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## Offshore no longer safe for trusts



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An offshore trust in tranquil Barbados was deemed taxable by Ottawa's tax collectors in a Supreme Court ruling.

Eva Holland/Postmedia News files

Tax jurisprudence develops slowly and ponderously, but occasionally, with tsunami-like shifts that radically change the landscape.

One such wave washed ashore in April with a Supreme Court of Canada case that has so far been largely ignored in the financial media.

The case is called *Fundy Settlement* and it changes the ground rules for determining the residence of offshore trusts established to minimize Canadian taxes. The court moves from formal to substantive analysis, and the practical impact of this new approach is that, much to the chagrin of beneficiaries, many purported non-resident trusts will now be taxable in Canada.

*Fundy Settlement* involved a non-resident individual in the Caribbean settling an irrevocable trust for beneficiaries resident in Canada. An accounting firm's corporation purported to manage the trust in Barbados. When the trust disposed of shares that it owned in two Ontario corporations for more than \$450-million, the purchaser prudently remitted \$152-million to the Minister of National Revenue as withholding tax on account of Canadian capital gains realized by the trusts on the sale of the shares. The trustee sought return of the withheld amount based on an exemption from capital gains tax in the Canada-Barbados Tax Treaty, under which tax is payable only in the country in which the seller is resident. The trustee claimed that because it was resident in Barbados, the trusts were also resident in Barbados.

The CRA was not amused and fought its assessment all the way up to the Supreme Court, which held that, as with corporations, the residence of a trust is determined by the principle that its residence is where it carries on its real business and is actually controlled and managed — in this case in Barbados.

Canada has long taxed persons — individuals and corporations — based on their residence, which for tax purposes is a mixed question of fact and law. The policy for residence-based taxation is to ensure that a person who enjoys the legal, political and economic benefits of associating with Canada pays his or her appropriate share for the costs of the association.

Thus, in the case of individuals, we determine residence by looking at factors such as physical presence, nationality, location of family home, social connections and other connecting factors.

For corporations, we determine residence by locating its “central mind and management” — the place where it makes its high-level corporate decisions. The focus is on the actual decision-making power, not the nominal location of its corporate head office.

Canadian law follows a 1906 case called *De Beers*, in which the U.K. House of Lords said: “A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business.- [A] company resides for purposes of income tax where its real business is carried on. [T]he real business is carried on where the central management and control actually abides.”

For example, a company incorporated in the Cayman Islands, but actively and effectively managed from Canada would be considered a Canadian resident for tax purposes and taxable on its worldwide income.

However, unlike individuals and corporations, which are legal entities, a trust is not an entity in private law. A trust is a relationship in which a person settles property on a trust, which the trustee holds and manages for the benefit of beneficiaries. The property must be held in such a manner that the real benefit of the property accrues to the benefit of the beneficiary, not the trustee, according to the terms of the trust.

For tax purposes, however, a trust is taxable as a separate person. Because of its unique legal character, determining a trust’s residence has been a troublesome issue in Canadian tax law. Since 1978 at least, the conventional view has been that one determines the residence of a trust by the residence of its trustees, regardless of their active involvement in managing the trust. The Canada Revenue Agency tacitly acquiesced in this approach for 30 years. This led to taxpayers gaming the system by emphasizing form over substance and creating offshore trusts in friendly jurisdictions under the control of nominal trustees. The rule allowed accounting firms to set up offshore branches to administer trusts. Barbados is particularly popular as a tax haven with Canadians because of its generous income tax treaty provisions with Canada.

In *Fundy Settlement*, the trial judge found that the Barbados corporate trustee, an entity owned by an accounting firm, was selected merely to provide administrative services. Its role was to execute documents as required. It was generally not expected that the corporate trustee would have responsibility for decision-making beyond that. Although the accounting firm had significant expertise in accounting and tax matters, it was questionable whether it had expertise in managing trust assets. The beneficiaries of the trust exercised actual management and control in Canada. Hence, the trust was resident in Canada for tax purposes. The Supreme Court confirmed the trust to be resident in Canada.

The decision will cause a seismic shift in offshore tax planning for trusts. Tax professionals, who have lived comfortably under the old regime for 30-plus years, must now review the structure of the hundreds of trusts located in off-shore jurisdictions, particularly in Barbados, to ensure that the named trustees actually manage and control the trust’s assets and make all of the high-level decisions that is expected of fiduciaries.

To be sure, tax jurisprudence develops slowly. The Supreme Court’s shift to the substance of trust management over its form will require a new generation of tax lawyers to review their predecessor’s offshore structures. Tax law students should also observe the shift and pay more attention to the policy of the law and not just recite technical rules in parrot-like fashion.