Tax Topics

July 14, 2020
Number 2523

COVID-19 Update

International........ 4

Recent Cases 5

International News............... 6

Due to fewer and less important updates, our weekly COVID coverage now follows our feature article.

CANADIAN APPEALS COURT UPHOLDS TAXPAYER WIN IN *CAMECO*

— Steve Suarez, Borden Ladner Gervais (Toronto)

Executive Summary

- The Federal Court of Appeal ("FCA") has upheld Cameco Corporation's transfer pricing, rejecting an appeal by the Canada Revenue Agency ("CRA") from the taxpayer's win in the Tax Court of Canada in September 2018.
- *Cameco* is the first court case to consider the portion of Canada's transfer pricing rules that potentially allow the CRA to go beyond merely repricing the taxpayer's transactions and instead replace them with the terms and conditions of different transactions.
- The FCA's unanimous judgment decisively rejected the CRA's expansive interpretation of this "recharacterization" rule, concluding that it may apply "only where a taxpayer and non-arm's length non-resident have entered into a transaction or a series of transactions that would not have been entered into between any two (or more) persons dealing at arm's length, under any terms or conditions", i.e., a "commercial irrationality" standard.
- This case demonstrates that the CRA can ignore the actual legal relationships created by the parties only in very exceptional circumstances, and not merely because the taxpayer would not have entered into the same transaction that it in fact entered into with a related non-resident, had that non-resident been arm's length.
- Canada's transfer pricing rules accept the commercial reality that multinational groups are structured and operate differently from stand-alone entities, and do not seek to force them to do otherwise — rather, they simply require that arm's length pricing be used to ensure that Canadian group members do not pay too much for goods and services they obtain from, or receive too little for goods and services they sell to, non-arm's length non-residents. If the taxpayer's transfer pricing meets the arm's length standard based on the actual legal rights and obligations its transactions create, there is no basis for the CRA to challenge it unless those transactions are commercially irrational.

In September 2018, the Tax Court of Canada issued its decision in *Cameco Corp. v. The Queen*, 2018 DTC 1138, in which the taxpayer was completely successful in reversing the

Wolters Kluwer

CRA's reassessments regarding its transfer pricing. Specifically, in *Cameco* the Canadian taxpayer (one of the world's largest uranium producers) entered into long-term contracts to sell uranium to a European subsidiary and guaranteed long-term contracts that its European subsidiary entered into to purchase uranium from two non-Canadian third parties. After the parties entered into these supply contracts, the price of uranium rose significantly. The result was that profits from sales by the European subsidiary outside of Canada were realized largely in Switzerland rather than Canada.

The Canada Revenue Agency ("CRA") reassessed Cameco to attribute to it all of the profits that its European subsidiary had earned. The CRA argued that the purchase and sales contracts involving the European subsidiary:

- were a "sham" that the court should simply look through; and
- did not meet the arm's length standard in Canada's transfer pricing rules, thus allowing the CRA to either completely ignore the actual contracts or revise their terms to reflect what arm's length parties would have agreed to.

The Tax Court rejected the Crown's arguments in full, concluding that the relevant transactions were exactly what they appeared to be, and could not be said to be commercially irrational or priced outside the range of what arm's length persons would have agreed to under similar circumstances.[1]

The CRA appealed to the Federal Court of Appeal, which issued its judgment on June 26, 2020 upholding the Tax Court's decision in full.[2] The CRA's primary argument on appeal related to the transfer pricing recharacterization rule ("TPRR") in paragraph 247(2)(*b*) of the *Income Tax Act* (Canada) (the "Act"), which applies when a Canadian taxpayer (here, Cameco) and a non-arm's length non-resident (its European subsidiary) participate in a transaction or a series of transactions that:

(i) would not have been entered into between persons dealing at arm's length, and

(ii) can reasonably be considered not to have been entered into primarily for *bona fide* purposes other than to obtain a tax benefit.

