The *Cameco* Decision: A Welcome Glimpse of Transfer Pricing in the Post-BEPS World

This article contrasts a recent transfer pricing decision of the Tax Court of Canada with the principles set out in the OECD’s *Base Erosion and Profit Shifting (BEPS)* Actions 8-10. The court decision confirmed the importance of selecting controlled transactions for review with care and precision, emphasized the contractual relationships between associated entities when determining the correct allocation of risk and affirmed the primacy of traditional transfer pricing methods, particularly the CUP method, over the transactional profit methods.

1. Introduction

In 2015, the OECD announced that it would overhaul its 1995 transfer pricing guidance, revised in 2010, to better align the profits of multinational enterprises (MNEs) and the locations where value added activities are performed. This initiative was to combat what the OECD called base erosion and profit shifting (BEPS). Many tax practitioners and commentators expressed reservations on the release of the Final Report on Actions 8–10 of the OECD’s BEPS Project. They were concerned that emphasizing the conduct of affiliated enterprises over their legal contracts and the expanded use of profit-based pricing methods would create uncertainty and unpredictability for taxpayers. These concerns are justified in Canada by some of the transfer pricing audit and assessment practices of the Canada Revenue Agency (CRA). Encouragingly, the Tax Court of Canada’s recent decision in *Cameco Corporation v. Her Majesty the Queen* criticized the CRA’s transfer pricing audit methodology, and it contains lessons for taxpayers and tax authorities alike as transfer pricing enters a post-BEPS world.

2. Traditional Transfer Pricing

In order to ensure that transfer pricing is applied consistently across the global economy and to prevent double taxation, the OECD released transfer pricing guidance and proposed methodologies in 1995. These guidelines were revised in the 2010 *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) (hereinafter 2010 Guidelines). The 2010 Guidelines are clear that applying the arm’s length principle requires a comparison between the conditions in a controlled transaction among members of an MNE with the conditions that would have been made between independent entities in a comparable transaction under comparable circumstances. The first step in this comparability analysis requires taxpayers or tax authorities to identify the commercial and financial relations between associated enterprises, and the conditions and economically relevant circumstances attached to those relations in order to identify with precision the controlled transaction subject to review. This step includes the performance of a functional analysis, which seeks to identify where (or by whom) economically significant activities are undertaken, assets are used or contributed, and risks are assumed. The level of integration or fragmentation between members of an MNE is also relevant. Identifying a defined controlled transaction will play an important role in producing a more accurate transfer pricing analysis since comparable uncontrolled transactions can be selected with greater precision.

After a controlled transaction is identified, the 2010 Guidelines set out five methods to determine or test for arm’s length transfer prices or conditions. The three traditional transfer pricing methods are the comparable uncontrolled price (CUP) method, the resale price method and the cost-plus method. (hereinafter Traditional Transfer Pricing Methods) Each of these involves a comparison between the price or other terms and conditions in the controlled transaction and those in uncontrolled transactions that occur under similar economic and financial circumstances. Since finding perfectly comparable transactions between independent entities can be difficult in practice, the OECD authorizes adjustments to the uncontrolled transaction to eliminate the differences that impair comparability. These adjustments are often

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5. The CUP method compares the price charged in a controlled transaction to the price charged in a comparable uncontrolled transaction in comparable circumstances. The resale price method begins with the price at which a product which has been purchased from an affiliated seller is resold to an independent purchaser. This price is then reduced by an appropriate markup representing the amount out of which the reseller would seek to cover costs and make a profit. The residual price can be regarded as an arm’s length price of the original sale. The cost-plus method is based on the supplier’s cost to which an appropriate profit markup is added.
made by trained economists using sound econometric or statistical methodologies.

The two transactional profit methods are the profit split method and the transactional net margin method.6 Unlike the traditional pricing methods, the profit-based methods are less concerned with the arm’s length nature of terms or conditions in particular transactions. Rather, they compare profit indicators between independent entities and members of MNEs to estimate the profit that MNE members would have made had they dealt with independent entities. The 2010 Guidelines, while noting it was impossible to determine with precision when a particular transfer pricing method should be employed, do outline a hierarchy of methods.7 The Traditional Transfer Pricing Methods are preferred as they perform a direct comparison of the controlled transaction between associated enterprises and an uncontrolled transaction between independent entities.8 Noting that the preference is always for a method that allows the greatest comparability and the closest relationship to the controlled transaction under review,9 where multiple methods may be applicable, the traditional methods are preferred to the transactional profit methods, and the CUP method is the most preferred traditional method.

