



ExxonMobil Canada Resources Company v. The King, Case Study

In a recent case, the Tax Court of Canada rejected the position of the Canada Revenue Agency (the “**CRA**”) that the Taxpayer’s payment of CAD\$36,207,810 for a feasibility study in connection with a gas pipeline project was not deductible in computing its income under the Income Tax Act (Canada)(the “**ITA**”). In addition, the Court rejected the CRA’s application of the Transfer Pricing Rules in the ITA to adjust or deny the deduction.¹

The Taxpayer (ExxonMobil Canada Resources Company) is indirectly owned by a U.S. resident corporation, ExxonMobil Corporation (“**Exxon**”). On December 5, 2000, a division of Exxon, ExxonMobil Production Company, entered into the Project Agreement with BP Exploration (Alaska) Inc. and Phillips Alaska, Inc. On June 15, 2001, Exxon assigned 68% of its 1/3 participating interest in the “rights, duties, benefits, obligations, costs, rewards, risks and liabilities arising in connection with the performance of the Project Agreement” to the Taxpayer under a Partial Assignment and Cost Allocation Agreement effective December 5, 2000 (the “**PACA Agreement**”), pursuant to which the Taxpayer held 22.67% of the participating interests in the Project Agreement. A feasibility study was conducted to evaluate and take steps to develop a pipeline project from Prudhoe Bay on the North Slope of Alaska through Western Canada and into the United States. The Feasibility Study Costs represented the Taxpayer’s proportionate share of the total feasibility study costs incurred under the Project Agreement, as allocated to the Taxpayer pursuant to the PACA Agreement.

The CRA disallowed the deduction on the basis that the Feasibility Study Costs were not expenditures made or incurred by the Taxpayer for the purpose of gaining or producing income from the Taxpayer’s business or property.² In contrast, the CRA asserted that the activities carried out under the Feasibility Study were in pursuit of the producers’ profits (EM Corp., BP Alaska and Phillips Alaska) and not in pursuit of the Taxpayer’s business.

Alternatively, the CRA took the position that if the Feasibility Study Costs were deductible, the Transfer Pricing Rules would have applied to adjust the deduction to nil, or, in the further alternative, that the Rules would have applied to recharacterize the transaction and deny the deduction.³

The Court first considered whether the Taxpayer had a source of business income.⁴ Recent jurisprudence appeared to provide conflicting views. After careful analysis, the Court concluded that the Taxpayer had a source of business income related to the Feasibility Study. This conclusion was based on a variety of factors including, the following:

¹ 2026 TCC 42, Unless specially described to the contrary, all statutory references herein are to the ITA.

² Paragraph 18(1)(a).

³ Paragraphs 247(2)(a) and (c), or in the alternative paragraphs 247(2)(b) and (d)..

⁴ Sections, 3, and 9, and paragraph 18(1)(a).

- the purpose of the Project Agreement was to undertake a feasibility study of a pipeline project, and not to determine whether it would be profitable for the producers to bring their Natural gas to market, as suggested by the CRA;
- the nature of the Taxpayer's business included pipeline development and owning interests in pipelines;
- feasibility studies are a norm in the pipeline industry, and the feasibility study was conducted in a commercial manner; and
- the Taxpayer had the potential to earn a profit from the project by either: (i) earning toll revenue as the owner of a Canadian segment of the pipeline, if a pipeline was built and the ExxonMobil group owned an interest in the pipeline; or alternatively (ii) licensing proprietary information and data gathered from the project, if a pipeline was not built.

The Court went on to clarify that the deductibility of an expense is not to be confused with a source analysis, and the profitability of the activity to which the expense relates does not affect the deductibility of the expense. The issue is instead whether the expense was made for the purpose of earning income from the business of the Taxpayer. The Tax Court concluded that there was a sufficient business connection between the Feasibility Study Costs and the Taxpayer's business, and that the Feasibility Study Costs were incurred for the purpose of gaining or producing income from the Taxpayer's business, which includes owning various interests in pipeline development and in pipelines.

The Court then considered whether the CRA was justified in disallowing the deduction of the Feasibility Costs under the Transfer Pricing Rules of the ITA. The Court set out the basic test being whether the price paid in this case would have been paid in the same circumstances if the parties had been dealing at arm's length. This involves taking into account all the circumstances which bear on the price whether they arise from the relationship or otherwise.

