Tax Notes

August 2012
Number 595

CCH
a Wolters Kluwer business

SALE TO TRUST NOT HIT BY REVERSIONARY TRUST RULES

— David Louis, tax partner, Minden Gross LLP, a member of MERITAS law firms worldwide

Last month, the *Sommerer* appeal was heard (*The Queen v. Peter Sommerer*, 2012 FCA 207), concerning the applicability of the so-called reversionary trust rules — one of the most dangerous traps to estate and tax planners. To summarize what these rules are all about, I will paraphrase the Court of Appeal's own words: Broadly speaking, subsection 75(2) is intended to ensure that a taxpayer cannot avoid the income tax consequences of the use or disposition of property by transferring it to a trust while retaining the right of reversion in respect of the property (or property for which it may be substituted), or retaining the right to direct the disposition of the property or substituted property. Subsection 75(2) operates by attributing any income or loss from the use of trust property, and any gain or capital loss to the person from whom the property (or property for which it was substituted) was received by the trust. (See paragraph 34.)

Until recently, cases centering on the provision were relatively infrequent. That trend was changed starting with the *Howson* case (2007 DTC 141), in which the Tax Court of Canada held that subsection 75(2) did not apply to a loan of funds to a trust, holding that "a *bona fide* loan is, on its face, not subject to reversion by the terms of the trust. It returns to the holder by operation of a loan itself and the law of creditor rights". (Other recent cases in which subsection 75(2) has been at issue include *Garron* and *Labow*.)

Sommerer involved a non-resident father, Herbert, who set up an Austrian foundation in the mid-1990s. His son, Peter, a beneficiary, sold shares to the foundation at fair market value, which were resold for capital gains within a couple of years after the original transactions. The CRA reassessed Peter under subsection 75(2) and a number of related grounds, some of which are relevant to the appeal and will be discussed later. The subsection 75(2) issues included whether the foundation arrangement was a trust in the first place, and if so, whether subsection 75(2) applied — particularly, whether the shares, having been sold at fair market value, were property that could revert to the person from whom they were received (i.e., Peter). The first issue (whether there was a trust) wasn't actually argued in the appeal: at this point, the parties assumed that the arrangement was a trust — but as we will see, the Federal Court of Appeal ("FCA") nonetheless commented on the issue.

As to the application of subsection 75(2), the FCA decision is simple: in spite of its broad wording, subsection 75(2) is not applicable to a fair market value sale by a beneficiary. Although the Tax Court of Canada had gone into an elaborate and lengthy analysis, the rationale articulated by the appeals court is straightforward: to interpret subsection 75(2) otherwise would lead to outcomes that are "absurd and could not have been intended by Parliament" (paragraph 49) — i.e., it would lead to double tax on the same gain. As a

result, the appeals court upheld the Tax Court of Canada's holding that only a settlor, or a subsequent contributor who could be seen as a settlor, can be the person to whom subsection 75(2) is applicable (see paragraph 57 of the FCA's judgment). That would be Herbert, the father (even though he was non-resident).

Simple? Perhaps not quite so: several commentators have stressed that the Tax Court of Canada focused on the person to whom subsection 75(2) applied as the original contributor to the trust at the time the trust is created. While there may be more than one contributor in a trust arrangement, the lower-court judge suggested that each such contribution can establish a separate trust. As commentators have observed, taken literally, this invalidated various CRA interpretations on subsection 75(2).

Mary and Jack

However, the *Sommerer* appeal judgment involves a simple example which bears on the above. Mary settles a $10,000 trust for her children, naming them all as beneficiaries, and naming herself as sole beneficiary in the event that all of the children predecease her. (As the FCA observes, subsection 75(2) would clearly apply to Mary.) Subsequently, one of Mary's children, Jack, "donates" a painting to the trust (rather than selling it at fair market value), stipulating that the terms of the existing trust apply except that, if the painting is still held by the trust in 10 years' time, the painting would revert to Jack. If the trust sells the painting five years later, the FCA said that the capital gain is attributed to Jack (and not Mary) because it was realized on the disposition of the property that the trust acquired from Jack, subject to the terms of the existing trust, and also subject to the condition that the property could revert to him.[1] (The example goes on to say that if Jack, instead of donating the painting to the trust, sells it to the trust at fair market value, subsection 75(2) would not apply to Jack but would apply to Mary, because in that case, rather than being donated to the trust, the painting is property substituted from Mary's original settlement.)

