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The double-edged sword of corporate tax avoidance

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The hot topic is taxes, what with the Panama Papers illustrating the lengths to which wealthy individuals use offshore companies to shield their income, and the U.S. government launching a broadside against “inversions,” the process by which some of its biggest corporations have merged with companies in low-tax countries in order to cut their American tax bill.

Against that backdrop, it's worth noting that there's plenty of tax avoidance going on in corporate Canada, given the epic battles between a number of TSX-listed companies and the Canada Revenue Agency over their offshore subsidiaries and the way they shift income out of Canada.

The CRA says it wants hundreds of millions of dollars in back taxes from Cameco Corp., Silver Wheaton Corp. and Loblaw Cos. Ltd. because, the CRA says, the companies inappropriately ran international transactions through subsidiary companies in low-tax foreign jurisdictions. The three companies are contesting the allegations, which remain untested in court.

Investors can take a lesson from these collected cases. It can be great for the bottom line, and the share price, when companies find ways to cut their tax bill. But when an aggressive tax-savings plan comes close enough to the line to raise the ire of the CRA, the result can be years of uncertainty, with huge tax liabilities hanging in the balance.

“The potential intervention of the taxman continues to be an underappreciated investment risk,” Al and Mark Rosen of the firm Accountability Research wrote in a December article for Advisor.ca. “Often forgotten is CRA's influence on corporate taxes and the disruptive effect that it can have on the share prices of companies”

The CRA's challenges to Cameco and Silver Wheaton are both twofold. One part rests on the way the companies structured their offshore subsidiaries – according to the CRA, with no real purpose other than tax benefits. The other matter of dispute is with the companies' “transfer pricing” arrangements, the contracts by which one subsidiary sells goods to another, thereby creating taxable income in places other than Canada.

Loblaw's disclosure on its dispute is not specific enough to say that the allegations are exactly the same. The company says the CRA objects to Loblaw's treatment of income at its Barbados subsidiary Glenhuron Bank Ltd. and has reassessed Loblaw's 2000 to 2010 tax returns, seeking \$341-million in taxes, interest and penalties. The company believes the CRA will also reassess the 2011 through 2013 returns. Loblaw “strongly disagrees with the CRA's position” and is appealing it through the CRA's internal processes. Loblaw declines to expand on its disclosure.

While Loblaw is working through the CRA's internal appeals process, the Cameco dispute is set for trial in the Tax Court of Canada, and the Silver Wheaton squabble is also headed there.

Cameco's fight with the CRA began in 2008; the tax agency has now reviewed the company's tax returns from 2003 to 2010 and told Cameco it believes it has \$3.4-billion more in Canadian income for those years than the company declared. Cameco says it expects CRA will add another \$3.6-billion in taxable income for 2011 through 2015. The total tax bill for the 13 years: \$2.1-billion, plus interest and penalties.

Canadian companies are required to remit 50 per cent of disputed amounts to CRA until the case concludes. So far, Cameco has provided \$232-million in cash, plus \$332-million through letters of credit.

In 1999, Cameco set up a subsidiary, Cameco Europe Ltd., in low-tax Zug, Switzerland. Cameco then signed a 17-year deal to take the uranium it produces in Canada and sell it to Cameco Europe before it made its way to the end customer. By selling the uranium to Cameco Europe at the low prices of 1999, Cameco is recording little to no profit in Canada, instead reporting the profits in Zug, where the tax rate is lower.

Veritas Investment Research analysts, who have been publishing reports on the Cameco matter for several years, think the CRA has a case because Cameco's Canadian operations performed virtually all operating functions for Cameco Europe, which has a CEO but little else by way of support staff. This suggests there was no true business purpose for the subsidiary other than tax benefits, **Veritas** says.

In its 2015 annual report, Cameco says it has consulted with external advisers and concluded "CRA's position is incorrect," and it expects to recover all the money it has submitted so far. Cameco's 2003, 2005 and 2006 reassessments are headed to the Tax Court of Canada in the third quarter of this year, with hopes to have a decision six to 18 months after. (The U.S. Internal Revenue Service is also pursuing Cameco over the matter.)

The Silver Wheaton case has many similarities to Cameco, in that the CRA objects both to the structure of the company's Cayman Islands subsidiary and to the company's transfer pricing. What makes Silver Wheaton different is that it's a "streaming" company that does not actually operate mines in Canada or anywhere else in the world. Instead, it enters into financial transactions with miners, paying cash up front in exchange for the right to buy their future production. CEO Randy Smallwood told The Globe and Mail that what CRA essentially wants to do is collect Canadian taxes on the profits from minerals that are mined by Silver Wheaton's partners in foreign countries and then sold abroad without ever touching Canadian soil.

Silver Wheaton said in January that it had abandoned its internal appeals with the CRA on its reassessment of the company's 2005 to 2010 tax returns, which sought to increase the company's income by \$715.3-million and collect taxes, interest and penalties of \$353.4-million. Silver Wheaton filed to take the matter to Tax Court instead. Shortly after that, the CRA told the company it would audit 2011 through 2013. The company says if CRA takes the same approach with those years, it would add another \$310-million to the company's taxes payable. In a statement, Mr. Smallwood said "we remain confident in, and we intend to vigorously defend, our business structure."

The **Veritas** analysts, who have also examined Silver Wheaton, say that while 12 of the company's 33 employees are based in the Caymans, their job functions, based on LinkedIn profiles, are more administrative in nature. About half of the company's total compensation is paid to Canadian-based executives, including its merger-and-acquisitions team and its top executives. Additionally, while the company says a Caymans location is convenient to its Latin American operations, **Veritas** found that flights from the company's Vancouver headquarters are typically shorter and cheaper to 14 of the 18 properties where Silver Wheaton has streams.

In addition, **Veritas** notes, other royalty companies such as Franco-Nevada, Royal Gold and Sandstorm Gold had effective tax rates from the high-teens to the high-20-per-cent range in 2014 and 2015. Since Silver Wheaton's inception in 2004 through 2014, **Veritas** says, the company has paid cumulative current taxes of \$2-million on pretax profit of \$2.5-billion, an effective tax rate of 0.1 per cent. Sandstorm, run by a former Silver Wheaton chief financial officer, used an offshore company through 2009 but has since abandoned the structure. "In our discussions with Sandstorm, we learned that the company determined the tax savings from using an offshore tax structure did not justify the potential risks," the **Veritas** analysts wrote.

In addition, **Veritas** says, recent court precedents on transfer pricing structures support the CRA's case.

Rory Quinn, Silver Wheaton's director of investor relations, says of the **Veritas** reports, "We strongly disagree with their understanding of the facts and their interpretation of tax rules and case law."

It is that confidence in its position – and at Cameco, as well – that ensures investors in the companies will watch the tax battle drag on for years to come, with hundreds of millions of dollars in the balance.