Tax Executives Institute (Calgary)
Transfer Pricing Update












Douglas Richardson
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CASSELS BROCK
LAWYERS

Transfer Pricing Update
Overview

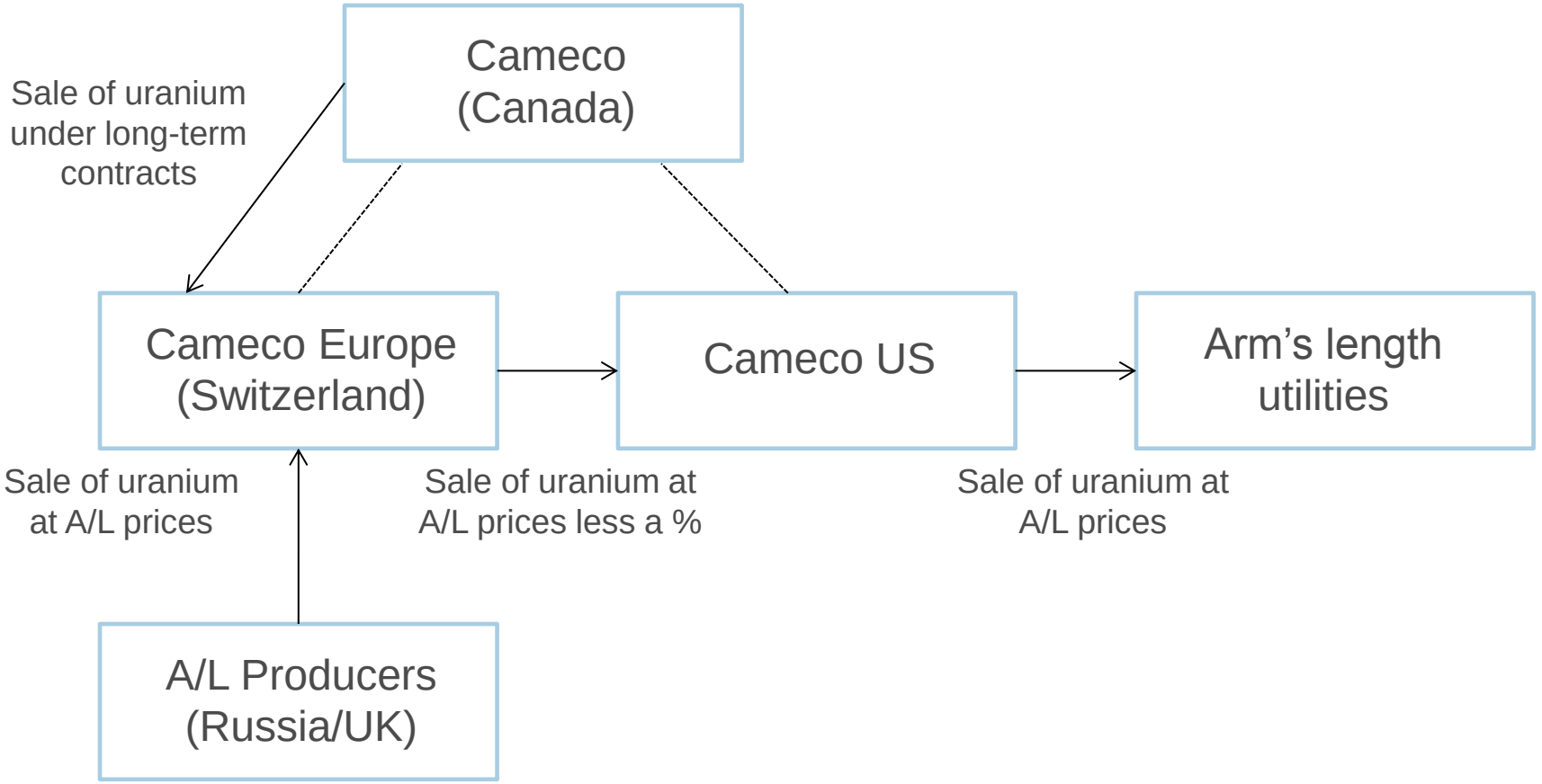
- *Cameco Corporation v. The Queen*, Court File No. 2009-2430(IT)G
- *Chevron Australia Holdings Pty Ltd. v. Commissioner of Taxation,* [2017] FCAFC 62
- *Amazon.com, Inc. v. Commissioner of Internal Revenue*, 148 T.C. No. 8, 3123117
- *Suncor Energy Inc. v. The Queen*, Court File No. 2014-4179(IT)G
- *Conoco Funding Company v. The Queen*, Court File No. 2013-2595(IT)G
- *Burlington Resources Finance Company v. The Queen*, Court File No. 2012-2683(IT)G

