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VIEWPOINT

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In this article, Boidman and Kandev consider the Supreme Court of Canada's recent judgment in *Loblaw*, its impact on Canada's foreign affiliate system, and whether some issues not adjudicated might be brought by other taxpayers.

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In 2018 we expressed concern with a Tax Court of Canada (TCC) decision applying the foreign accrual property income component of Canada's foreign affiliate rules (counterpart to the U.S. subpart F rules) to one of the country's largest publicly traded corporate groups.[1] Our concerns were shared by Canada's Federal Court of Appeal (FCA), which reversed the TCC decision and said the entity at issue qualified for an exception to the FAPI regime.

In 2020 we discussed the judicial history of the case, as well as the government's application to the Supreme Court of Canada (SCC) for leave to appeal the FCA decision.[2] Canada argued that the FCA subverted the policy objectives of the FAPI system and inappropriately narrowed its intended ambit. We predicted that leave would not be granted, and although the SCC did grant leave, it rejected the appeal, thus leaving intact the FCA's decision in favor of the taxpayer.[3]

This article reviews the entire matter to identify the SCC's key findings on aspects of the case most relevant to Canada's foreign affiliate system.

Facts and Party Positions

In 1992 Loblaw Companies Ltd. opened Barbadian subsidiary Glenhuron Bank Ltd. with an office and 16 full-time employees. Glenhuron obtained a Barbados banking license and engaged in investment activities with about 85 percent of its income being interest and gains on low-risk short-term debt securities and from interest rate and cross-currency swaps (all involving arm's-length counterparties). It was wound up in 2013 when the parent needed its funds for a Canadian acquisition.

It is evident that the subsidiary's location — a low-tax jurisdiction outside Canada — was chosen strictly to try to lower taxes on the income that the organization intended to generate and

[1] Nathan Boidman and Michael N. Kandev, "The Tax Court of Canada Strikes Offshore Bank in *Loblaw*," *Tax Notes Int'l*, Oct. 29, 2018, p. 513.

[2] Boidman and Kandev, "Canadian Appeals Court Upholds Loblaw's Offshore Bank Structure," *Tax Notes Int'l*, July 27, 2020, p. 505.

[3] *Loblaw Financial Holdings Inc. v. Canada*, 2021 SCC 51, *aff'g* 2020 FCA 79, *rev'g* 2018 TCC 182.

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that the same investments could have been made from Canada, but at a much higher tax cost.

But given case law that accepts the right of a taxpayer to tax plan, provided it is not abusive, that evident motive was no reason that Loblaw could not take the position (which it indeed did take) that under common law[4] its low-taxed Barbadian subsidiary earned active business income under the Canadian income tax system that was not to be included in computing FAPI as defined in section 95(1) of the Income Tax Act (Canada). If the income wasn't FAPI, it wouldn't be subject to ITA section 91, which attributes FAPI to a Canadian parent, such as Loblaw.

That FAPI definition generally excludes income from an active business — important here are exceptions to that general rule, which the Canada Revenue Agency tried to invoke in this case. It argued that even though the subsidiary had a common law active business, FAPI includes income from property, which under section 95(1) includes income from an investment business, which the government said Glenhuron's business was because it met the statutory definition and did not qualify for one of the eight exceptions thereto.

Loblaw countered that the subsidiary qualified for the exception for foreign banks, which requires that:

- the definition of foreign bank in section 95(1) apply;
- the business carried on as a foreign bank be regulated (an undefined term) in Barbados;
- the subsidiary employ more than five persons full time in carrying on the business; and
- the subsidiary conduct its business principally with arm's-length persons.[5]

The CRA countered that at least one of those four requirements was not met and, in the alternative, that even if all requirements were met, the general antiavoidance rule in ITA section 245 would deny the tax benefits from the arrangements, which the government said constituted an avoidance transaction that misused a provision of the ITA or abused the ITA as a whole. In addition to the attribution benefit explained above, the arrangements resulted in no Canadian tax on dividend distributions of the subsidiary's income by Glenhuron to Loblaw under Canada's dividend participation exemption.[6]

Court Decisions

Lower Courts

As noted, the TCC upheld the government's assessment, although on unexpected grounds. The FCA reversed that decision, finding that the subsidiary did not earn FAPI and that its income was therefore not taxed in the hands of its parent, Loblaw.

