

TAX UPDATE

A report on cross-border developments in Canadian tax law



Canada-US Tax Treaty: Important CRA Guidance on Scope of Article IV(7)(b)

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The Canada Revenue Agency (CRA) has recently provided administrative guidance on how it intends to apply the so-called "hybrid entity rules" of the Canada-US Tax Convention (Canada-US Treaty). This guidance is timely as these rules will enter into force on January 1, 2010.

This update focuses on the specific administrative guidance relating to the application of Article IV(7)(b). From a Canadian perspective, there has been considerable concern over the potential application of this article to unlimited liability companies (ULCs) organized under the laws of British Columbia, Alberta or Nova Scotia.

In general, Article IV(7)(b) provides that an amount of income, profit or gain will not be considered to be paid to or derived by a person who is a US resident where the person is considered for Canadian tax purposes to have received the amount from an entity that is resident of Canada, but, by reason of the entity being treated as fiscally transparent for US tax purposes, the treatment of the amount for US tax purposes is not the same as its treatment would be if that entity were not treated as fiscally transparent for US tax purposes. In the context of ULCs, if applied literally, this rule has the potential to significantly and adversely alter the tax efficiency of typical cross-border structures.

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Recent Administrative Guidance

Some of the specific transactions considered by CRA in its new administrative guidance are as follows.

Two-step distribution: A ULC may effect a distribution of its profits to its US corporate shareholder (US Shareholder) by a two-step transaction that is economically equivalent to paying an actual dividend. As a first step, the ULC would increase the stated capital of its shares by a particular amount. As a second step, the ULC would decrease the stated capital of its shares by the same amount and distribute such amount to US Shareholder as a return of capital.

On the first step, the ULC would be deemed to have paid, and US Shareholder to have received, a dividend equal to the amount of the increase in the paid-up capital of the shares of the ULC. Canadian withholding tax would apply to the deemed dividend. The second step would be treated as a return of capital, and would not be subject to Canadian withholding tax.

On November 24th, at the CRA Roundtable of the Canadian Tax Foundation's annual conference, the CRA took the position that Article IV(7)(b) would not apply to this two-step transaction – provided that the deemed dividend resulting from the increase in the paid-up capital of the shares of the ULC is disregarded for US tax purposes and would be similarly disregarded if the ULC were not fiscally transparent. The CRA indicated that generally it would not apply the general anti-avoidance rule (GAAR) to such an arrangement, but left open the possibility that specific facts and circumstances could result in the application of the GAAR. The CRA officially issued an advance tax ruling a day later that essentially confirmed its conclusion.

Luxembourg intermediary: A Luxembourg resident société à responsabilité limitée (SARL) is interposed between the ULC and US Shareholder. The SARL elects to be disregarded for US tax purposes. The ULC pays a dividend to the SARL.

At the CRA Roundtable, the CRA indicated that the five per cent withholding tax rate under the Canada-Luxembourg Tax Treaty would normally apply to the dividend paid by the ULC if the SARL is the "beneficial owner" of the dividends.¹

One important question the CRA did not address in this context is whether interest paid by the ULC in such a scenario could benefit from the nil withholding tax rate under the Canada-US Treaty on the basis that Article IV(6) would apply to deem the interest payment to be derived by US Shareholder for the purposes of the Canada-US Treaty.

We understand that a policy proposal in the US could potentially frustrate any planning consisting of inserting a SARL, or other foreign entity in a third country that is disregarded for US tax purposes, between a ULC and its US shareholder. The proposal would essentially allow a foreign entity to be treated as disregarded for US tax purposes only if the single owner of the entity were organized under the laws of the foreign country in which the foreign eligible entity is organized. Given that the ULC and its single owner, the interposed third-country entity, would be created in different foreign countries, the ULC would be treated as a corporation for US tax purposes under this proposal. Some planning might be available to avoid this rule as proposed, but much will depend on the actual language of the proposal if it is enacted into law.

¹ The most recent CRA view on the meaning of "beneficial owner" in light of the Federal Court of Appeal decision in *Prévost Car* is set out in CRA document no. 2009-032145.

Payments to US Grandparent: The ULC has an interest-bearing debt with US Shareholder, and the debt is rearranged so that instead of being payable to US Shareholder, it is payable to the corporate parent of US Shareholder (US Grandparent).

