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From transfer pricing to tax treaties: Canadian cross-border tax update

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The two most significant Canadian cross-border tax developments in 2018 relate to transfer pricing and tax treaties. On transfer pricing, Osler successfully represented the taxpayer, Cameco Corporation, at the Tax Court of Canada in the first case to address Canada's transfer pricing "recharacterization" rule. On tax treaties, Canada introduced legislation in 2018 (Bill C-82) to enact the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting — also known as the Multilateral Instrument or MLI — into Canadian law. This is the next step in the process for Canada to ratify the MLI – which will make significant amendments to many of Canada's tax treaties.

Taxpayer prevails in landmark transfer-pricing dispute

On September 26, the Tax Court of Canada released its decision in *Cameco Corporation v Her Majesty the Queen*, 2018 TCC 195.

The Minister of National Revenue reassessed Cameco Corporation (Cameco Canada) to include in its taxable income all of the uranium trading profits reported by its foreign subsidiary (Cameco Europe). Following a corporate reorganization in the late 1990s, Cameco Europe earned profits from market sales of uranium purchased pursuant to contracts with Cameco Canada (the Intercompany Contracts), as well as with arm's length non-residents of Canada (the Third-Party Contracts), after uranium prices rose dramatically. Cameco Canada provided Cameco Europe with a number of services (including contract administration, market planning and back office services) pursuant to an intercompany services agreement.

At trial, the Crown sought to defend the tax assessments on the basis of three alternative arguments. First, the Crown said that Cameco Europe and its business were a "sham," such that all of its trading profits properly belonged to Cameco Canada. Second, the Crown said that the transfer pricing "recharacterization" rule in paragraphs 247(2)(b) and (d) of the *Income Tax Act* (the ITA) applied to recharacterize all of Cameco Europe's trading profits as profits of Cameco Canada. Third, the Crown argued that the pricing rule in paragraphs 247(2)(a) and (c) of the ITA applied to move Cameco Europe's income to Cameco Canada.

In his 297-page decision, Justice Owen of the Tax Court of Canada found in favour of the taxpayer and rejected all three of the Crown's arguments.

There was no sham Owen T.C.J. found that the Crown's sham argument reflected "a fundamental misunderstanding of the concept of sham" and that there was "no evidence to suggest that the written terms and conditions of the many contracts entered into by [the relevant entities during the period] do not reflect the true intentions of the parties to those contracts, or that the contracts presented the resulting transactions in a manner different

from what the parties knew the transactions to be." Rather, he found as a fact that the parties entered into numerous contracts to create the very legal relationships described by those contracts. This case, along with another recent Tax Court of Canada decision, *Van Lee v her Majesty the Queen*, 2018 TCC 230 (also argued by Osler), confirms that Canadian courts will continue to apply the sham doctrine sparingly in tax cases, reserving it for instances where the Crown has proven deceit.

The recharacterization rule did not apply Owen T.C.J. also found that the rule in paragraphs 247(2)(b) and (d) of the ITA did not apply. Unlike the traditional "pricing" rule in paragraphs 247(2)(a) and (c) of the ITA, which adjusts the terms and conditions of a transaction between non-arm's length parties to reflect arm's length terms and conditions, the rule in paragraphs 247(2)(b) and (d) permits a transaction or series to be "recharacterized" for tax purposes where arm's length parties would not have entered into the transaction or series, which was done primarily to achieve a tax benefit. This is the first case in which a Canadian court has considered the scope and interpretation of these provisions.

Owen T.C.J. held that the rule applies when arm's length parties would not enter into the transaction or series on any terms or conditions, but in the circumstances there is an alternative transaction or series that arm's length parties would enter into, on arm's length terms and conditions. He found that neither the series of transactions by which Cameco Europe (and not Cameco Canada) entered into the Third-Party Contracts, nor any delivery of uranium pursuant to the Intercompany Contracts, was commercially irrational, such that this condition was not met. Thus, the only question to be determined was whether the terms and conditions of the series and the transactions complied with the "traditional" transfer pricing rule in paragraphs 247(2)(a) and (c).

No transfer pricing adjustment was warranted Owen T.C.J. further held that paragraphs 247(2)(a) and (c) did not apply to adjust the terms and conditions of any series or transaction. Owen T.C.J. reviewed the evidence, including the expert evidence, and found that it did not warrant any adjustment to Cameco Canada's income in respect of either the series of transactions by which Cameco Europe (and not Cameco Canada) entered into the Third-Party Contracts, or any delivery pursuant to the Intercompany Transactions. In this regard, Owen T.C.J. accepted the evidence presented by the taxpayer's expert, which relied upon a comparable uncontrolled price (CUP) analysis. Owen T.C.J. rejected the Crown's expert evidence in support of the Crown's "recharacterization" position because it treated Cameco Europe as a routine distributor and ignored the economic significance of the uranium price risk that it bore.

The Crown has appealed The Crown has filed an appeal of the Tax Court's decision with the Federal Court of Appeal. The appeal does not challenge the Tax Court's findings on the sham issue, but alleges that the Tax Court erred in its holdings on both the transfer pricing "recharacterization" rule in paragraphs 247(2)(b) and (d), and the traditional transfer pricing rule in paragraphs 247(2)(a) and (c).

International tax treaties – Multilateral Instrument

Canada introduced Bill C-82 to enact the OECD's Multilateral Instrument or MLI — into Canadian law. This is the next step in the process for Canada to ratify the MLI, which it signed in June 2017. (Canada indicated in its 2018 Federal Budget that it intends ratify the MLI in 2018).

Once in effect, the MLI will modify a significant number of existing bilateral tax treaties, including up to 75 of Canada's bilateral tax treaties (referred to as Covered Tax Agreements

– view a full list). The most significant treaty modifications implemented through the MLI will be to adopt the OECD-agreed minimum standards on treaty abuse and dispute resolution.

The minimum standard to address treaty abuse consists of two parts: (i) an amended preamble, suggesting that covered tax treaties are intended to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance; and (ii) a broad anti-avoidance rule, referred to as the principal purpose test or PPT. Under the PPT, a treaty benefit may be denied where it is reasonable to conclude that one of the principal purposes of an arrangement or transaction is to gain the benefit unless it is established that granting the benefit would be in accordance with the object and purposes of the relevant provisions of the treaty.

Unfortunately, Canada has provisionally reserved on Article 7(4) of the MLI – which would specifically allow treaty benefits that would otherwise be denied under the PPT to be granted in full or in part by the competent authorities in appropriate circumstances. This is particularly important, for example, for private equity and other collective investors that may be resident in multiple jurisdictions. Canada has also not provided any additional guidance on when or how the PPT is intended to apply to private equity and other collective investment vehicles – despite many suggestions that further guidance is needed (either on a unilateral or bilateral basis). In particular, the PPT is very broadly worded, and the current OECD guidance is ambiguous and open to different interpretations.

Canada has also agreed under the MLI to implement the minimum standard with respect to dispute resolution features of its tax treaties, and has also agreed to adopt mandatory binding arbitration to assist in resolving treaty-based disputes in a timely manner.