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Tax

Tax Court of Canada Decisions Relating to Non-Resident Trusts

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The Tax Court of Canada (the Court) recently released two decisions affecting the use of trusts as tax planning vehicles. Both cases involved offshore trusts that had trustees resident in Barbados and beneficiaries resident in Canada. In both cases, the taxpayers had arranged their affairs so that capital gains from the disposition of assets would be realized by the trusts in Barbados and not subject to tax. An exemption from Canadian tax liability would be claimed under the *Canada-Barbados Tax Treaty* (the Treaty). In both cases, the Court held the arrangements failed.

In *Garron Family Trust et al. v. The Queen*, the Court shifted away from the generally accepted, long-standing, common law basis for determining trust residency based on trustee residence to a residency determination based on the location of the central management and control of the trust. In *Antle et al. v. The Queen*, the Court held that the trust arrangement failed as the requirements for the valid formation of a trust were not met, and that in any event, the General Anti-Avoidance Rule (GAAR) would have applied to deny the benefit.

GARRON FAMILY TRUST ET AL. V. THE QUEEN – ESTATE FREEZE IN FAVOUR OF BARBADOS TRUSTS

Trust Residence determined based on Location of Central Management and Control, not Residence of Trustee

Garron concerned a disposition of shares of Canadian corporations by two offshore trusts with Canadian resident beneficiaries which were formed in 1998 (the 1998 Trusts). The sole trustee of each 1998 Trust was a corporation resident in Barbados (the Trustee). The 1998 Trusts had been settled in the context of a corporate reorganization of PMPL Holdings Inc. (PMPL). The reorganization involved an estate freeze in favour of the 1998 Trusts. The 1998 Trusts were sole shareholders of Canadian holding corporations which acquired non-voting common shares in PMPL for nominal consideration. In 2000, as part of an arm's-length sale, the 1998 Trusts disposed of the majority of their interests in the Canadian holding corporations, realizing capital gains of over C$450-million. In their income tax returns for the 2000 taxation year, the 1998 Trusts sought a return of the amounts withheld on the sale (pursuant to section 116 of the *Income Tax Act* (the Act)), claiming an exemption from Canadian tax liability under the Treaty. Article XIV(4) of the Treaty provides that, subject to exceptions that did not apply, gains from the alienation of property may only be taxed by the state where the alienator is resident. Under the Barbadian tax law, the gains would not have been subject to tax and, accordingly, if the Treaty exemption applied, the 1998 Trusts would not face any tax liability for the gains. The 1998 Trusts asserted that the Treaty exemption was available as the 1998 Trusts were resident in Barbados. The Minister of National Revenue (the Minister) took the position that the exemption did not apply and assessed the 1998 Trusts in respect of the gains.

The Minister's primary argument was that the Treaty exemption was unavailable as the 1998 Trusts were resident in Canada. Although the Trustee's residence was acknowledged to be in Barbados, the Minister submitted that the Trustee was a compliant trustee and that true management and control of the 1998 Trusts was exercised by certain Canadian resident beneficiaries. The 1998 Trusts relied on a 1978 decision of the Federal Court, *Thibodeau Family Trust v. The Queen*, for the position that a trust is resident in the jurisdiction where its trustee resides, and that the place of central management and control, the test that applies in determining the residency of corporations, does not apply to trusts. The 1998 Trusts' position was consistent with the general understanding of tax practitioners with respect to determinations of trust residency.

The Court dismissed the 1998 Trusts' appeals and held that the judicial test of residence that has been established for corporations, "where the central management and control actually abides", should apply to trusts with appropriate modifications. The Court stated that *Thibodeau* should not be taken as setting out a test for trust residence based solely on residence of the

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trustee; rather, *Thibodeau* was intended to be limited to its particular facts. The Court further held that the statement in *Thibodeau* rejecting the central management and control test was premised on the idea that management and control of the trust must reside with the trustees because trustees cannot delegate their authority to others as it would be a breach of their fiduciary obligations. In the Court's view, it is inappropriate to presume that trustees are complying with their fiduciary obligations and this must be determined based on the particular facts of the situation.

As for the meaning of "management and control", the Court in *Garron* looked to the corporate context and stated that management and control is usually found to reside with the directors even though they may be under significant influence from shareholders or others, and while no definitive statement could be made, something more than evidence of mere influence would be required to find that management and control was located with the shareholders. In the trust context, it was noted that effective management occurs where key decisions are made notwithstanding that a trustee may be making certain low level decisions elsewhere.

