

# Tax memo

Canadian tax updates



## FCA decides attribution rule did not apply on sale to trust by capital beneficiary (Sommerer)

*Discusses the FCA's decision that the income attribution rule in subsection 75(2) did not apply on a fair market value sale of property to a trust by a capital beneficiary of the trust.*

*August 15, 2012*

The Federal Court of Appeal (FCA) released its decision in **The Queen v. Sommerer**<sup>1</sup> on July 13, 2012, concluding that subsection 75(2) of the *Income Tax Act* (Canada) does not apply on a fair market sale of property to a trust by a person who is a capital beneficiary of the trust. This decision overrules the Canada Revenue Agency's (CRA's) long-standing position that the wording of subsection 75(2) is broad enough to include the fair market value sale.

### **Background**

Until the Tax Court of Canada (TCC) decision in **Sommerer v. The Queen**,<sup>2</sup> tax professionals usually followed the CRA's position on the broad reach of subsection 75(2), structuring transactions and jumping through hoops to ensure a trust did not acquire any property from a capital beneficiary. In fact, many trusts were drafted prohibiting any purchase of property from a capital beneficiary, even a purchase for fair market value consideration, to prevent an unintentional application of subsection 75(2).

The application of subsection 75(2) can be catastrophic for certain tax planning structures using trusts. Subsection 75(2) attributes income, losses, capital gains and capital losses earned in respect of the contributed property (or substituted property) to the person who contributed the property.

In addition, pursuant to subsection 107(4.1), if subsection 75(2) ever applied in respect of *any* trust property and the contributor is still alive, only the contributor and his/her spouse can receive the trust property that he/she contributed (or property substituted for that property) on a tax-deferred rollover basis under subsection 107(2). No other tax-deferred rollover of property to a beneficiary is available.

### **Subsection 75(2) attribution rule**

At issue in **Sommerer** was whether a sale of property to a trust for fair market value consideration resulted in the vendor being a person from whom the property was received (a contributor) for the purposes of subsection 75(2).

---

1. 2012 FCA 207

2. 2011 TCC 212

Subsection 75(2) applies “[w]here, by a trust created in any manner whatever since 1934, property is held on condition” that:

- the property (or property substituted therefor, also referred to here as “the property”) may revert to the person from whom the property was received (the “contributor”);
- the property may pass to persons to be determined by the contributor after the creation of the trust; or
- while the contributor is alive, the property shall not be disposed of except with the contributor’s consent or in accordance with the contributor’s direction.

With limited exceptions, when one of the above conditions is met, subsection 75(2) attributes any income or loss, or any taxable capital gain or allowable capital loss, realized by the trust on or in respect of the property to the contributor, so long as he or she is a resident of Canada.

## **Facts**

The taxpayer was a businessman who emigrated with his wife and children from Austria to Canada in 1978. The taxpayer was involved in the high-tech industry and through his business activities had acquired shares of Vienna Systems Corporation (Vienna) and Cambrian Systems Corporation (Cambrian).

In 1996, the taxpayer’s father created a private foundation (the Foundation) in Austria, pursuant to the Austrian *Private Foundations Act*. Under Austrian law, the Foundation was a juridical person in the same category as a corporation and had its own legal personality and the legal capacity to own property in its own right. The Foundation was endowed with 1,000,000 Austrian shillings (approximately \$126,000 in Canadian dollars at the time) by the taxpayer’s father, and was managed by three Austrian residents who were not related to the taxpayer’s family.

The “beneficiaries” of the Foundation included the taxpayer, his wife, and the children from their marriage, provided that these persons were also

resident in Austria. Because the taxpayer and his family were residents of Canada, they were only potential beneficiaries until they became resident in Austria. In addition, the taxpayer and his wife were named as the “ultimate beneficiaries” of the Foundation in a provision that contained no condition as to their place of residence. As an ultimate beneficiary, the taxpayer and his wife were entitled to receive the property of the Foundation upon its revocation or dissolution.

On the day following the creation of the Foundation, the taxpayer transferred all of his common shares of Vienna to the Foundation by way of a fair market value sale. The Foundation paid a portion of the purchase price with cash from its endowment. The balance of the purchase price became an amount owing on which interest accrued. In April of 1998, the taxpayer sold his shares of Cambrian to the Foundation for fair market value consideration.

In December 1997 the Foundation sold a portion of the Vienna shares to three individuals unrelated to the taxpayer’s family and realized a capital gain. In December of 1998 the Foundation sold the remaining Vienna shares to Nokia Corporation, realizing a further capital gain. Also in December of 1998, the Foundation sold the Cambrian shares to Nortel and realized a capital gain.

## **Minister’s position**

The taxpayer was reassessed on the grounds that the capital gains realized by the Foundation on the sales of the Vienna and Cambrian shares were attributable to the taxpayer under subsection 75(2). In issuing the reassessment, the Minister of National Revenue took the position that the Foundation was a trust resident in Austria and that the taxpayer was a person from whom the trust received property.

The Minister argued that:

1. a sale of property to the trust, even a sale for fair market value consideration, resulted in the vendor being a person from whom the trust received the property under subsection 75(2); and

2. the taxpayer's ability to receive the property of the trust as a capital beneficiary of the trust meant the property could revert to the taxpayer by virtue of the trust conditions.

