TAB 7A

Case Law Alert – *Garron* and *Antle*

Case Comment*: Garron et al v. The Queen*

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Case Comment: *Garron et al v. The Queen*

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The Tax Court of Canada recently considered the residency of a Barbados trust in *Garron et al* v. *the Queen* ("***Garron***").[1] The court held that a capital gain was realized by the trust and was taxable in Canada. The basis of the court's decision was that the trust was a resident of Canada because it was effectively managed by residents of Canada. Like *Antle* (to be discussed in the next issue of this Newsletter), Garron raises important issues with respect to:

- the residence of trusts;
- the role and powers to be exercised by discretionary trustees; and
- the interaction of the general anti-avoidance rule and treaty provisions.

Background

Mr. Garron and his business partner, Mr. Dunin, both Canadian residents, owned and operated a profitable Canadian company (OPCo). As part of a 1998 reorganization, Mr. Garron and Mr. Dunin each incorporated holding companies and established irrevocable, discretionary family trusts for the benefit of themselves and their families.

Each trust was settled by an individual residing on the island of St. Vincent, and had, as the sole trustee, a corporate trustee resident in Barbados. At the time of the transactions, the trustee was owned by an international accounting firm. Each trust also appointed a "protector", who could be replaced by a majority of the beneficiaries that had attained a certain age. Each trust subscribed for shares of the respective holding company of the appellants. The holding companies, in turn, subscribed for new common shares of OPCo.

In 2000, the business was sold to a private equity fund, which purchased the shares of the holding companies owned by the Barbados trusts, resulting in a capital gain of approximately $450,000,000. The gains realized by the trusts were not subject to income tax in Barbados.

The applicable non-resident withholding tax, under section 116 of the *Income Tax Act* (Canada) (the "**Act**") was remitted to the Canada Revenue Agency (the "**CRA**"). The trusts then filed Canadian income tax returns requesting a refund of the tax so withheld, on the basis that they were residents of Barbados and therefore exempt from Canadian income tax under the *Canada–Barbados Tax Treaty* (the "**Treaty**"). Under Article XIV(4) of the Treaty, gains from the alienation of shares may only be taxed in the country of residence, provided that the property of the corporation in question does not consist principally of property situated in the other country. The Minister of Revenue held that the trusts were residents of Canada and that the Treaty exemption therefore did not apply.

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[1] Docket 2006-1405(IT)G, September 10, 2009.

As a protective measure, the Minister also issued assessments against four Canadian residents (including the appellants) with respect to the same gains under the attribution rules of subsection 75(2) of the Act. The Minister also argued that the allocation of the sales proceeds was not reasonable and that a portion of the proceeds should be reallocated from the trusts to these other Canadian residents. Lastly, the Minister invoked the general anti-avoidance rule (the "**GAAR**") in support of all the assessments.

Taxation of the Trusts

The Minister's primary argument was that the management and control of each trust was situated in Canada. The appellants, relying on *Thibodeau*,[2] argued that the residence of a trust should be determined with reference to the residence of the trustee and that the central management and control test (historically applied to determine the residence of corporations) was inapplicable to trusts. In the alternative, the appellants argued that the corporate trustee exercised management and control of the trusts.

Justice Woods concluded that *Thibodeau* does not propose that the residence of a trustee is always the deciding factor in determining the residence of a trust. She noted that in *Thibodeau*, the ruling was a dismissal of the position that a single trustee resident in Canada with no special authority could override a majority of trustees located in Bermuda.

