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Tax Alert — Canada

SCC dismisses Crown's appeal in *The Queen v. Loblaw Financial Holdings Inc.*

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The Supreme Court of Canada (SCC) has released its decision in *The Queen v. Loblaw Financial Holdings Inc.*, 2021 SCC 51, unanimously dismissing the Crown's appeal concerning the interpretation of foreign accrual property income (FAPI) rules in the *Income Tax Act* (ITA). In its decision, the SCC considered whether a parent company that contributes capital (or makes loans) to, and exercises corporate oversight over, its controlled foreign affiliate (CFA) can be considered to "conduct business" with such affiliate.

The financial institution exception to the FAPI rules, as contained in the definition of "investment business" in s. 95(1) of the ITA, requires, *inter alia*, that a foreign affiliate not conduct its business principally with non-arm's length persons. If a parent company that funds and provides oversight of a CFA can be considered to be conducting business with that affiliate, then the taxpayer might not be able to rely on the financial institution exception, depending on the circumstances.

The SCC held that intra-group funding transactions and corporate oversight, coordination and collaboration should not be viewed as part of the conduct of the affiliate's business for these purposes. Accordingly, as discussed below in greater detail, the CFA's income did not constitute taxable FAPI to the Canadian parent.

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Facts

The taxpayer was a Canadian corporation that incorporated a subsidiary (Glenhuron) in Barbados in 1992. The taxpayer and its other affiliates made substantial capital contributions to Glenhuron between 1992 and 2000. Glenhuron operated as an offshore bank in compliance with Barbadian banking regulations until its dissolution in 2013.

Glenhuron earned foreign source income for certain taxation years (2001–2005, 2008 and 2010). The bulk of this income — representing at least 86% of Glenhuron's income during each of the years at issue — was earned through investments in short-term debt securities and swap agreements involving arm's length third parties.

The taxpayer did not include Glenhuron's foreign source income as FAPI in its Canadian tax returns for the relevant year on the basis that such income was excepted from the application of the FAPI regime as income from a financial institution (found in the definition of "investment business" in s. 95(1) of the ITA). For its foreign source income to qualify for the "financial institution" exception, Glenhuron would have been required to meet the following criteria during the relevant taxation years:

1. Glenhuron must have carried on business as a foreign bank (or other listed entity);
2. Glenhuron's activities must have been regulated under foreign law;
3. Glenhuron must have employed more than five full-time employees (or the equivalent thereof) in the active conduct of its business; and
4. Glenhuron's business must have been conducted principally with persons with whom it dealt at arm's length.

The sole issue in dispute before the SCC was whether the fourth criterion was met.

The decision of the Supreme Court of Canada

While acknowledging the complexity of the FAPI regime, the SCC considered the narrow question before it to be "remarkably straightforward", amounting to whether a parent corporation conducts business with a CFA when it provides capital and exercises corporate oversight. The answer, in the SCC's view, was also remarkably straightforward: no.

The SCC unanimously held that the taxpayer was entitled to rely on the financial institution exception, by virtue of Glenhuron meeting all of the requisite criteria. The sole issue in dispute before the SCC was whether Glenhuron conducted business principally with non-arm's length persons during the taxation years in issue. There was no dispute as to the activities carried on by Glenhuron or whether it met any of the other conditions for exclusion from "investment business" treatment.

The SCC held that a plain reading of the arm's length requirement in the "financial institution" exception did not encompass an assessment of capital contributions or corporate oversight. This was supported by the context of the FAPI regime, the entire function of which is to classify a foreign affiliate's income. The financial institution exception and the arm's length requirement were tied to this function and should be read in light of Parliament's intention that the characterization of income should focus on activities related to income generation.

There was also no basis for the Tax Court of Canada's consideration of corporate oversight as part of conducting business. A corporation is separate from its shareholders and conducts business separately from them. Where there is a controlled foreign affiliate (that is, a CFA), there must normally be corporate control — which implies oversight by the parent. Applying the principle that Parliament does not speak in vain, there must be a way to meet the arm's length requirement even where there is a CFA. Accordingly, the arm's length requirement must not consider corporate oversight by the (non-arm's length) parent corporation. Put another way: it must be possible for a CFA to carry on business with arm's length parties, or there would be no point to having a specified arm's length requirement.

Once the capital investments received by Glenhuron and corporate oversight by the taxpayer were excluded, only its investment activities remained to be considered for the application of the arm's length requirement. At least 86% of Glenhuron's income during the years at issue was the result of arm's length activities, thus substantially exceeding the 50% threshold required to meet the "principally" test. The arm's length requirement was thus met.

Implications

The SCC's decision references and reinforces Lord Tomlin's famous dictum from the *Duke of Westminster* that a taxpayer may arrange its affairs to minimize its tax payable. It also clarifies the interpretation of what it means to "conduct business" by distinguishing between income-earning activities (which should be included as business *conducted* of a CFA) and activities relating to capitalization, and oversight, coordination and collaboration among the members of the corporate group.

The SCC also clearly reiterated in this case, as well as in its decision the previous week in *The Queen v. Alta Energy Luxembourg S.A.R.L.*, 2021 SCC 49, that it is not the role of the court, whether in a General Anti-Avoidance Rule (GAAR) case or in a non-GAAR case, to "rewrite" the tax laws or Canada's tax treaties.

Some have wondered why the SCC would have granted leave to appeal in both of these cases if the conclusion reached by the Federal Court of Appeal in this case was "remarkably straightforward". The answer may be that it never hurts to remind the community that Canada is governed in accordance with the rule of law.

Learn more

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