Tax memo

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Supreme Court of Canada rules on trust residence – St. Michael Trust Corp. v. The Queen (Garron Family Trust)

*Provides a summary of the SCC ruling and PwC's comments on the implications of the SCC's decision in **St. Michael Trust Corp. v. The Queen**.*

April 12, 2012

The Supreme Court of Canada (SCC) today (April 12, 2012) released its decision in **St. Michael Trust Corp. v. The Queen (*sub nom.* Garron)**. The SCC agreed with the reasoning in the lower courts that central management and control over the trust property, rather than the residence of the trustees, was the appropriate test for determining trust residence for purposes of the *Income Tax Act* (the Act).

The case is important because it clarifies the principles to be applied to determine trust residence and, as well, provides some comments with broader implications for determining corporate residence.

Background

Until **Garron**, only one Canadian case had considered the issue of trust residence. In **Thibodeau Family Trust v. The Queen**, 78 DTC 6376, the Federal Court– Trial Division (FCTD) had determined that, on the particular facts of the case, the trust resided where the majority of the trustees were resident. In **Thibodeau**, the FCTD stated (although arguably in *obiter* comments) that the central management and control test (which has historically been applied in determining the residence of a corporation) was inapplicable to trusts.

Key aspects of the Garron decision

In **Garron**, the Tax Court of Canada (TCC) found that **Thibodeau** was insufficient authority to reject using the central management and control test to determine trust residence and ruled that test should also apply to trusts, with such modifications as are appropriate. Applying this test to the facts, the TCC held that the trusts in question were resident in Canada. The Federal Court of Appeal (FCA) upheld the TCC analysis on this point.

The SCC agreed with the lower courts that there were sufficient similarities between a trust and a corporation to justify the application of the central management and control test to determine the residence of a trust, just as it is used in determining the residence of a corporation.

Several subsidiary issues were also dealt with by the lower courts, but the SCC declined to deal with these, given its finding as to the residence of the trust based on common law principles. However, the SCC did specifically state that it should not be understood as endorsing the reasons of the FCA on those subsidiary matters.

Facts

There were actually two trusts involved in the cases, but in summary:

- a "freeze" transaction was carried out on a Canadian company for each of its shareholders (who were unrelated Canadian resident individuals); and
- the "growth" shares were acquired, indirectly through a Canadian holding company, by a trust of which the trustee was a trust company resident in Barbados.

The beneficiaries of the trusts were members of the family of each of the individual shareholders who carried out the freeze. The settlor of each trust was a non-resident, and each trust had a "protector" who was a non-resident individual and a friend of the holder of the freeze shares.

The freeze transactions were carried out in 1998, and two years later the shares in the Canadian holding company that held the growth shares were sold for very significant amounts. The trusts claimed that the capital gain was not subject to tax in Canada because the trusts were resident in Barbados and were entitled to the benefits of the *Canada-Barbados Income Tax Agreement (1980)* (the "Treaty").

Trust residence

A range of issues were dealt with by the lower courts, but of key importance was the issue of the residence of the trust.

For the trusts, it was argued that the fact that the trustees were resident in Barbados should be considered conclusive with regard to the residence issue. The Minister, on the other hand, argued that the role of the trustees was limited and of an administrative nature only and that the trusts were in reality managed in Canada and should be taxed as residents of Canada.

The TCC found that there was virtually no helpful guidance in the case law on the principles to be applied in determining where a trust is resident for tax purposes. The **Thibodeau** case was rejected as establishing that the residence of a trustee is always the deciding factor in determining the residence of a trust. Although in **Thibodeau**, the FCTD had suggested in *obiter* that the central management and control test applicable for determining corporate residence should not apply to trustees because of their fiduciary role, the TCC found that there was "every reason" to adopt a similar test of residence for trusts and corporations, in the interest of consistency, predictability and fairness.

The TCC acknowledged that in the corporate context, the courts have required more than evidence of shareholder influence to find that central management and control is located with shareholders; however, on the facts of the case, the TCC was unpersuaded by the evidence presented that the role of the Canadian individuals was limited to "influence" rather than "dictating." Instead, the TCC judge found as a fact that it was individuals resident in Canada who exercised the central management and control of the trusts and that the trustees' role was limited to the provision of administrative services.

