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TAX CONTROVERSY AND LITIGATION

Spotlight on statutory interpretation and tax avoidance: Three key decisions in 2021

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In 2021, the Supreme Court of Canada (SCC) heard two cases involving the permissible limits of international tax planning, giving the Court the opportunity to clarify the process of statutory interpretation in the tax context. The exercise of interpreting a tax provision involves examining three interrelated factors: the text of the provision; the context in which the text appears; and the purpose of the statutory scheme in which the provision is found. Canadian courts have repeatedly referred to this exercise as a "textual, contextual and purposive" analysis. The way in which this analysis is conducted is of particular interest in cases involving allegations of tax avoidance.

The first of the two cases decided by the SCC, *Canada v. Alta Energy Luxembourg SARL*, considered the application of the general anti-avoidance rule (GAAR) to provisions of an income tax convention. The Court released its decision in this case on November 26, 2021. The second case, *Canada v. Loblaw Financial Holdings Inc.*, considered the interpretation of a specific provision in the foreign accrual property income (FAPI) rules in the *Income Tax Act* (the Tax Act) and

the decision was released on December 3, 2021. The Court may also hear a third case in 2022 involving the application of the GAAR to tax planning undertaken in the domestic context.

The decisions in *Alta Energy* and *Loblaw Financial* provide guidance from our highest court on the application of the GAAR and on the conduct of ordinary statutory interpretation, giving important direction to taxpayers for future tax planning.

Canada v. Alta Energy Luxembourg SARL

In *Alta Energy*, a majority of the SCC confirmed the decision of the lower courts that the GAAR did not apply where the taxpayer, a Luxembourg-resident company, relied on the tax convention between Canada and Luxembourg (the Treaty) to exempt a capital gain from Canadian income tax. Wagner CJ and Rowe and Martin JJ dissented in favour of the Crown.

In this case, the FCA found that the purpose of the relevant Treaty provisions was clear from its text and that the Treaty benefit (in this case, the exemption from tax in Canada on the capital gain) should be available to any resident of Luxembourg that otherwise met the requisite conditions in the Treaty. The FCA declined the Crown's invitation to read in additional requirements not grounded in the text and that could in theory preclude certain residents from obtaining Treaty benefits.

On appeal to the SCC, the Crown took the position that the FCA had erred in its application of the GAAR, having grounded its analysis in the text of the relevant Treaty provisions rather than its policy or underlying rationale. The Crown argued that the policy of the Treaty provisions was to allocate taxing rights based on economic connections to each contracting state. Although the Crown conceded that the taxpayer was a resident of Luxembourg for purposes of the Treaty, it took the position that the taxpayer had limited economic or commercial ties to Luxembourg and therefore had engaged in "treaty shopping," contrary to the policy of the Treaty provisions on which the taxpayer relied.

In response, the taxpayer argued that the policy of the relevant Treaty provisions was no broader than the text itself and that a textual, contextual and purposive analysis of those provisions evidenced no intention to depart from the carefully defined criteria negotiated and agreed upon by the treaty partners. The taxpayer also argued that the Crown, in seeking to have the GAAR applied, was effectively adding an unexpressed condition to the test for residency under the Treaty (i.e., sufficient economic connections).

Justice Côté, writing for a six-member majority of the SCC, agreed with the taxpayer that the policy of the relevant Treaty provisions was clear from the text and was supported by the context and purpose of these provisions. The majority thus concluded that the Treaty benefit in question should not be denied to a resident of Luxembourg that has otherwise met the requisite conditions in the Treaty on the basis that its ties to Luxembourg are somehow insufficient.

The majority cautioned that in applying the GAAR courts should not conflate a transaction being primarily (or even solely) tax motivated with it being abusive. Nor should the GAAR analysis be conflated with value judgments. It should be grounded in the specific provisions at issue rather than on broader policy statements.

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The majority also pointedly rejected the Crown's argument that treaty shopping is inherently abusive and declined the Crown's invitation to read in additional requirements not grounded in the text of the Treaty and effectively allow Canada to "revisit its bargain" with Luxembourg such that certain residents may be precluded from obtaining Treaty benefits.

Writing for a three-member dissent, Rowe and Martin JJ held that treaty shopping is abusive where there is an absence of a "genuine economic connection with the state of residence." The dissenting judges found there to be an absence of such a "genuine" connection in this case.

At the time that Canada entered into the Treaty, the international community had not made significant efforts to curb treaty shopping. Such efforts have occurred more recently, resulting most notably in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the MLI), which Canada, Luxembourg and many of Canada's other treaty partners have signed and ratified.

The impact of the SCC's decision on future transactions has been tempered by the introduction of the MLI and, in particular, the introduction of the principal purpose test (PPT), as well as the amended preamble (which indicates that treaties are not intended to create opportunities for non-taxation or reduced taxation through treaty-shopping arrangements). The PPT is a broad anti-avoidance rule that is applicable to many of Canada's bilateral treaties pursuant to the MLI. Largely similar to the GAAR, the PPT denies a treaty benefit where it is reasonable to conclude that one of the principal purposes of the arrangement or transaction in question was to gain the benefit, unless it is established that granting that benefit would be in accordance with the object and purposes of the relevant treaty provisions.

Going forward, the interaction between the GAAR and the PPT will be a key issue as tax disputes arise involving treaties covered by the MLI. As well, Budget 2021 confirmed that the government would take steps to strengthen and modernize the GAAR, as had been announced in the 2020 Fall Economic Statement. It remains to be seen what, if any, modifications are made in response to *Alta Energy* and other recent GAAR decisions.

Canada v. Loblaw Financial Holdings Inc.

