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The Tax Court of Canada Strikes Offshore Bank in *Loblaw*

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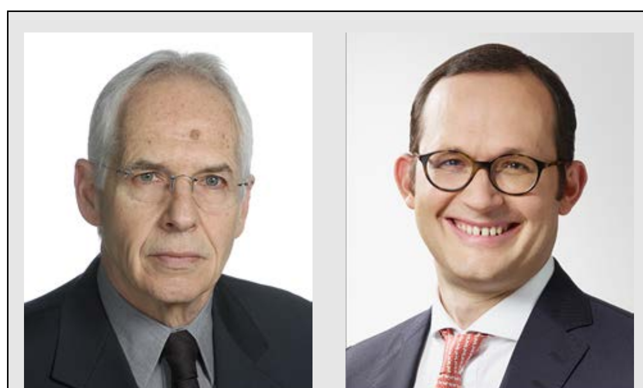

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Canada statutorily expanded its counterpart to the U.S. attributable subpart F notion in 1994 to include income from an "investment business." In this article, the authors examine that notion and the manner in which the Tax Court of Canada dealt with an exception therefrom for certain foreign bank subsidiaries of Canadian multinationals in its recent *Loblaw* decision.

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On September 7 the Tax Court of Canada held in *Loblaw Financial Holdings Inc. v. Canada*, 2018 TCC 182 (2018), that Canada's counterpart to the U.S. subpart F rules applied to one of Canada's largest publicly traded corporate groups — specifically, its wholly owned Barbados foreign affiliate, Glenhuron Bank Ltd. (GBL). That affiliate operated under an international banking license and had several employees who continuously and actively managed various financial investments but did not seek deposits to fund its activities and instead relied on funding from affiliates. The outcome was eagerly anticipated, but the court's reasoning surprised some observers, including us. This article summarizes the decision and comments on its more notable aspects.

Background

In 1972 Canadian lawmakers added to the Income Tax Act (to take effect in 1976) two interrelated approaches to the tax treatment of a Canadian resident owner (whether corporation, individual, or trust) of a nonresident corporation.[1] The first aspect of Canada's foreign affiliate rules is to exempt the Canadian owner from tax on the undistributed income an affiliate earns from carrying on an active business (unless that business is deemed inactive). If, however, the foreign affiliate is a controlled foreign affiliate,[2] the owner is immediately taxed on all other income, or foreign accrual property income (FAPI), unless that income is deemed active — whether or not it is distributed to the Canadian shareholder.[3]

Parliament has generally left it to the courts to establish how to determine if there is an active business being carried on, and the degree of activity involved in earning the income has largely

[1] The two approaches also apply when the Canadian taxpayer owns less than 100 percent but at least 10 percent of any class of shares of the nonresident corporation, or a minimum of 1 percent of those shares with related parties owning at least 9 percent. All nonresident corporations like that are foreign affiliates vis-à-vis the Canadian shareholders. *See* Income Tax Act section 95(1).

[2] A foreign affiliate is a controlled foreign affiliate if it is controlled (by reference to ownership of voting shares) by a Canadian shareholder, a non-arm's-length Canadian resident, that shareholder and no more than four other (unrelated) Canadian resident shareholders, or that shareholder and non-arm's-length parties. *See* ITA section 95(1).

[3] Under income attribution-type rules inspired by the 1962 U.S. controlled foreign corporation or subpart F rules.

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become the decisive criterion.[4] That is perhaps best seen in *Canadian Marconi Co. v. The Queen*, [1986] 2 S.C.R. 522, in which the taxpayer corporation sold a business division and assigned specific employees to continuously manage a portfolio of risk-free short-term fixed-income investments. The disposition proceeds were invested pending their use in a business acquisition or expansion, which the Supreme Court of Canada found constituted a separate active business of the taxpayer. In the foreign affiliate context, the Tax Court adopted that rationale in *Canada Trustco Mortgage Co. v. Canada*, 91 DTC 1312 (TCC).[5]

The second aspect of Canada's foreign affiliate rules (the so-called surplus rules) involves the tax treatment of an affiliate's active business income. In essence, if the foreign affiliate is resident in and carrying on business in at least one country with which Canada has an income tax treaty (or, since 2008, a tax information exchange agreement), a distribution to a Canadian resident corporation qualifies as an exempt surplus[6] dividend that is not taxable to the corporate owner.[7] If the treaty country nexus is inapplicable, a distribution is taxable to the corporate shareholder but with an effective gross-up and credit for foreign profits tax through calibrated deductions for those foreign taxes.[8]

To prevent taxpayers from effectively converting immediately taxable FAPI into active business income that might be distributed tax-free to a Canadian corporation by establishing a sufficiently active business structure, in 1995 Canada added numerous rules to the ITA that deem as FAPI what otherwise would be active business income under court-made criteria. Key to those legislative changes was the introduction of the defined notion of investment business in section 95(1).