At the CRA Roundtable, the CRA indicated that, assuming the interest is subject to the same treatment in the US in the hands of US Grandparent as it would be if the ULC were not fiscally transparent for US tax purposes, the CRA would agree that Article IV(7)(b) does not apply to such a restructuring. However, the CRA indicated that it would consider applying the GAAR where such restructuring is part of a double-dip or debt pushdown financing arrangement.

In its Technical Interpretation released on November 25th, the CRA clarified its general position with respect to the application of the same treatment test under Article IV(7)(b). In general terms, the CRA will look at the timing, character and quantum of an amount to determine whether it meets the "same treatment" test, but will not consider its geographical source to be relevant unless this affects its treatment as an item of income for US tax purposes.

In its Technical Interpretation, the CRA went further in blessing payments to a US grandparent where US Grandparent and US Shareholder file a consolidated tax return. This is an important clarification, because in a case where the ULC is a disregarded entity and its deductible payment is treated as a payment by the Canadian branch of US Shareholder, the net effect under the US consolidated return regulations would be to disregard the payment from a US tax perspective. By contrast, if the ULC were treated as a corporation for US tax purposes, payments from it would not be subject to the intercompany transaction rules, and thus there would be a net inclusion for US Grandparent without a corresponding expense in the consolidated group. The CRA effectively concluded that the "same treatment" test under Article IV(7)(b) is limited to a separate entity analysis, and that taxability of a payment in the US is not a relevant consideration in determining whether the payment receives the "same treatment."

A ULC with more than one shareholder: US Shareholder 1 and US Shareholder 2 own shares of a ULC. The ULC has an interest-bearing debt with US Shareholder 1. The ULC is treated as a partnership rather than as a disregarded entity for US tax purposes.

In its Technical Interpretation, the CRA concluded that Article IV(7)(b) would not apply to the payment of interest by the ULC to US Shareholder 1 on the basis that US Shareholder 1 will be considered to earn interest income from the debt with the ULC regardless of the ULC's status as a fiscally transparent entity for US tax purposes. In determining whether Article IV(7)(b) applies to the interest payment, the CRA's focus is on the tax treatment of the interest as an item of income, without reference to the allocation of expenses from the partnership. In other words, Article IV(7)(b) does not apply to such an arrangement even though the net tax effect for US Shareholder 1 will depend on the ULC's status. If the ULC is a fiscally transparent partnership for US tax purposes, US Shareholder 1 would be able to offset its interest income by its share of the ULC's interest expense, whereas if the ULC were regarded, US Shareholder 1 would not be able to offset any of its gross income inclusion with an allocation of interest expense.

In its Technical Interpretation, the CRA also reiterated its traditional position that Article IV(7)(b) would apply to the base case where the ULC pays interest to US Shareholder as its sole shareholder.

Royalty paid to a Third Party: A Third Party that is a US resident and a “qualifying person” under the Canada-US Treaty grants to a ULC the right to use a patented manufacturing process in exchange for a licensing fee.

In its Technical Interpretation, the CRA confirmed that Article IV(7)(b) would not apply to the payment of the licence fee by the ULC to the Third Party. The CRA has essentially clarified that it considers potential differences in the foreign tax credit implications for the Third Party to be irrelevant for the “same treatment” test under Article IV(7)(b).

Back-to-back dividends: A ULC owns a Canadian subsidiary (Cansub). Cansub pays a dividend to the ULC, which in turn immediately pays a dividend of an identical amount to US Shareholder. From a US tax perspective, US Shareholder is considered to have received a dividend from Cansub.

In its Technical Interpretation, the CRA takes the debatable view that Article IV(7)(b) will apply to the dividend paid by the ULC to US Shareholder. The CRA argues that the dividend paid by Cansub to the ULC is a distinct amount for which US Shareholder is not liable to pay Canadian tax, and that therefore the treatment of this amount is not relevant for the same treatment test under Article IV(7)(b).

Conclusion

The CRA's administrative guidance should provide clarity in most circumstances and will greatly diminish the adverse impact of Article IV(7)(b). In this respect, Article IV(7)(b) now presents itself much more as a trap for the unwary than as a significant obstacle to the use of a ULC in a cross-border arrangement.

As Article IV(7)(b) takes effect on January 1, 2010, we expect that further guidance will develop over time through other advance tax rulings and technical interpretations. Taxpayers should review their cross-border arrangements to determine what, if any, restructuring should be implemented to address this new rule.