In *Loblaw Financial*, the SCC unanimously affirmed the decision of the FCA that Canada's FAPI regime did not apply to tax Loblaw Financial Holdings Inc. on the income of its Barbados resident subsidiary, Glenhuron Bank Limited.

The decision provides rare guidance from our highest court on how to interpret and apply important elements of the foreign affiliate rules in 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.

In this case, the Minister of National Revenue (the Minister) assessed Loblaw on the basis that Glenhuron carried on an "investment business," as defined in subsection 95(1) of the Tax Act and that its income was FAPI. Under the FAPI regime, a Canadian resident taxpayer may be required to pay tax in Canada on certain income earned in a foreign subsidiary. The Minister's position was that Loblaw did not qualify for the financial institution exception to that definition. As an alternative to her primary assessing position, the Minister also relied on the GAAR.

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 to conduct business principally with arm's length persons (namely, the arm's length test). Glenhuron therefore could not benefit from the exception. The TCC also concluded in *obiter* that the GAAR did not apply because there was no avoidance transaction.

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.

Although the Crown did not rely on the GAAR in its appeal, it argued, among other things, that the arm's length test should be interpreted in its favour because Glenhuron's income would otherwise not be subject to tax in Canada. In response to this argument, the FCA observed that such concerns do not enable courts to give statutory provisions a broader interpretation than they can reasonably bear. Gaps in legislation, if any, are for Parliament to address.

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.

In response, Loblaw Financial took the position that Parliament had made explicit tax policy choices and enacted specific provisions in the FAPI rules to ensure that precisely the type of income earned by foreign affiliates like Glenhuron would not be taxed in Canada. It argued that the Crown's interpretation of the arm's length test was at odds with that explicit legislative direction. Osler acted for Loblaw Financial.

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, Justice Côté held that courts should "focus carefully on the text and context in assessing the broader purpose of the scheme."

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

This ruling accords with longstanding SCC precedent, and with the prior published administrative practice of the CRA interpreting the financial institution exception. The interpretive approach taken by the Court also echoes the majority reasons in the context of tax treaty interpretation in the *Alta Energy* decision. 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.

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.

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Canada v. Deans Knight Income Corporation

Most recently, on October 4, 2021, the taxpayer sought leave to appeal the FCA's decision in *Canada v. Deans Knight Income Corporation*. This third case concerned the application of the GAAR to a tax loss monetization arrangement. The application for leave to appeal was accompanied by a letter of support from the Tax Executives Institute, which was intended to provide a "cross-industry voice to the choir of business taxpayers concerned about the newfound uncertainty" created by the FCA's decision.

The case involves the application of the loss restriction rules in subsection 111(5) of the Tax Act as well as the GAAR. Under the rule in subsection 111(5), if a person or group of persons acquires *de jure* control of a corporation, the corporation's use of losses incurred before that time is restricted. The Canadian courts have confirmed that *de jure* control, which is also known as effective control, means the acquisition of a majority of voting shares by persons in a position to vote them in common.

The taxpayer in this case was a Canadian public corporation with tax attributes comprising unused non-capital losses and other deductions. The taxpayer sought to monetize these tax attributes. To do so, it underwent a reorganization that "turned the reins" over to a venture capital company, Matco Capital Ltd. (Matco). However, Matco did not acquire *de jure* control of the taxpayer. Matco arranged for the taxpayer to complete an initial public offering (IPO), with the taxpayer using the funds raised from the IPO to commence a new business that generated profits against which the losses were claimed. As a result of the IPO, the taxpayer became widely held and no specific person or group of persons acquired voting control of the taxpayer.

The Minister assessed the taxpayer to deny the pre-IPO losses on the basis that they had been lost as a result of an acquisition of control of the taxpayer or, alternatively, that the GAAR applied to prevent the taxpayer from claiming them. The TCC disagreed with this assessing position. It determined that the policy of subsection 111(5) is "to target manipulation of losses of a corporation by a new person or group of persons, through effective control over the corporation's actions," and that Matco did not have effective control.

The FCA allowed the Crown's appeal and overturned the TCC decision. Despite acknowledging that the term "acquisition of control" in subsection 111(5) had been judicially determined to mean *de jure* control,[1] the FCA concluded that the policy of the provision required it also to apply where there has been an acquisition of "actual control." The FCA thus "rearticulated" the policy of subsection 111(5) as restricting "the use of specified losses, including non-capital losses, if a person or group of persons has acquired actual control over the corporation's actions, whether by way of *de jure* control or otherwise." Having made this determination, the FCA concluded that Matco had "actual control" of the taxpayer and, as a result, the GAAR applied.

As in *Alta Energy* and *Loblaw Financial*, the decision in *Deans Knight* considers arguments in which the Crown seeks to characterize the policy of specific tax provisions broadly by reference to economic realities and use that characterization to interpret the relevant text. The decision has been criticized in the tax community for the uncertainty caused by the FCA's adoption of a novel and undefined concept of "actual control" that is distinct from the two other control concepts – *de jure* (legal) and *de facto* (factual) control – which are used throughout the Tax Act and have a generally understood meaning.

The SCC will likely render its decision on whether leave should be granted in *Deans Knight* in 2022.

1 This generally means the ability, through the ownership of shares, to elect the majority of the board of directors.

Concluding observations

In *Alta Energy* and *Loblaw Financial*, our highest court has provided important guidance on the principles of statutory interpretation, both in the ordinary and GAAR contexts. Additional guidance may be forthcoming if leave is granted in *Deans Knight*. Given the fundamental role of statutory interpretation in tax cases, the direction received from the Court is likely to impact the scope of future disputes and tax planning.

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