It was generally thought that Loblaw would prevail on the technical application of the rules — that is, that it met all four conditions to qualify for the foreign bank exception to the FAPI investment business category — but might be vulnerable to a GAAR attack. Instead, the TCC found the opposite: that Loblaw did not qualify for the foreign bank exception because it did not meet the requirement of conducting its business principally with arm's-length parties, making the court's comments that the GAAR would not have applied had the taxpayer prevailed on textual grounds to be dicta.

The FCA reversed the unexpected finding on the principally conducted requirement, and, somewhat surprisingly, the government did not seek reversal of the TCC's comments regarding the GAAR. Thus, the government could base its application to appeal only on the principally conducted issue. It asked the SCC to find that Glenhuron did not meet that requirement and therefore had an investment business that gave

[4] *See Canadian Marconi Co. v. The Queen*, [1986] 2 S.C.R. 522; and *Canada Trustco Mortgage Co. v. Canada*, 91 DTC 1312 (TCC).

[5] Under ITA section 249(1), related persons (for example, those with specified personal or corporate relationships) are deemed not to deal at arm's length, and it is a question of fact whether unrelated persons deal at arm's length.

[6] That is the exempt surplus component of the foreign affiliate rules, under which a dividend received by a Canadian corporation from a nonresident corporation is included in computing its income under ITA section 90 but is then deducted in computing its taxable income under section 113(1)(a) if the Canadian corporation owns at least 10 percent of any class of shares of the dividend-paying corporation. Further, the payer corporation must be resident in and earn non-FAPI income in a country with which Canada has a tax or information exchange treaty (which Barbados does), and the dividend must be paid out of that non-FAPI income — that is, income that is not converted to FAPI by any ITA provisions, such as the investment business rule explained above.

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rise to FAPI, which was to be taxed in the hands of Canadian parent Loblaw.

With at least 86 percent of income derived from assets requiring transactions with third parties, how did the TCC conclude that the principally conducted requirement was not met?

The TCC looked at Barbados's definition of banking, which discussed transactions with both depositors and investees. The court concluded that because the subsidiary did not take deposits and was instead funded with group capital investment and loans, it dealt with non-arm's-length parties on the funding side. On top of that arm's-length deficiency, Glenhuron diminished its position by taking advice and supervision from Loblaw in how it invested its funds.

The FCA concluded that those findings, including relying on the Barbadian definition of banking, were wrong: The funding transactions with affiliated parties should be ignored, as should the parent's supervisory or advisory activities.

SCC

The Big Picture

In light of the evident correctness of the FCA's judgment, it is hardly surprising that the SCC disposed of and rejected the government's appeal in three of the first four paragraphs of its judgment, with the balance of the judgment providing detail. Writing for the Court, Justice Suzanne Côté said:

> [2] The FAPI regime is one of the most complicated statutory regimes in Canadian law. Although it has come before us after several years of diligent work by sophisticated auditors and legal counsel, the question in this appeal is remarkably straightforward. Does a parent corporation conduct business with its [chartered financial analyst] when it provides capital and exercises corporate oversight? In my respectful view, the answer is an equally straightforward no.
>
> [3] I wish to emphasize from the start that while the tenor of the Crown's submissions is that Loblaw Financial has engaged in tax avoidance, the Crown did not raise any argument based on the general anti-avoidance rule ("GAAR") before this Court. We are tasked only with interpreting the precise words of the arm's length requirement — "the business (other than any business conducted principally with persons with whom the affiliate does not deal at arm's length)" — found in the financial institution exception, in accordance with the ordinary rules of statutory interpretation. When these words are read in their grammatical and ordinary sense, in harmony with their context and the ITA's objects, it becomes clear that they do not encompass an assessment of capital contributions or corporate oversight.
>
> [4] If capital and corporate oversight are excluded from consideration, the vast majority of business was conducted between Loblaw Financial's foreign affiliate and persons with whom it was dealing at arm's length. Therefore, Loblaw Financial can avail itself of the financial institution exception. Given the text, context and purpose of the provision at issue, there is no reason for a court to deny Loblaw Financial the ability to arrange its affairs so as to minimize its tax payable. As Lord Tomlin famously said:
>
>> Every man is entitled, if he can, to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. [Internal citations omitted.]

In essence, the SCC accepted the FCA's thinking on all major points.