Today's Topics

Cameco Corporation v. The Queen

- Cameco's Amended Notice of Appeal
  - Cameco is one of the largest uranium producers accounting for 15 - 20% of world production from mines in Canada and the U.S.
  - As a result of a depressed market for uranium in the 1990s Cameco restructured its affairs and established a Swiss trading subsidiary ("**Cameco Europe**") and a U.S. based marketing and distribution entity ("**Cameco US**")
  - Cameco Europe's head office is located in Switzerland and it functions as the aggregator of uranium inventory for the Cameco group
  - All of Cameco's uranium production was sold to Cameco Europe under long-term contracts
  - Cameco Europe also purchased uranium from various arm's length parties

Today's Topics
Cameco Corporation v. The Queen



Today's Topics
Cameco Corporation v. The Queen

- Cameco's Amended Notice of Appeal
  - In the 2003 taxation year, Cameco sold approximately $194 million of uranium to Cameco Europe
  - Due to production difficulties in Saskatchewan Cameco purchased approximately $78 million of uranium from Cameco Europe
  - Cameco US found customers (typically U.S. utilities) and there were back-to-back contracts for sale – Cameco Europe to Cameco US to third party customers
  - Cameco submits the terms and conditions of these contracts with Cameco Europe do not differ from the terms and conditions that would have been made between persons dealing at arm's length
  - Minister has failed to test the individual transactions that Cameco Europe entered into and has instead applied a global profit split methodology

Today's Topics
Cameco Corporation v. The Queen

- Cameco's Amended Notice of Appeal
  - Among other matters, the Minister originally reassessed Cameco to include all of Cameco Europe's profit (approximately $43 million) in Cameco's income relying on paragraphs 247(2)(a) and (c)
  - The key assumptions made by the Minister in the 2008 Position Papers were:
    - there are differences between the Cameco - Cameco Europe sales agreements and the agreements between the Cameco group and arm's length utility customers, such that the latter can not be relied upon in providing comparable uncontrolled prices; and
    - Cameco Europe provided no value-added functions and should not be regarded as having taken on functions it paid parties such as Cameco to perform

Today's Topics
Cameco Corporation v. The Queen

- Cameco's Amended Notice of Appeal
  - Paragraphs 247(2)(a) and (c) – the Pricing Rule
    - Paragraph 247(2)(a) applies where a taxpayer enters into a transaction with a non-arm's length non-resident and the terms or conditions differ from those that would have been made between arm's length parties
    - Where paragraph 247(2)(a) applies, amounts are adjusted to the quantum and "nature" of the amounts that would have been determined if there were arm's length terms and conditions
    - Purpose of paragraph 247(2)(a) is to ensure that, for Canadian income tax purposes, the pricing of non-arm's length transactions between Canadian taxpayers and non-residents conforms to arm's length pricing
    - No reference to paragraphs 247(2)(b) or (d) because Cameco takes the view that these paragraphs are not applicable where you can arrive at an arm's length price