The Court succinctly framed the legal question before it as one of competing interpretations of the first condition for applying the TPRR:

> [31] In this case, the focus will be on the interpretation of one of the conditions in paragraph 247(2)(*b*) of the Act (the condition in subparagraph 247(2)(*b*)(i) of the Act). In general, the interpretive issue for this condition relates to the subtle distinction between the competing interpretations proposed by the parties. Is this condition satisfied if the particular taxpayer (Cameco in this case) would not have entered into the transaction or series of transactions in issue with an arm's length person? Or, alternatively, is this condition only satisfied if no persons dealing at arm's length with each other would have entered into this transaction or this series of transactions?

Essentially, the Crown sought to frame subparagraph 247(2)(*b*)(i) as requiring the taxpayer to show that it would have entered into the same transaction with its European subsidiary had it been a completely arm's length party. The Court rejected this interpretation:

> [43] However, subparagraph 247(2)(*b*)(i) of the Act does not refer to whether the particular taxpayer would not have entered into the particular transaction with the non-resident if that taxpayer had been dealing with the non-resident at arm's length or what other options may have been available to that particular taxpayer. Rather, this subparagraph raises the issue of whether the transaction or series of transactions would have been entered into between persons dealing with each other at arm's length (an objective test based on hypothetical persons) — not whether the particular taxpayer would have entered into the transaction or series of transactions in issue with an arm's length party (a subjective test). . . .
>
> [44] Subparagraph 247(2)(*b*)(i) of the Act applies when no arm's length persons would have entered into the transaction or the series of transactions in question, under any terms and conditions. If persons dealing at arm's length would have entered into the particular transaction or series of transactions in question, but on different terms and conditions, then paragraphs 247(2)(*a*) and (*c*) of the Act would be applicable.

---

[1] For analysis of the Tax Court decision, see Steve Suarez, "The Cameco Transfer Pricing Decision: A Victory for the Rule of Law and the Canadian Taxpayer," *Tax Notes Int'l*, Nov. 26, 2018, p. 877, available at www.blg.com.

[2] See *Canada v. Cameco Corporation*, 2020 DTC 5059 (FCA), available at https://decisions.fca-caf.gc.ca/fca-caf/decisions/en/item/481730/index.do.

> [45] If Parliament had intended that subparagraph 247(2)(*b*)(i) of the Act would apply if the particular taxpayer would not have entered into the particular transaction with any arm's length person, this subparagraph could have provided:
>
> (b) the transaction or series
>
> (i) would not have been entered between the participants if they had been dealing at arm's length
>
> [46] If the Crown's interpretation is correct, then whenever a corporation in Canada wants to carry on business in a foreign country through a foreign subsidiary, the condition in subparagraph 247(2)(*b*)(i) of the Act would be satisfied. Because the company wants to carry on business in that foreign country either on its own or through its own subsidiary, it would not sell its rights to carry on such business to an arm's length party.

This passage highlights the fundamental flaw in the CRA's argument, both at trial and before the FCA, in that it advances an interpretation of Canada's transfer pricing rules that is at odds with both the scheme of the Act as a whole and basic common sense as to how a transfer pricing regime can and should work.

Multinational enterprises ("MNEs") are organized differently and operate differently than stand-alone entities. They rarely operate on the basis that each entity in each jurisdiction should perform all of the business functions that a stand-alone single entity does. For example, for reasons of efficiency and expertise, various back-office services are often centralized and provided to group members from a single group service provider. Production and/or distribution functions may be centralized within the group (or within particular geographic regions). Business opportunities are similarly organized and allocated to specific entities within the MNE. Strategic direction is provided by the MNE parent entity. All of this makes good business sense, and there is absolutely nothing within the Act that suggests any of this could or should be open to challenge so long as arm's length pricing is employed.

Indeed, the scheme of the Act as a whole is diametrically opposed to the interpretation of the TPRR the CRA's assessment was based on. Canada's rules governing foreign affiliates of Canadian residents describe in great detail the circumstances in which business income earned by a Canadian taxpayer's foreign subsidiaries is attributed back to the Canadian taxpayer (for example, profits from sales to Canadian customers). Outside of those limited situations, it is clear that Parliament does not consider the use of a foreign subsidiary to earn income that the Canadian taxpayer could otherwise earn directly to be objectionable — to the contrary, these rules clearly allow foreign sales corporations selling outside of Canada such as Cameco used. Instead, such intra-group arrangements are to be governed by Canada's transfer pricing rules, which are based on arm's length pricing. It is therefore not surprising that the FCA rejected an interpretation of section 247 of the Act intended to achieve a result (ignoring the European sales subsidiary and attributing all of its income back to the Canadian parent company) contrary to the explicit tax policy choices Parliament has made elsewhere in the Act.