3. BEPS – A Shift in Emphasis

Concerned that MNEs could manipulate the methodologies in the 2010 OECD Guidelines with elaborate and opaque contractual arrangements, the OECD launched the Action Plan on Base Erosion and Profit Shifting in 2013.10 The stated purpose of BEPS Actions 8-10 was to align transfer pricing outcomes with value creation and match the allocation of profits with the economic activity that produced those profits.11 This purpose was to be achieved, in part, by providing newly revised guidance on the focus of a functional analysis. When performing a functional analysis, taxpayers and tax authorities were now to focus on where and by whom value creating economic activities were performed, not necessarily on the contractual allocation of functions, assets and risks. This guidance from Actions 8-10 was adopted in the 2017 Guidelines.12

Risk allocations, for example, received specific commentary. BEPS Actions 8-10 demanded that the contractual allocation of risk between members of an MNE be tested against which member actually performed the functions related to controlling, managing and mitigating that risk. Where tax authorities were of the view that the contractual allocation of risk did not match where the control, management and mitigation functions were performed, BEPS Actions 8-10 authorized a reallocation of the profit associated with the particular risk to the member that performed the functions associated with that risk. Thus, while a functional analysis remained a key part of a typical transfer pricing analysis, the legal ownership of assets and the contractual assumption of risk would now be subordinate to the functions performed in relation to those assets or in controlling or minimizing such risk.

BEPS Actions 8-10 provided further guidance on the use of the profit split method. For example, it was noted that the profit split method is particularly useful for highly integrated operations, and where both parties make unique and valuable contributions.13 Further, as noted above, the focus in this pricing method is not the actual terms or conditions in transactions between members of an MNE. Rather, the focus is on whether each member realized the profit they would have had they been independent enterprises.14 If not, then profits can be reallocated between members on an “economically valid” basis.15

The global value chain focus was confirmed and reinforced in the new three-tiered reporting requirements (i.e., Master File, Local File, and country-by-country (CbC) reporting) mandated by BEPS Action 13. This required MNEs to provide additional information relating to where they earn income, perform economic activities and pay taxes around the world.16 MNEs were also required to report their number of employees, stated capital, retained earnings and tangible assets located in each jurisdiction where they operated.17 This additional information collected from the taxpayers readily allows tax authorities to conduct audits and make transfer pricing adjustments based on the principles set out in BEPS Actions 8-10.

Many practitioners and commentators expressed alarm over BEPS Actions 8-10 and Action 13. Concerns were raised that tax authorities would make transfer pricing adjustments based on their subjective views of how much profit should be associated with the activities they identified in their functional analyses, regardless of the contractual arrangements between members of an MNE.18 Commentators also noted that terms like “unique and valuable contributions” or “highly integrated”, which would favour the profit split pricing method, were undefined. Further, the guidance on how to apply the profit split method contained inconsistencies and was vague. The overarching concern of taxpayers was that the vagueness imbedded

6. The profit split method identifies the combined profit to be split between affiliated enterprises from a controlled transaction and then splits those profits between the affiliated enterprises based upon economically valid bases that approximates the profit that would have been earned had independent enterprises entered into that controlled transaction. The transactional net margin method examines a net profit indicator that a taxpayer realizes from a controlled transaction with the net profit earned in comparable uncontrolled transactions. The transactional net margin method operates in a manner similar to the resale price and cost-plus methods, but examines net profit rather than gross profit on resale or gross markup on cost.
7. 2010 Guidelines, supra n. 3, at para. 2.3.
8. Id., at para. 2.3.
11. BEPS Actions 8-10, supra n. 1, at Executive summary.
12. 2017 Guidelines, supra n. 4, at paras. 1.60, 1.82 and 1.98.
14. 2017 Guidelines, supra n. 4, at para. 2.121.
15. 2017 Guidelines, supra n. 4, at para. 2.114.
17. Id.
in BEPS Actions 8-10 would introduce intolerable uncertainty and unpredictability in transfer pricing. Further, the expanded reporting requirements in Action 13 would vastly increase the difficulties and costs of compliance for MNEs that were subject to it.

