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MLI, T1134 DEADLINE, AND *CAMECO*

In this edition of the International Tax Newsletter by McCarthy Tétrault, Yaroslavna Nosikova provides an update on the implementation of the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting and what it means for Canada and other signatories; Dean Xiao summarizes changes to the deadline for corporations to file their T1134 forms; and Justin Shoemaker and John Yuan summarize the Tax Court of Canada's decision in Cameco Corporation in regard to sham, recharacterization rules, and what taxpayers should take away from the case.

MLI Big Picture Changes Update

By Yaroslavna Nosikova

The *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ("MLI") is a multilateral treaty created by the Organization for Economic Co-operation and Development ("OECD") that modifies bilateral tax treaties between participating jurisdictions to implement international tax rules and lessen the opportunity for tax avoidance by multinational enterprises.

The MLI was released on November 24, 2016 and 84 jurisdictions have already joined the MLI, which now covers over 1,400 bilateral tax treaties.[1] Notably, the United States did not sign the MLI.

On June 7, 2017, Canada signed the MLI. On May 28, 2018, Canada introduced a *Notice of Ways and Means Motion*[2] to introduce an Act to Implement the MLI in Canadian law. Within a month, on June 20, 2018, Bill C-823, called *Multilateral Instrument in Respect of Tax Conventions Act*, was introduced. Bill C-82 has had Second Reading and has been referred to the Standing Committee on Finance.[4] The next steps in the process for Canada to ratify the MLI is for the Parliament to debate and approve Bill C-82. Assuming the bill receives Royal Assent, Canada will then deposit a notice of ratification with the MLI depository.[5]

Canada has listed 75 of its 93 tax treaties as Covered Tax Agreements[6] which will be affected by the MLI if Canada and the relevant Covered Tax Agreement partner ratify the MLI under their respective domestic laws. Some of the tax treaties that are not in the list, apart from the US, include Canada's tax treaties with Switzerland and Germany, presumably because Canada is currently holding bilateral treaty negotiations with these tax treaties.

For applicable tax treaties, the MLI will enter into force on the first day of the month beginning three months after Canada and the relevant treaty partner complete their notifications to the OECD and it will enter into effect for (a) withholding taxes, on the first day of the next calendar year, and (b) for other taxes, for tax years beginning six months after the MLI enters into force. [7]

As an example, if both Canada and the United Kingdom notified the OECD in December of 2018 that their domestic ratification procedures were complete, the MLI would enter into force for the Canada-UK tax treaty on April 1, 2019. The MLI would then enter into effect for the Canada-UK treaty (a) for withholding taxes, on January 1, 2020, and (b) for other taxes, for tax years beginning on or after October 1, 2019.

Every participating jurisdiction was required to sign on to the minimum standard provisions in respect of the prevention of treaty abuse and to improve dispute resolution mechanisms[8].

To address the situations of treaty abuse, the participating countries had an option to adopt a principal purpose test ("PPT") or a PPT supplemented with a simplified limitation on benefits rules ("LOB"). The PPT disallows a treaty benefit where obtaining the benefit was one of the principal purposes of doing a particular transaction or an arrangement, unless granting of the benefit would be in accordance with the object and purpose of the provisions of the treaty. Canada opted for the PPT as a substantive technical rule. In the long term, however, Canada, where appropriate, will seek to negotiate, on bilateral basis, a detailed LOB.[9]

Aside from these minimum standard provisions, the participating jurisdictions were able to opt in or opt out of various other provisions. When Canada signed MLI, it reserved on other provisions because a reservation can be withdrawn but there is no procedure for adding new reservations once the MLI is signed.

Canada has now expressed its intention to remove its reservations on some of the optional provisions dealing with dividends (Article 8), capital gains (Article 9), dual residency tie-breaker rules (Article 4) and relief from double taxation (Article 5). In particular, Canada proposes to:

- adopt a 365-day holding period for shares of Canadian subsidiaries held by foreign corporate shareholders for such shareholder to be entitled to the reduced withholding tax rate on dividends from its Canadian subsidiary. The changes in ownership resulting from a corporate reorganization are not taken into account for the purposes of computing that period;
- adopt a 365-day test period for non-residents who realize capital gains on the disposition of shares or other interests that derived their value principally from Canadian immovable property. Essentially, the MLI will deny the treaty benefit if this test is met at any time during such period preceding the disposition;
- introduce an approach to resolve dual resident entity cases (other than of individuals); and
- introduce a provision that will allow certain treaty jurisdictions to relief double taxation by moving from an exemption system to a foreign tax credit system. [10]

