Global Transfer Pricing Battleground: Canadian Federal Court ruling thwarting re-characterization of Cameco's transactions

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Canada's Federal Court of Appeal (FCA), in the case of Cameco Corporation[1], was keenly awaited by the stakeholders for the reason that it involved more than a decade old transfer pricing controversy arising out of re-characterisation provision contained in the Canadian transfer pricing regime[2]. This case was also the first ever case where re-characterisation provision under the Canadian transfer pricing rule was interpreted. The FCA has provided textual, contextual and purposive interpretation of "re-characterisation" which may have a high precedential value not only from a Canadian transfer pricing litigation perspective but may also be taken into account while interpreting principles of re-characterisation across jurisdictions, subject to differences in the text of transfer pricing provisions of respective jurisdictions dealing with re-characterisation. Although the magnitude of transfer pricing adjustment for three tax years in question was around Canadian $480 Million, its impact for future assessment years would have aggregated to a whopping Canadian $8 Billion approximately for Cameco Canada, had the ruling gone against it.

FACTS OF THE CASE

Cameco group, headquartered in Canada, is an integrated uranium producer and supplier and has its presence in the entire uranium supply chain right from mining to enrichment and supplying to nuclear power plants across the globe. Cameco Corporation (hereinafter referred to as 'Cameco Canada') is the group parent company based in Canada. Since 1993, Cameco Canada had been negotiating with a Russian Government company, Tanex, and another uranium enricher, Urenco, for supply of uranium of Russian origin. During 1999, as a result of operational restructuring, Cameco Canada started operating as a uranium miner and producer while its subsidiaries in Luxembourg and Switzerland as traders and its US subsidiary as a distributor. Cameco Switzerland entered into a service contract with Cameco Canada for availing various services including uranium contract administration legal and back office services. Cameco Switzerland had two employees and one of them was highly experienced in the uranium industry.

In pursuance of the operational restructuring, during 1999, Cameco Canada instead of directly entering into a contract of buying uranium with Tanex and Urenco, allowed its Luxembourg based entity, Cameco Europe SA, to enter into the said contracts. In 1999, Cameco Canada formed another subsidiary company, later rechristened as Cameco Europe AG (hereinafter referred to as 'Cameco Switzerland'), in Switzerland. Cameco Luxembourg transferred its business to Cameco Switzerland under which the rights of purchasing uranium from Tanex and Urenco were also transferred. Besides buying uranium from Urenco and Tanex, Cameco Switzerland would buy uranium from Cameco Canada also for reselling. As a distributor, Cameco US would buy uranium from Cameco Switzerland and sell the same to third party customers at a gross margin of two percent. The price of the uranium in the market during 1999, when the contract for supply of uranium was entered into between Cameco Europe with Urenco and Tanex, was low. However, after 2002 and at the time of reselling the uranium by Cameco Switzerland the price spiked substantially leading to earning of substantial profit by Cameco Switzerland.

The Canadian Revenue Agency (CRA) was of the view that the profit arising to Cameco Switzerland belonged to Cameco Canada. CRA reassessed the income of Cameco Corporation for tax years 2003, 2005 and 2006 and made an aggregated transfer pricing adjustment amounting to Canadian $480 Million.

ARGUMENTS BY THE PARTIES

CRA argued that Cameco Corporation transferred its uranium business to Cameco Switzerland but, in substance, all strategic decisions in respect of the trading business were continued to be performed by Cameco Canada and therefore the arrangement was a 'sham' to shift profit from Canada to Switzerland.

CRA argued that the arrangement was not commercially rational and a third party would not have let go a potentially profitable business opportunity. CRA further argued that Cameco Switzerland did not perform valuable functions to earn the significant profit from resale of uranium. Cameco Switzerland continued to avail contract administrative services from Cameco Canada. The whole affair was arranged principally with the objective of taking tax benefit arising from lower tax rate in Switzerland as compared to Canada. Therefore, arrangement structured by Cameco Canada should be completely disregarded and the transaction be re-characterised as if Cameco Canada had directly entered into uranium purchase agreement with Tanex and Urenco.

Cameco Canada argued that there was no incongruity in the form and substance of the transaction and therefore question of transaction being 'sham' does not arise. Cameco Canada also argued that a person would be willing to give up a business opportunity for an appropriate price and there was no significant economic value when the uranium supply contract was first entered into by Cameco Europe with Tanex and Urenco. It was only post 2002 that the price of uranium spiked and this spike in the price could not have been forecasted at the time the supply contract was entered into with Tanex and Urenco.