## ***Taxpayer's position***

The taxpayer's position was:

1. the Foundation was a corporation, so that subsection 75(2) had no application;
2. he did not contribute property to the trust in a way that attracted the application of subsection 75(2); and
3. in the event subsection 75(2) was found to apply, the Canada-Austria Income Tax Convention, 1980 (the Treaty) would provide relief.

## ***Tax Court of Canada decision***

The main issues the TCC addressed were whether there was a trust, and if so, whether the attribution rules in subsection 75(2) applied in respect of the capital gains realized by the Foundation on the sale of the Vienna and Cambrian shares. The TCC also addressed whether, if subsection 75(2) were found to apply, the Treaty would apply to override the attribution rules in subsection 75(2) when the trust was resident in Austria.

Regarding the existence of a trust, the TCC chose not to rule on whether the Foundation itself was a trust, and instead focused on whether the relationship between the taxpayer, his father, the Foundation and the taxpayer's family constituted a trust. Upon a review of the legal rights of the beneficiaries and the fiduciary duties of the Foundation to the taxpayer's family, the TCC found that the relationship between the parties regarding the shares constituted a trust, with the Foundation as the trustee.

Having determined that there was a trust, the TCC sought to identify the person from whom the property was received. As a starting point in its analysis, the TCC stated that the attribution rule in subsection 75(2) applies only to the person from whom property was received upon the trust's creation (i.e., the settlor). The TCC accepted that

another person can settle additional property in trust with the same trustee and on the same terms, but the TCC stated that in that case, another trust would be created. The TCC concluded that it is only the settlor, or a subsequent contributor who could be seen as a settlor, that could be the person from whom property was received for the purpose of subsection 75(2).

On application to the facts, the TCC concluded that the taxpayer did not transfer the shares of Vienna or Cambrian to the Foundation as a settlor, or as a contributor acting as a settlor. Instead, the taxpayer sold the shares to the Foundation, who, as trustee of the property, held the property on conditions created by the taxpayer's father; the original cash endowment (the only contribution to the trust) had been replaced by the shares. As a result, it was the taxpayer's father and not the taxpayer who was the person that contributed property to the trust. Consequently, subsection 75(2) did not apply and none of the capital gains realized on the sales of the shares by the trust was attributable to the taxpayer.

While *obiter*, the TCC also addressed the application of the Treaty in the event that subsection 75(2) did apply to the capital gains. The applicable provisions in the Treaty provide that gains from the alienation of any property, other than certain exceptions, are taxable only in the contracting state in which the alienator is resident. Pursuant to the Treaty, the capital gains realized by the Foundation as a resident of Austria would be taxable only in Austria.

The TCC concluded that subsection 75(2) did not deem the contributor of property to the trust to be the alienator of the property for the purposes of the Treaty. Rather, subsection 75(2) recognized the trust as the alienator of the property, but provided that the gain realized could be attributed to the person from whom the property was received. Because the trust was the alienator of the property, the Treaty was properly applicable to the trust, so that even if subsection 75(2) were found to apply, the taxpayer would not be required to include any of the capital gains in his income.

## ***Federal Court of Appeal decision***

The FCA upheld the TCC decision and, based on an assumption that there was a trust, cited with approval the reasoning of the TCC that only a settlor, or subsequent contributor who could be seen as a settlor, can be the person from whom the trust received the property for the purposes of subsection 75(2). Because the taxpayer did not settle any property on the trust, subsection 75(2) could not apply to attribute any of the capital gains realized by the Foundation on the sale of its property. While not argued at the FCA, the Court addressed the issue of whether there was a trust, stating doubt as to whether a trust actually existed.

In *obiter*, the FCA also agreed with the TCC that the Treaty can override the implications of subsection 75(2) to a Canadian contributor of an Austrian trust.

## ***PwC comments***

Both the TCC and the FCA rejected the Minister's position that a fair market value sale of property to a trust by a beneficiary will be subject to subsection 75(2) if the beneficiary can receive the property in its capacity as a beneficiary of the trust. This welcome limitation to the CRA's broad application of subsection 75(2) will allow more flexibility in planning with trusts and reduce the potential for unintended offside contributions to a trust.

Neither the TCC nor the FCA addressed the issue of whether subsection 75(2) could apply when a beneficiary vendor sells property to a trust for proceeds that are determined to be less than fair market value. In that situation, the excess value may constitute a settlement of property on the trust and all or a portion of the income or gain on the property could be subject to subsection 75(2). It remains to be determined whether a price adjustment clause could protect the vendor beneficiary from the application of the attribution rules.

Whether the Minister will appeal the FCA's decision to the Supreme Court of Canada is not yet known.

## ***Need more help?***

For more information on what the FCA's decision means for you, please contact any of the following individuals:

Jason Safar

905 972 4118  
[jason.safar@ca.pwc.com](mailto:jason.safar@ca.pwc.com)

Angela Ross

416 218 1541  
[angela.m.ross@ca.pwc.com](mailto:angela.m.ross@ca.pwc.com)

**Tax News Network (TNN)** provides subscribers with Canadian and international information, insight and analysis to support well-informed tax and business decisions. Try it today at **[www.ca.taxnews.com](http://www.ca.taxnews.com)**