4. The Canadian Experience

The audit and assessment practices of the CRA proved that the concerns of tax practitioners were valid. Even prior to BEPS, the CRA’s transfer pricing audit practices did not typically align with the traditional transfer pricing approach described in the 2010 Guidelines, as demonstrated by the recent Tax Court of Canada judgement in Cameco Corporation v The Queen.19

4.1. The facts in Cameco

Cameco Corporation (“Cameco Canada”) is a Canadian corporation and is one of the world’s largest uranium companies. The uranium market is comprised of producers, traders and utilities. A trader is an entity that buys uranium for resale at a profit. The two most commonly traded types of uranium are UO₂ and UF₆. Each of these is a fungible commodity. Uranium is highly regulated and not traded on an exchange. The prices at which it is traded in bilateral contracts are generally not publicly disclosed, however, during the years at issue, two companies did publish price indicators.

There are two types of bilateral uranium contracts: spot contracts, which call for delivery in under 12 months, and long-term contracts that call for delivery more than 12 months after the contract is executed. There are four types of pricing mechanisms for uranium contracts: (i) fixed prices; (ii) base-escalated prices, where the contract specifies a base price that is escalated over time, typically to account for inflation; (iii) market-related prices, where the price is usually determined by reference to the one or more public price indicators at a specified point in time; and (iv) hybrid prices, which are a combination of base-escalated and market-related prices. Base-escalated, market-related and hybrid prices can include price floors or ceilings.

After the Soviet Union collapsed, the governments of the United States and Russia executed an agreement concerning the disposition of enriched uranium extracted from decommissioned Russian nuclear weapons. The agreement provided that the United States Enrichment Corporation would receive enriched Russian uranium after it was blended down, would deliver natural UF₆ to Russia in exchange (the “highly enriched uranium feed” or “HEU Feed”).

In the 1990s, the uranium industry grappled with the prospect that Russia would flood the uranium market with the HEU Feed, substantially reducing prices. Cameco Canada, in conjunction with Cogema, a French state-owned uranium producer and Nuken Inc., a US trader in uranium, negotiated an agreement with the Russian government to purchase the HEU Feed and prevent price shocks (hereinafter the Tenex Agreement). The Tenex Agreement was ultimately signed by a Cameco Canada subsidiary in Switzerland, (hereinafter Cameco Europe), with Cameco Canada guaranteeing all of Cameco Europe’s obligations. Cameco Europe later executed another uranium purchase agreement with Urenco Limited.20

After a reorganization of the Cameco group in 1999, Cameco Canada continued to operate uranium mines and conversion facilities, Cameco Europe operated as a trader, aggregating the Cameco group’s uranium supply, and Cameco Inc., a US subsidiary (hereinafter Cameco US), operated as the marketing arm, responsible for selling the uranium to third parties.

Beginning in 1999, Cameco Canada made twelve long-term contracts with Cameco Europe under which it sold Cameco Canada’s uncommitted uranium supply. The contracts with market-based pricing mechanisms included ceiling prices ranging from USD 11.00 to USD 12.50 per pound. The base price for contracts with fixed price terms and base-escalated pricing mechanisms ranged from USD 8.25 to USD 33.00 per pound, depending on the contract and applicable year. Each contract included flex options that ranged from plus or minus 20% to 30% of the quantity deliverable under the contract.

Once Cameco US located a third-party buyer, it purchased uranium from Cameco Europe for the price the third party was to pay for it minus 2%. During the 2000s, as uranium prices rose, Cameco Europe earned substantial profits under this arrangement. Cameco Europe had two employees, one of whom had a wealth of experience in the uranium industry. Under a services agreement, Cameco Canada provided administrative services to Cameco Europe for a fee.

4.2. The CRA’s audit and assessment of Cameco Canada

The CRA’s audit practices, and its assessment of Cameco Canada in particular, do not follow the rigorous process set out by the 2010 Guidelines. Instead, they align more closely with the 2017 Guidelines and the guidance in BEPS Actions 8-10, notwithstanding that the audit began many years earlier. The divergence from the traditional process is best seen in the CRA’s selection of the controlled transaction under review in Cameco, and the similarities to BEPS Actions 8-10 are demonstrated by the functional analysis conducted and transfer pricing method chosen and applied.

