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Fundy Settlement v. Canada: FINAL DECISION ON THE PROPER RESIDENCY TEST FOR TRUSTS

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On April 12, 2012, the Supreme Court of Canada (SCC) issued its decision in *Fundy Settlement v. Canada*[1] (commonly known and hereinafter referred to as *Garron*), finding that the relevant trusts were resident in Canada rather than Barbados. In rejecting the appeals of the taxpayer trusts, the SCC held that the residency of a trust is where the trust's central management and control is exercised. This decision is significant as it represents a marked departure from previously established jurisprudence and the former administrative practice of the CRA. Surprisingly, until *Garron*, no litigation had reached the SCC to adjudicate on the proper test for residency of trusts despite the common use of trusts for tax and estate planning purposes.

Background

Canada taxes Canadian residents on their worldwide income. For individuals, the factual inquiry used to determine residency is often pretty straightforward due to the physical nature of human beings. For corporate taxpayers, a factual inquiry is conducted under the central management and control test. Stemming from the U.K. decision of *De Beers Consolidated Mines, Ltd. v. Howe*[2], this test tries to determine where the real business of a corporation is being carried on; holding that where a corporation "really keeps house and does business" is where the central management and control actually abides.[3] This test has been long adopted in Canada and consistently applied to determine the residency of corporations.

However, making determinations on residency is not an easy task when it comes to trusts because there are no characteristics that we can easily physically locate. A trust, in its most basic form, represents an obligation imposed by the settlor on the trustee towards the beneficiaries. How does one ascertain from this obligation where the trust is actually located? Turning to legislative guidance, there is no explicit residency test for trusts to be found in the *Income Tax Act*[4] so we must then look to case law. Due to the very nature of trusts, courts must look to the individuals who make decisions which affect the assets of a trust in order to determine residency. The question is which individuals should the courts look to?

Previous guidance on this question came from *Thibodeau Family Trust v. The Queen,*[5] a decision of the Federal Court of Appeal. The trust in *Thibodeau* involved three trustees: one of which was a Canadian resident and the remaining two trustees were resident in Bermuda. The trust deed set out that a majority decision was necessary in all matters of trustee discretion. Since decisions relating to trust assets and administration were made at meetings held in Bermuda and the approval of at least one Bermuda trustee was necessary for all decisions, it was determined that residence of the trust was in Bermuda. Following *Thibodeau*, the CRA released Interpretation Bulletin IT-447 which stated that:

> ...[A] trust is generally considered to reside where the trustee, executor, administrator, heir or other legal representative (hereinafter referred to as the trustee) who manages the trust or controls the trust assets resides.[6]

However, this did not resolve the issue in *Garron*, as it was found by the Tax Court judge that the trustees did not manage or control the trust assets; rather, such management or control was exercised by the beneficiaries. In this type of situation, the issue is, to what or to whom are we to refer in order to determine residency?

Facts

The facts of *Garron* have been discussed at length and will only be briefly summarized here. Two trusts, the Fundy Settlement and the Summersby Settlement, were settled by an individual resident in St. Vincent at the instruction of one of the beneficiaries. The trustee of the trusts was St. Michael Trust Corp. (St. Michael), a corporation resident in Barbados. St. Michael had only one office in Barbados and its sole business activity was to act as trustee and administrator of certain trusts. The beneficiaries of the trusts, Mr. Garron and Mr. Dunin, were individuals resident in Canada. The main assets of the trusts were shares in two Ontario corporations. The trusts subsequently disposed of the shares to a third party purchaser and realized a $450 million capital gain on the sale.

As a result of the disposition, the purchaser remitted approximately $152 million to the Minister of National Revenue (the Minister) in compliance with section 116 to account for Canadian tax on the capital gains realized on the sale of the shares. The trustee sought a refund of this remitted amount based upon an exemption from Canadian tax on capital gains as set out in the tax treaty between Canada and Barbados[7] (the Treaty). According to the Treaty, tax on a gain in respect of the sale of shares is only payable in the country in which the seller was resident. Since St. Michael claimed that the residence of the trusts was Barbados, there would be no basis for Canada to tax the gain. However, the Minister was of the view that the trusts were resident in Canada, and that as such, the tax on the capital gains was payable.