Today's Topics
Cameco Corporation v. The Queen

- Cameco's Amended Notice of Appeal
  - Cameco's Position
    - The "Pricing Rule" in paragraphs 247(2)(a) and (c) does not apply
    - Even if paragraphs 247(2)(a) and (c) apply, there is no basis for attributing all of Cameco Europe's income to Cameco in order to adjust for any differences in the terms and conditions in the Cameco–Cameco Europe transactions and the terms and conditions in the arm's length Cameco group sales to utility customers
    - Cameco was not a party to Cameco Europe's agreements with arm's length third party suppliers and it did not provide value added services to Cameco Europe and therefore, no basis for any transfer pricing adjustment

Today's Topics
Cameco Corporation v. The Queen

- Minister's assumptions
  - Cameco Europe
    - Cameco Europe had one employee assigned to it who lived in Germany
    - Cameco Europe rented an office within the law firm that performed legal services for Cameco Europe
    - Cameco Europe employed on a part-time basis one of the employees of the law firm
    - Cameco Europe's business functions restricted to cash management, review of its legal status and review of the Swiss regulatory regime only as it related to its existence; Cameco Europe contracted with Cameco to perform contract administration, inventory management and market analysis

Today's Topics
Cameco Corporation v. The Queen

- Minister's assumptions (cont'd)
  - Cameco
    - Cameco sold all of its uranium based on long-term contracts through Cameco Europe and Cameco US
    - Continued to perform contract administration, inventory management and market analysis under contract with Cameco Europe
    - Provided administrative services and guarantees for Cameco Europe
    - Continued to carry out the exploration, mining, processing, regulatory, marketing, logistics and storage of uranium
    - Assumed all risks related to price, inventory, market, delivery and supply

Today's Topics
Cameco Corporation v. The Queen

- Minister's assumptions (cont'd)
  - Cameco US
    - Cameco transferred sales personnel to Cameco US in 1999, but retained final decision-making authority for all sales within the group
    - Cameco transferred most of existing contracts with customers outside Canada to Cameco US
    - Cameco US interacted and negotiated with arm's length customers
    - Cameco US sourced uranium from Cameco Europe and earned a 2% marketing fee

Today's Topics
Cameco Corporation v. The Queen

- Minister's Amended Amended Reply
  - Main issues in the appeal:
    i. Whether the arrangements with Cameco Europe were a sham?
    ii. Does the Recharacterization Rule in paragraphs 247(2)(b) and (d) apply?
    iii. Does the Pricing Rule in paragraphs 247(2)(a) and (c) apply on the basis that the pricing was not based on arm's length terms and conditions?

Today's Topics
Cameco Corporation v. The Queen

- Minister's arguments
  - Sham
    - This case has the potential to revisit the notion of what constitutes a "sham"
    - Minister's argument is based on a combination of the business purpose test and economic substance.
    - Significant departure from the commonly understood meaning of "sham" enunciated in *Stubart Investments Ltd.* where the Supreme Court rejected the business purpose test and held that a sham requires a facade different from reality and involves an element of deceit (see *Antle v. The Queen*, 2010 DTC 5172 (FCA) where Court says the taxpayer and trustee gave a false impression of the rights and obligations)
    - Minister argues that the deception was that the arrangement was designed to give the appearance that work was being done by Cameco Europe when Cameco continued to negotiate all contracts and to perform all mining, marketing and managerial functions

Today's Topics
Cameco Corporation v. The Queen

- Minister's arguments (cont'd)
  - Paragraphs 247(2)(b) and (d) - the Recharacterization Rule
    - Paragraph 247(2)(b) applies on the basis that transaction would not have been entered into between arm's length parties and can reasonably be considered not to have been entered into for *bona fide* business purposes
    - Where paragraph 247(2)(b) applies the amount is adjusted to the quantum and nature of the amount that would have been determined had the transaction been entered into based on arm's length terms and conditions