The Court analyzed the testimony of the expert witnesses for both sides, and found the Taxpayer's witness to be persuasive and reliable. In doing so, the Court endorsed this expert's description of the foundational elements of a Transfer Pricing analysis, namely the following:

- a company analysis,
- an industry analysis,
- a functional analysis of the functions actually performed, and
- an economic analysis, which involves selecting a Transfer Pricing method and a comparable transaction, and then considering adjustments.

In contrast, the Court gave limited weight to the opinion of the CRA's expert, on the basis that he did not appropriately apply the OECD Guidelines, did not take into account the PACA Agreement as drafted by the parties, and was, at many times, inappropriately speculative and laden with hindsight bias.

Under the Transfer Pricing Rules applicable in respect of the 2001 taxation year, there were two ways in which the Transfer Pricing Rules could modify transactions that are not consistent with the arm's length principle:

- The terms and conditions may be adjusted to reprice the transaction (the "**Repricing Rule**"). The Repricing Rule generally applies where the terms and conditions of the

parties' transaction differ from the terms and conditions that would have been agreed to by arm's length parties;

- If the transaction is not one that arm's length parties would have entered into at any price, the transaction may be recharacterized to be one that would have been entered between arm's length parties (the "**Recharacterization Rule**"). For the Recharacterization Rule to apply, it must be the case that (i) a hypothetical arm's length person would not have entered the transaction under any terms and conditions; and (ii) it is reasonable to consider that the transaction was not entered into primarily for *bona fide* purposes other than to obtain a tax benefit.

With respect to the Repricing Rule, the Court found that the Rule did not apply to adjust the deduction of the Feasibility Study Costs to nil. The Court was again persuaded by the opinion of the Taxpayer's expert that the terms and conditions of the PACA Agreement did not differ from those that would have been agreed to by arm's length parties.

Ultimately, the evidence adduced by the CRA's expert failed to establish that any of the terms were not reflective of arm's length terms and conditions when measured against the expected benefits under the PACA Agreement. In particular, the Court stated that there was no basis upon which to conclude that an arm's length pipeline investor would be unwilling to bear a comparable proportion of feasibility costs in exchange for toll revenues and ownership interests of a projected pipeline; particularly, when the expected benefits would be calculated in proportion to the costs incurred under a regulated environment.

In concluding that the first requirement of the Recharacterization Rule was not satisfied (being a hypothetical arm's length person would not have entered the transaction under any terms and conditions), the Court found that the evidence demonstrated that the PACA Agreement was a commercially rational transaction. The Court accepted the Taxpayer's expert's opinion that it was commercially reasonable for arm's length parties to engage in a similar transaction, based on an objective assessment informed by an analysis of the North American pipeline industry, the routine use of joint ventures to diversify risk in that industry, and an economic analysis of the expected benefits to the parties.

The Court emphasized that the question under the first requirement is whether any hypothetical arm's length person would have entered into the transaction under any terms and conditions. The CRA's expert applied a subjective test, rather than an objective one, based on what he speculated that Exxon and the Taxpayer would have done had they been dealing at arm's length, instead of what notional arm's length parties would have done. The Court also criticized the inappropriate use by the CRA's expert of hindsight to suggest that arm's length parties would not have entered the transaction because it was too uncertain.

With respect to the second requirement, the Court found that, even if the first requirement was satisfied, the proposed recharacterization of the PACA Agreement as a fee-for-services agreement by the CRA's expert was inappropriate, because doing so was purely speculative and unreasonable. Importantly, the CRA's expert failed to provide any terms for the proposed fee-for-services agreement, notwithstanding that the arm's length terms and conditions that would have been adopted become the terms and conditions for the relevant participants in applying the second requirement. As noted by the Court, the second requirement does not allow for a recharacterization into nothing.

In summary, when examining the issue of cost deductibility, the Court will examine the commercial reality, and the connection between the taxpayer's business to see if the cost is laid out to produce income from that business.

When examining the application of the Transfer Pricing Rules, the Court will determine if the fundamental building blocks are present to ground a Transfer Pricing Analysis. Where a Transfer Pricing expert misinterprets the underlying transaction documents, fails to consider the economically relevant circumstances, or otherwise improperly relies on hindsight to ground their analytical work, their conclusions are likely to be given little weight or to be disregarded altogether.

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