purchase uranium from Cameco and unrelated sellers outside Canada. The company also sold uranium to Cameco's U.S. subsidiary for resale to non-Canadian purchasers. The CRA challenged the transfer pricing method used by Cameco for its contracts with the Swiss subsidiary as well as the corporate structure of the arrangement. In the most recent development of this case, in a decision dated July 12, 2015, the Federal Court of Canada found that the government should provide its position on what the arm's-length price should have been. See 24 Transfer Pricing Report 255, 7/9/15.

[4] Karen J. Cooper, "Avoiding Director's Liability in Troubled Economic Times," *Charity Law Bulletin* 162 (2009), available at http://www.carters.ca/pub/bulletin/charity/2009/chylb162.htm.