Today's Topics
Cameco Corporation v. The Queen

- Minister's arguments (cont'd)
  - Paragraphs 247(2)(b) and (d) - the Recharacterization Rule
    - Rule was introduced because in certain circumstances a controlled transaction is not the correct starting point. Replace controlled transaction with hypothetical
    - OECD says recharacterization should be saved for exceptional circumstances (*i.e.,* where economic substance differs from legal form or where transaction is irrational and for which no arm's length comparable exists)
    - OECD and the Department of Finance agree that the Pricing Rule is intended to be the "everyday" rule and the Recharacterization Rule is the "unusual" or "exceptional rule"

Today's Topics
Cameco Corporation v. The Queen

- Minister's arguments (cont'd)
  - Paragraphs 247(2)(b) and (d) - the Recharacterization Rule
    - At trial, Cameco admitted that they never would have entered into a sale of all its production to an arm's length party
    - Minister says that this is sufficient to trigger the Recharacterization Rule while the taxpayer argues that this is overly broad and would make all transactions with affiliates subject to recharacterization
    - Minister applies the rule to recharacterize a company out of existence, something that has never been done in the past under the Recharacterization Rule

Today's Topics
Cameco Corporation v. The Queen

- Minister's arguments (cont'd)
  - Paragraphs 247(2)(a) and (c) – the Pricing Rule
    - CUP method for determining transfer price was inappropriate for the following reasons:
      - Spot pricing for uranium is not used by arms length third parties
      - Volumes purchased by Cameco Europe far exceeded volume purchased in CUP transactions
      - Objectives of third party utility generators is to acquire uranium for power generation and this differs from objectives of Cameco Europe (acquired large volumes to further the tax benefits)

Today's Topics
Cameco Corporation v. The Queen

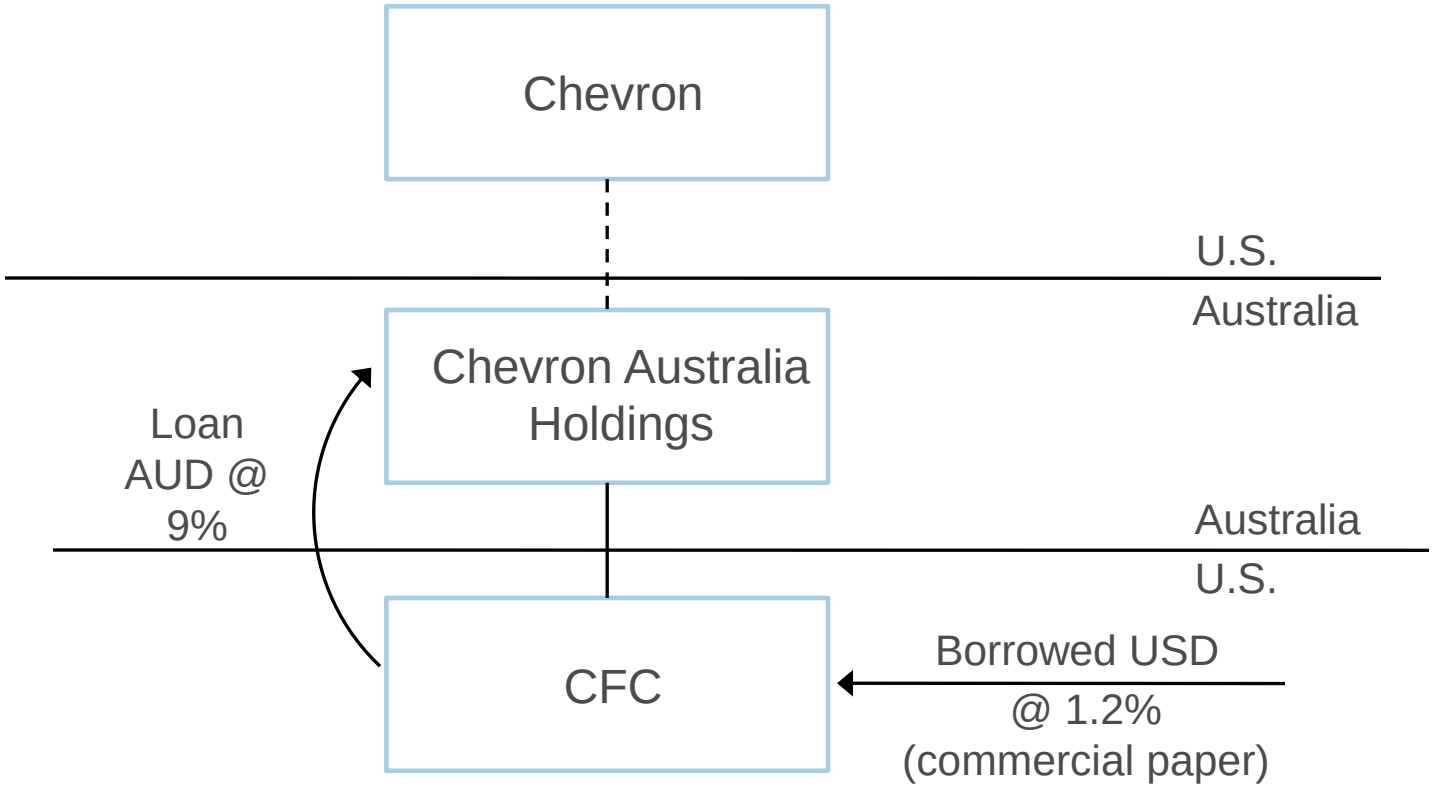
- Minister's arguments (cont'd)
  - Paragraphs 247(2)(a) and (c) – the Pricing Rule
    - Minister relied on a profit-split approach based on a functional analysis
      - Cameco would have sold to Cameco Europe at price Cameco US received from arm's length parties less 2%
      - Cameco would have received compensation for uranium purchased by Cameco Europe from arm's length parties and sold to Cameco US
      - Cameco would have purchased from Cameco Europe at same price Cameco Europe purchased from third parties

