# Antle and Garron – The Federal Court of Appeal – Focus on the Fundamentals

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The Federal Court of Appeal decisions in *Antle* [2010 FCA 280, 2010 DTC 7304] and *Garron* [2010 DTC 5189, [2011] 2 CTC 7] provide welcome direction for those engaged in the planning, implementation and maintenance of trust structures, both domestic and offshore, reminding us to focus on the fundamentals.

***Garron***

On November 17, 2010, the Federal Court of Appeal rendered its decision in respect of the appeal by the Garron Family Trust of its loss at the Tax Court of Canada. (2009 TCC 450, 2009 CarswellNat 2600)

In *Garron*, two Canadian resident families were involved (the appeals were heard on common evidence). For each family, an offshore trust governed by the laws of Barbados had been settled by an individual resident in St. Vincent. The sole trustee of each trust was a corporation resident in Barbados. The beneficiaries of the trusts were the respective family members. Each trust was then utilized by Canadian resident individuals in the families to effect what appeared to be a freeze of a Canadian operating corporation with old common shares exchanged for retractable preference shares and new common shares issued at a nominal amount to newly incorporated Canadian holding corporations owned by the Barbados trusts.

Some two years later, the Barbados trusts sold the majority of the shares they owned in the Canadian holding corporations, resulting in capital gains of over $450,000,000. The Barbados trusts applied for certificates under s. 116 of the Income Tax Act in respect of the dispositions of the shares and paid amounts on account of potential Canadian income tax in accordance with the procedures set out in s. 116. The Barbados trusts then sought the return of the amounts paid on the basis that Article XIV(4) of the Canada-Barbados Income Tax Convention applied to exempt the capital gains from Canadian income tax.

The Crown took the position that the treaty exemption did not apply and issued assessments in respect of the gains both against the Barbados trusts and against the individuals who participated in the initial freeze transaction (reassessments against the trusts were upheld).

While the Crown raised several arguments in support of its assessments of the Barbados trusts, the one with traction was the contention that the trusts were resident in Canada by reason of the fact that the management and control of each trust was in Canada, notwithstanding the acknowledged fact that the sole trustee of each trust was a corporation resident in Barbados.

Justice Woods engaged in a very thoughtful analysis of the factual evidence, the provisions of the Barbados tax treaty and the very scant jurisprudence on the issue: the principal Canadian case, *Thibodeau v. the Queen*, 78 DTC 6376, has long been said to stand for the proposition that a trust is resident where the trustee is resident.

Justice Woods concluded that the appropriate test to be used to determine the residence of the trusts was not solely the trustee's residence. Rather, the judge-made test for the residence of corporations should govern: where the central management and control actually abide. In the result, the trusts were found to be residents of Canada because the individuals from the families making the material decisions with respect to the Barbados trusts were located in Canada. This finding does align with the definition of "resident" in Article IV(1) of the Barbados treaty as it looked to one of the listed criteria set forth in that provision. But it was a substantial departure from conventional wisdom. Enter the Federal Court of Appeal.

Justice Sharlow in rendering the decision for the Federal Court of Appeal agreed with Justice Woods that the central management and control test is the appropriate one in determining the residence of a trust. Although the residence of the trustee may often align with the residence of the trust, a rigid test that relies solely on the residence of the trustee was held not to be sound in principle "because it denies the central theme of the jurisprudence on the determination of residence for tax purposes, which is that residence is fundamentally is a question of fact". Consequently, the Federal Court of Appeal concluded "it is appropriate to undertake a fact driven analysis with a view to determining where the central management and control of the trust is actually exercised." (at paragraph 62)

The decision makes it clear that there is a bright line between persons making recommendations, even strong ones, where the trustee is nevertheless free to exercise its decision making powers and persons really exercising the powers and discretions under the trusts displacing the trustee. The latter will direct the residence of the trust away from the residence of the trustee to the residence of the persons with the management and control.

Having established the appropriate test for residency, the Federal Court of Appeal agreed that there was ample factual evidence to support the Tax Court of Canada's conclusion that individual Canadian residents, rather than the titular trustee, were exercising the central management and control of the trusts so as to cause the trusts to be resident in Canada.

While that finding was sufficient to dispose of the appeal, Justice Sharlow went on to provide some obiter comments on the alternative arguments that were argued.

The potential application of section 94 was considered. Justice Sharlow concluded that the attempted freeze transactions had been improperly executed because the freeze shares had redemption values substantially less than the value of the corporations at the time. This resulted in a transfer of value to the new common shares issued on the freeze. That transfer of value caused section 94 to apply which would have deemed the trusts to be resident in Canada. However, the Federal Court of Appeal agreed with the Tax Court of Canada in concluding that had the trusts been resident in Barbados, the paramount provisions of the Canada Barbados Tax Treaty would have protected the trusts from the application of section 94.

The Federal Court of appeal also concluded that the general anti-avoidance rule was of no application.

In summary, had the structures been implemented and maintained so that, as a factual matter, central management and control abided with the titular trustee in Barbados, the taxpayers' plans would have worked and the exemption from capital gains in the Barbados treaty would have protected the trusts from any Canadian income tax notwithstanding the ineffective implementation of the freeze transactions.