Lower Court Decisions

Both the Tax Court of Canada[8] (TCC) and the Federal Court of Appeal[9] (FCA) held that the Minister's assessments were correct on the basis that the trusts were resident in Canada.

At the TCC, Justice Woods made a marked departure from previously established jurisprudence in determining the residence of a trust and confined *Thibodeau* to its own facts. Instead, Justice Woods conducted a factual inquiry under the central management and control test, formerly used only to determine residence of corporations, to the trusts at issue. Upon a review of the evidentiary record, Justice Woods found that the Canadian-resident beneficiaries made all the substantive decisions in regards to the trust assets while St. Michael acted only in an administrative capacity. The substantive decisions, being the acquisition of the shares in the two operating companies and the eventual disposition of them, were made by the beneficiaries along with their investment advisors in Canada. St. Michael only acted upon receiving instructions from the beneficiaries and did not exercise any discretion. This arrangement was agreed upon by the parties as reflected in internal memoranda by St. Michael which were created after the trust indenture was executed.

On the alternative grounds advanced by the Minister, Justice Woods held that section 94 (which if applicable would deem the trusts to be resident in Canada) did not apply as the trusts did not acquire property "directly or indirectly" as a result of the disposition. Justice Woods also rejected the Minister's arguments advanced on the grounds of the general anti-avoidance rule ("GAAR") under section 245.

At the FCA, Justice Sharlow confirmed the correctness of the application of a central management and control test to determine residency of a trust which she held to be a factual inquiry. However, on the issue of the alternative grounds advanced by the Minister, Justice Sharlow implied that section. 94 would have deemed the trusts to be resident in Canada but that this deemed residency would have been negated by the Treaty. For the purposes of the definition of residence in the Treaty, a trust would not be considered to be fully "liable to tax" under section 94 as it is not a comprehensive tax on the worldwide income of the trusts (the income base for such tax excluded foreign active income from Canadian taxation). As a result, the trusts would not be residents of Canada for Treaty purposes and could have relied upon the Treaty exemption applicable to capital gains for Barbados residents. Additionally, Justice Sharlow held that the GAAR would not apply to deny the Treaty benefits if they were otherwise available. The trusts, if resident in Barbados for Treaty purposes, would not have misused or abused the Treaty by claiming a benefit that had been negotiated by Canada as being available to Barbados residents.

SCC Decision

In a unanimous decision, the SCC held that a trust resides for the purposes of the Act where its real business is carried on, which is where the central management and control of the trust is exercised. In so concluding, the SCC upheld the application of the central management and control test by the lower courts. The alternative arguments advanced by the Minister were very briefly touched upon in the SCC's decision.

As put succinctly by Justice Abella during the hearing, the main inquiry is "not where the decision maker lives but where the decision maker makes decisions." Although this may coincide with the residence of the trustee, it may not, depending upon the facts of each case. It is possible for the decision maker to live in one jurisdiction but to make decisions in another. It is interesting to note that the decision was written by the Court as a whole (LeBel, Deschamps, Fish, Abella, Rothstein, Moldaver and Karakatsanis JJ.) and was not specifically authored by any one member.

In dismissing St. Michael's appeal, the SCC reasoned that the reference to a "person" contained within the basic charging provision under subsection 2(1) is a reference to the trust, the taxpayer subject to tax, not to the trustee. This follows from the separation of the trust from the trustee in respect of trust property as found in subsection 104(2). The SCC rejected both of the two main propositions advanced by St. Michael: (1) a trust is not a person like a corporation, so that the application of the central management and control test is inappropriate; and (2) subsection 104(1) links a trust to the trustee such that the residence of a trust must be the residence of the trustee.

The first proposition (whether or not the trust is only an obligation and not a separate legal person) was held to have no bearing on the inquiry. The SCC held that for purposes of applying the Act it is irrelevant that a trust at common law does not have an independent legal existence. Since the Act deems the trust to be an individual in respect of trust property, the trust is therefore the taxpayer that the residency inquiry should be directed towards. Arguments made by the appellants to the effect that the trust is a "deemed individual standing alone with no attributes" and that it merely constitutes "a computational vessel" were rejected by the SCC.