Garron and Antle: “Offshore Trusts 101” in the Tax Court of Canada

By Soraya M. Jamal, Kara M. Levis and John C. Yuan

Two recent cases of the Tax Court of Canada have given the Canadian tax community much on which to reflect in the context of offshore tax planning. Each case involved a transaction in which a non-resident trust was the centerpiece of a series of transactions undertaken by a Canadian-resident individual to avoid Canadian income taxation on gains arising on a disposition of property – in each case, shares of a Canadian-resident corporation – to an arm’s-length party. The Tax Court upheld the reassessment under appeal in each case and, while the outcome of the cases may not have been surprising, the approaches that the Tax Court used to get there were perhaps a bit unexpected.

Garron

*Garron Family Trust v. The Queen*¹ involved tax planning that shareholders of a Canadian-resident company had undertaken in anticipation of a possible future sale of the company’s shares. In effect, the tax planning involved an estate freeze transaction with growth shares issued to an offshore trust. Prior to implementation of the tax planning, shares of the corporation, PMPL Holdings Inc., were held equally by Andrew Dunin and a holding company whose shareholders included Myron Garron, Mr. Garron’s spouse, and a Garron family trust. Each of the direct and indirect PMPL shareholders was a person resident in Canada for purposes of the *Income Tax Act* (Canada).

At the outset, separate trusts were established under the laws of St. Vincent for the benefit of the Dunin family (Summersby) and the Garron family (Fundy), respectively. The sole trustee of each trust was a corporate trustee incorporated in, and licensed under the laws of, Barbados. The terms of each trust appointed a “protector” who had the power to replace the trustee. The protector of each trust was an individual who resided in St. Vincent and, under the trust terms, the protector could be replaced by a majority of the beneficiaries who had attained a certain age. Under the estate freeze, the existing PMPL shareholders exchanged their common shares for fixed-value preference shares and the new PMPL growth shares were issued to two newly incorporated Canadian holding companies. Summersby was the sole shareholder of one holding company, and Fundy was the sole shareholder of the other holding company.

Two years after the implementation of the estate freeze, Summersby and Fundy disposed of shares of their respective Canadian holding companies in an arm’s-length sale, realizing a capital gain of over \$450 million in aggregate. Even though the tax planning contemplated that the trusts’ gains from the sale would be exempt from Canadian income taxation in accordance with the provisions of the *Canada-Barbados Tax Treaty* (Treaty), the purchaser of the shares had an obligation to withhold and remit a portion of the sale proceeds to the Canada Revenue Agency (CRA) pursuant to section 116 of the Act. This was done. Summersby and Fundy each filed Canadian income tax returns for the year of sale seeking a refund of the amount remitted.

¹ 2009 DTC 1287 (T.C.C.).

The Minister of National Revenue denied the refund and issued an assessment for each trust, imposing Canadian income tax on the gain from the disposition of the shares. The basis for the Minister's assessment was that the two trusts were resident in Canada, either under common law principles or by virtue of paragraph 94(1)(c) of the Act, such that Article XIV of the Treaty did not apply to restrict Canada's ability to tax the gain in the circumstances. As an alternative position, the Minister alleged that the general anti-avoidance rule (GAAR) applied to deny the trusts the benefit of the Treaty exemption. As a protective measure only, the Minister also reassessed Mr. Dunin, Mr. Garron, Mrs. Garron, and the Garron family trust on the basis that either (i) subsection 75(2) of the Act applied to attribute the same aggregate capital gain to these persons, or (ii) a portion of the sale proceeds were to be reallocated to each of these persons pursuant to section 68 of the Act. At the hearing, the Minister confirmed that there was no intention to tax the same gain more than once, and that the assessments issued to the individuals should be vacated in the event that the assessments of Fundy and Summersby were upheld.

Trusts Resident in Canada under Common Law

The Tax Court of Canada (*per* Woods, J.) upheld the assessments of Summersby and Fundy on the basis that they were each resident in Canada under common law principles. Before reaching this conclusion, the court first had to address the Federal Court Trial Division's decision in *Dill and Pearman, Trustees of Thibodeau Family Trust v. The Queen*,² which had been widely accepted as establishing that a trust is resident in the jurisdiction in which a majority of its trustees are resident. The Tax Court was satisfied that the judge in the *Thibodeau* case never purported to state a general test with respect to trust residency and that the *Thibodeau* test was limited to the particular facts of that case, which were distinguishable from the present circumstances. The Tax Court further found that it would be "wrong ... to conclude that *Thibodeau* stands for the proposition that the residence of a trustee is always the deciding factor in determining the residence of a trust."