The TCC's reasoning and analysis of the principles to be applied in determining the residence of a trust was upheld in the FCA.

SCC decision

The SCC agreed with both lower courts' residence analysis and clearly endorsed the principle that, as with corporations, the determination of residence of a trust should be based on where "its real business is carried on," which is where the central management and control of the trust actually takes place.

The SCC did not rule out that a trust could be found resident where its trustee resides, but in order for the residence of the trust to be based on the

residence of the trustee, the trustee must carry out the central management and control of the trust and perform the duties connected with management and control in that jurisdiction.

Subsidiary issues

Several subsidiary issues were also raised by the Minister at each level:

- Whether, even if under the common law tests the trusts were resident in Barbados, the provisions of subsection 94(1) deemed the trusts to be resident in Canada. This provision deems a non-resident trust with Canadian resident beneficiaries to be resident in Canada where the trust has "directly or indirectly in any manner whatever" received property from a Canadian resident person with a certain relationship to the beneficiaries. Related to this issue was the question of whether the Treaty provisions over-rode the provisions of subsection 94(1).
- Whether, assuming that the trusts were resident in Barbados and otherwise entitled to the benefits of the Treaty, the transactions resulted directly or indirectly in an abuse or misuse of the provisions of the Act or treaty such that the general anti-avoidance rule (GAAR) in section 245 of the Act applied to deny the Treaty exemption claimed by the trust.

Application of subsection 94(1)

At each court level, the finding that the trust was resident in Canada was sufficient to dispose of the appeal. However, the TCC considered the Minister's alternative arguments based on the application of subsection 94(1) and on GAAR.

The Minister argued that property had been transferred to the trusts, in the form of the "growth rights" attached to the common shares, by the individuals who carried out the freeze. This argument was based largely on the assertion that the "freeze" shares taken back did not have a value equal to the common shares that were "frozen," so that at the time of the freeze the growth shares held by the holding companies owned by the trusts already had significant value.

The TCC found that while the Minister's argument on the value of the freeze shares was supportable, property had not been transferred to the trusts for the purposes of section 94, because of the holding company structure. On this point, the FCA disagreed with the TCC analysis and found that in the circumstances, property could be considered to have been transferred directly or indirectly to the trusts because the freeze transaction had resulted (based on the evidence as to the value of the company at the date of the freeze) in a shift in value to the trusts.

Treaty and GAAR

The TCC found that even if subsection 94(1) applied, the trusts were subject to a more limited scope of taxation under that provision than persons that are resident under general tax principles and thus would not have been residents of Canada for the purpose of the Treaty. Accordingly, section 94 did not affect the Treaty exemption.

The TCC further stated that it was not satisfied that an abuse of the Treaty had been established. If the trusts were resident only in Barbados then the treaty contemplated that the exemption from Canadian tax on a capital gain provided by Article XIV(4) would be available to them; it did not matter that the trust had few connections with Barbados. The TCC also stated that if Canada had intended that section 94 should override the treaty, then the treaty should have specifically provided for this result.

Although the FCA disagreed with the conclusion that subsection 94(1) did not apply to the trusts, the FCA agreed with the TCC that if in fact the trusts were resident in Barbados when they realized the capital gain on the sale of the common shares, the Treaty "trumped" section 94. Further, GAAR would not apply to tax the gain – the trusts would not have avoided section 94 but fallen squarely into it. The capital gain would be exempt from Canadian tax by virtue of the trusts being resident in Barbados and entitled to the benefits of the Treaty; Canada agreed to the treaty exemption and relying on it would not be abusive.

The SCC expressly declined to weigh in on the subsidiary issues, although making it clear that in

not dealing with them it should not be understood to endorse the reasons of the FCA on those matters.

PwC comments

The SCC decision on the trust residence point is not particularly surprising, given the factual findings at the TCC level and the fact that the FCA had upheld the TCC's reasoning on this point. It is somewhat disappointing that the SCC declined to comment on the subsidiary issues, which are both important issues in their own right and have some significant implications.

Need more help?

For more information on the implications of this decision and what is means for you or your company, contact any of the following individuals.

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