The logical endpoint of the Crown's interpretation is that whenever a business decision within an MNE results in lower taxes payable in Canada relative to some plausible theoretical alternative, the Canadian taxpayer is in danger of being re-assessed under the TPRR. Since under Canada's foreign affiliate rules earning business income outside of Canada directly almost always results in more Canadian tax payable than doing so through a foreign subsidiary, the Crown simply had no answer to the Court's question as to why using a foreign subsidiary would not routinely trigger the TPRR under the Crown's reasoning.

The Crown's interpretation of section 247 rejected by the FCA is also inconsistent with "one of the fundamental principles of [the Canadian] tax system: that tax consequences flow from the legal relationships or transactions established by taxpayers."[3] In *Cameco*, the Tax Court judge reviewed the taxpayer's legal documentation and actual business practices in great detail, and concluded that there was no valid reason for challenging their legal efficacy — they indeed created the legal rights and obligations that they purported to create. In applying the TPRR, the CRA sought to ignore those very same legal relationships and treat Cameco as if it had earned the profits in fact earned by another legal entity under business contracts validly entered into. This was clearly a result the Court could not countenance in the absence of clear and explicit language in the statute authorizing such, which was not the case here:

> [81] Parliament has chosen to indirectly address the issue of a Canadian taxpayer shifting profits to a non-arm's length person located in another jurisdiction by implementing the transfer pricing rules found in Part XVI.1 of the Act. These rules will adjust prices paid for goods purchased and sold and for services provided in transactions between a taxpayer and a non-resident person with whom that taxpayer is not

[3] *Jean Coutu Group Inc. v. Canada*, 2016 DTC 5134 (SCC), para. 41.

> dealing at arm's length, if such prices differ from the amount that would be paid in an arm's length transaction. By adjusting prices for goods and services, the profit realized by the Canadian taxpayer will be adjusted. However, the rules in paragraph 247(2)(*b*) and (*d*) of the Act are not as broad as the Crown suggests. They do not allow the Minister to simply reallocate all of the profit of a foreign subsidiary to its Canadian parent company on the basis that the Canadian corporation would not have entered any transactions with its foreign subsidiary if they had been dealing with each other at arm's length.
>
> [82] Paragraphs 247(2)(*b*) and (*d*) of the Act apply only where a taxpayer and non-arm's length non-resident have entered into a transaction or a series of transactions that would not have been entered into between any two (or more) persons dealing at arm's length, under any terms or conditions. In such a situation, the transaction or series of transactions that would have been entered into between arm's length persons is substituted for the transaction or series of transactions in question, with the appropriate terms and conditions. In particular, paragraphs 247(2)(*b*) and (*d*) of the Act cannot be used to simply reallocate all of the profits earned by CEL to Cameco, its Canadian parent corporation, in the circumstances of this case.

Various other arguments put forward by the Crown were dismissed by the Court as being effectively challenges to the detailed findings of fact made by the trial judge (which the CRA ostensibly claimed not to be challenging).[4] Fundamentally the Crown's approach to this case never accepted the correct starting point or demonstrated an understanding of what it is that Canada's transfer pricing rules are trying to achieve. Canada's transfer pricing rules accept the commercial reality that multinational groups are structured and operate differently from stand-alone entities, and do not seek to force them to do otherwise. Indeed, forcing Canadian members of MNEs to operate commercially as stand-alone entities would be itself commercially irrational (as well as contradictory to the foreign affiliate rules in the Act itself).

The policy objective of Canada's transfer pricing rules is limited to ensuring that Canadians use arm's length pricing in transactions with non-arm's length non-residents, for the purpose of ensuring that they do not pay too much for goods and services they obtain from, or receive too little for goods and services they sell to, such non-arm's length non-residents. Unless a taxpayer has engaged in commercially irrational behaviour, transfer prices that comply with the arm's length standard leave no basis for challenge under section 247 of the Act, a message that the FCA's decision in *Cameco* makes very clear.