Further, Justice Woods disagreed that the central management and control test was not appropriate for trusts simply because trustees are fiduciaries at law and, as such, would be in breach of their fiduciary obligations if they were to adopt a "policy of masterly inactivity". In her opinion, one cannot presume that trustees will always appropriately discharge their fiduciary obligations, and reference must be made to the particular facts of any situation.[3]

While Justice Woods acknowledged that there are significant differences between the legal natures of a trust and a corporation, she concluded that corporations and trusts share similar characteristics, primarily the management of property. Further, adopting a similar test of residence for trusts and corporations would promote consistency, predictability and fairness in the application of tax law – a clear nod to the Supreme Court of Canada (SCC) decision in *Canada Trustco*.[4]

Therefore Justice Woods concluded that one must determine where the central management and control of a trust actually abides. Applying this test, she ruled that the corporate trustee handled very little outside of routine administrative matters for the trust:

> Based on the evidence as a whole, I find that St. Michael was selected by Mr. Dunin and Mr. Garron, or advisers acting on their behalf, to provide administrative services with respect to the Trusts. Its role was to execute documents as required, and to provide

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2 *Thibodeau Family Trust* v. *The Queen*, 78 DTC 6376 (FCTD).

3 Support for this approach was found in *Robson Leather Company Ltd.* v. *MNR*, 77 DTC 5106 (FCA), a decision of the Federal Court of Appeal released just prior to *Thibodeau* but not mentioned in the decision.

4 *Canada Trustco Mortgage Co.* v. *R.*, 2005 SCC 54 (SCC).

> incidental administrative services. It was generally not expected that St. Michael would have responsibility for decision-making beyond that.[5]

She also noted that the corporate trustee, as an "arm" of a major accounting firm, seemed to be established to provide complementary services to the core tax services offered by the accounting firm, rather than specializing in the management of trust assets. This failure to appoint a "well-recognized trust corporation with significant experience and expertise in managing trusts" seems to have led to the conclusion that one cannot presume that the trustee would act in the best interests of the beneficiaries in the discharge of its fiduciary responsibilities.

Justice Woods also focused on a number of other facts:

- the purpose of the trusts, namely to avoid Canadian tax;
- the active role Mr. Dunin played in selling the shares owned by his trust;
- the active role played by the appellants and their personal advisers in developing the investment strategy of the trusts;
- the appellants' ability to replace the corporate trustee (through the protector);
- the inability to provide documentation showing that the corporate trustee played an active role in managing the trusts;
- an internal memorandum setting out the intention of the corporate trustee (which indicated a more limited role than the trust indenture – notably, that the corporate trustee would act in an administrative capacity with respect to the sale of the business and would not make distributions to the beneficiaries without the consent of the appellants); and
- the lack of credible witnesses actively involved in the management of the trusts at the relevant time.

Accordingly, Justice Woods concluded that the real decisions were ultimately made by the appellants in Canada. As the central management and control was exercised in Canada, the trusts were resident in Canada and ineligible to use the Treaty to avoid Canadian income tax on the capital gains. Notably, even though Justice Woods concluded the appellants effectively managed the trusts, she did not go so far as to say that the trusts were never validly constituted.

The Minister had argued in the alternative that, if the test of central management and control was not the proper test in determining residency, the trusts would still be ineligible to use the Treaty because they would be deemed resident under section 94 of the Act. Section 94 deems a non-resident trust to be a resident of Canada for purposes of Part 1 of the Act where, generally, property is transferred directly or indirectly to a non-resident trust by a Canadian resident who is related to the beneficiary of the trust.[6]

The issue was whether the appellants had transferred property "directly or indirectly in any manner whatever" to the trusts. Mr. Garron argued that the trust subscribed for shares of a holding company and had not received the shares of the holding company from him.

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5 Paragraph 189.

7 For discretionary trusts, the taxable income of the trust is deemed by paragraph 94(1)(c) to be the total of its Canadian source income and its foreign accrual property income (FAPI).

Mr. Dunin's circumstances were slightly different as he owned the shares directly before transferring the shares into a holding company as part of the reorganization. He argued that, although he transferred the shares to the holding company, which, in turn, issued shares to his trust, the transactions were separate and did not constitute an indirect transfer under paragraph 94(1)(b).