In essence, a foreign affiliate's investment business is a business whose principal purpose is to derive income from property (including interest, dividends, rents, royalties, or returns, or any similar returns or substitutes for interest, dividends, rents, royalties, or returns), the insurance or reinsurance of risks, or the factoring of trade accounts receivable; or profits from the disposition of investment property. That is so unless specific saving conditions are satisfied — principally, that the business be carried on as a foreign bank (or other foreign financial institution) regulated under foreign law and that the business employ the equivalent of more than five full-time employees.[9]

It was the investment business notion and its carve-out conditions that gave rise to the dispute in *Loblaw*. The case is mainly of historical interest only because for tax years beginning after 2014, Canada imposed additional conditions (new section 95(2.11)) on the availability of the investment business carve-out, effectively limiting its application only to the subsidiaries of Canadian regulated financial institutions.[10]

The Case

In *Loblaw*, the taxpayer claimed its Barbados foreign affiliate, GBL, had active business income, and given that Barbados and Canada have an income tax treaty, that GBL's Canadian parent, Loblaw Financial Inc., was not taxable on those profits either when earned or distributed. The government claimed the income was from an investment business and hence was FAPI taxable in the Canadian parent's hands as soon as it was earned. In the alternative, the government claimed that the general antiavoidance rule under ITA section 245 would apply to the same effect.

In writing for the Tax Court, Justice Campbell J. Miller said:

> 1. The large corporation rules in subsections 165(1.11) and 169(2.1) of the

[4] Decisions regarding the ownership or operation of residential rental property are decided on other grounds. *See Burri v. The Queen*, 85 DTC 5287 (FCTD); and Nathan Boidman, "Property Income Versus Business Income: *Burri v. The Queen* and Other Recent Developments," Canadian Tax Foundation (1986).

[5] This was acknowledged in the *Loblaw* case at para. 232.

[6] *See* reg. 5907.

[7] *See* ITA sections 90 and 113.

[8] *See id.* and reg. 5900.

[9] If the employee test is met, there is also an exclusion for business carried on as a regulated trader in securities or commodities or for real estate development, money lending, leasing, or licensing or insuring of risks.

[10] For discussion of a proposed extension of section 95(2.11), see Boidman, "Canada Targets Conduits and Tracking Shares," *Tax Notes Int'l*, Sept. 17, 2018, p. 1223.

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[ITA] are not applicable to preclude the Appellant from making certain arguments.

2. [GBL] was a regulated foreign bank with the equivalent of greater than five full time employees in 2001 to 2005, 2008 and 2010 but was principally conducting business with non-arm's length persons and consequently its income was from an investment business and is to be included in the Appellant's income as [FAPI].

3. Pursuant to paragraph 95(2)(b) of the Act, GBL's fees from managing assets for non-arm's length persons is deemed to be income from a separate business other than an active business. The fees from Weston Acquisitions Inc., Weston Foods, Inc., Weston Foods US, Inc. and JFS Inc. are also FAPI as if not caught by paragraph 95(2)(b) of the Act they would otherwise be caught as part of GBL's investment business.

4. The calculation of the foreign exchange gains/losses in respect of GBL's investment in short term securities was on income account.

5. Although it is unnecessary to address the application of the [GAAR] given the above decisions, I do so for completeness' sake:

i. The waivers for 2001-2005 taxation years preclude the Respondent from relying on GAAR in those years.

ii. For the 2008 and 2010 taxation years, GAAR is not applicable because, while there was a tax benefit (the avoidance of FAPI) and transactions that could reasonably be considered to result in a misuse of the FAPI provisions, the transactions were not avoidance transactions as they could reasonably be considered to be undertaken primarily for bona fide purposes other than to obtain the tax benefit.