COVID-19 UPDATE

Given the rapidly changing information related to COVID-19 we are providing continuously updated information at https://blog.intelliconnect.ca/.

Federal

2020 Economic and Fiscal Snapshot (July 8, 2020)

On July 8, 2020, Federal Finance Minister Bill Morneau delivered the 2020 Economic and Fiscal Snapshot. The deficit for 2020–2021 is projected to increase to $343.2 billion — it was originally projected to be $34.4 billion. A large proportion of the deficit is from $212 billion in direct support to Canadians and businesses to help them weather the COVID-19 pandemic.

Personal income tax revenues are expected to decline to $146.3 billion in 2020–2021 from $170.9 billion in 2019–2020. Corporate income tax revenues are projected to decline to $38.3 billion in 2020–2021 from $49.2 billion in 2019–2020. Revenue from excise taxes and duties is projected to decrease to $46.4 billion in 2020–2021 from $55.6 billion in 2019–2020.

Though there are many COVID-19 response measures contributing to the deficit, the largest expenditures include:

- Canada Emergency Response Benefit ("CERB"): $80 billion;
- Canada Emergency Wage Subsidy ("CEWS"): $82.3 billion;
- Safe Restart Agreement: $14 billion; and
- Canada Emergency Business Account: $13.75 billion.

[4] An appeals court in Canada will entertain challenges to findings of fact (as opposed to questions of legal interpretation) only in cases of "palpable and overriding error" by the trial judge.

The snapshot did not announce any tax changes in response to the significant change in the fiscal position. However, the snapshot reiterated the government's commitment to two previously proposed tax changes.

First, as economies reopen and business activity resumes, the government will soon announce changes to the CEWS to stimulate rehiring, provide support to businesses during reopening, and help businesses adapt to the new normal. In anticipation of this forthcoming announcement, the government has set aside additional funding as part of the 2020 Economic and Fiscal Snapshot.

Second, to encourage businesses to adopt zero-emission vehicles, the government proposes to provide a full tax write-off to business investments in: used on-road battery electric, plug-in hybrid (with a battery capacity of at least 7 kWh), or hydrogen fuel cell vehicles; and new and used fully electric or hydrogen powered rail, aerial, marine, or off-road zero-emission automotive equipment and vehicles. The full tax write-off will apply to eligible vehicles purchased on or after March 2, 2020 and will be gradually phased out beginning January 1, 2023 and ending December 31, 2027.

Tax Court of Canada Reopens (July 8, 2020)

The Tax Court of Canada reopened for the transaction of business on July 6, 2020. This includes the Court's Registry offices except for Hamilton. The Court's sittings will resume on July 20, 2020. Conference calls may resume earlier. In a Notice to the Profession and Public dated July 8, 2020, the Court provided more important details that professionals should be aware of for the purposes of the reopening of the Court. For more information see the Notice at https://www.tcc-cci.gc.ca/tcc-cci/pdf/Notice%20to%20the%20Public%20and%20the%20Profession-%20July%208,%202020-EN.pdf.

RECENT CASES

Minister ordered to reassess amount of unremitted source deductions owing by corporate respondent

The corporate respondent, a heavy equipment contracting company, paid wages and allowances to its employees. The Minister determined that certain of these allowances (the "Allowances") were pensionable and insurable earnings. The Minister therefore assessed the respondent for unremitted source deductions on these pensionable and insurable earnings. On appeal to the Tax Court of Canada the respondent acknowledged that the workers receiving the Allowances were employees so that the Tax Court was required to determine whether the Allowances were taxable under the *Income Tax Act* in order to determine whether they were subject to withholding obligations. In allowing the respondent's appeal (2019 UDTC 37 (TCC)), the Tax Court of Canada concluded, in part, that some of the Allowances were reasonable and hence were properly excluded from income for income tax purposes, and that some of the Allowances were properly only partially excluded from such income. The Crown appealed to the Federal Court of Appeal.