Justice Woods reviewed *Romkey*[7] and *Kieboom*[8] and concluded that the reorganization did involve a transfer of property, as the 1998 reorganization resulted in a "movement of share rights."[9] However, she also concluded that neither of the appellants had directly or indirectly transferred property to the trusts. In Mr. Garron's case, she concluded he merely participated as a shareholder of his holding company. With respect to Mr. Dunin, she stated that "directly or indirectly in any manner whatever" is highly ambiguous and that it was not clear whether Parliament intended this phrase to apply only to the manner in which the transfer is effected or to indirect shareholdings as well. In her opinion, having to look through all transfers and levels of corporations would result in much uncertainty and ambiguity:

> I am particularly troubled by the uncertainty that is inherent in the Minister's position. Determining ownership of property through a chain of corporations is a murky exercise with unclear results. Should one look through more than a first tier subsidiary? Should one look through a corporation that is not wholly owned? Should one look through if the shares are non-voting?[10]

The number of persons that could potentially be caught under a broad reading of "directly or indirectly" could not have been what Parliament intended; therefore, she concluded that "directly or indirectly" should be read narrowly.

Justice Woods also commented on whether a trust deemed resident under section 94 of the Act would be considered to be a resident for Treaty purposes. Section 94 subjects trusts to taxation on a formula or source basis whereas a resident of Canada is subject to taxation on their worldwide income. Justice Woods concluded that the drafters of the Treaty did not intend to include as "residents" persons subject to taxation on a more limited scope than persons subject to taxation under general principles. The Minister's position was also determined to be inconsistent with the approach taken by the SCC in *Crown Forest.*[11] Therefore, the fact that section 94 deemed a trust to be resident in Canada did not result in the trust being a resident for Treaty purposes.

Taxation of the Canadian Residents

In the event that the trusts were not found to be residents of Canada, the Minister made two alternative arguments seeking to tax the gains in the hands of the appellants directly.

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7 *The Queen* v. *Kieboom*, 92 DTC 6382.

8 *Romkey* v. *The Queen*, 2000 DTC 6047.

9 This conclusion may raise interesting questions in the context of an estate freeze.

10 Paragraph 300.

11 *The Queen* v. *Crown Forest Industries Ltd.*, 95 DTC 5389 (SCC).

The first argument was that the attribution rules under subsection 75(2) of the Act applied. Subsection 75(2) states that where property held by a trust may revert to the person from whom it was directly or indirectly received, the capital gains and losses arising from the property are taxable in that person's hands so long as the person is alive and resident in Canada.

The appellants again argued that the transfer was not from them but rather from their holding companies. Justice Woods agreed, but also went on to comment that attribution under subsection 75(2) would frustrate one of the primary objectives of the Treaty, the avoidance of double taxation, because Article XIV(4) of the Treaty clearly reserved to Barbados the right to tax capital gains of trusts resident there.[12] If it was intended that Canada be allowed to tax in these circumstances, such right should be included in Article XXX(2), similar to the override provision of the Treaty to allow for the taxation of FAPI earned by non-resident corporations.

The second argument raised by the Minister was that the trusts received an unreasonable portion of the proceeds from the sale of the companies and that a portion should be reallocated to the appellants and the other Canadian residents under section 68 of the Act. The Minister's position was that the fair market value of the common shares exchanged for the preferred shares in the reorganization was substantially higher than the value assigned to them by the appellants. Justice Woods agreed with the Minister that the common shares were worth substantially more. However, in light of her conclusion on the other issues, Justice Woods declined to make further comments on this point.

The GAAR

Lastly, the Minister argued that the transactions were subject to the GAAR. In accordance with *Canada Trustco,*[13] the GAAR requires a three-step analysis: there must be a tax benefit; the identification of an avoidance transaction; and a finding of misuse and abuse of the legislative provisions.

As both sides agreed that a tax benefit and avoidance transaction occurred, Justice Woods only considered whether there was a misuse or abuse of legislative provisions or the Treaty. The Minister argued that the 1998 reorganization was undertaken solely to minimize Canadian income taxation; in particular, the transactions were undertaken to avoid the application of section 94 and subsection 75(2) of the Act, and that it was an abuse of the Treaty to avoid section 94.