As noted above, the selection of a precise controlled transaction (or series of transactions) is essential to selecting appropriate comparator uncontrolled transactions. This not only increases the accuracy of the comparability analysis, but also narrows and focuses an audit undertaken by tax authorities, minimizing costs and disrup-

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20. Urenco is a nuclear fuel company operating several uranium enrichment plants in Germany, the Netherlands, the United States, and the United Kingdom.
tion. However, far from a precisely delineated controlled transaction, in Cameco the CRA sought to apply a transfer pricing adjustment to a single series of transactions that included: the reorganization in 1999, the incorporation of Cameco Europe, Cameco Canada’s decision to have Cameco Europe execute contracts to purchase uranium from the Russians (via the Tenex Agreement) and from Urenco, and the sale of uncommitted uranium production by Cameco Canada to Cameco Europe.

The CRA performed a functional analysis and determined that with respect to the uranium trading business “[Cameco Canada] performed all the functions and undertook all the risks and [Cameco Europe] undertook no functions and assumed no risks.” Notwithstanding that Cameco Europe was legally obligated to purchase uranium and hold it until Cameco US located a buyer, at trial the Crown argued that since Cameco Europe did not perform the functions related to managing and controlling the price risk, it was not entitled to any profit.

The CRA applied the profit split methodology and reallocated all of Cameco Europe’s profit to Cameco Canada. Court documents described the basis for doing so as being that

> [a]rm’s length parties, in such circumstances, would give [Cameco Europe] negligible or nil consideration and provide [Cameco Canada] with all the income commensurate with each party’s functions and risks in the transactions.

While the profit split method’s flexibility may be useful for tax authorities, its lack of certainty and predictability causes difficulty for taxpayers. For example, Cameco Canada repeatedly asked Canadian courts to order the CRA to provide what it said were arm’s length prices for uranium. The CRA’s repeated response was to refer to the results of its functional analysis and its conclusion that the “Cameco Group was not allocating its profits in accordance with the arm’s length principle.”

4.3. The Tax Court’s decision

Encouragingly, the Tax Court of Canada rejected all three of these positions. It held that Canadian law requires the identification of controlled transactions capable of undergoing a comparability analysis, rejected the conclusions of the CRA’s functional analysis, and accepted expert evidence based on the traditional transfer pricing methods, rather than the profit split method. In doing so, the Court cast doubt on the applicability of certain parts of the 2017 Guidelines in Canada.

The Court strongly criticized the CRA’s practice of selecting overly broad controlled transactions. Affirming that a comparability analysis is at the heart of transfer pricing, the Court wrote that an “overly broad series renders the [comparative] analysis required by the transfer pricing rules impractical or even impossible by unduly narrowing (possibly even to zero) the set of comparable circumstances.” The Court held that Canadian law required the CRA to identify a controlled transaction or a series of controlled transactions that were capable of undergoing a comparability analysis. This finding should reduce the pernicious effect of a tax authority identifying an incredibly broad controlled transaction, claiming there are no comparators, and making adjustments based on transactional profit pricing methods or recharacterization approaches.

The CRA’s approach to valuing and allocating risk, which largely complied with BEPS Actions 8-10, as reflected in the 2017 Guidelines, was found to be wrong in fact and law. The Court found that price risk was inherent in the ownership of uranium (a fungible commodity with a market-driven price) not attached to “the information or judgment used to determine when to purchase or sell uranium and how much to pay or accept for each purchase or sale.”

The Court found that Cameco Europe assumed significant price risk under the Tenex Agreement and the other uranium purchase and sale contracts. This risk arose because Cameco Europe was often committed to purchasing more uranium (under primarily base-escalated prices) than Cameco US had found third-party buyers for (and who paid primarily market-based prices). The Court held that Cameco Europe was properly entitled to the profit associated with this price risk and that there was no basis in law to shift the price risk to Cameco Canada simply because it provided services to Cameco Europe.