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Facts
  - Intra-group financing case involving draw-downs under a Credit Facility Agreement, dated June 6, 2003 (the "**Facility**") between Chevron Texaco Funding Corporation ("**CFC**") a U.S. Company and Chevron Australia Holdings Pty Ltd. ("**Chevron Australia Holdings**"), the parent of CFC and an Australia resident
  - Chevron Australia Holdings was an indirect wholly-owned subsidiary of Chevron Corporation, a publicly traded U.S. company ("**Chevron**")
  - The draw-downs were used to refinance external AUD-denominated debt that had been borrowed to fund Chevron Australia Holdings' acquisition of various operating entities

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Facts



Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Facts
  - Australia's transfer pricing law was in a state of flux for the years in question (2004-2008)
  - In 2012, Australia enacted added a new provision to its transfer pricing laws that was back-dated to July 1, 2004 (Div 815-A)
  - The old transfer pricing rules (Div 13) were not repealed until June 2013
  - The Australian Taxation Office ("**ATO**") decided to challenge Chevron Australia Holdings' interest deduction under both laws (under Div 13 for 2004-2008 and under Div 815-A for 2006-2008)

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Facts
  - The Facility
    - Term: 5 years
    - Security: Unsecured and no guarantee from Chevron or its affiliates
    - Principal Amount: AUD equivalent of USD$2.5B
    - Interest Rate: 1 month LIBOR + 4.14% (approximately equal to 9%)
    - Payments: Interest only payable monthly in arrears
    - Prepayment Privilege: Option to prepay without penalty
    - Termination: At any time at option of CFC

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Facts
  - After paying its own interest expense, CFC made sizable profits and paid substantial non-taxable dividends to Chevron Australia
  - CFC's profit was not taxable in the United States or Australia (participation exemption in Australia and CFC was a disregarded entity for U.S. tax)