The Court considered a number of factors to be relevant in determining that management and control of the 1998 Trusts resided with the Canadian resident beneficiaries and not the Trustee. The Court found that the Trustee had been selected by or on behalf of the beneficiaries to provide administrative services with respect to the 1998 Trusts. The Court found that the Trustee's role was to execute documents as required and provide incidental administrative services, and it was generally not expected that the Trustee would have responsibility for decision-making beyond that. Although there was no explicit evidence that this was the case, the Court came to this conclusion based on the evidence as a whole including the failure of the appellants to provide evidence establishing otherwise. The Court noted that although the administrative nature of the trustee arrangement was likely unwritten, it was effectively enforceable through a protector mechanism that allowed the protector to replace the Trustee, and the protector itself could be replaced by the beneficiaries. The Court also found that, more likely than not, the Trustee had agreed from the outset that it would defer to the beneficiaries' recommendations, and that the beneficiaries also understood this to be the arrangement. The factors the Court considered in concluding that the Trustee had a limited role were as follows:

1. *Internal Memoranda indicating Limited Role:* There were internal memoranda setting out the intentions of the Trustee, and these documents showed that the Trustee's role would be more limited than contemplated in the trust indentures. Specifically, the Court found that the internal memoranda indicated that the Trustee's role in respect of the arm's-length share sale was administrative in nature and that the Trustee would not make distributions to certain beneficiaries without the consent of other beneficiaries.

2. *Trust Investments appeared to be Under Control of the Beneficiaries:* In the Court's view, the evidence also suggested that investment of the share sale proceeds was under the direction of certain Canadian resident beneficiaries of the 1998 Trusts because the investment advisors were the same as the applicable beneficiaries' investment advisors and the advisors appeared to have been selected and directed by these beneficiaries rather than the Trustee.

3. *Tax Advisors appeared to be Directed by the Beneficiaries:* The Court found that the evidence suggested that the tax minimization plans developed by the tax advisors were under the direction of certain of the beneficiaries of the 1998 Trusts rather than the Trustee.

4. *No Documentation was provided as Evidence that the Trustee played an Active Role:* There was no documentary evidence that the Trustee had any involvement beyond executing agreements and providing administrative services.

5. *Trustee's Expertise in Managing Trust Assets was Questionable:* For a significant period of time, the Trustee had been an arm of an accounting firm, and was likely formed to complement the tax services offered by the firm. The Court found that it was questionable on the evidence whether the firm had any expertise in managing trust assets.

6. *Oral Testimony was not inconsistent with the view that the Trustee had a Limited Role:* The Court found that the oral testimony was also consistent with the view that the Trustee had a limited role because it appeared that the Trustee was not sufficiently informed of matters related to the share sale transactions, the

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beneficiaries seemed to have little interest in what the Trustee was doing, the Trustee appeared to have done minimal due diligence (e.g., on investments of the 1998 Trusts) to ensure that its fiduciary obligations were being complied with and the Trustee did not appear knowledgeable about the 1998 Trusts' investments.

On the basis of the foregoing, the Court found the management and control of the 1998 Trusts to reside with certain Canadian resident beneficiaries and, accordingly, the 1998 Trusts were found to be resident in Canada.

The Minister had also argued, in the alternative, that if the 1998 Trusts were not Canadian residents under the common law test, they should be deemed residents pursuant to paragraph 94(1)(c) of the Act, which deems an offshore trust to be a Canadian resident for certain purposes where particular conditions are met. Among other things, paragraph 94(1)(c) applies where the trust has acquired property, directly or indirectly, from a Canadian resident beneficiary. The Court found there was no transfer of property, but commented that even if paragraph 94(1)(c) had applied, the exemption pursuant to Article XIV(4) of the Treaty would still be available as the scope of taxation imposed under paragraph 94(1)(c) was limited and not sufficient to result in Canadian residency for Treaty purposes.

The Minister further argued that even if tax would not otherwise be exigible under the Act, the GAAR should apply to deny the benefit. The Minister argued that it was abusive to use the Treaty to avoid anti-avoidance legislation such as section 94. The Court rejected this argument, and held that it is not necessarily a misuse or abuse to use the Treaty exemption to avoid an anti-avoidance rule under the Act. Further, the Organisation for Economic Cooperation and Development's commentary to the model treaty, upon which the Treaty was based, noted that while treaties are not intended to assist with tax avoidance, they should be amended to take into account domestic tax avoidance legislation. The Court found that, had the drafters intended section 94 to override the Treaty, they would have specifically provided for this. The Minister made other arguments in an attempt to establish an abuse of the Treaty. However, the Court concluded that the Minister had failed to establish that the avoidance transactions resulted in an abuse of the Treaty.

