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Cameco Trial: Opening Remarks Raise Fundamental Issues In $2.2B Case That Could Transform Transfer Pricing

Cameco Corp.'s transfer pricing dispute with the Canada Revenue Agency went to trial in early October. The central issue is whether a Swiss subsidiary used by the Canadian parent as an intermediary in selling uranium actually contributed substantively to the sales or simply served as a conduit that allowed Cameco to siphon profits out of the country. In this article, the authors probe the opening remarks made by the parties to glean insights into the potential impact the case could have on transfer pricing in Canada and internationally.

BY DAVID HOGAN AND ANDRE OLIVEIRA

Opening remarks in Cameco Corp.'s $2.2 billion transfer pricing trial drew global attention in October to what is sure to become a landmark case in Canada and internationally.

Cameco Corp. (Cameco) and the Canada Revenue Agency (CRA) are at odds over the company's practice of selling uranium through its Swiss subsidiary, Cameco Europe Ltd. (SwissCo). While Cameco defends the transactions as arm's-length sales between related parties, the Crown maintains that the Swiss company contributed nothing of substance and was, in fact, an intermediary only on paper.

The trial before the Tax Court of Canada will test the application of the sham doctrine and the recharacterization rule to a degree never seen before in Canada.

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While the case is technically a transfer pricing dispute, the Crown is essentially arguing that, despite the existence of contracts between the Canadian and Swiss entities, no related-party transactions actually occurred.

Further, the case represents the first time that the government's ability to recharacterize a transaction is being tested in court.

The CRA contends that SwissCo was never engaged in the uranium business. Rather, Cameco used its Swiss subsidiary to avoid paying taxes at the higher Canadian rate. On these grounds, the CRA seeks to shift some C$7 billion ($5.4 billion) in foreign earnings to Canada for tax years 2003 through 2015, an income adjustment that would result in an estimated tax bill of over $2.2 billion for Cameco.

The fundamental issues in the case are:

- the use, implementation and validity of legal intercompany agreements;
- the level and extent of the actual operations to prove and sustain that a business was being carried on;

- the quality and extent of the evidence and documentation required to support the functions, risks and assets in each jurisdiction;
- the critical importance of the functional analyses;
- the thresholds and limits for the application of the sham doctrine and the recharacterization rule; and
- the use of the comparable uncontrolled price (CUP) and profit-split methods in the context of commodities and other transactions.

In this article, we analyze the main aspects of the case, taking as a basis the opening remarks made during the first day of the trial by Cameco's attorneys and the Crown's lawyers.

The Facts

Cameco is one of the world's largest uranium producers. In 1999, the company entered into a restructuring through various intercompany agreements and the incorporation of new entities in Luxembourg, Switzerland, the U.S. and Barbados. It established SwissCo to purchase uranium both from the Canadian parent and arm's-length sellers and to sell the uranium to Cameco's U.S. subsidiary for resale.

Cameco has characterized SwissCo as an aggregator and its U.S. subsidiary as a distributor and marketer, but the Crown disputes this characterization.

The Crown's belief is that these new intercompany agreements existed only ''on paper.'' According to the Crown, Cameco did not transfer any uranium business to Switzerland and, therefore, the Swiss subsidiary ''did nothing, did little more than rubber-stamp paperwork.''

The Parties' Positions

Cameco maintained that SwissCo was carrying on the business of buying and selling uranium, as demonstrated by the intercompany agreements and its own conduct. Further, Cameco asserted that the prices used in the uranium sales from the Canadian parent to the Swiss subsidiary were at arm's length as were the terms and conditions of their intercompany agreements.

Cameco stated that its 1999 legal entity reorganization, from which spawned its Swiss trading business, was intended to accomplish a tax result that was consistent with the provisions of the Canadian Income Tax Act (the Act) dealing with Canadian foreign affiliates and international transfer pricing practices.

In contrast, the Crown asserted that Cameco understated its Canadian taxable income substantially and should be reassessed under:

- the sham doctrine, as no business was undertaken by SwissCo and all the intercompany arrangements were created to deceive the Minister in pretending that a business was conducted;
- the recharacterization rule under paragraphs 247(2)(b) and (d) of the Act, which allows adjustment to exclude SwissCo from the transactions if there were no bona-fide non-tax reasons for its involvement; or
- the traditional transfer pricing provisions in paragraphs 247(2)(a) and (c) of the Act, which allow adjustments to the prices at which the intercompany transactions occurred, such that they should reflect the negligible contribution of the Swiss subsidiary.

So far, Cameco's defense strategy has been to seek to limit the case to an examination of whether the Canadian parent sold any uranium to its Swiss subsidiary for less than an arm's-length price. Cameco's position is that this is the only real issue in this case.

When Is a Reorganization Not a Reorganization?

The Crown openly stated that taxpayers have the right to pay no more tax than what is required by law and that taxpayers can organize their affairs to do so. The Crown, however, also alleged that the restructuring implemented by Cameco in 1999 did not result in any material change in the operations of the Cameco Group, with the exception of certain sales and marketing activities actually transferred from Canada to the new U.S. subsidiary. The only material change was that the profits, which used to be earned in Canada, were subsequently being recorded offshore.