The procedural aspects of the decision, items 1 and 5.i, are of importance. Of particular note is the Tax Court's holding that the large corporation rule, which bars large corporations from advancing arguments in a tax appeal not specifically identified, quantified, and substantiated in some detail at the objection phase, does not bar a taxpayer from advancing new arguments on appeal that do not:

- take the dispute down a different path;
- take the Canadian Revenue Agency by surprise;
- require additional evidence;
- cause prejudice to the CRA; or
- represent a shift in direction or reconstruction of the taxpayer's tax position.[11]

Those factors, though important, are not the focus of this article.

On the substantive aspects of the decision, the surprising effect of the holding was aptly anticipated by Justice Miller in the first paragraph of his reasons for judgment:

> It was suggested at the outset of this case by the Appellant's counsel, reaffirmed in closing argument, that, at its core, this was a general anti-avoidance rule ("GAAR") case. The Respondent appeared to take this opening salvo to heart as she proceeded to paint a picture of an organization intent on avoiding the foreign accrual property income ("FAPI") rules found in subsection 95(1) of the Income Tax Act of Canada (the "Act"). After a lengthy trial, with lengthy expert evidence on foreign banks, followed by lengthy written argument and two days of oral argument, I have concluded this case is not, at its core, a GAAR case. It is a FAPI case.

Seemingly against the expectations of the parties, the Tax Court held that GBL had an investment business. At the outset, the court accepted that GBL fell within the preamble to the definition of investment business and went on to consider each of the carve-out conditions. First, it held that GBL was a regulated foreign bank under subparagraph (a)(ii) of the definition of

[11]We thank our tax litigation partner, Michael H. Lubetsky, for his input on this point.

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investment business. It was satisfied that GBL met the criteria of paragraph 2(a) of the Bank Act (Canada) because it was a bank according to the laws of the foreign country where it carried on its business and therefore was a foreign bank as defined in section 95(1). It was also conceded by the government that GBL was regulated under the laws of Barbados.

Second, the court considered whether GBL conducted its business principally with arm's-length persons in accordance with the parenthetical reference in paragraph (a) of the definition of investment business. That was the focal point of the Tax Court's analysis and reasoning and the basis on which the taxpayer's position failed.

The Tax Court found that as part of its business, GBL made both unrelated and related-party loans, bought and sold short-term debt securities, engaged in cross-currency and interest rate swaps and equity forwards, and managed investments for some affiliates. In interpreting the requirement to conduct business principally with arm's-length persons, the court said that in a banking business context, one must analyze both the receipt (raising of) and the use of funds. On that premise, it found that GBL received its funds (capital) from related parties.

Regarding the deployment of GBL's capital, the Tax Court said that "to overcome the lack of arm's length conduct on the receipt of funds side of the banking business, GBL must demonstrate on the use of funds side that there was little or no conduct of business with non-arm's length persons." The court found that GBL had transactions with affiliated companies within the group — that is, some bridge loans — and even its transactions conducted with clearly arm's-length counterparties — that is, its loans to independent distributors of one of the Loblaw operating affiliates — were sometimes tainted by the involvement or supervision of GBL's parent company or other affiliates. For example, the independent distributor loans made by GBL "were effectively handed over to GBL by Loblaw." Accordingly, the Tax Court held that GBL did not conduct its business principally with arm's-length persons and thus could not benefit from the carve-out to the definition of investment business.

Finally, the court examined whether the more-than-five-FTE test in paragraph (c) of the investment business definition; the court reviewed the responsibilities of 16 GBL employees to readily find that it was.

Despite the government's success on the technical FAPI arguments, the Tax Court followed up with dictum on the alternative GAAR argument. To find that the GAAR applies, there must be a tax benefit that results from an avoidance transaction that is abusive under the relevant ITA provisions. The court found that the waivers for tax years 2001 to 2005 precluded the government from relying on the GAAR in those years. Although it found a tax benefit, the court focused on the transactions in 2008 and 2010 to decide that no avoidance transaction existed in those years because the transactions were entered into primarily for bona fide commercial purposes. Even so, the court found that the taxpayer's structure abused the policy of the foreign regulated bank exception to investment business treatment, which was ineffectual, given its finding that there was no avoidance transaction.

Analysis

Several aspects of the decision raise concerns, and we believe the case was wrongly decided.

The Conducting Business Issue

The Tax Court's analysis of whether GBL conducted its business principally with arm's-length persons in accordance with the parenthetical reference in paragraph (a) of the definition of investment business is incorrect.