With respect to subsection 75(2), the Minister had failed to raise this argument in pleadings and therefore Justice Woods refused to consider it. With respect to section 94, she commented that in accordance with *Canada Trustco*, the onus was on the Minister to identify an object, spirit or purpose of provisions that are misused or abused. However, she concluded that the mere fact that a transaction is subject to tax under an anti-avoidance provision of the Act, but is relieved by a

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[12] Justice Woods' logic as to the appropriate interpretation of treaties in such circumstances should be familiar to the CRA. They previously ruled on a treaty interpretation issue that a partnership treated as a corporation in the United States for purposes of the Internal Revenue Code and the Canada-U.S. tax treaty was entitled to exemption from Canadian tax on certain gains. Similarly, the fiscally transparent LLCs which were the partners were not subjected to Canadian tax on the gain. See 2005-0140221R3 -- Disposition of taxable Canadian property.

[13] 2005 SCC 54.

treaty, does not necessarily result in a misuse or abuse for the purposes of the GAAR. In support of her conclusion, Justice Woods noted that commentary to the OECD Model Tax Convention suggests that countries should adopt language in their bilateral tax treaties to preserve the application of domestic tax avoidance legislation and that Canada had adopted the commentary at the time that the Treaty was signed. Since no such language had been included in the Treaty, however, Canada had presumably not intended for the GAAR to override the Treaty. The transactions therefore did not constitute an abuse or misuse of the Treaty and the GAAR did not apply.

Implications of *Garron*

Garron has important implications for taxpayers and their advisers, notably in relation to the use of trusts and the interaction of tax treaties and the Act. It is too early to know, but we anticipate that the *Garron* decision may be appealed in light of the amounts involved and the complexity of the issues at hand.

Residency of Trusts

The fact that the trustee was determined to have little independent decision-making authority and that other persons exercised considerable influence over the management of the trust was critical to the conclusions reached in *Garron*. It is clear from this decision that the actual conduct and intention of the parties will be taken into account, and not simply the trust agreement and related transaction documentation.

Garron is heavily fact dependent. It remains to be seen how the central management and control test will be applied in other scenarios. For example, many trusts may only hold shares of an investment holding corporation. What level of active management and control is realistic to expect when that is the only asset of the trust? Did it matter in *Garron* that the trustee was a corporation and might a different conclusion have been reached with compelling testimony from an individual trustee?

The decisions in *Garron* appear to strengthen the CRA's position in relation not only to offshore, but also interprovincial, trust arrangements. *Garron* suggests that, depending upon the facts, a trust may be resident in the jurisdiction in which the contributor or beneficiary resides, on the basis that that central management and control does not in fact rest with the trustee. Further along the spectrum, *Antle* is authority that in more questionable situations, the degree of control exercised by the beneficiary or settlor may be a factor that is inconsistent with the very existence of the trust.

Garron is also arguably consistent with the approach adopted by the CRA in determining the residency of trusts with corporate trustees (*i.e.*, trust companies).[14]

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[14] In paragraph 7 of Interpretation Bulletin IT-477 "Residence of Trusts" it is noted that

> Where a corporation exercises the management and control of a trust, the residence of that corporation is determined based on the normal factual tests for determining residence of a corporation. An exception to the general rule may be encountered where the management and control of a trust is exercised by a branch office, for example, a branch of a trust company. In these circumstances, the trust may be determined resident in the jurisdiction where the branch office is located even though the corporation itself is resident outside that jurisdiction.