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Cameco responded by alleging that the Crown is infringing on Cameco's legal right to engage in tax planning and to organize its affairs to minimize its tax liability.

The Sham Doctrine

The Crown asserts that to apply the sham doctrine, the court must find that the parties have presented the transaction as being different from what they know it to be. The Crown said it would provide evidence that Cameco and SwissCo prepared documentation to create ''the illusion'' that a business was being carried on by the Swiss subsidiary, when all the work and all the core business decisions were made by the Canadian parent.

The Crown argued that the companies intended to deceive the Minister into believing that SwissCo was carrying out a uranium business pursuant to various agreements, when it was not involved at all.

Cameco responded that anything that did not speak to the arm's-length standard for uranium sales and pricing would be a ''sideshow'' presented by the Crown. It argued that the Crown had no evidence to show that the Swiss subsidiary was not carrying on the business of buying and selling uranium.

If the court finds that the sham doctrine applies, SwissCo would be removed from the economic equation on the basis that it is not actually carrying out the activity of buying and selling uranium. If a sham were found, then it follows that SwissCo's income from its trading operations would be Canadian income for tax purposes.

   ISSN 1063-2069

Recharacterization of Transactions

Under the transfer pricing recharacterization provisions, the Crown claimed that Cameco entered into intercompany transactions that were commercially unreasonable and only implemented to achieve tax reduction in Canada. If Cameco were operating at arm's length, the Crown argued, it would not have entered into the fixed-price agreements with its Swiss subsidiary. As a result, Cameco would not have suffered operating losses from the sale of almost all its uranium to the Swiss affiliate.

If the court concludes that Cameco has no bona fide non-tax purposes for using its Swiss subsidiary as an intermediary, then recharacterization should apply, the Crown argued. Its position is that the restructuring in 1999 was entirely tax-driven, and ''so-called'' business reasons for the restructuring were developed later and were not bona fide.

Transfer Pricing Based on Profit Split

However, if the court rejects the sham and recharacterization arguments, the Crown said, then it should allow an adjustment to the transfer price based on the profit-split method. Under the profit-split method, if Cameco did all the work and SwissCo merely signed paperwork, substantially all of the profit in Switzerland must be reallocated to Canada. The Crown insisted that the court look at the entire arrangement between the entities and apply a broader view than just looking at the specific prices and terms in the intercompany agreements.

CUP Analyses

Cameco responded that the intercompany agreements were consistent with at least two major supply agreements entered into by SwissCo with arm's-length parties. So the comparable uncontrolled price (CUP) method should be followed. This would result in a minimal or nil adjustment.

The Crown countered:

- Cameco agreed to sell most of its uncommitted uranium at prices that were too low to cover its mining costs and which were below Cameco's own forecasts,
- Cameco agreed to terms and conditions that were significantly more favorable to SwissCo than the terms and conditions that third-party suppliers had with SwissCo, and
- Cameco locked itself into these intercompany contracts for a long period of time, at fixed prices, and extended the contracts despite market conditions.

Moreover, the two arm's-length supply agreements that Cameco references were negotiated and guaranteed by Cameco, then simply given to SwissCo. Thus, they are not appropriately comparable.

Functions Based on Who Did What

The Crown strongly pushed the functional analysis to the center of the dispute, focusing on which parties performed what functions, and what was the arm's-length remuneration for those functions. The Crown said it would specifically focus on questioning what exactly SwissCo did or did not do. The company had only one employee who performed only minimal administrative activities, the Crown said. It did not negotiate any contracts with suppliers or customers, did not identify any business opportunities, did not decide what contracts to enter into, did not decide on what prices to purchase or sell, or at what volumes, in what locations, nor when to purchase or sell.

The Crown maintained that Cameco performed the all-important functions and made the strategic decisions regarding the uranium business, including contract negotiation and administration, pricing analysis, inventory management, delivery, forecasting supply and demand, price forecasting, and modeling Cameco's overall position.

Cameco responded that its Swiss subsidiary conducted a trading business purchasing uranium mainly from Cameco and third parties, and that it bore market risks, which led to certain losses in the first years of operation. It asserted that SwissCo hired the Canadian parent to advise it on certain matters, and that was simply part of its business.

Conclusion

This case has so many angles and issues to be followed that it will become a critical reference source to all involved in transfer pricing planning and implementation, including business owners, management of multinationals, and advisors.

Important arguments and decisions are sure to be made during the course of the trial in relation to many essential issues, such as the use, implementation and enforcement of legal agreements, the importance of an accurate and complete functional, risk and asset analysis of all parties involved in a value chain, the importance of demonstrating changes pre- and post- business restructurings, the importance of maintaining proper evidence and support for the activities performed and risks taken, the use of CUPs, and the use of the profit-split method to propose transfer pricing adjustments. Finally, this case may also provide key jurisprudence and insights into the requirements for the application of the sham doctrine and recharacterization rule in the Canadian transfer pricing environment.