That aspect of the investment business carve-out has generally been considered easy to manage, so the court's interpretation of it comes as an utter surprise. Two aspects of the reasoning raise concerns. First, the court premised its analysis on the notion that both the receipt and the use of funds by GBL must be examined. While that approach may be appropriate for the unique deposit-taking business model of a retail bank, it generally does not apply to other businesses, including an investment banking operation like GBL's.

In determining with whom GBL was conducting its business, the focus must be on what the bank does with its capital, not how it raises its capital. That creates the parameters for looking at the requirement of not principally

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conducting business with non-arm's-length persons. That means the court should be looking at the use of funds, not the raising of funds. Even if it were appropriate in the circumstances to look at the fund-raising side, the focus should be on the existence and identity of depositors. However, this was not a case of GBL taking deposits from non-arm's-length parties but not from arm's-length parties; it was a case of GBL not taking deposits from anybody. Unfortunately, because the court found that GBL was funded by its affiliates, its further analysis on that point was irremediably skewed.

Second — and in a sense a more worrisome — was the court's analysis on the use-of-funds side of the purported analytical equation. Admittedly, some GBL transactions were done with affiliates. For example, in 2002 GBL bridge-loaned $325 million to Weston Acquisition and was repaid 38 days later, and in 2008 GBL lent $300 million to Loblaw Cos. Ltd. and was repaid a month later. However, even a merely superficial analysis of GBL's other transactions would normally lead one to conclude they were conducted with arm's-length parties:

- GBL's short-term debt securities activity was all with or through third parties, although GBL dealt both for its own account and on behalf of other members of the group. The latter was done as part of investment management services and in no way makes the income or gains GBL realized on securities purchased for its own account income from transactions with related parties.[12]
- GBL's equity-forward activity was conducted with Citibank as counterparty, with GBL paying Citibank a three-month banker's acceptance rate plus a spread and in return receiving the rate of return on an underlying stock. GBL also entered into cross-currency and interest rate swaps with arm's-length counterparties.
- GBL acquired from an affiliate 1,875 separate loans (the I/O loans) made to independent distributors for Best Foods Baking Co. The counterparties to those loans were individual drivers who had purchased the rights to distribute Best Foods baked products along specified U.S. routes.
- Finally, GBL entered into derivative cross-currency and interest rate swaps with arm's-length counterparties.

Obviously, the above profit-making arrangements, which constituted a substantial part of GBL's operations, were all with unrelated parties. However, the Tax Court did not stop there. Instead, it engaged in a somewhat difficult-to-follow analysis of the requirement to conduct business with arm's-length parties that led it to believe the investment business definition and its carve-outs were a balancing act between capital export neutrality and capital import neutrality. In particular:

> Capital import neutrality provides that a parent country not impose additional tax on the foreign subsidiaries' income earned in the source country, thus facilitating competitiveness for foreign subsidiaries in the source country market, as all foreigners would presumably be taxed at the same rate.

That underlying notion of competitiveness seems to have misled the court in its analysis. Its determination of whether GBL conducted its business with arm's-length parties was made through the prism of its quest to identify whether GBL actually competed with others. Thus, for example, regarding the I/O loans, the court said:

> With respect to the I/O Loan portfolio, the Appellant argues that from 2001 to 2005 thousands of independent operators received loans from GBL, clearly conducting business with arm's length persons, according to the Appellant. Yet, there was no element of competing to get these borrowers. They were effectively handed over to GBL by Loblaw. There was no evidence from either of the employees who managed the loan portfolio as to how much, if any, business was conducted directly with the borrowers. Indeed, GBL was not even paid by the borrowers but through a related company. I find this aspect of the business was conducted as much with Loblaw as with the borrowers.

[12] Investment management fees earned from those related parties would not be part of investment business. They are either treated as part of FAPI through section 95(2)(b) or they are active business income.