The Crown's appeal was allowed. The Tax Court erred in law in its interpretation of subparagraph 6(1)(*b*)(vii) of the *Income Tax Act*. It also erred by failing to consider the reasonableness of the Allowances actually paid to the respondent's employees. The Minister was ordered to reassess accordingly.

¶50,495, *Canada (MNR) v. Al Saunders Contracting*, 2020 DTC 5050

Taxpayers denied charitable donation tax credits in excess of actual cash donated by them to certain gift programs

Both taxpayers participated in certain charitable gift donation programs, which enabled them, in essence, to acquire certain pharmaceuticals and then donate them to a registered charity in return for a charitable donation receipt. Under this arrangement, both taxpayers received charitable donation receipts in excess of 300% of the amounts of cash actually contributed by them. Following receipt of the taxpayers' Notices of Objection, the Minister reassessed them to allow a claim for a charitable donation tax credit based on the amount of the cash actually contributed by them to the programs. The taxpayers' appeals to the Tax Court of Canada were allowed in part (2018 DTC 1155 (TCC)), and they appealed to the Federal Court of Appeal.

The taxpayers' appeals were dismissed. The Tax Court Judge made no palpable and overriding error in concluding that the charitable donation certificates produced by them were "worthless pieces of paper", and that they did not own the pharmaceuticals that they purported to donate to the charities involved. The Minister's assessments were affirmed accordingly.

¶50,496, *Eisbrenner v. The Queen*, 2020 DTC 5051

INTERNATIONAL NEWS

US IRS Issues Guidance on Consolidated Groups' NOLs

On July 2, 2020, the United States Treasury Department and the Internal Revenue Service ("IRS") issued proposed regulations and temporary regulations that provide guidance for consolidated groups regarding net operating losses ("NOLs").

The proposed and temporary regulations deal with changes to the net operating loss rules brought about by the Tax Cuts and Jobs Act ("TCJA") and the Coronavirus Aid, Relief, and Economic Security Act ("CARES" Act).

The IRS noted that as a result of these amendments, the NOL deduction is the sum of:

- The total of the NOLs arising before January 1, 2018, that are carried to that year; plus
- The lesser of:
  - the total of the NOLs arising after December 31, 2017; or
  - 80 per cent of taxable income less pre-2018 NOLs ("the 80 per cent limitation").

The TCJA generally eliminated NOL carrybacks and permitted NOLs to be carried forward indefinitely, the IRS said. The TCJA also provides special rules for non-life insurance companies and farming losses. Non-life insurance companies are permitted to carry back NOLs two years and forward 20 years, and the 80 per cent limitation does not apply.

Farming losses are permitted to be carried back two years and carried forward indefinitely, subject to the 80 per cent of taxable income limitation.

The CARES Act effectively delays the application of the TCJA amendments until January 1, 2021. Additionally, the CARES Act permits a five-year carryback for NOLs, including farming losses and NOLs of non-life insurance companies, for taxable years beginning after December 31, 2017, and before January 1, 2021.

According to the IRS, the proposed regulations provide guidance to consolidated groups on the application of the 80 per cent limitation. Additionally, the proposed regulations would remove obsolete provisions from the rules for consolidated groups that contain both life insurance companies and non-life insurance companies.

The IRS also said that because the CARES Act allows certain NOLs to be carried back five years, the temporary regulations allow certain acquiring consolidated groups to make an election to waive all or a portion of the pre-acquisition portion of the extended carryback period for certain losses attributable to certain acquired members.

IRS Adds Transition Tax to Compliance Campaigns

The US Internal Revenue Service's Large Business and International Division has announced it will focus efforts on ensuring taxpayers comply with the transition tax.

The transition tax was introduced into Section 965 of the Internal Revenue Code by the 2017 Tax Cuts and Jobs Act ("TCJA"). It is a tax on the untaxed foreign earnings of foreign subsidiaries of US companies.

Prior to the TCJA, US tax on the income of a foreign corporation could be deferred until the income was distributed as a dividend or otherwise repatriated by the foreign corporation to its US shareholders. The transition tax seeks to regularize these holdings, as part of the switch from a tax system with a worldwide corporate tax basis towards a territorial tax basis system, with a concessionary tax rate offered for newly repatriated income.