The FCA found that the TCC erred by giving any relevance or weight to the subsidiary's fundraising activities when deciding the issue of relationships with non-arm's-length parties — particularly, whether it raised funds from within the Loblaw group or from third parties. Fundraising is not to be considered part of

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conducting a business. The SCC conclusively accepted that, noting the irony in the government's having taken that position in earlier technical interpretations (Ruling Nos. 9509775 and 2000-0006565):

> [61] I again reiterate that if taxpayers are to act with any degree of certainty, then full effect should be given to Parliament's precise and unequivocal words. The grammatical and ordinary meaning of the words "business conducted," read in the context and in light of the purpose of the FAPI regime, clearly shows that Parliament did not intend capital injections to be considered. Again, this is a view that the CRA itself previously shared. In a 1995 Ruling, the CRA said that the criteria for conducting business are "primarily directed at measuring sources of income, income earning activities, and the assets, etc., used in each business (i.e. the revenue side of corporate operations)." The CRA further stated that "*the fact that a foreign affiliate receives funding* to carry on its income earning activity *by way of debt or equity from a related party would have little if any relevance* in the determination of whether its business is carried on with persons with whom it does not deal at arm's length." Similarly, in 2000, the CRA reiterated its position, stating that the relevant criteria are "directed at measuring sources of income, employee time and effort and assets used in each business and no indication is given whether or how the amount of the debt or equity or the amount of time that is spent by employees administering debt or equity associated with a business would be relevant." It further noted that the aforementioned set of criteria is "in most cases, a complete set of relevant criteria in the determination of whether a business is conducted principally with persons with whom the affiliate does not deal at arm's length *and the source of a corporation's debt and equity financing would generally not be material to that determination*." [Original emphasis, internal citations omitted.]

Finally, the Court said there is a difference between capitalizing a subsidiary and the subsidiary's conducting business, which is wrapped up in the simple fact that capitalization is the prelude to conducting business. It noted that the ordinary meaning of the words "business conducted" conveys a different meaning than "business" alone; "the addition of the verb 'conducted' emphasizes Parliament's intent to focus on the active carrying out of the business rather than on the establishment of pre-requisite conditions that enable a foreign affiliate to conduct business."

The FCA also found that the TCC erred when, in considering the use of funds, it gave more than passing consideration to the internal communications between the subsidiary and members of the Loblaw group. The SCC accepted that, saying:

> [63] The Tax Court judge found that corporate oversight of Glenhuron by its parent transformed Glenhuron's interactions with third parties into activities conducted with persons not at arm's length. In particular, he found that the Loblaw Group exercised close oversight of Glenhuron's investment activities via derivative policies, regular reporting requirements, and regular attendance at Glenhuron's board meetings. In his view, "Loblaw influence pervades the conduct of business."
>
> [64] I cannot find any basis in the text, context or purpose of the arm's length requirement to support the Tax Court judge's consideration of corporate oversight as part of conducting business. Fundamentally, a corporation is separate from its shareholders. Its business may be conducted using money provided by shareholders or in accordance with policies adopted by the board of directors on behalf of the shareholders, but this does not change the fact that the corporation remains the party conducting business. Treating oversight by a parent corporation as shifting the responsibility for conducting business is also incompatible with the rest of the FAPI regime. As

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discussed above, the regime applies only where there is a controlled foreign affiliate. If there is a CFA, there is necessarily corporate oversight by its parent. Considering whether corporate oversight has been exercised at arm's length with a CFA is asking a question to which one already knows the answer. Parliament does not speak in vain; it would not have added an arm's length requirement if it could never be met. The intervener the Canadian Bankers' Association aptly encapsulates this situation:

> It is incongruous to posit that Parliament has consistently provided a safe harbour for Canada's largest multinational financial enterprises since 1995, yet intended to undermine that safe harbour if the oversight, cooperation, and coordination that is to be expected in such a group is present. [Internal citations omitted.]

Errors in the Big Picture

The SCC also addressed other TCC errors, including some not noted by the FCA.

According to the FCA, the tax court's error in focusing on raising funds was induced by the underlying error of relying on the Barbadian definition of an international banking business, which points to both receipts and use of funds. The SCC agreed, noting that Canada "failed to provide any persuasive reason why the Barbados Parliament's understanding of international banking business is in any way reflective of the Parliament of Canada's understanding of conducting business."