The Court also rejected the CRA’s reliance on the profit split method, noting that the “valuation method” proposed by one of the CRA’s experts at trial was not even included in the OECD’s 1995 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Instead, the Court accepted Cameco Canada’s “rigorous transfer pricing analysis that sought to determine if the prices agreed to under the contracts between Cameco Canada and Cameco Europe were arm’s length prices” by undertaking three iterations of a CUP analysis and a corroborative analysis using the resale price method to check for reasonableness.

The CUP analyses adopted by the Judge were highly quantitative. Cameco Canada’s expert witness determined five key elements to consider in adopting the appropriate transfer pricing method initially and identified

24. In tax litigation in Canada, the government is styled Her Majesty The Queen, while the litigation is conducted by lawyers in the federal Department of Justice who represent the CRA.
twenty-two internal and external comparable contracts. There were some material differences between the long-term contracts under review and the CUPs that Cameco Canada identified. Adjustments needed to be made to the CUPs to account for: different market conditions when the contracts were signed, a general preference for U\textsubscript{3}O\textsubscript{8} over UF\textsubscript{6} in the market, the presence of flex options that allowed the buyer to increase the quantity to be delivered, and variations in future spot market and base-escalated prices. After these adjustments were made, Cameco Canada posited that the prices in the contracts between Cameco Canada and Cameco Europe fell within an arm’s length range. The Court agreed. Table 1 contrasts many of the positions taken by the CRA with the conclusions of the Tax Court.

5. Summary and Recommendations

The Tax Court of Canada’s decision in *Cameco* is a welcome rejection of the more worrisome aspects of the BEPS initiative, in particular the elevation of subjective views of conduct over contractual relationships and vague notions of the proper profit over rigorous objective data. In the most optimistic scenario, the court’s interpretation will inform the practices of the Minister at the audit stage, in particular the selection of appropriately precise controlled transactions for review. MNEs should take heed of the decision when they determine and support the transfer prices used in transactions between member companies. Controlled transactions should be identified with precision. Economically and statistically sound adjustments to potential CUPs should be made to ensure that a sound comparative analysis can be performed. Notwithstanding the simple attractiveness of the BEPS formulation that profits should slavishly follow functions, the *Cameco* decision affirms the continuing prominence of contractual relationships and the traditional transfer pricing methods, especially the CUP method. In Canada at least, granularity is preferable to generality, sophistication (where necessary) is preferable to simplicity for its own sake and, most importantly, accuracy is paramount over vagueness and ambiguity. As such, tax authorities must, in transfer pricing as in all other areas, ensure that their transfer pricing audits, adjustments and methodologies are, first and foremost, certain, predictable and fair.

| Table 1 – Comparison of the CRA’s audit and assessment methodology and the opinions of the Tax Court of Canada in *Cameco* |
| Aspect | CRA |
| Controlled transaction under review | A single series of transactions that included the 1999 reorganization, the incorporation of Cameco Europe, Cameco Canada’s decisions to have Cameco Europe execute the Tenex and Urenco agreements, all the long-term uranium sale contracts between Cameco Canada and Cameco Europe, and Cameco Europe’s sales to Cameco US. |

| Tax Court |
| An overly broad transaction or series renders a comparative analysis impossible by unduly reducing the set of comparable circumstances. As such, Canadian law requires the identification of a transaction or series that is susceptible to the comparative and substitutive analysis at the heart of transfer pricing. |

| Functional analysis |
| Performed a high-level functional analysis and concluded that Cameco Canada performed all the functions and assumed all the risks while Cameco Europe undertook no functions and assumed no risks. Any price risk (and associated profit) allocated by contract to Cameco Europe was shifted to Cameco Canada because Cameco Canada performed the functions related to managing and controlling the risk. |

| The CRA’s functional analysis was fundamentally flawed. Price risk is inherent with the ownership of an asset. Since Cameco Europe purchased uranium from Cameco Canada and others, it bore the price risk and was entitled to the profit. |

| Transfer pricing method |
| Profit split method; all economically significant functions were performed in Canada, thus all the profit should be allocated to Canada. The Cameco group was not allocating its global profit in accordance with the arm’s length principle. |

| CUP method is preferred. The actual uranium prices in Cameco Canada and Cameco Europe’s contracts were within an arm’s length range. |