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Issues
  - Div 13 involves 4 core elements:
    - What was the property acquired?
    - What was the consideration actually paid for the property acquired?
    - Were the parties dealing at arm's length?
    - Did the consideration equal the amount that might reasonably be expected to have been given for that property (hypothetical amount)?
  - Div 13 substitutes the arm's length consideration for the price actually paid
  - Ultimate purpose is to determine the consideration that would have been given had there not been a lack of independence
  - Chevron argued that the Court should price the loan based on the interest rate that would be paid by a stand-alone borrower from an independent lender for a loan structured on the identical terms

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Issues
  - Must the property be exactly the same?
  - Can the ATO change (or mandate) the property?
  - Who is the hypothetical borrower – Is it identical or just similar? Is it a stand-alone company? What does it do?
  - What do you assume about the hypothetical lender?
  - What price would the hypothetical parties pay for this (hypothetical) property if they were dealing at arm's length?
  - Are there other amounts that would have to be paid?
  - What evidence should be adduced to prove arm's length?

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Judgment
  - What was the property acquired?
    - Is it the amount advanced or the entire bundle of rights and obligations under the Facility?
    - The Full Federal Court held that the bundle of rights did not include the absence of security or covenants
    - Not being part of the property acquired meant absence of security and covenants did not enter into pricing
    - What is unclear is how much of the actual Facility must appear in the hypothetical Facility (term, prepayment privilege)
    - Independence means you may have to assume some variation between property acquired and hypothetical property – What can be reasonably expected, assuming independent commercial parties?

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Judgment
  - Can the ATO change (or mandate) the property?
    - Currency – AUD or USD?
      - CFC raised funds in USD so ATO said reasonable expectation that loan would be in USD (*i.e.,* lower interest cost in USD)
      - Full Federal Court disagreed and said the hypothetical loan might be expected to be made in AUD because it eliminates the currency exposure in Chevron Australia Holdings and funds were used to refinance AUD debt of Chevron Australia Holdings

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Judgment
  - Who is the hypothetical borrower – Is it identical or just similar?
    - Div 13 says arm's length price is consideration that might reasonably be expected if the property had been acquired under an agreement between independent parties dealing at arm's length
    - Who are the independent parties? What do we know about them?

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Judgment
  - Who is the hypothetical borrower – A stand-alone company?
    - ATO wanted hypothetical borrower to be part of a substantial worldwide group *i.e.*, implicit support of the parent company
    - Full Federal Court agreed and rejected the "orphan theory" (see, also, *General Electric Capital Canada v. The Queen*, 2010 DTC 1007 (TCC))
    - Did it matter? Chevron Australia Holdings led evidence that implicit support had little impact on pricing

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Judgment
  - Does the hypothetical borrower share the borrower's limitations?
    - For instance, the loan by CFC was unsecured and there was an absence of financial covenants or a parent guarantee
    - Joint venturers of Chevron Australia Holdings subsidiaries already held a charge over the subsidiaries' assets and Chevron Australia Holdings was prevented from charging the assets

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Judgment
  - What does the hypothetical borrower do?
    - Full Federal Court held that the hypothetical borrower would be an oil and gas exploration and production company
    - Industry matters as does the state of the business and the market for purposes of establishing “risk” (*e.g.*, evidence from bankers that hypothetical lender would have looked at proved reserves)

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Judgment
  - The hypothetical lender
    - Do you have to assume the hypothetical lender is a single entity?
    - Do you assume it is an SPV?
    - Do you assume only one customer?
    - Do you assume it was willing to accept the currency risk?
- The proposition is that the parties must be independent from each other – beyond that not much guidance is given

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Judgment
  - What price would hypothetical parties pay for hypothetical property if they were dealing at arm's length and how would they pay it?
    - Full Federal Court held interest was excessive and that there was an absence of consideration for the property (*i.e.*, lack of security and covenants)
    - Interest expense reduced to 5%
    - Hypothetical borrower would have given consideration in the form of interest and the balance of the consideration in another way

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Judgment
  - Trial Judge and Full Federal Court disagree on what the balance of the consideration would be
    - Trial Judge says borrower would have given security and operational and financial covenants.
    - Allsop, C.J. says there would have been a parent guarantee
    - Pagone, J. says hypothetical loan would have been (i) secured; (ii) have covenants; and/or (iii) a parental guarantee

