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Tax Alert – Canada

Clear transfer pricing guidance from the TCC: *ExxonMobil Canada Resources Company v. The King*, 2026 TCC 42

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

In *ExxonMobil Canada Resources Company v. The King*, 2026 TCC 42, the Tax Court of Canada issued a judgment that significantly expands the transfer pricing jurisprudence in Canada. Madame Justice Lafleur conducted a thoughtful and comprehensive legal analysis of the reassessing provisions found in paragraphs 247(2)(a) and (c) as well as paragraphs 247(2)(b) and (d) of the *Income Tax Act* (the Act).

Publisher's note: The taxpayer's expert witnesses referenced in this Tax Alert are Greg Noble and Caton Walker, Ernst & Young LLP partners who provided expert testimony and an Expert Report in the proceedings. The Court's reasons include notably favourable comments on that evidence, including that the testimony and report "carry a lot of weight." For readability, Greg Noble and Caton Walker are referred to below as the EY Expert Witnesses.

Justice Lafleur provides important guidance on the elements of transfer pricing analysis that the Court found reliable and persuasive in the circumstances of the case. In doing so, the Court accepts the Expert Testimony and Expert Report provided by the EY Expert Witnesses, including their opinion about the concept of "Building Blocks" of a reliable transfer pricing analysis.

This Tax Alert provides a summary of the decision, including the facts, the issues under review and the rationale for the Court's decision with respect to the transfer pricing provisions at issue. This Tax Alert also provides commentary on the application of this case to the administration of the transfer pricing laws in Canada, including the impact on taxpayers and practitioners.

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Background facts

In 1968, large natural gas reserves were discovered in Prudhoe Bay on the Alaska North Slope (ANS). These reserves represented 10% of the known gas reserves in the US at the time.

Due to the location of Prudhoe Bay on the coast of the Beaufort Sea in the Arctic Ocean, it was not possible to transport the gas by ship because of the danger caused by ice.

Accordingly, in 1969, various parties began investigating the feasibility of the construction of a pipeline from the ANS to the lower 48 US states.

Various efforts were made until 5 December 2000, when ExxonMobil Production Company (ParentCo) and two unrelated companies entered into a project agreement (PA) to study the feasibility of such a pipeline. Under the PA, each party owned a 1/3 participating interest in the rights and obligations arising from the PA. The PA anticipated a gas treatment plant on the ANS and a pipeline from the ANS to Alberta; this segment of the pipeline was referred to as A to B pipeline. The PA also contemplated an extended pipeline from Alberta to the lower 48 US states. This segment of the pipeline was referred to as B to C pipeline.

On 15 June 2001 (effective on 5 December 2000), ParentCo and its wholly owned subsidiary, ExxonMobil Canada Resources Company (the Taxpayer), entered into a Partial Assignment and Cost Allocation Agreement (PACA Agreement) whereby ParentCo assigned 68% of its 1/3 participating interest in the PA to the Taxpayer. This allocation was based on the estimated portion of the pipeline that would be constructed in Canada versus the US.

Under the PA, various work was carried out for the feasibility study, which incurred costs of approximately US$125M. ParentCo was allocated 1/3 of the associated costs (i.e., US$41.6M) and the Taxpayer was reallocated 68% of these costs in accordance with the PACA Agreement (i.e., US$28.3M). The Taxpayer's share was approximately CA$36.2M.

In early 2002, the parties to the PA determined that the project was not commercially viable at the time and work ceased.

Assessing position with respect to the transfer pricing provisions

The Minister of National Revenue denied the deduction (i.e., the CA$36.2M reallocated to the Taxpayer) on the following basis:

- The amounts are not deductible under paragraph 18(1)(a) of the Act, or in the alternative;
- The amounts are not deductible under paragraph 247(2)(b) of the Act, or in further alternative; and
- The amounts are not deductible under paragraph 247(2)(a) of the Act.

Judgment

With respect to these particular issues, the appeal of the reassessment by the Taxpayer was allowed on the following basis:

- Paragraph 18(1)(a) of the Act does not apply to deny the deduction; and
- Subsection 247(2) of the Act does not apply to limit the deduction of the feasibility costs.

Legal analysis of the transfer pricing provisions

While the Court discussed paragraphs 247(2)(b) and (d) before proceeding to paragraphs 247(2)(a) and (c), for the purposes of this Tax Alert, we will discuss the provisions in the normal ordering of the Act.

Paragraphs 247(2)(a) and (c) of the Act

Justice Lafleur states that the expert testimonies and the Expert Report prepared by the EY Expert Witnesses "carry a lot of weight". In particular, the Court notes that the Expert Report "contains a thorough transfer pricing analysis informed by the interpretative aide the OECD Guidelines" and that it "refers to comparable transactions and uses reliable assumptions verified by evidence".[1]

Importantly, Justice Lafleur referenced the framework provided by the EY Expert Witnesses in their Expert Report as the "Building Blocks" of a reliable transfer pricing analysis, which includes:[2]

- A company analysis of the parties to the transaction, including an overview of the business, a review of the multinational group and review of the parties involved;
- An industry analysis of the industry group or segment relative to the tested transaction;
- A functional analysis, including the functions performed, risks assumed and assets used; and
- An economic analysis that involves:
  - The selection of a transfer pricing method;
  - A selection of a comparable transaction(s); and
  - Comparability adjustments.