The GAAR

The decision in *Garron* is important for Justices Woods' conclusion that reliance on a Treaty provision to avoid the application of an anti-avoidance provision of the Act was not inherently abusive. Notably, in *Antle*, a different conclusion was reached on GAAR. In *Antle*, Justice Miller found reliance on the Treaty to be abusive. A factor for the difference in the GAAR conclusions might have been the manner in which taxation of capital gains was avoided. In *Antle*, the appellant tried to avoid subjecting to Canadian tax the full gain resulting from the sale through the use of the spousal trust rollover provisions and the Treaty. In *Garron,* the avoidance was limited to the increase in value of the shares from the date of the reorganization to the date of sale.[16]

Deemed Residency

The decision is also significant in that Justice Woods reached the same conclusion as Justice Miller in *Antle*, that a trust deemed resident under section 94 of the Act is not considered resident of Canada for treaty purposes, and, as such, is not precluded from invoking the benefits of a treaty. This is a significant blow to the CRA and raises further doubt as to the effectiveness of the long-standing proposed amendments to section 94.

Transfers of Property – Directly or Indirectly

Justice Woods' interpretation that the phrase "directly or indirectly" (which appears throughout the Act) is to be applied in a narrow manner is a pragmatic approach that provides greater comfort for various tax planning strategies that could otherwise be considered to involve an indirect transfer of assets. Previous decisions have generally interpreted "directly or indirectly" to look at the substance of the transaction

In conclusion, taxpayers and their advisors will have to carefully consider *Garron* when implementing tax planning strategies involving a trust where the residence of the trust is a critical component of the plan. In light of *Antle*, it is unlikely that *Garron* will be the last word on the issues of trust residency, the interaction of the GAAR and tax treaties and the meaning of "directly or indirectly". Further developments are anticipated.

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[16] One might reasonably conclude – particularly in light of the comments of Justice Miller – that *Antle* was simply viewed as far more abusive. Indeed, the facts in *Antle* combine two elements, each of which was independently considered problematic in earlier GAAR jurisprudence: the avoidance of taxation on accrued capital gains (*OGT Holdings Ltd.*, 2009 CarswellQue 527 (Que.CA); and abuse of the interspousal rollover provisions (*Lipson*, supra).

TAB 7B

7B

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Case Comment: Antle

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Case Law Alert: Antle

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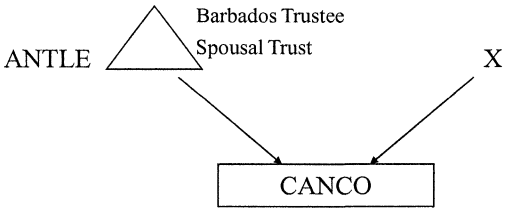
Paul Antle v. MNR
2009 TCC 465

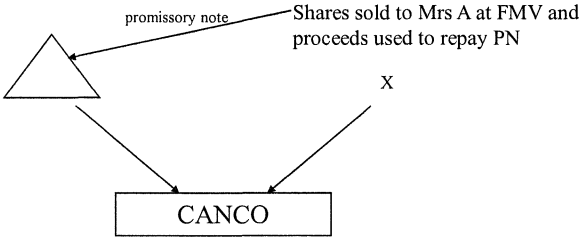
- "Capital property step up strategy"
- Shifting of capital property with an accumulated gain from husband (H) to Barbados spousal trust
- Spousal trust sells property to wife
- wife sells property to third party and uses proceeds to pay off the trust
- trust distributes funds to wife as beneficiary
- trust dissolves.

2

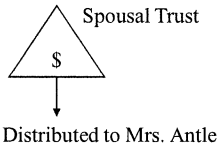


94(1)(c) ITA – Trust deemed to be Canadian resident so s. 73(1) spousal rollover rules applied and no liability arose on the transfer

3



4



Result

Capital property step up strategy → capital gain not taxable in Barbados

Antle trust in Barbados – exempt from tax pursuant to Article XIV(4) of Canada Barbados Tax Treaty.