CHANGES TO THE T1134 FILING DEADLINE

By Dean Xiao

Multinational corporations that are required to file an information return in prescribed form (T1134) in respect of their foreign affiliates will soon see a tightened filing deadline. The Department of Finance released a Notice of Ways and Means Motion on October 25, 2018 that includes a provision to shorten the deadline for corporations to file their T1134 forms to 12 months (from 15 months) after their year-end for taxation years beginning after 2019, and to 10 months for taxation years beginning after 2020. The 2018 federal budget had proposed to shorten this filing deadline to six months (from 15 months) after the taxpayer's year-end. This change was initially intended to align the information return filing deadline with the taxpayer's income tax return filing deadline. Despite receiving submissions that the shortening of the filing deadline should be reversed in light of the significant compliance challenges it will place on many taxpayers[11], the Department of Finance appears only willing to provide limited relief. Note that the filing deadline for country-by-country reports of a multinational enterprise group is 12 months.

TAX COURT OF CANADA REJECTS MINISTER'S UPWARD ADJUSTMENTS IN CAMECO TRANSFER PRICING CASE

By Justin Shoemaker and John Yuan

CAMECO CORPORATION V. THE QUEEN, 2018 CARSWELLNAT 5346 (TAX COURT OF CANADA)

On September 26, 2018, the Tax Court of Canada released its ruling in a much-anticipated transfer pricing case involving Cameco Corporation ("Cameco"). This is the first Tax Court decision that considers the Minister's ability to "recharacterize" a Canadian taxpayer's transactions with non-arm's length, non-resident persons pursuant to paragraphs 247(2)(b) and (d) of the transfer pricing rules in the *Income Tax Act* (Canada) ("ITA").

OVERVIEW

At issue in the appeal were reassessments issued by the Minister of National Revenue (the "Minister") to increase the taxpayer's income for the 2003, 2005, and 2006 taxation years by almost $500 million in aggregate. Although only three taxation years were before the Tax Court, it is understood that the Minister relied on the position that it took in this case to issue reassessments for post-2006 taxation years.

At the heart of the appeal was the decision that the taxpayer's group of companies made at the end of the 1990s to move its uranium trading business offshore to a European subsidiary motivated, as least in part, by a desire to minimize the tax that would be paid from operating that business. As a result of the reorganization undertaken by the taxpayer to restructure the sales function within the global companies and fluctuations in the price of uranium, the taxpayer's European subsidiary earned significant profits through certain trading contracts.

In general, the Minister's reassessments increased the taxpayer's income to include the foreign subsidiary's profits from uranium trading, on the following alternative bases:

- the transactions undertaken by the taxpayer and its foreign subsidiary to establish the subsidiary's uranium trading business amounted to a sham;
- the taxpayer had entered into non-arm's length transactions that were not commercially rational allowing the Minister to recharacterize the transactions under paragraphs 247(2)(b) and (d); or
- if paragraphs 247(2)(b) and (d) did not apply to the transactions, that the transfer pricing provisions in paragraphs 247(a) and (c) should apply to increase the price the taxpayer received for uranium sold to the foreign subsidiary.

In a 286-page decision by Justice John R. Owen, the Tax Court allowed the taxpayer's appeal in its entirety and, in so, doing rejected each of the Minister's three alternative bases for increasing the taxpayer's income in respect of the foreign subsidiary's profits from uranium trading. The Tax Court also allowed the taxpayer's appeal of a secondary issue concerning the computation of the taxpayer's resource allowance entitlement; namely, whether the taxpayer's resource allowance entitlement in respect of its uranium mining operations was reduced as a consequence of losses that the taxpayer suffered on the resale of uranium that it purchased from the foreign subsidiary.

The following is a brief distillation of the factual background giving rise to the decision and the Tax Court's interpretation and application of the doctrine of sham and the transfer pricing provisions in subsection 247(2).

FACTUAL BACKGROUND

At all relevant times, the taxpayer's worldwide group of companies was in the business of mining uranium to produce uranium concentrates, selling produced and acquired uranium and providing uranium conversion services and uranium enrichment services to utilities.

In March 1999, the taxpayer, along with several of its competitors (the "Western Consortium") entered into a long-term contract to purchase uranium derived from weapons grade uranium from the former Soviet Union (the "HEU Feed Agreement"). Rather than enter into the HEU Feed Agreement directly, the taxpayer allowed a Luxembourg subsidiary ("Luxco") to enter into the agreement with a performance guarantee from the taxpayer, with Luxco's obligations under the agreement to be undertaken through a Swiss branch. Pursuant to the HEU Feed Agreement, members of the Western Consortium had the option of purchasing Russian-sourced uranium at the greater of a US$29 per kgU price floor (later reduced to a US$26.30 per kgU price floor) and 92% of one of two relevant price indicators.