With respect to St. Michael's second proposition, the SCC held that the linkage found in subsection 104(1) does not inevitably lead to the conclusion that the residence of the trust is to be determined based on the residence of the trustee. The appellants advanced several examples in the Act to illustrate why the linkage between the trust and the trustee should be applied to determine residency. However, the SCC rejected these, holding that there were no provisions in the Act that expressly equated the trust with the trustee for the purpose of determining the residency of the trust. Instead, the SCC held that the linkage in the Act is not a principle of general application.

The Supreme Court outlined several similarities between corporations and trusts which would justify the application of the same test to determine residency including:

1. Both hold assets that are required to be managed;
2. Both involve the acquisition and disposition of assets;
3. Both may require the management of a business;
4. Both require banking and financial arrangements;
5. Both may require the instruction or advice of lawyers, accountants and other advisors; and
6. Both may distribute income, corporations by way of dividends and trusts by distributions.

The SCC agreed with the TCC that the function of both corporations and trusts at a basic level is the management of property, further justifying the application of the same test. Additionally, the SCC found that applying the same test for such similar entities promotes the values of consistency, fairness and predictability in Canadian tax law. During oral argument, Justice Abella focused on the words "ownership or control" found in subsection 104(1) to lend further support to adopting the same test for corporations and trusts. Justice Abella addressed the purpose of the words in subsection 104(1) in this fashion during the hearing:

> If the definition is any one of these string of people who have ownership or control, don't we then look at the residency question in the same way? Where does the person who has control exercise control so that there is a confluence between the residence concept and the central management and control.

The SCC declined to address the reasons advanced by the FCA in connection with sections 94 and 245. In its decision, the SCC went out of its way to state that in so doing it should not be taken to be endorsing the FCA on these issues. The SCC may not have agreed with Justice Sharlow's reasoning in connection with section 94. More significantly, this suggests that there may have been differing views within the Court regarding what constitutes an abuse of the Treaty for purposes of the GAAR. The FCA held that the taxpayers would have been entitled to

the Treaty exemption in question if they were found to be residents of Barbados. Justice Sharlow reasoned that if the trusts were resident in Barbados for the purposes of the Treaty then there would be no misuse or abuse of the Treaty when the Treaty exemption was claimed. It is possible that the SCC would have held otherwise but this is only speculative as no reasons were provided. One thing that appeared from the oral submissions was that the judges did not seem to find the Minister's arguments under the GAAR to be very persuasive. Justice Lebel remarked to Daniel Bourgeois, counsel for the respondent, in a disapproving tone:

> So even if you fail in your first argument about residence and if you fail in your second argument about section 94, you would rely on GAAR and apply it to an entity that would have been held to be a resident in Barbados under the proper test under the Act and the common law. I must say that I have some problems at this stage.

It is possible that the SCC may have seen the GAAR arguments to be inappropriate in this case and used more as a last ditch effort. However, it remains to be seen how the SCC would deal with the FCA finding that the GAAR would not apply to deny the Treaty benefits if the trusts were deemed to be Barbados residents for the purposes of the Treaty.

Conclusion

Other offshore trust cases such as *Antle v. The Queen*[10] decided at approximately the same time as *Garron*, highlight the underlying policy concerns inherent in disputes involving non-resident trusts. Fears from the Department of Finance and the Canada Revenue Agency (the "CRA") that these types of structures try to "offshore" Canadian income may have some influence on outcomes in court. Increased uncertainty in the treatment of offshore trusts may dissuade some taxpayers from using them as tools in tax planning. Moving forward, at least there is now some certainty that the factual inquiry used for determining the residency of a corporation will be applied to trusts.

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[1] [2012] S.C.J. No. 14.
[2] [1906] A.C. 455 (H.L.).
[3] *Ibid.*, at p. 458.
[4] R.S.C. 1985, c.1 (5th Supplement), as amended (the Act).
[5] 78 DTC 6376 \(hereinafter *Thibodeau*).
[6] CRA, IT-447 "Residence of a Trust or Estate" (May 30, 1980).
[7] *Agreement Between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital* Can T.S. 1980 No. 29 (incorporated into Canadian law by the *Canada-Barbados Income Tax Agreement Act, 1980*, S.C. 1980-81-82-83, c. 44, s.25)
[8] 2009 DTC 1287 (T.C.C.).
[9] 2010 DTC 5189 (F.C.A.).
[10] 2009 DTC 1305 (T.C.C.).