GARDINER ROBERTS

AgraCity Ltd. v. The Queen, Case Study [1]

In a recent case in the Tax Court of Canada, the Minister of National Revenue failed to support a reassessment of AgraCity Ltd. (the "**Taxpayer**") under the transfer pricing rules of the Income Tax Act (Canada)(the "**ITA**").

The Taxpayer was part of a corporate group in Saskatchewan, the Farmers of North America ("**FNA**"), that was established to act as agent to purchase a glyphosate-based herbicide, "**ClearOut**" (being a generic version of Bayer-Monsanto's RoundUp), for sale to farmers in Canada. Originally, FNA used an American subsidiary to act as the wholesaler, but then caused the activities to be transferred to a Barbados subsidiary of the Taxpayer, "**NewAgco Barbados**", apparently in order to reduce the high taxes payable in the U.S.A. New Agco Barbados would acquire its inventory of ClearOut from an arm's length supplier, and determined its selling price on the basis of its costs plus a markup for profit.

NewAgco Barbados and the Taxpayer entered into a service agreement under which the Taxpayer provided logistical and related support for the sales and deliveries to the Canadian buyers. Meanwhile, the FNA group promoted the sales of ClearOut to the target market of Canadian farmers.

The Canada Revenue Agency (the "**CRA**") reassessed the Taxpayer on several bases and allocated all of the profits of NewAgco Barbados to the Taxpayer in respect of the sales of ClearOut to FNA's Canadian farmers.

First, the CRA asserted that the transactions were a *sham*. The CRA alleged that NewAgco Barbados held no assets and performed no economic activities; it performed no value-add functions and assumed no risk; in fact it was the Taxpayer that undertook all of the functions and assumed all of the risks. In addition, the service agreement did not reflect the true agreement between the parties. These parties acted in concert to give the false appearance that NewAgco Barbados was carrying on the business of selling ClearOut. The parties knew that the profits reported by NewAgco Barbados from selling ClearOut were actually the profits of the Taxpayer,

Second, the CRA asserted that under the transfer pricing rules of section 247 of the ITA, the transactions were primarily entered into to obtain tax benefits under the ITA; the parties' transactions would not have been entered into between arm's length parties; and the terms and conditions of the transactions were not the same as those that would have applied between arm's length parties.

The Court found against the CRA on the issue of *sham*, as the evidence fell short of establishing that:

- the parties to the transactions sought to present that the legal rights and obligations of the parties were different from what they knew or understood, and
- any of the parties sought to deceive anyone.

In particular, the evidence showed that FNA set up an American subsidiary to act as the wholesaler of ClearOut because there had to be a non-Canadian wholesaler, and establishing a company in a high-tax jurisdiction like the U.S.A. could not have been to improperly avoid Canadian tax. Furthermore, moving the same activities to a Barbados subsidiary is consistent with reducing foreign not Canadian taxes.

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[1] 2020 DTC 1066 (TCC).

Moreover, the evidence showed that NewAgco Barbados had assets and resources, and had assumed real risks in terms of product liability, price risk, currency risk, etc.

The Court also rejected the CRA's attempt at transfer pricing re-characterization under section, and in so doing set out the guiding principles as follows:

> "One of the express requirements for re-characterization is that non-arm's length parties must be participants in a transaction or series of transactions that would not have been entered into between arm's length persons. That is, the issue of concern to the fisc is not simply the price or other terms agreed to by the parties, it is that the very transactions agreed to and completed by the parties "would not have been entered into between parties dealing at arm's length".

The CRA was unable to adduce any evidence to support its assumption that no arm's length parties would have entered into these transactions. In fact, the expert transfer pricing witness for the CRA acknowledged that with proper inter-corporate pricing, the Service Agreement between the Taxpayer and NewAgco Barbados was an agreement that arm's length parties could have entered into.

In connection with the CRA's final position that the prices charged under the Service Agreement were subject to adjustment under section 247 as to what arm's length parties would have charged in similar circumstances, the Court found that the CRA's expert failed to consider foreign exchange, product liability, or other risks borne by NewAgco Barbados. The Taxpayer's evidence was the best available using the cost plus method, with the result that the payments were within the range of payments under comparable service agreements.

Accordingly, the Taxpayer was completely successful in demolishing all the assumptions made by the CRA.

Given the succession of losses realized recently by the CRA in transfer pricing cases and other international tax cases, [2] we should not be surprised if the Federal Government brings in toughening rules in the next Budget. Such an action may seriously weaken Canada's competitive international tax regime, resulting in making it more difficult for Canadian multinationals to remain headquartered in Canada.

For more information please contact:

Lorne Saltman, Partner at 416.865.6689 or lsaltman@grllp.com.

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[2] *The Queen v. Cameco Corporation,* 2020 DTC 5059 (F.C.A.); *Loblaw Financial Holdings Inc. v. The Queen,* 2020 DTC 5040 (F.C.A.), and *Bank of Montréal v. The Queen,* 2020 FCA 82 (F.C.A.).