Note that in the above example, the FCA concludes that subsection 75(2) applies to Jack, but he is not the original contributor to the trust, and the FCA does not say anything about Jack's contribution establishing a separate trust. In a sense, this example elaborates and fleshes out the lower court's decision emphasizing that, besides the original settlor, subsection 75(2) applies to "a subsequent contributor who could be seen as a settlor".

As mentioned at the beginning of the article, subsection 75(2) is fraught with problems and anomalies — even if loans and sales at fair market value are taken out of the equation.[2] I also remind readers that the *Sommerer* case does not specifically deal with what is often the real problem with the reversionary trust rules: the inability to distribute assets on a rollover basis where subsection 75(2) has ever applied to the trust (see subsection 107(4.1)).

Does *Sommerer* have any bearing on other problems? In my writings, I have cautioned about a beneficiary who makes out a cheque to pay the trust expenses, on the concern that the funds (or substituted property) could revert to the beneficiary.[3] Query whether this is a problem if the FCA's wording is taken literally, since this type of situation would not seem to be akin to a contributor who could be "seen as a settler" (the FCA also uses the word "endowed"). But note that, as in the *Sommerer* situation, the applicable wording of subsection 75(2) itself is much broader, using the terminology "revert to the person from whom the property . . . was directly or indirectly received" (so pending CRA clarification, my observation should not be interpreted as a green light for such actions).

Likewise, the FCA decision itself does not speak to the "veto powers" contained in subsection 75(2) — that the reversionary trust rules could be triggered if the contributor has the power to pass the property to persons determined by him or her, or the property cannot be disposed of without the contributor's consent. But in this case, the CRA may provide administrative relief: it has been stated by the CRA that if two or more trustees, acting in their fiduciary capacity, decide issues by majority, this will not normally, in and by itself, give rise to the application of subsection 75(2).[4]

If you ask me, the *Sommerer* case may at least in a broad sense validate such administrative largesse. The courts (not to mention the CRA and practitioners) have obviously struggled with subsection 75(2)'s arcane language. Per the FCA, "subsection 75(2) must be interpreted and applied to give effect to its language, read in its proper context and with a view to giving effect to its intended purpose" (i.e., as stated at the beginning of the article) in order not to lead to outcomes that are "absurd and could not have been intended by Parliament" (paragraphs 48 and 49).

This is not just a knock against the CRA (in fact, as we just saw, the CRA has often interpreted subsection 75(2)'s provisions with administrative largesse). In my view, the case does not support the assertion — made by many practitioners — that "revert" should be interpreted in the legal sense, as opposed to "return to" (e.g., in the capacity of a beneficiary).

In the end, the problems with subsection 75(2) will be remedied by a common-sense interpretation of its provisions that manages to minimize "absurd" results. To me, that's what the FCA's decision is all about.

Other Issues

As I said earlier, another issue mentioned in the FCA's decision was whether the foundation arrangement was a trust, so that subsection 75(2) applied in the first place. The Tax Court of Canada held that, while the foundation itself was not a trust, it was a trustee for a trust relationship established by the father. The Tax Court of Canada's approach to the entity classification issue has been discussed at length: a number of commentators have emphasized the Tax Court's focus on whether there were sufficient similarities between the arrangement and a trust under Canadian law, as well as the legislation and governing documents that created the foundation, which made it a trustee of a "trust".

As I said, the issue itself was not challenged at the Court of Appeal level. However, the Court went out of its way to express the view that the existence of a trust was a "doubtful proposition", observing (in paragraphs 41 and 42):

> . . . that possibility cannot be realized unless those conditions are formally established. Nothing in the constating documents of the Sommerer Private Foundation or the law of Austria, as reflected in the record of this case, supports the conclusion that the right of the Sommerer Private Foundation to deal with its property is constrained by any legal or equitable obligations analogous to those of a common law trustee. . . . Nothing in the Austrian *Private Foundations Act* or the constating documents of the Sommerer Private Foundation gives Peter Sommerer a legal or equitable claim to the corporate property that is different from that of a shareholder or member of a corporation.