TAX COURT'S DECISION

The Tax Court of Canada (TCC) agreed with Cameco Canada's argument that there was no evidence of any deception or deceit on the part of Cameco Canada and they represented their legal arrangement in the same form that the arrangement was existed. The arrangements created by the contracts were not a facade but were the legal foundation of the implementation of Cameco Canada's tax planning. TCC, very Importantly, ruled that just because an arrangement is motivated by tax, it does not render it a 'sham'.

In regard to 're-characterization' TCC opined that there is nothing commercially irrational in giving up a business opportunity and that a commercially rational arrangement should be looked at from pricing adjustment perspective and not from the structural adjustment/re-characterisation perspective. TCC also observed that Cameco Switzerland assumed price risk in respect of its assigned contract with Urenco and Tanex and therefore, it was entitled to the favorable movement in the market price of the uranium. Further, in respect of sale of uranium by Cameco Canada to Cameco Switzerland, the tax court concluded that the prices charged were well within an arm's length range and, consequently, no transfer pricing adjustment was warranted for the tax years under consideration.

FEDERAL COURT OF APPEAL DECISION

Aggrieved by the order of the TCC, CRA appealed before FCA. However, before FCA it did not litigate the ground that the transaction was a 'sham' and merely argued on 're-characterisation' and 'pricing adjustment' grounds which were also negated by the TCC. However, before we deal with FCA ruling any further, it would not be out of place to briefly touch upon the Canadian transfer pricing provision especially those dealing with re-characterisation.

Section 247 (2) of the Canadian Income Tax Act deals with transfer pricing provisions and has four paragraphs. While paragraph (a) and (c) deals with conditions of pricing adjustment, paragraph (b) and (d) deals with conditions of re-characterisation and guidance for making adjustment if conditions of re-characterisations are met. For the sake of simplicity, section 247(2) of the Canadian IT Act is rephrased as below:

Where a Canadian taxpayer enters into a transaction with a non-resident on a non-arm's length basis and

- the terms and conditions in respect of this transaction differ from those that would have been made between persons dealing at arm's length then the amount determined between the taxpayer and the non-resident would be adjusted to the quantum of the amount to reflect the amount determined as if the transactions were entered at arm's length ***[Essence of Paragraph (a) and (c) of Section 247 (2), Pricing adjustment]***.

- the transaction would not have been entered into between the persons dealing at arm's length and such transaction has been entered into primarily for tax benefit then the amount determined between the taxpayer and the non-resident for such transaction shall be adjusted to the quantum or nature to reflect the transaction that would have been entered into between persons dealing at arm's length under terms and conditions that would have been made between persons dealing at arm's length. ***[Essence of Paragraph (b) and (d) of Section 247 (2) structural adjustment as a result of re-characterisation]***.

Simply put, paragraph (a) and (c) of section 247(2) permits CRA to make adjustment when the terms and conditions in respect of a transaction entered into between non-arm's length parties are different from terms and conditions in respect of a transaction entered into between arm's length parties under similar circumstances***. The adjustment under paragraph (a) and (c) of the said section is done through a 'comparative' analysis.***

However, under paragraph (b) and (d) adjustment arises when twin pre-conditions of triggering re-characterisations are met, firstly, the transactions entered between non-arm's length parties would not have been entered into by any arm's length parties not even with changed terms and conditions and, secondly, the non-arm's length parties have entered such transactions primarily for the purpose of tax benefit. The adjustment in such cases is made by making a presumption that an alternative (hypothetical) transaction would have been entered into between arm's length parties under arm's length conditions and then 'substituting' the terms and conditions of this alternative transactions to actual transaction entered into between non-arm's length parties primarily for tax benefit purpose. ***The adjustment under paragraph (b) and (d) of the said section is done through a 'substitution' analysis.***

The CRA in its appeal before the FCA did not dispute facts of case as presented before the TCC and, therefore, the issue raised before the FCA was interpretation of section 247(2) of the Canadian IT Act, especially, paragraph (b) and (d) of 247(2) dealing with re-characterisation.

In order to adjudicate the issue whether there was a need to recast the transaction entered into by Cameco Canada with non-arm's length parties, the question that was required to be answered was whether the twin pre-conditions mentioned in para (b) of section 247(2) were met in the given facts and circumstances or not. In respect of first pre-condition, FCA remarked that instead of asking question whether Cameco Canada would have entered into the arrangement it actually entered into with an arm's length party, the question that needed to be answered was whether any party would have entered into such a transaction with arm's length party at arm's length conditions. FCA also observed that commercial rationality of the transaction was established from witnesses from both the sides and challenging the same before FCA would mean indirectly challenging facts that were decided in favour of taxpayer by TCC. FCA held that If a transaction is commercially not irrational then it was reasonable to assume that arm's length persons would enter into the transaction.