IMPLICATIONS

Contrary to what many in the tax and estate planning community have long believed, it appears that the residence of a trustee will not suffice to establish the trust's residence for tax purposes. This will likely be relevant for determining trust residency not only at the federal level, but also with respect to inter-provincial trust arrangements. If the reasoning in *Garron* is followed, the Canada Revenue Agency and Canadian courts will now be applying a test of central management and control.

To avoid a finding that someone other than a trustee effectively controls a trust, management and control of a trust must remain with the trustees. It is critical that authority for significant decisions remain with the trustee. The mere fact that beneficiaries or other persons have some influence over the trustee should not be sufficient to shift the trust's residence to align with these persons. However, it will be necessary to ensure that the trustee has sufficient independent decision-making power and it will also be prudent to compile express evidence of this arrangement. This evidence may include communications with persons advising the trustee, with such communications providing evidence that the trustee is independently making decisions and is complying with its fiduciary obligations. In situations where the trustee does not follow recommendations made to it by beneficiaries or other persons connected with the trust, evidence of these independent actions should also be maintained as evidence of the exercise of authority by the trustee.

ANTLE ET AL. V. THE QUEEN – CAPITAL PROPERTY STEP-UP STRATEGY

Court Finds that Trust Not Validly Constituted and Concludes that GAAR would have Applied

Antle involved a transaction known as a "capital property step-up strategy". Mr. Antle had transferred shares with an accumulated gain to a Barbados spousal trust (the Antle Trust) in favour of his wife. Because paragraph 94(1)(c) deemed the Antle Trust to be a Canadian resident, the spousal rollover rules applied and no tax liability arose on the transfer. The Antle Trust then sold the property to the beneficiary wife in exchange for a promissory note, who in turn sold it to a third party for the same amount and used the proceeds

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to pay off the Antle Trust. The Antle Trust then distributed the funds tax-free to the wife and was dissolved. Had the arrangement succeeded, the result would have been zero tax liability, as there was no capital gain taxable in Canada (the wife personally made no profit on the share sale, and the Antle Trust could claim the exemption pursuant to Article XIV(4) of the Treaty), and the gain arising to the Antle Trust was not subject to tax in Barbados. The Minister challenged the strategy on a number of grounds, issuing assessments against both Mr. Antle and the Antle Trust.

The Court disposed of the appeal on the basis that the Antle Trust had not been validly constituted and, thus, never came into existence. To constitute a valid trust, three certainties must exist (intention, subject matter and object), and there must be a completed transfer of the subject property by the settlor to the trust. The Court found that certainty of intention had not been made out. Notwithstanding that the trust deed was explicit as to the intent to settle the Antle Trust, the Court held that the search for intention should not be limited to the trust document alone, and that the actual conduct of the parties was relevant to determining the settlor's true intent. Here, the steps in the transaction had all been pre-ordained by legal and financial advisors, and Mr. Antle's sole concern was that the transactions were effective so as to avoid or minimize tax. The Court held that the circumstances were not indicative of an intention to settle a trust, but rather, if Mr. Antle had intended the trustee to play any role, it was at best as an agent in a gift from Mr. Antle to his wife. The Court further found that certainty of subject matter was lacking, and the Antle Trust also failed as Mr. Antle had never properly settled the shares. The trust deed itself was not worded to effect a transfer, and the directors' resolution purporting to authorize the transfer was backdated. As well, Mr. Antle's share certificate did not indicate a transferee, was not in fact delivered until after the purported settlement of the Antle Trust, and was not delivered to the trustee but directly to the ultimate third-party purchaser. Finally, the share certificate was pledged as security and the release by the Creditor made no mention of a transfer to the Antle Trust. Given these findings, the Court held that no trust was duly constituted, quashed the Antle Trust's appeal and dismissed Mr. Antle's.

The Court also considered whether, if the Antle Trust had been validly constituted, it was nonetheless a sham. The Minister argued that the terms of the Antle Trust giving the trustee discretion were a deception. The Court found that the trustee did not have any real discretion as the matters were pre-ordained. The trustee received the shares on the basis that the sole beneficiary had already agreed to buy them and, by distributing the proceeds of such sale back to the beneficiary, there was no possibility of any comeback against him. As such, the arrangement was, in and of itself, void of discretion. Further, the sole purpose for the arrangement was to avoid tax. However, the Court noted that a sham requires an element of deceit, and that it is necessary for both the settlor and the trustee to be parties to the sham. The Court found that if there had been any deception, it was an innocent self-deception on the part of Mr. Antle and the trustee, as Mr. Antle did not fully appreciate what a trust was, and the trustee was "a young pawn in a masterful game of chess by some experienced chess masters" (i.e., the legal and accounting advisors). Accordingly, the Court held that notwithstanding the lack of discretion and avoidance motivation, the Antle Trust was not a sham.

