OSLER

Loblaw Financial wins tax appeal at Supreme Court of Canada

DEC 3, 2021 7 MIN READ

Related Expertise

- International Tax Law
- International Trade and Investment
- Tax
- Tax Disputes

In this Update:

- On December 3, 2021, the Supreme Court of Canada released its decision in *Loblaw Financial* regarding the interpretation and application of important elements of Canada's system for taxing income earned by foreign subsidiaries of Canadian companies
- In particular, the decision focuses on the foreign accrual property income (FAPI) regime, which, if applicable, would impose Canadian tax on income earned in another country by a controlled foreign affiliate of a Canadian company
- The Supreme Court rejected the government's argument and concluded that a Canadian parent corporation does not conduct business with its controlled foreign affiliate when it provides capital and exercises corporate oversight
- The Supreme Court also rejected the government's position that additional requirements should effectively be read into the provision at issue because it should be viewed and interpreted as an anti-avoidance provision
- In addition to a detailed legal analysis, the Supreme Court noted that practical difficulties would arise from the government's arguments
- The reasons contain useful guidance on how to interpret detailed and complex tax provisions such as the FAPI regime

In a decision released earlier today, the Supreme Court of Canada (the SCC) unanimously dismissed the government's appeal from a 2020 Federal Court of Appeal (FCA) decision. The SCC agreed with the FCA that the income earned by a Barbados subsidiary of Loblaw Financial Holdings Inc. (Loblaw Financial) was not foreign accrual property income (FAPI) and therefore not taxable to Loblaw Financial in Canada.

This decision provides rare guidance from our highest court on how to interpret and apply important elements of the foreign affiliate rules in the *Income Tax Act* (the Tax Act). The decision is directly relevant to Canadian financial institutions and other Canadian companies with subsidiaries carrying on banking and other financial businesses outside of Canada. However, the decision has broader implications for tax planning, particularly in the context of complex statutory provisions like those applicable to Canada's foreign taxation system. The appeal also highlights the importance of planning ahead for factual disputes that may arise years — or decades — after the events in question.

Osler represented Loblaw Financial throughout the dispute, with a team including tax litigators Al Meghji, Pooja Mihailovich, Mary Paterson, and Mark Sheeley as well as international tax specialists Drew Morier and Robert Raizenne.

Background to the appeal

Loblaw Financial is a Canadian subsidiary of Loblaw Companies Limited. The Canada Revenue Agency (the CRA) asserted that Loblaw Financial was taxable in Canada on approximately $475 million of income earned outside of Canada by its Barbados-resident subsidiary, Glenhuron Bank Limited (Glenhuron), between 2001 and 2010. The CRA argued that Glenhuron carried on an "investment business," as defined in subsection 95(1) of the Tax Act, and that its income was therefore FAPI and not active business income. In addition, the CRA attempted to invoke the general anti-avoidance rule in section 245 of the Tax Act (the GAAR).

After a four-week trial involving 14 witnesses, extensive documentary evidence and numerous disputed issues, the Tax Court of Canada (TCC) found that Glenhuron satisfied all but one of the conditions necessary to qualify for the financial institution exception: the requirement that Glenhuron must conduct its business as a foreign bank principally with arm's length persons.

The Tax Court was of the view that a banking business necessarily involves two components: the receipt and use of funds. The Tax Court also found that the arm's length component of the financial institution exception imposed an unexpressed requirement for competition that justified an emphasis on the "receipts" side of the equation. Glenhuron's non-arm's length sources of capital, particularly equity capital, led the TCC to conclude that Glenhuron was not conducting its business as a foreign bank principally with arm's length persons.

In allowing Loblaw Financial's appeal, the FCA found that the TCC had erred in its interpretation of the arm's length test by reading in conditions not grounded in the text, context and purpose of the exception. The FCA applied the plain meaning of the phrase "business conducted ... with," and held that the focus should be on business relationships, and not on receipts and uses of funds. The FCA thus concluded that Glenhuron conducted business principally with arm's length persons.

For a more detailed discussion of the FCA's decision, please see the Osler Update dated May 6, 2020.

Unanimous decision in favour of the taxpayer

The fundamental premise of the Crown's case before the SCC was that Parliament *intended* Glenhuron's business income to be subject to tax in Canada as FAPI. According to the Crown, the financial institution exception was meant only for foreign affiliates that compete for capital or customers and not for foreign affiliates that use their own capital and retained earnings to generate income. The Crown argued that Glenhuron did not compete for capital and essentially managed an investment portfolio for its own account, and therefore should not benefit from the exception.

A unanimous Supreme Court conclusively rejected this argument.

Justice Côté, writing for the Court, characterized the FAPI regime as "one of the most complex tax schemes, with hundreds of definitions, rules, and exceptions that shift regularly." Given the particularity of the provisions found in this regime, Côté J held that courts should "focus carefully on the text and context in assessing the broader purpose of the scheme."

This interpretive approach echoes the majority reasons in the context of tax treaty interpretation in the recently released *Alta Energy* decision (for more details of this decision,

please see the Osler Update dated November 26, 2021). Both decisions emphasize predictability and certainty as essential components of a well-functioning tax system. The decisions also stress the need to respect the deliberate policy choices made by Parliament, as reflected in the text, and by the context, of the relevant provisions.

Applying this approach to the financial institution exception at issue, Côté J held that a parent corporation does not conduct business with its controlled foreign affiliate when it provides capital and exercises corporate oversight.

The grammatical and ordinary meaning of the words "business conducted", read in the context and light of the purpose of the FAPI regime, clearly shows that Parliament did not intend capital injections to be considered the conduct of business. Similarly, the Court could not find any basis in the text, context or purpose of the arm's length requirement to support consideration of corporate oversight as part of conducting business. This ruling accords with longstanding SCC precedent, and with the prior published administrative practice of the CRA interpreting the financial institution exception.

The SCC also rejected the Crown's argument that the financial institution exception had an anti-avoidance purpose or imposed a requirement for competitiveness. Acknowledging that there was no direct evidence that specifically spoke to the purpose of the arm's length requirement, the Court concluded that the purpose was the same as the FAPI regime overall: an attempt to balance the conflicting goals of preserving the ability of Canadian companies to compete abroad and preventing the erosion of Canada's tax base.

Since a significant majority of Glenhuron's income-generating activities were conducted with arm's length persons, Glenhuron qualified for the financial institution exception and its income was not included in FAPI (or included in the income of Loblaw Financial).

Implications and takeaways

The financial institution exception has been amended since the taxation years at issue in this case to restrict the class of Canadian taxpayers that can claim the exception. However, the decision has broader implications for tax planning because it offers guidance on how to approach the tension between interpreting tax provisions purposively while respecting their precise language. The decision also provides comfort to taxpayers that courts may take into account prior published administrative practices of the CRA in situations where the CRA tries to repudiate them at a later date.

As a practical matter, this appeal highlights not only the need to create and preserve the necessary evidence to establish the requisite facts, but also the importance of successfully establishing them at trial. Of the many lessons to be learned from this appeal, it is clear that the earlier evidentiary issues are considered — preferably at the time the relevant planning is undertaken — the fewer challenges taxpayers may face at a later time should a tax dispute arise.