The Tax Court then held that the appropriate test for determining the residence of a trust is the one developed by the courts in the context of corporations – namely, the location "where the central management and control actually abides." The Tax Court came to this conclusion notwithstanding the *obiter dictum* of the Federal Court in *Thibodeau* that the central management and control test could not be applied for purposes of determining a trust's residence, because a trustee cannot adopt a "policy of masterly inactivity" with respect to its fiduciary duties. The Tax Court found that the Federal Court's rationale presumed that trustees are always compliant with their fiduciary obligations, a position that was rejected by the Federal Court of Appeal in *Robson Leather Co. v. The Queen*.³

The Tax Court felt that using a similar test for determining the residency of trusts and corporations promoted consistency, predictability and fairness – all fundamental principles underlying the Canadian tax regime. While acknowledging that there are significant differences between the nature of a trust and a corporation, the Tax Court noted that "From the point of view of determining tax residence, the characteristics are quite similar. The function of each is, at a basic level, the management of property." Moreover, the Tax Court was not satisfied that there were good reasons to establish different tests of residence for trusts versus corporations.

² 78 DTC 6376 (F.C.T.D.).

³ 77 DTC 5106 (F.C.A.).

Having decided that the appropriate test for determining the residency of a trust was the central management and control test, the Tax Court turned to the facts of the case to try to identify where the key decisions pertaining to the trust had been made. Although there was no explicit evidence establishing the nature of the trustee's role, the Tax Court found that the trustee had played a limited role in the management and operation of the trusts based on a number of factors, including the following:

1. The internal memoranda setting out the trustee's intention evidenced a role undertaken by the trustee that was more limited than contemplated in the trust indenture.
2. Summersby's and Fundy's investment decisions appeared to be under the direction of Mr. Dunin and Mr. Garron, respectively, who had direct contact with and gave instructions to the trusts' investment advisors.
3. The trusts' tax advisors were under the direction, explicit or otherwise, of Mr. Dunin and Mr. Garron.
4. Virtually no documentation was entered into evidence to demonstrate that the trustee had taken an active role in managing the trusts. Instead, the documentary evidence was consistent with the trustee having been only involved, for the most part, in the execution of agreements and in administrative, accounting and tax matters.
5. At the relevant time, the trustee was the arm of an accounting firm that provided significant tax advice regarding the overall offshore structuring of the property held by the trusts. The Tax Court questioned whether the trustee had sufficient expertise in managing trust assets.
6. The oral testimony did not provide a clear picture as to how the trusts were operated, and the Tax Court found that the oral testimony given was not inconsistent with the trustee having a limited role.
7. The protector mechanism "effectively enforced" the subordination of the trustee because the trustee could be replaced by the protector of the trust and a majority of the beneficiaries could replace the protector.

Based on the evidence as a whole, the Tax Court found that Mr. Dunin and Mr. Garron had made the substantive decisions with respect to Summersby and Fundy – either directly or indirectly (through advisors in Canada) – such that the management and control of each trust resided in Canada. Accordingly, the trusts were resident in Canada for purposes of the Treaty and, therefore, not entitled to protection from Canadian income taxation on the gain arising on the disposition of shares under Article XIV(4) of the Treaty.

Having concluded that the appeals of the Summersby and Fundy assessments should be dismissed on the basis of the Canadian residence of the trusts under common law, the Tax Court did not need to address the Minister's alternative assessing positions based on paragraph 94(1)(c) or on the GAAR. However, the court nonetheless went on to provide its views on the two alternative positions.

Paragraph 94(1)(c) Would Not Have Supported Assessments

Paragraph 94(1)(c) is a provision that can deem a trust that is otherwise a non-resident of Canada to be a resident of Canada for purposes of the Act. The Tax Court found that the requirements for the application of that provision were not met in the circumstances. More specifically, the paragraph required a transfer of

property to the trust by a Canadian-resident person with whom the trust did not deal at arm's length. There was no such transfer here. In any event, even if the deeming rule had applied, the Tax Court observed that the rule did not have the effect of causing the trust to be a resident of Canada for purposes of the Treaty, since the trust would only be subject to partial taxation and not on its worldwide income, as required under the Treaty concept of residence.