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Judgment
  - Are there other amounts that would have to be paid?
    - According to Allsop, C.J. and Pagone, J., there is force in the argument that Chevron Australia Holdings should be paying a fee to Chevron for guaranteeing its debts
    - Pagone, J. refers to OECD *Transfer Pricing Guidelines* which contemplate a cross-border guarantee fee
    - Evidence did not establish any likelihood of Chevron charging a cross-border guarantee fee, with the result that the impact and size of a hypothetical fee was not discussed

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Judgment
  - Who can give evidence to prove arm's length price and what should it show?
    - Chevron Australia Holdings had opinions from 2 investment bankers when it set up the loan and at trial it led evidence from 2 commercial lenders about pricing
    - ATO led evidence from an oil industry expert and a transfer pricing economist, but the essence of the evidence was to show how credit rating agencies would rate Chevron Australia Holdings
    - Trial Judge says Div 13 requires the Court to price the hypothetical loan from the perspective of a commercial lender and not approach the issue of credit worthiness in the same way as a rating agency (Full Federal Court accepted this position and did not re-examine the issue)
    - The evidence of Chevron Australia's commercial lenders was important

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Implications
  - Currency – ATO cannot insist that the loan be denominated in a strong currency
  - Guarantee fees – parent can demand an explicit guarantee with the result that subsidiary will pay reduced interest rate and receive a deduction for the guarantee fee that would partially offset reduced interest deduction
  - Australian borrower should not be treated as an “orphan”
  - If borrower has policy to borrower externally at the lowest cost and has a policy that parent will generally provide a guarantee then in the non-arm’s length context the interest rate should be set at a level that assumes a parent guarantee

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Implications
  - Interest rate on internal debt will be close to global cost of funds
  - Unclear whether assumption of parent guarantee means you can assume a fee paid for fictitious guarantee
  - Judges suggest that a taxpayer may be able to avoid problems if it provides financial covenants and guarantee
  - Lasting consequence may be that it allows the revenue authority to challenge both the terms of a transaction as well as its price (taxpayer argued ATO limited to pricing the loan on the terms on which it was made)

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Div 815-A
  - Analysis is far less elaborate
  - Four core elements
    - Parties are “associates” in the sense used in a tax treaty (ownership or control test) and a requirement that the parties are not dealing at arm’s length)
    - Conditions between the parties are different from the conditions under which arm’s length parties would operate
    - Hypothetical profits which might have been expected to accrue to an Australian entity but did not
    - Profits did not accrue by reason of the conditions
  - Different terms used, but it too is based on hypothesis and speculation

Transfer Pricing Update
Chevron Australia Holdings Pty Ltd.

- Issues
  - What are conditions and where are they to be found?
  - What would arm's length conditions have been?
  - Cause and effect
    - Profits must be missing by reason of the missing conditions
  - Were there missing profits?
    - Div 13 operated at the level of an individual transaction whereas Div-815A operates on the overall result

Today's Topics
Amazon.com Inc. v. Commissioner of Internal Revenue

- Facts:
  - Deals with buy-in payments in the context of an intra-group cost sharing agreement ("**CSA**")
  - Multinational groups, like Amazon.com Inc., typically share intellectual property within the group through license agreements or cost sharing arrangements
  - A cost-sharing arrangement involves related parties sharing among themselves the costs and risks associated with efforts to develop intangible property in return for each having an interest in any intangible property developed

Today's Topics
Amazon.com Inc. v. Commissioner of Internal Revenue

- Facts (cont'd)
  - Amazon launched 3 Amazon-branded retail websites focused on European customers: Amazon.co.uk and Amazon.de in 1988 and Amazon.fr in 2000 (the "**European Websites**")
  - Not able to simply re-launch Amazon.com website in foreign countries
  - Had to develop sites specifically tailored to the browsing and purchasing habits, language and cultural preferences of the European market
  - Between June 2004 and April 2006, Amazon reorganized European operations and moved ownership and management of the European Websites to Luxembourg