Lastly, the FCA upheld the Tax Court of Canada's conclusion that, even if subsection 75(2) were to apply, it would be overridden by Article XIII(5) of the *Canada–Austria Tax Convention*, which provides that in the circumstances, the gain shall be taxable only in the state of which the alienator is resident. The FCA rejected the CRA's argument that the treaty didn't apply because subsection 75(2) would, if applicable, attribute the gain to the appellant (i.e., Peter Sommerer, the son, a resident of Canada), rather than the foundation (resident in Austria). The FCA held that the interpretation of the treaty should be approached with a view to avoiding economic double tax, rather than double tax on a particular person ("juridical double tax"). I will not comment further on the last two issues, as there will no doubt be considerable commentary thereon.

Notes:

[1] The FCA noted the following: "It is important to observe that, because the painting was donated to the trust by Jack and the trust gave nothing to Jack in return, it cannot be said that the painting is property substituted for any property that the trust received from Mary, so there could be no attribution to Mary of any gain on the sale of the painting, or any income or gains associated with property substituted for the painting." See paragraph 52.

[2] See, for example, "Is a Family Trust Vulnerable to the CRA? More Warning Signs: Subsections 75(2)–107(4.1)", David Louis, *Tax Notes* No. 569, June 2010.

[3] The warning is expressed in the article noted above. Subsequently, I have drawn a possible distinction between paying the funds to the trust and directly defraying the trust expenses by paying the third party. See further discussion, for example, at page 279 of *Implementing Estate Freezes*, 3rd Edition, 2011, CCH Canadian Limited.

[4] For details, see CRA Document No. 2008-0292061E5 and earlier technical interpretations (including CRA Document Nos. 2003-0050671E5 and 2004-0086921C6), e.g., the policy would not apply where the trust expressly requires the contributor's consent.

CREDITOR PROTECTION SAVES INCOME-SPLITTING STRATEGY

— Stefanie Morand, McCarthy Tétrault LLP

McClarty Family Trust v. The Queen, 2012 DTC 1123 (Tax Court of Canada)

Although 2011 amendments to the "kiddie tax" provisions in section 120.4 of the *Income Tax Act* have rendered obsolete the planning which enabled Darrell McClarty to split income with his minor children, the decision in *McClarty Family Trust* is nonetheless noteworthy for the taxpayer-friendly GAAR analysis and the Court's comments in respect of section 84.

Darrell McClarty was a professional engineer who parted from his employer, Clifton, in the summer of 2001 after a failed management buyout. Together with three other former Clifton employees, Darrell formed a new corporation, PSI, which acted in competition with Clifton. Concerned about potential legal action from Clifton as well as potential liability in respect of PSI's business, Darrell met with his accountant in August or September 2002 with a view to obtaining greater creditor protection.

Simplified, the following steps were implemented:

(1) The shareholdings in PSI were restructured to interpose a newly incorporated holding company, MPSI, between Darrell and PSI. Darrell held 100% of the Class A voting shares of MPSI, while a newly settled family trust, MFT, held 100% of the Class B non-voting shares. MFT was settled by Darrell's father with a gold coin and had as its beneficiaries Darrell, his wife, and their three minor children. The trustees of MFT were Darrell and his wife.

(2) Darrell incorporated a second corporation, 101 SK, to "capture future investments and facilitate the creditor protection scheme".

(3) On September 30, 2003:

(a) MPSI declared a stock dividend on its Class B shares held by MFT consisting of 48,000 Class E non-voting preferred shares of MPSI with an aggregate paid-up capital and adjusted cost base of $1 and with a redemption price of $1 per share.

(b) MFT sold the Class E shares to Darrell in exchange for a $48,000 promissory note. MFT allocated the resulting $47,999 capital gain to its minor beneficiaries.

(4) On December 31, 2003:

(a) Darrell sold the Class E shares to 101 SK in exchange for a $48,000 promissory note.

(b) MPSI redeemed the 48,000 Class E shares for their redemption price of $1 per share.

(c) 101 SK paid the redemption proceeds to Darrell. In turn, Darrell paid the proceeds to MFT in satisfaction of indebtedness owed by Darrell to MFT, MFT paid the proceeds to MPSI in satisfaction of indebtedness owed by MFT to MPSI, and MPSI paid the proceeds to Darrell in satisfaction of indebtedness owed by MPSI to Darrell.