The GAAR (As Pleaded) Did Not Apply

As the taxpayers conceded the first two components for the application of the GAAR analysis – namely, the existence of a tax benefit, and an avoidance transaction – the only issue left to be determined was whether there had been a misuse or abuse of a provision of either the Act or the Treaty. Since the Minister had restricted his GAAR position to an alleged misuse or abuse of the Treaty (and not of the Act) in his pleadings in the tax appeal, the Tax Court's analysis was limited to a consideration of this aspect only. (At the hearing, the Minister also attempted to argue for a finding that the transactions had resulted in a misuse or abuse of subsection 75(2). The Tax Court refused to consider the point because the Minister had raised it at such a late stage.)

The Minister argued that there had been an abuse of the object, spirit and purpose of the Treaty on five grounds: (i) it is abusive to use the Treaty to avoid an anti-avoidance provision such as section 94,⁴ (ii) the Treaty was not intended to exempt foreign accrual property income, (iii) the trusts had strong ties to Canada and should be denied Treaty benefits, (iv) Article XIV(4) of the Treaty was only intended to apply in situations where there would otherwise be double taxation, and (v) the Treaty is not intended to permit the erosion of the Canadian tax base that occurs by allowing these types of transactions, which are designed with the objective of causing capital gains to avoid Canadian taxation.

With respect to the allegation that the Treaty allowed the trusts to avoid the application of an anti-avoidance rule in section 94, the Tax Court found that the term "anti-avoidance provision" is very broad and refers to a wide range of rules, not all of which are abusive to avoid. To ensure specific anti-avoidance rules apply to transactions involving a treaty, the contracting states entering into a tax treaty may make express reference to such domestic tax rules in the provisions of the tax treaty. Since section 94 was not specifically mentioned by the contracting states in the Treaty, section 94 does not override the Treaty and avoiding its application does not automatically constitute an abuse of the Treaty.

With respect to the Minister's argument that the trusts inappropriately used the Treaty to avoid taxation of foreign accrual property income, the Tax Court found that there was no evidence that the contracting states intended to prevent the application of the Treaty to exempt a gain of the trust that would otherwise have been subject to tax under section 94. While there was a Treaty article making it clear that its provisions were not intended to exempt from Canadian income tax foreign accrual property income that would arise under section 91, there was nothing to indicate that the contracting states intended this restriction to extend to similar income arising under section 94.

⁴ There could only be misuse or abuse under this category to the extent that section 94 applied to the trusts either by its terms or by operation of the GAAR.

As for the Minister's suggestion that the trusts, with their strong ties to Canada, should be denied Treaty benefits because they were not "true" non-residents of Canada, the Tax Court rejected this ground on the basis that the implication of the position is that residents of Barbados would be entitled to varying Treaty benefits based on criteria that were different from those specifically enumerated by the contracting states in Article IV of the Treaty.

The allegation that Article XIV(4) of the Treaty should only be available in situations of double taxation also did not gain any credence. The Treaty does not require any contracting state to tax capital gains. The Treaty allows only the country of the alienator's residence to tax certain types of gains. The fact that Barbados chose not to tax capital gains taxation on Barbados residents does not give Canada the right to tax such gains, even if no double tax will result.

Finally, the Tax Court rejected the Minister's submission that the Treaty is not intended to allow for the erosion of the Canadian tax base in such a way as the transactions in *Garron* allowed. Looking to the intent of the Treaty drafters, the Tax Court could not find a clear intent to preserve for Canada the right to have the provisions of section 94 apply to income that would otherwise be exempt from Canadian taxation under the Treaty.

As the Tax Court rejected each one of the Minister's arguments for supporting a finding of misuse or abuse of the Treaty, the Tax Court ultimately concluded that the GAAR would not have applied to the deny the tax benefits enjoyed by Summersby and Fundy pursuant to the transactions that were the subject of the *Garron* case.

Antle

Like the *Garron* case, *Paul Antle v. The Queen*⁵ also involved the use of a non-resident trust to avoid Canadian income tax that would otherwise have arisen on an arm's-length disposition of shares of a corporation by a Canadian-resident individual. However, unlike the tax planning in the *Garron* case, the non-resident trust in the *Antle* case was structured to meet the requirements for the application of paragraph 94(1)(c) such that it would be deemed to be a Canadian-resident trust for purposes of the Act; this was to allow the trust to claim the benefits of being a spousal trust for Canadian tax purposes.

Mr. Antle is a Canadian-resident individual who, together with another Canadian-resident individual, formed PM Environmental Holdings Ltd. to acquire shares of SCC Environmental Group Inc. in 1998 from Stratos Global Corporation. Stratos received preferred shares and debt in PM as consideration for the transfer.