The taxpayer and Luxco also entered into a services agreement pursuant to which the taxpayer agreed to provide administrative and back-office services for the Swiss branch, including administration of Luxco's uranium contracts, assistance in market forecasting, legal services, human-resources-related services and financial, bookkeeping and accounting services.

As part of the worldwide reorganization of the sales structure for the taxpayer's group of companies, Luxco transferred its Swiss branch operations to a Swiss subsidiary of the taxpayer ("Swissco"), Swissco purchased the taxpayer's existing uranium inventory, and Swissco entered into a series of long-term contracts with the taxpayer (the "BP Contracts") to purchase the taxpayer's future uncommitted uranium production. In general, the BP Contracts were priced according to one of three mechanisms: fixed prices, prices based on market prices at the relevant time, or a fixed base price with formulaic escalation to the base price over time.

Luxco/Swissco also entered into an agreement with a uranium enricher (the "Urenco Agreement") to purchase additional uranium considered to be of Russian origin. The Urenco Agreement initially fixed the supply price of uranium at a base escalated price starting at US$25.05 plus 50% of the amount by which a spot price indicator exceeded US$30.10 but was subsequently amended to reduce the base escalated price.

Following the reorganization, Luxco/Swissco began to enter into uranium sales contracts with a U.S. marketing and sales subsidiary ("USco"). As part of its sales process, USco would enter into contracts with customers outside of Canada to supply uranium. In order to meet its supply obligations pursuant to those contracts, USco would enter into contracts with Luxco/Swissco on terms that mirrored the agreements between USco and its customers except that the price paid by USco to Luxco/Swissco was 2% lower than the price obtained by USco in its back-to-back sale to its customer.

In 1999, the taxpayer also began to repurchase uranium from Luxco/Swissco under certain contracts (the "CC Contracts") until the taxpayer determined that doing so was creating foreign accrual property income ("FAPI") in Luxco/Swissco, at which point, the agreements were amended to so that Swissco provided only uranium conversion services to the taxpayer.

As a result of increases in the market price of uranium, Luxco/Swissco earned significant profits, in part, from the spread between (i) the price at which it was selling uranium to USco and the taxpayer, and (ii) the price at which it was obtaining uranium supplies under the Urenco Agreement, the HEU Feed Agreement and the BP Contracts.

SHAM

Under her first assessing position, the Minister alleged that the structuring (or restructuring) of the operations of the taxpayer's group of companies to have Luxco/Swissco undertake the uranium trading business was an illusion designed to give the appearance that Luxco/Swissco was carrying on the trading business when, in fact, all of the important functions and strategic decisions relating to the trading business were performed by the taxpayer in Saskatoon. In the Minister's view, Luxco/Swissco did little more than rubberstamp paperwork in order to allow it to record the uranium trading profits in Switzerland rather than Canada.

After a lengthy review of the case law on the doctrine of sham, the Tax Court concluded that the Minister's position appeared to reflect a fundamental misunderstanding of sham. As stated by the Tax Court, sham requires an element of deceit: factual representation of the existence of legal rights when the parties know those legal rights either do not exist or are different from the representation. In the taxpayer's case, the legal rights created through numerous supply and service contracts were reflective of the sales and purchases of uranium carried out by the taxpayer and its affiliates. In the Tax Court's view, Luxco/Swissco was entitled to undertake its uranium trading through its own employees or through independent contractors as was the case under the services agreement with the taxpayer. While the Tax Court noted that there were some irregularities in Luxco/Swissco's operations, notably a history of failing to give contractual notices on a timely basis and several incidents of backdating of agreements, the Tax Court found that these de *minimis* occurrences did not displace the properly constituted existence of Luxco/Swissco, Luxco/Swissco's functioning boards of directors and the fact that Luxco/Swissco's employees were experienced participants in the uranium industry and actively engaged in intercompany sales meetings involving the taxpayer and its affiliates.

The Tax Court found it to be inconsequential that top executives of the taxpayer had entered into high-level discussions with third parties on behalf of the multinational group (including Luxco/Swissco). The Tax Court also suggested that even if a board approves transactions that benefit the broader interests of its multinational group of affiliates, this fact alone should not be enough to call into question a corporation's separate existence and that it would not be reasonable to expect a wholly-owned subsidiary to act in a manner at odds with its ultimate parent.