(5) In 2004, the process of MPSI paying a stock dividend to MFT, MFT selling the stock dividend shares to Darrell, Darrell selling the shares to 101 SK, and MPSI redeeming the shares was repeated such that an additional $47,999 capital gain was allocated to the minor beneficiaries.

In reassessing MFT for its 2003 and 2004 taxation years, the Minister invoked the GAAR to treat as dividends the $47,999 capital gain realized by MFT in each year. The Minister also reassessed the minor beneficiaries to include, as other income or as dividends rather than as capital gains, $16,000 in each such beneficiary's income for 2003 and 2004. At trial, the Crown argued in the alternative that subsection 84(3) applied to deem MFT to have received a dividend of $47,999 in each of 2003 and 2004, such that $16,000 was properly included as dividends in the 2003 and 2004 income of each of the minor beneficiaries. As discussed below, Justice Angers held in favour of the taxpayers in respect of both GAAR and section 84.

Angers J began his GAAR analysis by reviewing the approach set out by the Supreme Court of Canada in *Canada Trustco* (2005 DTC 5523). The taxpayers conceded that there was a tax benefit but argued that the transactions at issue were undertaken primarily to place Darrell beyond the reach of creditors such that there was no avoidance transaction. The Crown countered with the argument that "the alleged *bona fide* purpose [was] not supported by a reasonable assessment of the facts and circumstances of the transactions in that the creditor-proofing was ineffective, the documentation reveals a circular flow to the transactions, and the transactions were in fact an off-the-shelf tax plan".

Angers J agreed with the taxpayers that there was no avoidance transaction and, accordingly, that the GAAR did not apply. Notably, the Crown had argued that the declaration of the stock dividend and the sale of those shares to Darrell followed by the subsequent sale to 101 SK were avoidance transactions. Angers J rejected these arguments, stating that "Parliament recognized the Duke of Westminster principle that tax planning with the objective of attracting the least possible tax is a legitimate and accepted part of Canadian tax law". In respect of the stock dividend specifically, he stated:

> The stock dividend declared in both years at issue resulted in a shift of the value of assets from MPSI to MFT. This is consistent with the creditor-proofing strategy. [. . .] I do not find that transaction to be an avoidance transaction. As argued by the appellants, if MPSI had paid a dividend to MFT, allocated the income to the minor beneficiaries by way of a promissory note, and loaned the funds to Darrell McClarty, some creditor protection could have been achieved but it would have been less effective because of the higher tax rate on the dividends to the minor beneficiaries, and it would have resulted in less funds being available to establish the debt between MFT and the minor beneficiaries.

As for the sale of the shares to Darrell, Angers J stated:

> It could be argued that the sales of the shares by MFT to Darrell McClarty followed by the subsequent sales to 101 SK were done basically to lessen the tax consequences of the creditor-proofing plan, but those transactions would never have occurred in the absence of the need to protect MPSI's assets. They were an integral part of the strategy to protect those assets. As stated in *Canada Trustco* [. . .], if there are both tax and non-tax purposes to a transaction, it must be determined whether it was reasonable to conclude that the non-tax purpose was primary. If so, the GAAR cannot be applied to deny the tax benefit.
>
> To hold that the sale of shares should be considered an avoidance transaction because some alternative transaction may have achieved a similar result but with higher taxes would, in my opinion, be inconsistent with the Supreme Court's comments in *Canada Trustco* and the Explanatory notes relating to section 245[.] (emphasis added)

Finally, Angers J noted that there was "a definite gap left by Parliament in enacting section 120.4", but held that it was inappropriate for the Minister to use GAAR to "fill the gaps left by Parliament".

As for subsection 84(3), the Crown relied on the decision of the Tax Court of Canada in *RMM* (97 DTC 302) for the proposition that the wording "in any manner whatever" found in subsections 84(2) and (3) is to be interpreted broadly such that a person who did not hold shares immediately prior to the redemption falls within the scope of the words "each person" in subsection 84(3). Angers J rejected this interpretation. He stated that the wording in subsection 84(3):

> . . . would warrant an analysis of how the shares in question were actually redeemed, acquired or cancelled in that the method of redemption, acquisition or cancellation could have an impact on who the actual persons are who hold the shares. The manner in which each person who holds the redeemed, acquired or cancelled shares came to be in possession of the shares is not what needs to be determined under subsection 84(3). (emphasis added)

In the case at bar, Angers J held that all of the transactions were legally effective and that subsection 84(3) operated as intended when it deemed 101 SK to have received a dividend on the redemption of the MPSI shares; subsection 84(3) did not apply to deem MFT to have received a dividend.