The tax functions by deeming any untaxed foreign earnings of US companies' foreign subsidiaries to have been repatriated. Foreign earnings held in the form of cash and cash equivalents are taxed at a 15.5 per cent rate, and the remaining earnings are taxed at an eight per cent rate. The tax generally may be paid in installments over an eight-year period.

The new compliance campaign affects US shareholders, including individuals who directly or indirectly owned at least 10 per cent of the stock of a specified foreign corporation ("SFC").

These taxpayers are required to include in gross income their share of the SFC's accumulated post-1986 deferred foreign income for the last taxable year of the SFC beginning before January 1, 2018, and report this amount on their returns for the taxable year in which or with which their SFC's taxable year ends (generally, 2017 and/or 2018).

The Division said it intends to address non-compliance through soft letters and examinations.

OECD Releases MNE Tax Data as Part of BEPS Work

As part of its work on tax base erosion and profit shifting, the OECD has released new data on the global tax and economic activities of nearly 4,000 multinational enterprises.

The data, released in the OECD's annual Corporate Tax Statistics publication, is a major output based on the Country-by-Country Reporting requirements for MNEs under the OECD/G20 Base Erosion and Profit Shifting ("BEPS") Project. It covers groups headquartered in 26 jurisdictions and operating across more than 100 jurisdictions worldwide.

Under Country-by-Country Reporting, large MNEs are required to disclose important information about their profits, tangible assets, and employees, as well as where they pay their taxes, in every country in which they operate. Country-by-Country reports ("CbCRs") provide tax authorities with the information needed to analyze MNE behaviour for risk assessment purposes.

The OECD said the release of the anonymized and aggregated statistics, relating to 2016 and provided by BEPS Inclusive Framework members, is intended to support the improved measurement and monitoring of BEPS.

According to the OECD, the data suggests:

- There is a misalignment between the location where profits are reported and the location where economic activities occur, with MNEs in investment hubs reporting a relatively high share of profits compared to their share of employees and tangible assets;
- Revenues per employee tend to be higher where statutory CIT rates are zero and in investment hubs;
- On average, the share of related party revenues in total revenues is higher for MNEs in investment hubs; and
- The composition of business activity differs across jurisdiction groups, with the predominant business activity in investment hubs being "holding shares and other equity instruments".

The OECD said, while the data contain some limitations, the findings are indicative of the existence of BEPS behaviour and "reinforce the need to continue to address remaining BEPS issues as part of the Inclusive Framework's work on Pillar 2 of the ongoing international efforts to address the tax challenges arising from digitalization."

The proposal under Pillar 2 looks to minimize tax base erosion and profit shifting by ensuring that income is not inappropriately shifted to territories that levy no or low tax rates by ensuring that income is subject to at least a minimum level of tax, wherever that may be.

The new OECD analysis also shows that corporate income tax remains a significant source of tax revenues for governments across the globe. It accounted for 14.6 per cent of total tax revenues on average across the 93 jurisdictions in 2017, compared with 12.1 per cent in 2000.

This second edition of Corporate Tax Statistics also collects, for the first time, information on controlled foreign company ("CFC") rules, which are designed to ensure the taxation of certain categories of MNE income in the jurisdiction of the parent company in order to counter certain offshore structures that result in no or indefinite deferral of taxation (BEPS Action 3); as well as new data on interest limitation rules.

TAX TOPICS

Published weekly by Wolters Kluwer Canada Limited. For subscription information, see your Wolters Kluwer Account Manager or call 1-800-268-4522.

For Wolters Kluwer Canada Limited

Email: cservice@wolterskluwer.com *Phone: 1-800-268-4522 or (416) 224-2248 (Toronto)*

Notice: *Readers are urged to consult their professional advisers prior to acting on the basis of material in Tax Topics.*

Wolters Kluwer Canada Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
1 800 268 4522 tel
1 800 461 4131 fax
www.wolterskluwer.ca

© 2020, Wolters Kluwer Canada Limited

Wolters Kluwer