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Vern Krishna discusses the Supreme Court of Canada moved from formal to substantive analysis and changed the ground rules for offshore trusts established to minimize Canadian taxes. Under the new rules, and much to the chagrin of beneficiaries, many purported non-resident trusts will now be taxable in Canada.

Offshore Trusts

Date: November 1, 2012

Offshore Trusts

Vern Krishna

Tax jurisprudence develops slowly and ponderously, but occasionally, with tsunami-like shifts that radically change the landscape. In a low-profile decision largely ignored by the financial media, the Supreme Court of Canada moved from formal to substantive analysis and changed the ground rules for offshore trusts established to minimize Canadian taxes. Under the new rules, and much to the chagrin of beneficiaries, many purported non-resident trusts will now be taxable in Canada.

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 decisionmaking power, not the nominal location of its corporate head office. As the House of Lords said *in De Beers*[1] in 1906 [a decision followed in Canada]:

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 … the 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. According to the terms of the trust, 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.

For tax purposes, however, a trust is taxable as a separate person. Because of their 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 (CRA) 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.

The Supreme Court's decision in *Fundy Settlement*[2] requires closer examination of the substance of offshore trusts. In essence, the case 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 it resides where it carries on its real business and is actually controlled and managed.

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 they 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 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 offshore 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 are 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 new generation tax lawyers to review their predecessors' offshore structures. Tax law students should also observe the shift and may have to pay more attention to the policy of the law and not just recite its technical details.

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Footnotes

1 *De Beers Consolidated Mines, Ltd. v. Howe,* [1906] AC. 455.

2 *Fundy Settlement v. Canada,* [2012] S.C.J. No. 14.

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