Notably, *McClarty Family Trust* is the first of two recent decisions in which the Tax Court of Canada rejected the Crown's attempt to rely on *RMM* to support, in the author's view, an unduly broad interpretation of section 84 in circumstances where GAAR did not apply. In *MacDonald* (2012 DTC 1145), the issue was whether subsection 84(2) applied to recharacterize as dividends amounts received by a former shareholder *qua* creditor in the context of a surplus strip. Justice Hershfield held in favour of the taxpayer and noted that he favoured the approach to subsection 84(2) adopted in *McNichol* (97 DTC 111) to that adopted in *RMM*. As at the time of preparing this comment, the Crown has not appealed the decision in *McClarty Family Trust*; however, it has appealed the decision in *MacDonald*. Accordingly, practitioners can look forward to additional guidance from the Federal Court of Appeal in respect of both GAAR and section 84.

PRESCRIBED INTEREST RATES — THIRD QUARTER OF 2012

The prescribed interest rates for the third quarter of 2012 were released by the Canada Revenue Agency on June 28, 2012. They are unchanged from the first and second quarters of 2012 and are noted below.

- 1% to calculate a deemed interest taxable benefit on subsidized employee and shareholder loans;
- 1% on refunds of income tax overpayments paid to corporate taxpayers;
- 3% on refunds of income tax overpayments paid to non-corporate taxpayers; and
- 5% on payments of overdue income taxes, insufficient income tax instalments, unremitted employee source deductions, CPP contributions or EI premiums, and unpaid penalties.

These rates will be in effect from July 1, 2012 to September 30, 2012.

LIST OF REGISTERED INVESTMENTS

The CRA has published the list of registered investments, as at December 31, 2011, in the *Canada Gazette* Part I, dated June 23, 2012. This list is published annually, pursuant to section 204.5 of the *Income Tax Act*. For subscribers of the *Canadian Tax Reporter* online or on DVD, this list links from the commentary for section 204.5, as well as from the Quick Links page in the table of contents.

RECENT CASES

Cost of hot tub not eligible for METC, even though required for severely disabled person

Tax Court of Canada, May 29, 2012

The taxpayer claimed a medical expense tax credit ("METC") in 2008 for the cost of a hot tub and installation to be used as a hydrotherapy pool by her daughter, who was significantly disabled. The cost of the hot tub and installation was slightly more than $10,000. The METC was denied, and the taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. The amendments to the relevant provision in 2005 set the bar much higher for claims to qualify for a METC. In particular, the requirement under subparagraph 118.2(2)(*l.2*)(ii) could not be satisfied in this case since a hot tub, despite being installed for the benefit of a severely disabled individual, was a type of expense that would normally be incurred by persons who have normal physical development or who do not have a severe and prolonged mobility impairment.

Johnston v. The Queen, 2012 DTC 1175

Taxpayer could not transfer tax appeal to corporate successor

Tax Court of Canada, June 1, 2012

The taxpayer was an income trust that was wound up and rolled into a separate fund, which was later transferred into a corporation called Clearwater Seafoods Incorporated ("Seafoods Inc."). Seafoods Inc. acquired assets and assumed liabilities of the taxpayer, a trust holding company. The taxpayer brought a motion for direction by the Court under section 29 of the *Tax Court of Canada Rules (General Procedure)* to allow the appellant in the main appeal to be changed to Seafoods Inc., the corporate successor of the taxpayer. The Minister argued that Seafoods Inc. could not take the place of the taxpayer because a taxpayer could not transfer an income tax liability.

The taxpayer's motion was dismissed. There are no provisions in the *Income Tax Act* that would allow the taxpayer to substitute its successor as the appellant in the main appeal. An assignment or assumption of any potential tax debt of the taxpayer does not result in Seafoods Inc. acquiring those rights, and an agreement whereby one party assumes another party's tax liability cannot be binding on the Minister.