The FCA rejected the TCC's view that Canada's foreign affiliate system is intended to reward foreign subsidiaries that compete in the market, a characteristic lacking in Glenhuron's activities, even though it had a license to do so. Although the SCC agreed, its comments in paragraphs 31 and 51 might be seen as supporting those who argue that Canada should not adopt the OECD's suggested 15 percent minimum tax.

The FCA gave short shrift to the government's attempt to weaken the foundation of Loblaw's position by questioning whether Glenhuron really was conducting a traditional banking business. The SCC agreed:

> [47] The Crown also argues that the fact that Glenhuron is a bank changes the meaning of conducting business in this context because it is part of a bank's business to accept deposits. However, I do not believe the banking context changes anything. Every corporation needs capital, not just banks. And there is undoubtedly a distinction between receiving funds from depositors and receiving funds from shareholders. Depositors are clients of the bank, for whom the bank provides the services associated with holding their funds. Shareholders are not.

The FCA criticized the TCC for not respecting the fundamental notion that a corporation and its shareholders are separate and distinct entities. Again, the SCC agreed.

The FCA also rejected the TCC's conflation of the rationale of the legislation for purposes of a GAAR analysis with the purpose of the legislation in a statutory interpretation analysis, another point the SCC accepted.

The principle of interpretation generally applicable to the ITA entails looking at the text, context, and purpose, but with priority given to clear text. However, the principle applicable to the GAAR focuses on purpose. It seeks to determine whether there is a clear rationale for the provision the government is asserting has been abused and whether the taxpayer has subverted, defeated, or frustrated that rationale. The TCC conflated those two very different approaches to interpretation, which the FCA rejected.

The SCC provided two stand-alone reasons for its decision:

> [49] The FAPI regime also shows why considering capitalization as part of conducting business for the purposes of the financial institution exception would create practical problems. The FAPI regime may divide a single foreign affiliate into multiple businesses — as it does for Glenhuron. However, the FAPI regime does not provide a method for assigning capital to the different businesses within a single corporation. If

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> we were to interpret "business conducted" to include the capitalization of the business, it would be necessary to somehow divide the debt and equity from various sources (some arm's length and some not) and then assign the ensuing quotient to the various businesses conducted by a foreign affiliate. Parliament's failure to provide a method for distributing capital suggests that it did not have capital in mind. Furthermore, this is simply not how money is normally handled. Money being fungible, capital received is unlikely to be earmarked so that it becomes possible to trace back which capital investment relates to which line of business.
>
> [50] A further practical difficulty arises when considering the receipt of corporate capital in relation to newly formed foreign affiliates. FAPI only applies to a CFA. By definition, the Canadian parent will have provided some capital to set up the CFA. In most cases, this means that the CFA will fail the test in its early years when it is trying to build a customer base, because the ratio of corporate capital to other business receipts will likely be high.

Finally, the Court discussed Parliament's purpose in enacting the arm's-length requirement, including the government's allegation that the purpose is antiavoidance, but concluded somewhat disappointingly that because it was unnecessary in the appeal to determine the specific purpose of the arm's-length requirement, it thus left the issue "for another day."

Conclusion

In our view, the SCC decision in *Loblaw* is correct. While the Court's clarification of what it means to conduct a business is welcome, its holding is of limited application because the expression is used only rarely in the foreign affiliate rules (and nowhere else in the ITA, other than section 244.3).

As noted, it is surprising that the SCC decided to hear the case, given the FCA's unimpeachable analysis and the apparent absence of a national interest: the criteria used by the SCC to accept or reject applications for leave to appeal. In fact, the whole *Loblaw* saga has been quite disappointing to tax commentators. The judicial history, which involved a well-known taxpayer and a large tax bill, started with an exciting list of issues — most notably, the possible application of the GAAR in a foreign affiliate context. But the TCC decision upset all expectations and narrowed the issue that proceeded through the courts to the business conduct question — a decidedly thin edge of the basis on which to hang an appeal.

Finally, the outcome in *Loblaw* is only of limited future relevance: In 2014 Parliament enacted section 95(2.11) to severely limit the financial institution exception to investment business. Still, the SCC decision will apply to historical offshore bank situations challenged by the CRA. Those kinds of cases have been gaining momentum in the CRA's administrative process, and some will likely reach the courts. The next series of offshore bank cases to be decided are expected to address the remaining set of (more interesting) issues relevant to those structures, including the possible application of the GAAR. Time will tell what the outcome of the cases will be, but our modest prediction is that taxpayers will be successful again. ■

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