In the Tax Court's view, the arrangements created by the taxpayer were not a façade but instead represented the legal foundation of a tax plan implemented by the taxpayer and its group of companies.

PARAGRAPHS 247(2)(B) AND (D)

In order to determine if the recharacterization rules in paragraphs 247(2)(b) and (d) were applicable to the transactions undertaken by the taxpayer, the Tax Court considered the proper statutory interpretation of the provisions.

The Tax Court reflected on the overall structure of subsection 247(2) and recognized a distinction between the Minister's authority to adjust the "quantum" or "nature" of an amount stating that only where the conditions in paragraphs 247(2)(b) are met is the Minister entitled to recharacterize *both* the quantum and the nature of an amount.

Paragraph 247(2)(b) is divided into two subparagraphs.

Parsing the plain words of the subparagraph 247(2)(b)(i), the Tax Court concluded that it will apply where arm's length parties would not have entered into the transaction or series on *any* terms or conditions but instead would have entered into an *alternative* transaction or series.

The Tax Court cautioned that comparability analysis lies at the heart of the transfer pricing rules and, as a result, any alternative transaction or series identified by the Minister must be constructed with due regard for all the relevant circumstances in which the actual transaction or series was entered into.

The Tax Court noted that subparagraph 247(2)(b)(ii) contains a conjunctive requirement that it be reasonable to consider that the transaction or series was not entered into primarily for *bona fide* purposes other than to obtain a tax benefit. Taking note of the Guidelines to the OECD Model Tax Convention, the Tax Court acknowledged that the purpose of paragraphs 247(2)(b) and (d) is not to capture all transactions between non-arm's length parties, but only those transactions necessarily motivated by tax avoidance in accordance with the arm's length principle.

In respect of the first prong of the test in subparagraph 247(2)(b)(i), which asks whether the transaction or series would not have been entered into by persons dealing at arm's length, the Tax Court concluded that the test should be read as asking if arm's length persons acting in a commercially rational manner would have entered into the transaction. In the Tax Court's view, the determination of whether a transaction or a series is commercially rational requires an objective assessment of the transaction or series, and that assessment may be aided by expert opinion.

In Cameco's case, the Tax Court considered the application of the recharacterization rules to four transactions/series of transactions involving the taxpayer:

1. The series of transactions involving the separate incorporation of Luxco/Swissco and its entry into the HEU Feed Agreement, including the taxpayer's guarantee with respect to Luxco/Swissco's obligations under the HEU Feed Agreement;
2. The series of transactions involving the separate incorporation of Luxco/Swissco, and its entry into the Urenco Agreement, including the taxpayer's guarantee with respect to Luxco/Swissco's obligations under the Urenco Agreement;
3. Each transaction where the taxpayer entered into a BP Contract with Luxco/Swissco and delivered uranium to Luxco/Swissco; and
4. Each transaction where the taxpayer and Luxco/Swissco entered into a CC Contract and Luxco/Swissco delivered uranium to the taxpayer.

In respect of the HEU Feed Agreement and the Urenco Agreement – transactions under which the taxpayer allowed Luxco/Swissco to participate in a transaction that it could have undertaken on its own behalf – the Tax Court accepted the taxpayer's expert evidence that it is commercially rational for a taxpayer to give up a business opportunity to an arm's length person so long as the taxpayer is fairly compensated. Therefore, the transfer pricing issue in respect of the HEU Feed Agreement and the Urenco Agreement was not whether the taxpayer would have allowed an arm's length party to enter into those agreements and obtain their benefit, but on what terms the taxpayer would have allowed an arm's length party to do so.

Relying on U.S. case law, the Tax Court further noted that there is nothing inherently commercially irrational about placing a business opportunity of a parent company in a particular foreign subsidiary and that the ITA sets acceptable limits on doing so pursuant to various foreign affiliate taxation rules, including the FAPI provisions.

In respect of the transactions under the BP Contracts, the Tax Court noted that they were generally consistent with arm's length practices in the uranium industry and that it would not be commercially irrational for a commodity producer to sell future production under a base escalated contract to secure a guaranteed revenue stream even if there is an expectation that uranium prices might rise. Similarly, in respect of the CC Contract transactions, the Tax Court noted that the CC Contracts were for short durations or single deliveries, neither being so commercially irrational that arm's lengths parties would not have entered into them.

Having found none of the series or transactions were so commercially irrational that arm's length parties would not have entered into them, the Tax Court concluded that the correct transfer pricing analysis of the series/transactions was under paragraphs 247(2)(a) and (c) in order to determine whether or not the correct amount of compensation had been received by the taxpayer in each of the four situations.