Clearwater Seafoods Holdings Trust v. The Queen, 2012 DTC 1177

Taxpayer could not be public foundation with only one trustee

Federal Court of Appeal, May 4, 2012

The taxpayer was an *inter vivos* trust that was settled by an individual for the purpose of making gifts to Canadian registered charities. It was a charitable foundation and a registered charity. The taxpayer had a single trustee, a registered trust company. All, or substantially all, of the capital was contributed by the individual, his wife, and/or entities they controlled. The Minister determined that the taxpayer was a private rather than a public foundation, and the taxpayer appealed to the Federal Court of Appeal.

The taxpayer's appeal was dismissed. After finding that the Minister's interpretation of the definition of "public foundation" was an extricable question of law, to be reviewed on the standard of correctness, the Court concluded that

Parliament had precisely and unequivocally evidenced its intent that public foundations must have more than one trustee (or director, officer, or like official). Implicit in the reference in the definition to more than 50% of the trustees was that there be more than one trustee. The phrases "each other" and "arm's length" in the definition also signalled Parliament's intent that a public foundation must have more than a single trustee. The Minister's decision that the taxpayer was a private foundation was therefore correct.

The Sheldon Inwentash and Lynn Factor Charitable Foundation v. The Queen, 2012 DTC 5090

Taxpayers challenged CRA's issuance of *Income Tax Act* and *Excise Tax Act*-related search warrants under the *Criminal Code*; taxpayers' applications for judicial review struck out

Federal Court of Appeal, April 24, 2012

In the course of investigating criminal offences under the *Income Tax Act* (the "ITA") and the *Excise Tax Act* (the "ETA"), the Canada Revenue Agency (the "CRA") obtained search warrants (the "Warrants") under section 487 of the *Criminal Code*. A prothonotary of the Federal Court struck out the taxpayers' application for judicial review, which had been based on the allegation that the Warrants should not have been obtained under the *Criminal Code*, but under section 231.3 of the ITA or section 290 of the ETA. The prothonotary found that the Warrants had been issued by provincial authorities, and that the proper forum in which to challenge them was the provincial courts and not the Federal Court. While affirming the prothonotary's reasoning, a Federal Court judge still allowed the taxpayers' appeal from the decision (2011 DTC 5129), since new evidence was brought forward in those appeals. The judge concluded that the taxpayers were not challenging the issuance of the search warrants, but the CRA's written policy of applying for the warrants under section 487 of the *Criminal Code*. Therefore, the Federal Court judge determined that the taxpayers' application should not be struck out as there still remained an issue for the Federal Court to address. The Crown appealed to the Federal Court of Appeal.

The Crown's appeal was allowed. The Warrants were orders that could only be challenged in the forum in which they were made, namely the provincial courts. Therefore, the Federal Court judge erred in finding that there was still another issue for the Federal Court to consider, i.e., whether the CRA's practice of using section 487 warrants in ITA and ETA matters was legally acceptable. Raising this issue in the Federal Court was an inappropriate collateral attack on the Warrants in the wrong forum.

Canada (AG) v. Lewry, 2012 DTC 5093

TAX NOTES

Published monthly by CCH Canadian Limited. For subscription information, contact your CCH Account Manager or call 1-800-268-4522 or (416) 224-2248 (Toronto).

For CCH Canadian Limited

Susan Peart, C.A., LL.M.
(416) 224-2224, ext. 6434
email: Susan.Peart@wolterskluwer.com

Natasha Menon, Content Product Manager
Tax, Accounting and Financial Planning
(416) 224-2224, ext. 6360
email: Natasha.Menon@wolterskluwer.com

Notice: *Readers are urged to consult their professional advisers prior to acting on the basis of material in this newsletter.*

CCH Canadian Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 · 1 800 268 4522 tel
416 224 2243 · 1 800 461 4131 fax
www.cch.ca

PUBLICATIONS MAIL AGREEMENT NO. 40064546
RETURN UNDELIVERABLE CANADIAN ADDRESSES TO CIRCULATION DEPT.
330–123 MAIN ST
TORONTO ON M5W 1A1
email: circdept@publisher.com

CCH
a Wolters Kluwer business