In August 1999, Mr. Antle began negotiations towards the sale of all the issued and outstanding shares of PM to an arm's-length party, M-I Drilling Fluids Canada, Inc.. There were internal complications to the sale negotiations, as Stratos alleged that, pursuant to rights negotiated under the sale of SCC to PM, Stratos was entitled to receive proceeds from the sale to M-I in excess of the amount corresponding to the value of Stratos's preferred shares and debt in PM. Stratos ultimately consented in late November 1999 to the sale of PM to M-I after Mr. Antle and the other PM shareholder agreed to permit Stratos to receive 50 per cent of the proceeds for the sale of PM shares not owned by Stratos.

⁵ 2009 TCC 465 (T.C.C.).

After negotiations for the sale of PM were well underway, Mr. Antle and his advisors were put in touch with an individual in the Bahamas who made them aware of the “capital property step-up strategy” that became the subject of the tax appeal. The principal objective of the strategy was to avoid Canadian income tax on the gain that otherwise would have arisen on a direct sale of the PM shares by Mr. Antle. The transactions implementing the strategy consisted of the following elements: First, a Barbados-resident trust would be established with Mr. Antle’s spouse as its sole beneficiary. Second, Mr. Antle would transfer his PM shares to the trust and, since the trust would be deemed to be a Canadian-resident trust pursuant to paragraph 94(1)(c), the tax rollover for a Canadian-resident spousal trust under subsection 73(1) would apply to treat Mr. Antle as having transferred his PM shares to the trust at his cost for Canadian tax purposes. Third, the trust would sell the PM shares to Mr. Antle’s spouse for a promissory note equal to their fair market value, with the trust’s gain from the disposition of the PM shares exempt from Canadian income taxation by virtue of the provisions of the Treaty. Fourth, Mr. Antle’s spouse would sell the shares to M-I for the previously negotiated price, and the sale proceeds would be used to repay the promissory note the spouse had issued to the trust. Fifth, the trust would pay the proceeds from the repayment of the promissory note to Mr. Antle’s spouse as a distribution to the beneficiary of the trust.

Through these transactions, it was intended that Mr. Antle’s gain on the disposition of his PM shares to the trust would be nil by virtue of the application of the subsection 73(1) rollover to the transfer. The trust would realize a gain on the disposition of the PM shares to Mr. Antle’s spouse, but the trust would be entitled to relief from Canadian income taxation on the gain by virtue of being a resident of Barbados for purposes of the Treaty. (The strategy contemplated that there would be no adverse Canadian tax consequences from the remaining steps of the transaction implementing the strategy.)

Mr. Antle decided to proceed with the capital property step-up strategy, and beginning in late October 1999, steps were taken to implement the required transactions in advance of the ultimate sale of the PM shares to M-I on December 14, 1999.

The Minister reassessed Mr. Antle to treat him as having received proceeds from the disposition of his PM shares equal to the amount that his spouse had received from M-I for such shares on December 14, 1999. The Minister advanced several alternative theories for supporting the reassessment of Mr. Antle, including the following: (i) the trust was a sham, (ii) the trust was not properly constituted, (iii) the requirements for the subsection 73(1) spousal trust rollover were not met in the circumstances, (iv) the anti-avoidance rule in subsection 69(11) for transfers of property to a person that was not affiliated with the transferor, and (v) the GAAR. As an alternative, the Minister also assessed the trust in connection with the gain from the disposition of the PM shares.

Although Mr. Antle’s appeal in the Tax Court was heard at the same time as the trust’s appeal of its assessment, the focus of the court’s decision (per C. Miller, J.) was Mr. Antle’s reassessment, which the Tax Court upheld on the basis that the spousal trust was not properly constituted. In *obiter*, the Tax Court went on to conclude that the transaction was not a sham and that, even if the spousal trust had been properly constituted, the GAAR would have applied to cause the gain on the PM shares to be included in Mr. Antle’s income, as was done in the reassessment under appeal.

Invalid Trust

It is trite law that there must be the “three certainties” for a valid trust: certainty of intention, certainty of subject-matter, and certainty of objects. The Tax Court found that the purported trust in this case lacked both the certainty of intention and the certainty of subject-matter. Moreover, the Tax Court found that the trust could not have been a valid trust because it was not properly constituted.