PARAGRAPHS 247(A) AND (C)

Having concluded that paragraphs 247(2)(b) and (d) did not apply to the series/transactions undertaken by the taxpayer, the Tax Court then considered whether the Minister could justify the transfer pricing adjustments in the reassessments under appeal on the basis of the "traditional" transfer pricing provisions in paragraphs 247(2)(a) and (c).

It is worth noting that the strength of the Minister's position on this aspect of the case seems to have been compromised by the fact that the bulk of the Minister's case was based on the notion that the profits of the Luxco/Swissco from the uranium trading operations should be taxed as income of the taxpayer and less effort was dedicated to trying to create a comparability framework to establish an arm's length price for (i) the assignment to Luxco/Swissco of the opportunity to participate in the HEU Feed Agreement or the Urenco Agreement, or (ii) the taxpayer's sale of its uranium to Luxco/Swissco.

The Tax Court accepted that, at the particular times when Luxco/Swissco entered into the HEU Feed Agreement and Urenco Agreement, there was no evidence that the taxpayer was foregoing an economic windfall since the agreements had been negotiated on arm's length terms (and there was no evidence to suggest an inequality of bargaining power which might allow one party to obtain a material advantage in terms of pricing). The Tax Court also noted that the taxpayer had negotiated the agreements, in part, to prevent Russian-sourced uranium from being dumped on the uranium market causing a reduction in global uranium prices. As the taxpayer would obtain such a benefit regardless of whether it or a subsidiary entered into the HEU Feed Agreement and Urenco Agreement, from this perspective the taxpayer had not lost any opportunity.

With respect to the pricing of the taxpayer's sale of uranium to Luxco/Swissco, the Tax Court was critical of the Minister's expert evidence which tended to rely on hindsight to ascribe a portion of the profits resulting from the increase in uranium prices to the taxpayer. Instead, the Tax Court was comfortable with Luxco/Swissco being entitled to the upside of price swings because Luxco/Swissco bore significant price risk stemming from Luxco/Swissco's commitment to purchase more uranium than it had commitments in place to sell. The Minister also sought to support is pricing adjustments on the basis of internal taxpayer information such as the taxpayer's cost of production or its subjective price forecasts, but the Tax Court rejected this type of data as a possible pricing indicator because uranium is a commodity with a readily-determined market value. Instead, the Tax Court accepted the evidence of one of the taxpayer's expert witnesses, which showed that the prices that the taxpayer received were within an arm's length range of prices.

As a result, the Tax Court found that no adjustment was necessary to compensate the taxpayer for allowing Luxco/Swissco to enter into the HEU Feed Agreement and Urenco Agreement or for the terms and pricing of the BP Contracts and the CC Contracts.

TAKEAWAYS

As the first decision to interpret and apply paragraphs 247(2)(b) and (d), the Cameco decision offers a very narrow interpretation of the charging provisions that must be met for the Minister to recharacterize a transaction. Given the Tax Court's willingness to ascribe commercial rationality to any transaction or series that could be transfer priced under paragraphs 247(2)(a) and (c), it remains difficult to predict what types of transactions would be so commercially irrational that paragraphs 247(2)(b) and (d) would actually apply.

The Minister has filed a notice of appeal of the Tax Court decision on the grounds that the Tax Court failed to properly apply the arm's length standard and erred in fact and law in concluding that paragraphs 247(2)(b) and (d) and paragraphs 247(2)(a) and (c) did not apply. The Minister did not appeal the Tax Court's finding that there was no sham.

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[1] The Organization for Economic Cooperation and Development ("**OECD**"), Saudi Arabia signs landmark agreement to strengthen its tax treaties (September 18, 2018), online: OECD <http://www.oecd.org/tax/beps/saudi-arabia-signs-landmark-agreement-to-strengthen-its-tax-treaties.htm>.

[2] Canada, Department of Finance, Notice of Ways and Means Motion to Introduce an Act to Implement a Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion And Profit Shifting (May 2018), online: Department of Finance: <https://www.fin.gc.ca/drleg-apl/2018/adtpfe-edipef-eng.asp>.
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[6] Department of Foreign Affairs, Trade and Development, Status of List of Reservations and Notifications at the Time of Signature (May 30, 2017), online: OECD <http://www.oecd.org/tax/treaties/beps-mli-position-canada.pdf>.
[7] OECD, Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting at paras 322-327, online: OECD <https://www.oecd.org/tax/treaties/explanatory-statement-multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf>.
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[10] Supra note 8.
[11] See the May 18, 2018 Joint Committee Submission re Reporting Requirements in Respect of Foreign Affiliates.