[1] *ExxonMobil,* at para 896.
[2] *ExxonMobil*, at para 898.

Justice Lafleur linked the Building Blocks concept with the transfer pricing principles previously outlined in *General Electric Capital Canada Inc. v R., 2010 FCA 344* [*GE Canada*]:

> *I find that the use of the building blocks as described by EY accord with the GE Canada decision, where the Federal Court of Appeal stated that the concept underlying paragraphs 247(2)(a) and 247(2)(c) involves taking into account "all the circumstances which bear on the price whether they arise from the relationship or otherwise" (GE Canada, at para 54). (ExxonMobil, at para 899)*

The Court stated that the EY Expert Witnesses selected the comparable uncontrolled price (CUP) method using the PA itself as an internal comparable to the PACA Agreement for how arm's length parties would behave in similar circumstances.[3] Justice Lafleur also linked the comparability analysis to the *GlaxoSmithKline* Supreme Court of Canada[4] case where the Court accepted the five comparability factors from paragraphs 1.39 to 1.60 of the 1995 Organisation for Economic Co-operation and Development (OECD) Guidelines, namely: (i) characteristics of the property of services; (ii) functional analysis; (iii) contractual terms; (iv) economic circumstances; and (v) business strategy.

The Court specifically addressed the concept of "expectation of benefits" in respect of the economic analysis conducted in the Expert Report, particularly as it applied to the allocation of costs depending on estimated milage:

> *In applying the CUP method to the PACA Agreement, EY opines that, in accordance with section 247 and the OECD Guidelines, an application of the arm's length principle to cost allocation arrangements requires that costs be allocated in proportion to the expected benefits for the parties involved (EY Expert Report pp. 44 and 50). The underlying reasoning is that cost allocation criterion aligns with what independent enterprises would establish in similar transactions among themselves. (ExxonMobil, at para 925)*

The Court then cites the proportionality standard derived from paragraph 7.23 of the OECD Guidelines from 2009, which provides that:

> *The expectation of mutual benefit is fundamental to the acceptance by independent enterprises of an arrangement for pooling resources and skills without separate compensation. <u>Independent enterprises would require that each participant's proportionate share of the actual overall contributions to the arrangement is consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement</u>. (ExxonMobil, at para 926)*

(Emphasis added)

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[3] *ExxonMobil*, at para 901.
[4] *GlaxoSmithKline v. R.*, 2012 SCC 52.

Paragraphs 247(2)(b) and (d) of the Act

Justice Lafleur commences her transfer pricing analysis by discussing the transactional recognition principle outlined in the 1995 OECD Guidelines:[5]

> *1.36 A tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapters II and III. <u>In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transactions should be structured.</u>*
>
> (Emphasis added)

Justice Lafleur did not agree with the Crown's expert opinion and indicated that the three questions posed to the expert "were flawed questions, not in line with the wording of subsection 247(2)." (*ExxonMobil*, at para 641)

Justice Lafleur accepted the exceptional circumstances where the 1995 OECD Guidelines state in paragraph 1.37 that it is legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer. These exceptions are incorporated into Canadian law via the recharacterization provisions contained in paragraph 247(2)(b) of the Act.

The Court then lays out the applicable principles and transfer pricing rules contained in paragraphs 247(2)(b) and (d) as previously decided in *Cameco Corporation v The* Queen, 2018 TCC 195 (*Cameco TCC*).

The Court clarifies that both subparagraphs 247(2)(b)(i) and (ii) must be satisfied for the recharacterization provisions of paragraph 247(2)(d) to apply. (*ExxonMobil*, at para 585)

Specifically, with respect to subparagraph 247(2)(b)(i), the Court reiterates the reasoning in *Cameco TCC* when considering whether arm's length parties would enter into the transaction. The Court states:

> *…the question that must be answered…is whether any hypothetical arm's length persons would have entered into the transaction under any terms and conditions. The analysis …is not a speculative exercise but involves an objective assessment of the commercial rationality of the transaction…. (Cameco TCC, at para 714). (ExxonMobil, at para 588)*

[5] *ExxonMobil*, at para 629.