The FCA held that the first condition of para (b) of section 247(2) is not fulfilled and therefore there was no need to adjudicate on adjustment proposed by the CRA under para (d) of section 247(2) of the Canadian IT Act. However, for the sake of completeness, the FCA did analyse the adjustment proposed by the CRA. The FCA observed that once the twin conditions of recasting of transactions are met, para (d) requires replacing of the transactions entered by the taxpayer with a non-arm's length party by an alternative arm's length transaction. The FCA held that the CRA's proposition of disregarding the purchase contract between Cameco Switzerland and Tanex and Urenco as if the said purchase contracts were entered into directly between Cameco Canada and Tanex and Urenco would virtually mean amalgamation of separate legal entities with Cameco Canada.

FCA held that CRA's proposition of replacing the transaction with nothing was against the mandate of para (d) of section 247(2) which requires replacement of transaction with an alternative transaction having arm's length characteristic. Consequently, FCA dismissed the appeal of CRA and decided in favour of Cameco Canada.

INTERPLAY OF OECD TP GUIDELINES ON RE-CHARACTERISATION WITH CANADIAN & INDIAN TP REGIME

Generally, transfer pricing regulations are associated with testing or determining arm's length price and making "pricing adjustment". Re-characterisation, full or partial, or disregarding of a transaction deals with transactional/structural adjustment which in turn affects the tax base. Final BEPS Action Plan 8-10, now adopted in OECD TP Guidelines, 2017, also revised the rules regarding re-characterization/recognition of controlled transaction for transfer pricing purposes. Like earlier transfer pricing guidelines issued in 1995 and then in 2010, OECD has always recommended respecting the transaction as structured by the entities.

The earlier OECD TP Guidelines (released in 1995 and 2010) listed two circumstances where a transaction could be re-characterized. First, where form of the transaction is different from the "commercial substance" (by analysing the conduct of the parties) and second where form and substance are same but transaction/arrangement, viewed in totality, lacks "commercial rationality" and transaction is structured such that it would impede the determination of arm's length price. Just to emphasise the point that re-characterisation and disregarding should be resorted only rarely, the OECD Guidelines 2010 also clarified that a transaction should not be re-characterized or disregarded just because transaction/arrangement similar to one entered into by taxpayer with its group companies are not found in the open market between third parties. The guidance on re-characterisation and disregarding a transaction created significant disputes between taxpayers and revenue authorities.

The revised guidance on re-characterization and disregarding of transaction in the OECD TP Guidelines, 2017[3] does not specifically mention the word "re-characterization" and simply focusses on "disregarding" or "non-recognition". Further instead of two circumstances mentioned in earlier versions of

OECD TP Guidelines, the current OECD TP Guidelines only mentions one circumstance, ie, transaction/arrangement lacking commercial rationality, which may qualify for non-recognition or disregarding. Only explanation, though not clearly reflecting in the current OECD TP Guidelines, for such a change seems to be that current OECD TP Guidelines focus on “delineation” of controlled transaction. Put simply, delineation means “going behind the transaction” to understand the “real deal” in the transaction. The delineation process does not merely go by the form of the transaction as represented in inter-company contract but focusses on “commercial substance”. Therefore, “substance over form test” is already subsumed during the delineation process. Therefore, does it mean that change brought in by the current OECD TP Guidelines is merely a matter of semantics? Perhaps not, as proposition of rare application of re-characterization is not required for delineation process as was necessary under the earlier TP Guidelines. The implication of subsuming the “substance over form test” in the delineation process is that it allows the revenue authority significant discretionary power and latitude to re-characterize the transaction structure under the garb of delineation.

Let us analyse one fundamental issue in respect of re-characterization or non-recognition. From where does the revenue authority of a country draw power to re-characterize and/or disregard a transaction structured by the taxpayer? There would be hardly any tax jurisdiction which considers article 9 of the treaty self-executing. Generally, double tax treaty is considered as restricting the charge on tax imposed by the domestic tax regulation. Treaty generally does not create a charge in absence of one existing in the domestic tax legislation. Therefore, tax authority may not be able to disregard a transaction unless the domestic tax legislation of a country enables the tax authority to do so. Therefore, the taxpayer should analyse their domestic tax legislation before taking a view on tax administration’s approach of non-recognition or disregarding or re-characterising a transaction.