The Federal Court Trial Division had earlier expressed the view that the application of section 94 deemed residence would be displaced by the paramount provisions of the Barbados tax treaty in *RCI Trust v. Canada*, 5 C.T.C. 85, 2009 D.T.C. 6127, at para 33-35 and Justice Woods expressed the same view in the Tax Court of Canada decision in *Garron* at para 308-319. These decisions were sufficiently disturbing to the tax authorities to cause the Department of Finance to propose an amendment to the *Income Tax Conventions Interpretation Act*, a statute which by its terms will override tax treaty provisions that would otherwise be paramount to domestic law. In particular, proposed section 4.3 of that statute provides that where a trust would otherwise be deemed to be a

resident of Canada under subsection 94(3) of the *Income Tax Act*, that deemed Canadian residence will apply notwithstanding the provisions of a tax treaty. If enacted, this effectively overrides the Federal Court of Appeal's view that the deemed residency provisions of section 94 cannot displace the paramount residence of a person established under the provisions of a tax treaty.

***Antle***[1]

On October 21, 2010, the Federal Court of Appeal rendered its decision (2010 FCA 280) in respect of the appeal by *John Antle* from his loss at the Tax Court of Canada (2009 TCC 465, CarswellNat 2792).

The case involved individual Canadians who attempted to use an offshore trust to obtain a tax benefit. Assessments were issued against the offshore trust and John Antle and were heard on common evidence.

It was an ambitious plan. The transaction before the court involved a Canadian resident husband who purported to transfer shares in a Canadian corporation to a trust resident in Barbados. The plan was to structure the trust as a spousal trust so that theoretically the transfer could occur on a rollover basis for Canadian income tax purposes. The offshore trust would then sell the shares to the wife at fair market value for a note. The wife would then sell the shares to a third party purchaser, pay off the note to the offshore trust. The offshore trust would make a distribution of capital to the wife of the note proceeds, again theoretically so that the wife could receive that distribution of capital on a tax-free basis. Since Barbados does not tax capital gains, no tax would be paid on any of the transactions.

The taxpayers argued at the Tax Court of Canada that the trust, as a resident of Barbados, was entitled to rely on the exemption from Canadian income tax in respect of the gain on the sale of the shares pursuant to Article XIV(4) of the Canada-Barbados Income Tax Convention. The Crown did not dispute the contention that the trust was resident in Barbados. Rather, it raised a number of arguments regarding the ineffectiveness of the trust. After reviewing the evidence, Justice Miller of the Tax Court of Canada accepted the Crown's contention that the trust had never been settled so it never came into being. That being the case, the disposition of the shares to the third party purchaser was held to have been undertaken by the husband and the assessment against him for Canadian income tax on the capital gain was upheld.

That should have been the end of the matter but Justice Miller went on to provide a lengthy analysis of whether the general anti-avoidance rule could be applied and whether the transactions constituted a sham. He concluded in *obiter* that GAAR was applicable to stop the husband from using the spousal rollover and the provisions of the Barbados tax treaty in an attempt to circumvent Canadian capital gains tax. Justice Miller also expressed the opinion in *obiter* that the trust was nevertheless not a sham.

The sole basis argued on behalf of the taxpayers at the Federal Court of Appeal was that the decision of the Tax Court of Canada was incorrect because it was based on "circumstances external to the trust deed". This was a somewhat surprising argument as one of the critical certainties that must be met to support the creation of a valid trust is certainty of intention. The Court of Appeal very quickly disposed of this argument citing several decisions in support of the proposition that "intention is determined by all of the evidence" including the conduct and the activities of the parties.

Justice Noël in rendering the decision for the Federal Court of Appeal agreed that the trust had never been properly constituted since, by admission, it was never the husband/settlor's intention to relinquish control of or discretion over the shares to the trustee.

While the finding that the trust had not been constituted was sufficient to dispose of the appeal, Justice Noël felt that it would be useful to address the trial judge's *obiter* opinion that the trust was not a sham.

The Court of Appeal took issue with the trial judge's finding that where the parties had "some legitimacy" to think the trustee had discretion over the shares, that was sufficient to conclude that there was no sham because it displaced the prerequisite element of

intentional deception required to find a sham.

The Court of Appeal examined the factual findings made by the trial judge that demonstrated that the settlor and trustee "gave the false impression of the rights and obligations created between them". The Court of Appeal concluded the trial judge was bound to hold that the trust was a sham based upon those findings.

While the Court of Appeal did not cite the ubiquitous quote from *Snook v. London West Riding Investments Ltd.* [1967] 1 All ER 518 at 528 that a sham constitutes:

"acts done or documents executed by the parties to the sham which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create",

the Court of Appeal effectively summarized that classic definition in its conclusion that to have a sham "it suffices that the parties to a transaction present it as being different from what they know it to be". That is sufficient to satisfy element of intentional deception in the context of "sham".

This very concise description by the Federal Court of Appeal provides welcome guidance on the factual underpinnings necessary to support the application of the sham doctrine in Canadian tax law.

**Conclusion**

Setting up a trust structure properly has always been important. Now it is clear that anyone dealing with a trust would be well advised to ensure that the actual relationships, arrangements and decision-making are monitored throughout the existence of the trust to ensure that the residence of the trust remains as intended and that all actions taken by the settlor, trustees, beneficiaries and advisors are consistent with the existence of the trust as it is held out to third parties.

1 The discussion on *Antle* is reprinted with the permission of the Ontario Bar Association. It originally appeared in the December 2010 issue of *Deadbeat*, Vol. 29, No. 2.



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