The Court simplifies this question by paraphrasing the test, namely: "subparagraph 247(2)(b)(i) will only be satisfied if it is determined that 'no arm's length person would have entered into the transaction...under any terms and conditions'." (*Cameco FCA*, at para 44). (*ExxonMobil*, at para 587)

(Emphasis added)

The Court then spends significant time outlining the test in subparagraph 247(2)(b)(ii), which will only be satisfied "when it is determined that the 'transaction... can reasonably be considered not to have been entered into primarily for *bona fide* purposes other than to obtain a tax benefit.'" (*ExxonMobil*, at para 589)

The Court states that the term "tax benefit" was defined at the time under subsection 247(1) as meaning a "reduction, avoidance or deferral of tax or other amounts payable under this Act or an increase in a refund or tax or other amount under this Act." (*ExxonMobil*, at para 590)

Justice Lafleur provides explicit commentary on the evidence that she found credible and persuasive as well as what evidence she found to be unreliable and unpersuasive, noting that the EY Expert Witnesses' opinions were credible and persuasive.

When considering the "tax benefit" question in subparagraph 247(2)(b)(ii), Justice Lafleur states that it "requires a weighting of the evidence to make an objective assessment of the relative importance of the driving forces behind the transaction." (*ExxonMobil*, at para 674)

(Emphasis added)

Justice Lafleur then goes on to determine that the sole tax benefit achieved as a result of the transaction was the reduction of tax payable under the Act as a result of the deduction of the feasibility study costs. Then, emphasizing the word "primarily", she concludes that "just because the Appellant obtained a tax benefit by entering into the PACA Agreement, that does not mean that the primary purpose of the PACA Agreement was to obtain a tax benefit." (*ExxonMobil*, at para 687)

In fact, the driving force of the transaction "was to advance and progress a potential pipeline from ANS to Western Canada and the Lower-48, within a regulated industry that is lucrative." (*ExxonMobil*, at para 688)

Takeaways – impacts on taxpayers

This decision provides useful guidance to taxpayers and practitioners regarding the administration of the transfer pricing rules in Canada. Significantly, Justice Lafleur articulates what constitutes a reliable and persuasive transfer pricing analysis as well as what she finds unreliable and unpersuasive.

Specifically, in respect to the constituents of a reliable and persuasive transfer pricing analysis under paragraph 247(2)(a), Justice Lafleur referred to a framework provided by the EY Expert Witnesses in their Expert Report as the "Building Blocks" of a reliable transfer pricing analysis. That framework includes: (i) a company analysis; (ii) an industry analysis; (iii) a functional analysis; and (iv) an economic analysis. The economic analysis should include: (i) the selection of the transfer pricing method; (ii) the selection of a comparable transaction; and (iii) any comparability adjustments necessary.

The Court's favourable view of the EY Expert Witnesses' evidence creates a robust framework for taxpayers and practitioners, particularly given the limited explicit administrative guidance historically available since the introduction of the arm's length standard in 1998 – especially since neither the (now cancelled) Information Circular 87-2R, *International Transfer Pricing*, nor the Transfer Pricing Memoranda series (Issue 2 to17) provided this explicit guidance.

The legacy of this case with respect to the interpretation of paragraph 247(2)(b) of the Act is less clear due to the introduction of new Canadian transfer pricing legislation on 4 November 2025, since the new legislation collapses the two-part assessing provisions in paragraphs 247(2)(a) and (b) of the Act.[6]

That said, the new transfer pricing rules will only be in effect for taxation years commencing after 4 November 2025, and, as a result of the typical seven years domestic statute of limitation for transfer pricing matters, we should anticipate that the guidance provided by Justice Lafleur related to the two-prong recharacterization test in paragraph 247(2)(b) of the Act will remain useful for many years to come.

Justice Lafleur's guidance regarding the application of the arm's length test in subparagraph 247(2)(b)(i) of the Act is exceptionally clear – the provision will only be satisfied if it is determined that no arm's length person would have entered into the transaction under any terms and conditions.

Similarly, Justice Lafleur's guidance that the mere existence of a tax benefit does not trigger the provisions in subparagraph 247(2)(b)(i) of the Act, rather, it is necessary to objectively determine the "driving force" behind the transaction.

The legacy of this decision in relation to the recharacterization powers of the Canada Revenue Agency (CRA) for taxation years commencing after 4 November 2025 is less clear. This is due to the fact that the new Canadian transfer pricing provisions specifically incorporate the OECD Guidelines into Canadian law. As such, it seems reasonable to presume that the fundamental concept of transactional recognition continues to prevail in Canada, even under the new legislation where the former distinction between subparagraphs 247(2)(a) and (b) of the Act have been collapsed. This seeming contradiction will need to be clarified in the future, either through the provision of administrative guidance from the CRA in the form of a new Information Circular or Transfer Pricing Memorandum, or through litigation.

[6] For more information, see EY Tax Alert 2026 Issue No. 53, *Budget 2025 introduces revised transfer pricing rules*.

This case represents the most comprehensive judicial discussion of transfer pricing principles in Canada. The Court's analysis, including its guidance on what constitutes the Building Blocks of a reliable transfer pricing analysis, will likely be employed for many years to come.

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