Finally, the Court considered whether, if the Antle Trust was properly constituted and not a sham, the GAAR should apply to deny the tax benefit. The Court found this to be the case for Mr. Antle but not for the Antle Trust. The Court noted that it should consider not only the provisions relied on by the taxpayer, but also those circumvented, being the attribution rules in sections 74.1 to 74.5 of the Act. Looking at the rollover and attribution rules, together with the paragraph 94(1) (c) deemed residency for certain offshore trusts, the Court found that the object, spirit and purpose of the provisions was to ensure taxation of Canadian residents on capital gains arising on disposition of capital property outside the marital unit, including through the use of offshore trusts. The Court held that while the Treaty might save the Antle Trust, it was not intended to save the Canadian resident from the application of GAAR in the circumstances before it. The Court held that the Act and Treaty contemplate payment by Canadian residents of Canadian income tax on a gain arising on the sale of property held by a Canadian marital unit, and did not contemplate running property through Barbados and returning it to the Canadian marital unit for the sole purpose of escaping that Canadian payment of tax. Accordingly, the Court found there had been an abuse of the Act, of the Treaty and of the joint operation of both.

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IMPLICATIONS

The decision in *Antle* indicates that where a trust is perceived as having been settled for tax purposes, the courts will scrutinize the arrangements and transactions very closely.

In finding that the Trust in *Antle* never came into existence, the Court made the following comments:

> "This conclusion emphasizes how important it is, in implementing strategies with no purpose other than avoidance of tax, that meticulous and scrupulous regard be had to timing and execution. Backdating of documents, fuzzy intentions, lack of transfer documents, lack of discretion, lack of commercial purpose, delivery of signed documents distributing capital from the trust prior to its purported settlement, all frankly miss the mark – by a long shot. They leave an impression of elaborate window dressing. In short, if you are going to play the avoidance game, it is not enough to have brilliant strategy, you must have brilliant execution."

Accordingly, when entering and carrying out trust arrangements for tax planning purposes, care should be taken to ensure that all formalities are strictly complied with and the timing of various steps in the process is given due attention up front.

With respect to the GAAR, the Court clearly felt the taxpayer should not be able to avoid tax on the gain. In arriving at its conclusion, the Court appears to be saying that the Canadian government could never have contemplated this use of an offshore trust to avoid Canadian tax by a marital unit, and that an absence of anti-avoidance rules for a particular transaction cannot be taken as a basis for inferring policy. One significant factual difference in the GAAR analysis between *Garron* and *Antle* is that in *Antle*, the gain had accrued while the property was owned by a Canadian resident whereas in *Garron*, had the 1998 Trusts been found to be resident in Barbados, the gains would have accrued while the property was owned by non-residents of Canada. The implications of the *Antle* decision for inter-provincial tax planning are not clear. The Act includes deemed disposition rules to ensure that tax is paid on a change of federal residency while the provincial income tax acts do not generally contain rules that would trigger provincial income tax where a taxpayer's provincial residence changes. The only GAAR case to date dealing with the application of a provincial GAAR to inter-provincial tax planning is *OGT Holdings Ltd. v. Quebec* where the Quebec Court of Appeal found a Quebec shuffle transaction that resulted in a complete avoidance of provincial tax to be abusive.

The comments of the Court in both *Garron* and *Antle* may be of assistance when considering whether the GAAR could apply to a taxpayer on the basis of treaty shopping. In *Garron*, the Minister argued that the 1998 Trusts should not benefit from the Treaty because they had little connection to Barbados. The Court was unwilling to accept this argument stating that it would not be acceptable to apply the Treaty to residents of Barbados based on some criteria other than residence. In the Court's view, if the 1998 Trusts are resident in Barbados, the Treaty applies – it does not matter that the 1998 Trusts have few connections to Barbados. In *Antle*, the Court found that the GAAR applied to Mr. Antle rather than the Antle Trust. Throughout the GAAR discussion in *Antle*, it is clear that the Court was offended by the fact that Mr. Antle transferred a gain that had accrued in Canada to a Barbados trust which was not subject to Canadian tax. In looking at the Antle Trust in isolation from the rest of the series of transactions, the Court was not offended by the application of Article XIV(4) of the Treaty to the Antle Trust. In considering Article XIV(4) of the Treaty, the Court stated, "*Article XIV(4) is what it is*" – i.e., it simply states that gains are to be taxed in the alienator's country of residence, there is no further object or purpose to be found. Of course, it will always be necessary to consider the totality of the transactions to determine whether the GAAR could apply to other parties involved or in respect of provisions of the Act itself which may have been abused.

At the time of writing, neither case had been appealed, but the time for filing such appeals has not expired. We understand that *Garron* will likely be appealed.

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