Today's Topics
Amazon.com Inc. v. Commissioner of Internal Revenue

- Facts (cont'd)
  - Effective January 1, 2005, Amazon Inc., Amazon Europe Holdings Technologies SCS ("**Amazon Holdings**") and other related Amazon parties entered into a CSA
  - Agreed to pool resources to develop new intangible property and enhance value of existing intangibles
  - Amazon and Amazon Holdings agreed to share all costs associated with development in proportion to their reasonably anticipated benefits

Today's Topics
Amazon.com Inc. v. Commissioner of Internal Revenue

- Facts (cont'd)
  - Amazon developed a formula for allocating Intangible Development Costs ("**IDC**") to various "cost centers" (costs of sales, fulfillment, marketing, technology and content, general and administrative)
  - Amazon Holdings made cost sharing payments through 2011 of US $1.1 B
  - In 2005, Amazon Holdings was given a license to Amazon's preexisting technology and marketing intangible property
  - Amazon Holdings used the comparable uncontrolled transaction method to determine a buy-in payment of US$216.7 million

Today's Topics
Amazon.com Inc. v. Commissioner of Internal Revenue

- Facts (cont'd)
  - The IRS applied a discounted cash flow ("**DCF**") method to determine the present value of the projected cash flow from 2005-2011 period for the European business
  - Based on an 18% discount rate, the IRS issued an adjustment to the buy-in payment of US$3.468B

Today's Topics
Amazon.com Inc. v. Commissioner of Internal Revenue

- Tax Court
  - Tax Court focused on Amazon's scale of innovation and technology development
  - Constant innovation is essential to Amazon's survival
  - Tax Court held that the useful life of the trademarks, brand names and other marketing intangibles was 7 years (substantial portion of source code remaining after 6 years was dormant or commoditized)

Today's Topics
Amazon.com Inc. v. Commissioner of Internal Revenue

- Tax Court (cont'd)
  - Unreasonable when determining a buy-in payment to assume that a third party, acting at arm's length, would pay royalties in perpetuity for the use of short-lived assets
  - Tax Court found that DCF methodology assumes a perpetual useful life and, in effect, treats the transfer of preexisting intangibles as economically equivalent to the sale of a business (work force in place, going concern value and growth options ("aggregated" approach))

Today's Topics
Amazon.com Inc. v. Commissioner of Internal Revenue

- Tax Court (cont'd)
  - Aggregation approach improperly aggregates:
    - preexisting intangibles and subsequently developed intangibles; and
    - compensable intangibles (software and trademarks) and residual business assets (work force in place and growth options)

Today's Topics
Amazon.com Inc. v. Commissioner of Internal Revenue

- Tax Court (cont'd)
  - IRS tried to rely on the "realistic alternative" approach contained in the regulations (*i.e.*, namely continued ownership of all intangibles in the U.S.)
  - Tax Court held that the "realistic alternative" approach was not appropriate for several reasons:
    - First, whenever a taxpayer makes a cost-sharing election, which the regulations make available, they have a realistic alternative of not entering into such an arrangement
  - Second, the regulations enunciating the realistic alternative principle state that the IRS "will evaluate the results of a transaction unless its structure lacks economic substance"
    - Amazon Holdings European subsidiaries that had been in business for 6 years. They had tangible and intangible assets and had goodwill and going concern value

Tax Executives Institute (Calgary)
Transfer Pricing Update
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Cassels Brock & Blackwell LLP

Suite 2100, Scotia Plaza
40 King Street West
Toronto, ON Canada M5H 3C2

Tel: 416 869 5300
Fax: 416 350 8877

Suite 2200, HSBC Building
885 West Georgia Street
Vancouver, BC Canada V6C 3E8

Tel: 604 691 6100
Fax: 604 691 6120








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