Indian Income Tax Act, 1961 (the Act) does not provide any reference to OECD TP Guidelines for interpreting arm’s length principle as mandated in Section 92 read with 92F(ii) of the Act. A close reading of Section 92, 92F (ii) of the Act and Rule 10B of the Income Tax Rules, 1962 (the Rules) suggest that arm’s length price will be the price fetched by an uncontrolled entity having FAR, terms and condition, product and service characteristics, market conditions etc. same and or similar to the taxpayer. If there is a difference in the terms and conditions of the taxpayer’s transaction and the benchmark transaction then either benchmark transaction has to be rejected or an adjustment needs to be made in the uncontrolled transaction (and not to the tested transaction/entity) for accounting the difference in terms and conditions to enhance the reliability of substitute consideration and determine arm’s length price therefrom. Transfer Pricing Officers (TPOs) in India have been disregarding several intra group transactions, viz, payment of management fee etc. on the basis that there was no documentary evidence to support that such services were in fact availed. However, in order for re-characterisation to take place, there has to be a transaction in the first place. Mere recording of entry in the books is not a transaction. Further, in many instances TPOs have attempted to recast the transactions actually entered into by the taxpayer into altogether a different type of agreement. TPO’s re-characterisation of Japanese Sogo Shosha Companies in Itochu India Private Ltd [TS-428-HC-2019(DEL)-TP] Marubeni Itochu Steel P Ltd [TS-275-HC-2016(DEL)-TP] Mitsui & Co India Pvt Ltd [TS-195-HC-2016(DEL)-TP] (functioning as sales and marketing entity and/or business support services providers or their indenting segment) as trading companies/segment is a case in point. ITAT and HC have consistently rejected TPO’s approach of re-characterisation in such cases. In the case of Aegis Limited [TS-342-ITAT-2015(Mum)-TP] the TPO attempted to re-characterize subscription in preference share capital as loan. The Mumbai Tribunal rejected TPO’s approach although interestingly remarked that exceptional circumstances described in OECD Guidelines were not present in the instant case. Several of these cases are pending at higher appellate levels including Apex Court of India for final adjudication. It would be interesting to note the final outcome of such cases and the comments/observation that may be made by the higher appellate authorities.

KEY TAKEAWAYS AND WAY FORWARD

Whether this more than a decade long transfer pricing issue is laid to rest or CRA will appeal before Supreme Court is not in the public domain as yet. It is expected that the subtle difference in interpretation of ‘re-characterisation’ in pre and post 2017 version of OECD TP Guidelines will keep the litigation ground busy in near future on the issue. As the tax years under consideration were prior to 2010, TCC and FCA relied on the OECD TP Guidelines issued in 1995. Subsequent and more recent analysis of “recognition” of transaction as provided in 2017 version of OECD TP Guidelines were not considered. Further, recently, on 26 February 2020, the CRA issued a draft notice informing tax professionals that information Circular IC87-2R containing guidance on transfer pricing provisions contained in section 247 stands cancelled. In respect of re-characterisation, this circular relied on interpretation of ‘re-characterisation’ based on 1995 version of OECD TP Guidelines. CRA has stated that IC87-2R was cancelled due to its inconsistency with the CRA’s current interpretation and application of Canadian transfer pricing legislation, and does not reflect updated OECD TP Guidelines. More importantly, the CRA also mentioned in the draft notice that the practice of resorting to re-characterisation only in exceptional circumstances is out of date and is a clear indication that in future it may apply re-characterisation provisions more freely as compared to current practice. However, whether such a broad application of re-characterisation would prevail in the courts or not would depend upon the facts and circumstances of the case.

While Indian GAAR covers cases where the arrangement creates rights or obligations which are not ordinarily created between persons dealing at arm's length, its practical implementation in respect of mode of re-characterisation is yet to be experienced. Given the Government of India's stand on most of the aspects of BEPS Action 8-10 and GAAR provisions covering transactions lacking commercial rationale, taxpayers in India should evaluate their international transactions and structures as to whether they meets substance and commercial rationale test.

(views expressed are personal views of the authors)

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[1] Her Majesty The Queen Vs Cameco Corporation (2020 FCA 112)

[2] Section 247(2)(b) and Section 247(2)(d) of the Canadian Income Tax Act

[3] Para 1.119 through 1.128 of OECD TP Guidelines, 2017