With respect to certainty of intention, the Tax Court rejected the taxpayer’s position that the language in the trust deed was determinative on the question of intention. Rather, the Tax Court concluded that it was required to look beyond the trust deed to ascertain whether the intentions expressed in the trust deed were consistent with the conduct of Mr. Antle leading up to the transfer of the PM shares to the Barbados trust.

There were inconsistencies in the dating of some of the implementing documentation. However, the Tax Court noted that Mr. Antle did not execute the trust deed until December 14, 1999 – which was the same day as the closing of the sale of the PM shares to M-I – and that, on December 12, 1999, Mr. Antle communicated with one of the advisors to suggest that the trust needed to be finalized. This led the Tax Court to make a finding of fact that the date Mr. Antle signed the trust deed (i.e., December 14, 1999) was the earliest date on which the trust could have been created. As most of the necessary steps for completing the implementation of the capital property step-up strategy were already in place by December 14, 1999, the Tax Court concluded that Mr. Antle could not have had the intention to settle a discretionary trust on that date, particularly in light of the fact that the documents needed to effect the distribution of the entirety of the trust’s property to Mr. Antle’s spouse shortly after the sale of the PM shares to M-I were already in place at that time.

The Tax Court’s conclusion that there was a lack of certainty of subject-matter was driven by its view that Mr. Antle purported to transfer something less than full ownership of the PM shares to the trust. As noted above, Stratos alleged that it had an entitlement to a portion of the profit from a third-party sale and, to allow the sale to M-I to be completed, the parties had provided for Stratos to receive a portion of the amount that M-I would otherwise have paid the other PM shareholders. After the completion of the sale to M-I, Mr. Antle successfully sued Stratos for recovery of the redirected sale proceeds on the basis that Mr. Antle and the other PM shareholder had agreed to the arrangement under duress. Since Mr. Antle personally retained the amount recovered from Stratos, and the transactions implementing the capital property step-up strategy did not provide for the possibility that either the trust or Mr. Antle’s spouse would receive the benefit of any amount recovered from Stratos, the Tax Court concluded that there was a component of Mr. Antle’s ownership interest in the PM shares that he did not intend to transfer. Consequently, this created uncertainty as to the property that was to be the subject-matter of the trust.

The Tax Court came to the conclusion that the trust was not properly constituted because the implementing documentation and steps undertaken by Mr. Antle and the trust did not conclusively establish that Mr. Antle had intended to transfer his PM shares to the trust on December 14, 1999. For example, the trust deed did not expressly speak to the transfer of the shares, the corporate resolution of PM purporting to authorize the transfer from Mr. Antle to the trust contemplated a transfer on a different date (i.e., December 5, 1999), the share certificates were never delivered to the trustee, and the endorsement on the share certificate reflected a transfer by Mr. Antle but did not identify the trust as the transferee. All in all, the evidence did not satisfy the standard (expressed in the literature and jurisprudence) that, unlike a transfer for consideration, the settlor must have done everything necessary to effect a transfer of the property for purposes of constituting the trust.

Having concluded that the capital property step-up strategy in this case was defeated due to the fact that the parties had purported to transfer property to an ineffective trust, the court stated the following:

...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 the 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....

Having found that Mr. Antle did not effect a transfer of his PM shares to a valid trust, the Tax Court went on to consider the tax consequences to Mr. Antle in such a circumstance. There were two possibilities: Mr. Antle could sell his shares to his spouse for proceeds equal to their fair market value, or the shares could be transferred to his spouse at their cost and the gain on the sale to M-I would be attributed back to him. Either scenario was consistent with the Minister's reassessment of Mr. Antle under appeal.

Not a Sham

Although it was not necessary for the Tax Court to consider whether the transactions were a "sham," the court went on to provide its views on that question.

As established in the jurisprudence, the hallmark of a "sham" is deceit. While there were several issues with timing and backdating of documents in the course of the implementation of the transactions in this case, the Tax Court was unable to conclude that there was intentional deceit by Mr. Antle or the trustee to justify the application of the "sham" doctrine. In coming to this conclusion, the Tax Court acknowledged that there was clearly artificiality to the arrangements and that Mr. Antle continued to "call the shots" throughout. Notwithstanding, it was clear that the parties wanted to establish a trust – even if it was to be able to avail themselves of the tax benefits from the capital property step-up strategy – and, so long as it was intended that the trust would take effect according to its terms, the fact that Mr. Antle was in a position to influence the decisions of the trustee would not cause an otherwise valid trust to be void as a sham.