5

Result

- Transfer to offshore spousal trust: Although trustees resident in Barbados, trust deemed to be resident in Canada (94(1)(c) for purposes of 73(1) deferral
- Therefore no tax as there is no capital gain taxable in Canada
- Sale of shares to wife at fmv for promissory note,and sale by spouse to third party: gain on sale to third party is treaty-protected in Barbados

6

MNR arguments

1. Trust not validly constituted and gain on sale to third party is taxable to H (MNR won)
2. Trust was a sham (MNR lost…there was no deception)
3. Taxable capital gains taxable in Canada on basis that trust resident in Canada 94(1)(c) (MNR lost)
4. SS. 73(1) not available so no rollover to spousal trust (MNR lost)

5. GAAR applies: abuse of 73(1), 74.2(2), 94(1)(c) (MNR wins)

7

Additional Relevant Facts

- 1998: Shares acquired by H in a transaction whereby he promised Seller 50% of profits of future sale; promise secured by delivery of share certificates to Seller endorsed in blank
- Sept 1999: H and partner negotiate sale to Third Party and enter into letter of intent
- Oct and Nov 1999: negotiations with Seller to release security and discussions re intention of H to engage in tax planning

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Trust settlement: additional facts

- Barbados Trustee signs deed of trust on Oct 27, 1999 but trust deed dated Dec 5, 1999
- Transfer of shares to trust planned for Dec 5, 1999
- Transfer from trust to spouse intended for Dec 8, 1999
- Antle signs all docs authorizing transfer of share to Trust on Dec 14, 1999 including Trust deed, directors' resolutions authorizing transfer of shares to the Trust etc)
- Sale closes on Dec 14 and proceeds received directly by H counsel.

9

Validity of Trust: Certainty of Intention

- No certainty of intention
- Court not restricted to reviewing the documents in determining certainty of intention
- Trust settled only on Dec 14 when H signed the trust deed.
- Prior to Dec 14, terms of ultimate sale transaction had been settled
- Trustee was compliant trustee and at most an agent for the transfer to the spouse
- No intention to settle trust, thus Barbadian trustee not really the trustee

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Validity of Trust: Certainty of Subject matter

- The obligation of H to pay Seller to release shares meant that H retained some interest in the shares
- H made duress claim for recovery of the amounts paid to seller
- Seller was paid out of proceeds of sale of shares to third party
- Result: lack of certainty re what constituted subject matter of trust

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Validity of Trust: No actual transfer

- Directors resolution dated "as of December 5" but directors didn't meet till Dec 14
- Share certificates endorsed but not delivered till Dec 14 closing and never actually delivered to the Barbadian Trustee

- Conclusion: no valid trust. H sold shares to wife and gain on sale attributed back to H

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GAAR applied (s. 245)

- Lipson v. Canada and Canada Trustco Mortgage Co. have indicated that GAAR is a 3 step process:

  1. There must be a tax benefit arising from a transaction or series of transaction

  2. The transaction must be an avoidance transaction in that it cannot have been reasonably undertaken or arranged primarily for a bona fide purpose other than to obtain the tax benefit

  3. avoidance transaction must be abusive in that it cannot be reasonably concluded that tax benefit would be consistent with object, spirit or purpose of the provisions relied on by taxpayer

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GAAR and Antle Facts

- Settlement of trust was an avoidance transaction as sole purpose of taking advantage of 73(1) was tax avoidance and sale by trust to wife and by wife to third party and subsequent distribution to wife were transactions that were part of a series whose sole purpose was to obtain tax benefit
- Contrary to the object, spirit, purpose and policy of Canada's taxation laws and its international conventions

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Obiter Comments: Sham

- Court held no sham since no intention to deceive nor misrepresentation of the actual transaction taking place and even though artificiality, preplanned series of transactions and tax motivation

- (Snook v. London West Riding Investments Ltd (1967) 1 All ER 5518 (CA); Faraggi (Federal Court of Appeal); Shalson v. Russo (2005) Ch 281 (July 11, 2003)

15

Obiter: Residence of Trust

- If trust valid, it was resident in Canada for purposes of 73(1) because of application of 94(1)(c) and 250(5)
- Resident in Barbados for treaty purposes ..not subject to tax on worldwide income under 94(1)(c)

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