

International tax: Loblaw successful at Federal Court of Appeal

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In a [decision](#) released on April 23, 2020, the Federal Court of Appeal (the FCA) unanimously allowed Loblaw's appeal from a 2018 Tax Court of Canada (Tax Court) [decision](#).

The FCA concluded that the income earned by a Barbados subsidiary of Loblaw Financial Holdings Inc. (Loblaw) was not foreign accrual property income (FAPI) and therefore not taxable in Canada.

The decision provides rare appellate court guidance on the proper interpretation of important elements of the complex foreign affiliate rules in the *Income Tax Act* (the Tax Act). The decision is particularly important to Canadian financial institutions with subsidiaries carrying on banking and other financial businesses outside of Canada. The appeal also highlights the importance of planning ahead for factual disputes that may arise years — or decades — after the years at issue.

Background

Loblaw is a Canadian subsidiary of Loblaw Companies Limited. The Canada Revenue Agency (the CRA) asserted that Loblaw 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).

In Loblaw's view, Glenhuron's income was from an active business, since it was a regulated foreign bank conducting its business principally with arm's-length persons and requiring more than five full-time employees. The business therefore qualified for the "financial institution" exception of the investment business category of FAPI. Loblaw also denied that the GAAR could apply.

Narrow loss by taxpayer at trial

After a four-week trial involving 14 witnesses, extensive documentary evidence and numerous disputed issues, the Tax Court found that Glenhuron satisfied all but one of the conditions necessary to qualify for the financial institution exception.

Specifically, the Tax Court concluded that Glenhuron was a "foreign bank" as defined in the

Tax Act, that it was regulated as a foreign bank under the laws of Barbados, and that it employed the requisite number of full-time employees in the active conduct of its business. The Court also concluded in *obiter* that the GAAR did not apply because there were no avoidance transactions.

However, the Tax Court found against Loblaw on the basis that Glenhuron did not conduct its business as a foreign bank principally with arm's-length persons (a point that was not the subject of detailed submissions at trial).

The Tax Court determined that a proper interpretation of the arm's-length test in a banking context requires an examination of both the receipt and use of funds. This was based on the Court's view that a bank's business necessarily involves two components, receipt of funds and uses of funds. The Court grounded this conclusion on its understanding of a "banking business" in the abstract, as well as on the definition of "international banking business" in the relevant Barbados legislation under which Glenhuron was licensed to operate.

The Tax Court found that an unexpressed competition requirement in the arm's-length component of the financial institution exception was relevant to its conclusion, and that this competition requirement justified an emphasis on the "receipts" side of the equation. The Court therefore placed significant emphasis on Glenhuron's non-arm's-length sources of capital, including especially equity capital received from its shareholder.

In addition, the Tax Court focused on the influence exerted by the Loblaw group from Canada in its capacity as shareholder and appeared, at times, to ignore Glenhuron's separate legal existence.

Taxpayer success on appeal: Rationale and takeaways

In allowing Loblaw's appeal, the FCA found several legal errors in the Tax Court's decision.

The FCA explained Canadian law required a formal, institutional approach to define a banking business. Under this approach, the application of the arm's-length test does not require consideration of both business receipts and uses.

Applying the plain meaning of the phrase "business conducted ... with," the FCA held that the focus should be on business relationships. The determination of the "principal" conduct of a business requires a factual analysis that focuses on the income-earning activities that occupy the time and attention of employees engaged in the conduct of the business. For this reason, the source of Glenhuron's capital should be given little weight in considering whether its business activities were conducted principally with arm's-length persons.

The FCA also observed that this conclusion was consistent with the distinction between the receipt of capital by a business and the activities by which such capital is employed to earn income. Other dealings with related parties, which may result in business relationships depending upon the facts, must also be weighed in relation to their significance to the business's income-earning activities as a whole.

The FCA held that the Tax Court had failed to respect the separate legal existence of a subsidiary from its shareholder and erroneously considered that Glenhuron's money belonged to Loblaw.

In addition, the FCA held that the Tax Court had erred by reading an unlegislated requirement for competition into the financial institution exception. Citing the Supreme Court of Canada's decision in *Shell Canada Ltd. v. Canada*, the FCA observed that courts must

be cautious before finding an unexpressed legislative intention implicit in clear provisions of the Tax Act. The FCA also clarified that the purpose of a provision, as determined in the course of ordinary statutory interpretation, should not be conflated with the policy or underlying rationale of the provision, as determined in the course of conducting a GAAR analysis. These are distinctly different exercises.

Applying the correct analysis, the FCA concluded that Glenhuron conducted its business principally with arm's-length persons, being those persons with whom Glenhuron dealt in the context of acquiring short-term debt securities and entering into related derivative transactions.

Finally, while the FCA acknowledged the Crown's concern that Glenhuron's income would be exempt from taxation in Canada, it observed that such concerns do not enable courts to give statutory provisions a broader interpretation than they can reasonably bear. Gaps, if any, in legislation are for Parliament to address.

Parliament has, in fact, acted to limit the availability of the financial institution exception. Pursuant to a 2014 amendment, this exception is now generally available only to foreign affiliates of significant Canadian financial institutions. The FCA's decision provides welcome clarity to these taxpayers, confirming that the arm's-length element requires a factual analysis that focuses on a foreign affiliate's business relationships and the time and attention required to generate income.

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 those requisite factual elements 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.

Osler represented Loblaw 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](#).