The GAAR Would Have Applied

In *Antle*, the GAAR analysis centred on the use of the subsection 73(1) spousal rollover and the deeming rule in paragraph 94(1)(c) to enable the Barbados-resident spousal trust to take advantage of such spousal rollover.

Under the capital property step-up strategy, the spousal trust, if a valid trust, would have been a resident of Barbados. And in the absence of the application of the GAAR, paragraph 110(1)(f) would have authorized the trust to reduce its income subject to Canadian tax to nil on the basis of the spousal trust's entitlement to an exemption from Canadian taxation under the Treaty. This, despite the fact that paragraph 94(1)(c) would have applied to deem the trust to be Canadian resident for purposes of Part I of the Act.

The tax benefit was obtained directly through the use of the spousal rollover that was facilitated through the application of paragraph 94(1)(c) to deem the trust to be resident in Canada.

As in the *Garron* case, the sole issue in the GAAR analysis was whether there had been a misuse or abuse of the Act or the Treaty. The Tax Court began its analysis by looking at the object and spirit of subsection 73(1), paragraph 94(1)(c) and subparagraph 110(1)(f)(i), as well as Article XIV(4) of the Treaty.

With regard to subsection 73(1), the court found that the purpose of that subsection is to allow property transfers between spouses on a tax-deferred basis, in recognition of the unique “economic mutuality” that exists between spouses. As such, transfers between spouses (and by extension, to a qualifying spousal trust) may be made without triggering capital gains, but such gains should trigger tax when sold outside of the marital unit.

Paragraph 94(1)(c) deems certain non-resident trusts to be residents of Canada for purposes of Part I of the Act. This anti-avoidance rule was put in place to ensure that Canadians could not escape taxation simply by transferring assets to off-shore trusts. However, Mr. Antle used paragraph 94(1)(c) to trigger deemed residence status to avail himself of the spousal trust rollover rules in subsection 73(1).

Finally, the capital property step-up strategy made use of Article XIV(4) of the Treaty and subparagraph 110(1)(f)(i) to preserve for Barbados the right to impose income tax on the spousal trust’s capital gain realized on the implementing transactions. However, since Barbados chooses not to tax capital gains, the transactions created a situation of double non-taxation of the accrued gain on the shares sold even though the principal objective of the Treaty is to avoid double taxation of income.

Beginning with the Treaty and subparagraph 110(1)(f)(i), the Tax Court found that there had not been a misuse or abuse in either case. Article XIV is plain. It simply allocates jurisdiction to tax, and exhibits little underlying tax policy. Similarly, the purpose of subparagraph 110(1)(f)(i) is to exempt treaty-exempt income and gains from taxation in Canada. This subparagraph is contained in the Act to prevent double taxation. The fact of double non-taxation of the gain of the spousal trust in this case arises through the use of other provisions of the Act.

However, the Tax Court found that, when looking at the overall result of the transactions implementing the capital property step-up strategy, the combined use of subsection 73(1) and paragraph 94(1)(c) achieves results that those provisions seek to prevent, and frustrates the object, spirit and purpose of those provisions. More particularly, there was no taxation of the gain when the PM shares were sold to M-I and moved outside of the marital unit. At the conclusion of its GAAR analysis, the Tax Court was moved to suggest that the capital property step-up strategy “could become a classic law school model of what the GAAR was intended to capture.”

Where Are We Now?

Since their release, the reasons for decision in the *Garron* and *Antle* cases have created quite a stir in the Canadian tax community. The *Garron* case has changed the way we look at the residence of a trust, and the *Antle* case has taken the inquiry for the three certainties far beyond the express language in the trust deed. These issues are fundamental matters for trusts as a category and not just non-resident trusts employed in offshore tax avoidance strategies.

The analyses in these cases not only serve as food for thought for future transactions that contemplate the transfer of property to a non-resident trust, but may operate to cast doubt on the tax efficacy of transactions previously believed to have met the strict technical requirements under the Act and applicable tax treaty for obtaining the desired tax benefits. No doubt most taxpayers who have previously implemented offshore tax planning similar to the types of transactions undertaken in the *Garron* and *Antle* cases gave careful consideration to whether the GAAR might apply to deny the intended tax benefits. However, many of them might now be surprised to learn that, on the basis of these cases, the transaction simply did not work as planned, without resort to the GAAR.

As appeals to the Federal Court of Appeal have been filed by the respective taxpayers in the *Garron* and *Antle* cases, there will likely be more to come on these two cases in the near future.

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