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Further, even when GBL was clearly conducting business with arm's-length counterparties, the court suggested there was some influence or involvement by GBL's parent or other affiliates that tipped the scales against the taxpayer:

> Turning finally to the swaps activity, the Appellant identifies the major financial institution counterparties as arm's length persons with whom GBL conducted business. The Respondent suggests that because GBL was a customer of these institutions, and had to provide security it was therefore not carrying on business with the dealer who sold the investment. The test is not the carrying on of business but the conduct of business. Did GBL conduct business with these counterparties? Does contracting with a third party constitute the conduct of business? On its face, it does. However, in the context of developing an elaborate investment strategy to make money for Loblaw, I do not consider this swap activity as constituting the principal portion of GBL's overall conduct of business. It is certainly not sufficient to outweigh all the non-arm's length elements of the conduct of business I have identified.
>
> Further, even the swap activity has a considerable element of conducting business with non-arm's length persons, as the swaps were subject to Loblaw derivative policies. Also, the evidence was that certain ISDA agreements could be terminated if GBL was no longer affiliated with Loblaw. So, even considering the swaps as being business not directly conducted with non-arm's length persons (excuse the double negative but the statutory language demands it), Loblaw influence pervades the conduct of business. This is further brought home in spades by the exhaustive regular reporting requirements imposed on GBL by Loblaw as to how GBL was using the funds. Representatives of Loblaw also regularly attended GBL board meetings.

The Tax Court's reasoning is inconsistent with the plain meaning of the requirement to conduct business with arm's-length parties. The word "conduct," which is used instead of the phrase "carry on," focuses the analysis on the counterparties to the affiliate's profit-making arrangements. GBL's use of its capital met that requirement.

The GAAR

As noted, the parties framed the case as a GAAR issue. The government argued that even if not from an investment business, GBL's income should still be taxed as FAPI. It claimed that GBL abused or misused the investment business exception for regulated foreign banks because it was not doing what banks are ordinarily thought of as doing. It did not take deposits or extend personal or commercial credit; instead, it basically invested its parent's funds. The surprising outcome in favor of the government on the technical FAPI question made the GAAR argument moot, but the Tax Court still offered thoughts on the topic.

In dicta, the court said that if it had to decide the case based on the GAAR — which it did not — it would have rejected the argument because the second requirement for a GAAR challenge — that the structure was established primarily for tax purposes — was not met. In particular, the court thought the three objectives of the GBL structure were to make money for Loblaw Financial through an elaborate investment strategy using offshore money; to do so in a low-tax jurisdiction with a recognized international financial infrastructure; and avoid FAPI. It held that the last objective was not the primary reason for the GBL structure and thus the avoidance transaction requirement for the application of the GAAR was not met.

But oddly, the Tax Court went on to say that GBL's use of the foreign bank exception was abusive:

> Having concluded the rationale for the financial institution exemption is grounded in "competition," it follows that Loblaw Financial was misusing this exemption as it was not competing in any manner in any international market. It basically managed an investment portfolio for Loblaw. Yes, this took many employees and yes, GBL was regulated as

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a foreign bank, but look at what it did, and more specifically what it did not do. Loblaw Financial took great umbrage at the Respondent's reference to it as simply playing with its own money. Yet, that is exactly the picture the witnesses have painted for me. The only scintilla of evidence that had GBL vying for business was in obtaining the Waterman contract, but that is minor to the point of insignificance. It was no surprise to hear from Mr. Berry that the so-called marketing arm (GGMI) never amounted to much — there was no need to market. This is not the business the policy was designed to relieve from the application of FAPI — just the opposite. The difference though between the Respondent's approach to this view and mine is that the Respondent infers an intentional overriding avoidance plan and thus casts the term "playing with its own money" in an implicit derogatory manner. I do not read it that way. There is nothing wrong with playing with your own money, even when there is a lot of it, with an objective that one result may be a favourable tax consequence. Where this objective is not the driving force, GAAR should not come into play. I have concluded, however, the objective in this case was misconceived: a difference of interpretation of the financial institution exemption.

Although those comments are dicta, the court's approach does not appear to find support in the language of ITA section 245. For the GAAR to apply, subsection 245(2) requires a transaction to be an avoidance transaction as defined at subsection 245(3). Yet subsection 245(4) states that subsection 245(2) applies to a transaction only if it may reasonably be considered abusive. That clearly suggests that once it a transaction is found not to be avoidant, the GAAR analysis stops. A transaction that is not an avoidance transaction cannot be abusive because the exercise mandated by section 245(4) — a search for the policy rationale behind a provision and a determination whether it has been frustrated or defeated — can have meaning and be carried out only if provisions of the ITA have led to avoidance under section 245(3).

Conclusion

The taxpayer has 30 days to appeal *Loblaw* to the Federal Court of Appeal. The Tax Court's decision on the technical FAPI aspects of the case should be reversed. The GAAR arguments will then take (back) center stage. While the application of the GAAR is not easily predictable, we believe the taxpayer should prevail, given the factors discussed in this article. ■

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