GARDINER ROBERTS

DISCOVERY TRUST AND BOETTGER CASES

Re: Residence of a Trust for Provincial Tax Purposes

In Canada, a taxpayer (whether corporation, individual or trust) has federal tax to pay, as well as provincial tax. While federal tax is uniform throughout the country, provincial tax rates vary from province to province. In the last several years, it has been common for trusts to be established in Alberta by individuals in the high-rate provinces, in order to shift income and capital gains to take advantage of the lower provincial tax rate in Alberta. The Minister of National Revenue (the "Minister") has lately been auditing many trusts and challenging their entitlement to the lower tax rate, in order to protect the tax base of the higher-rate provinces.

Two recent cases illustrate the difficulty facing a court in determining the tax residence of a trust after the decision in *Fundy Settlement v. Canada* (also known as "*Garron*").[1] As stated by the Supreme Court of Canada the test is as follows:

> "As with corporations, residence of a trust should be determined by the principle that a trust resides for purposes of the Act where 'its real business is carried on' (*De Beers*, at p. 458), which is where the central management and control of the trust actually takes place." [2]

In *Discovery Trust v. Canada (National Revenue)* ("**Discovery**"),[3] the Discovery Trust was settled in 2002 by a resident of Newfoundland who was the founder of a successful company, CHC Helicopter Corporation ("**CHC**"). The settlor's children, a majority of whom were resident in Newfoundland, were Beneficiaries and Trustees of the trust. Discovery Trust acquired shares in Discovery Helicopters Inc. ("**DHI**"), a holding company whose principal assets were shares of CHC. In 2006, the Beneficiaries were replaced as Trustees by Royal Trust Corporation of Canada("**RT**"), through its Alberta office. The assets of the trust were moved from Newfoundland to Alberta, and the laws governing the trust were changed from Newfoundland to Alberta. Subsequently, CHC was sold and the proceeds received by DHI were distributed to Discovery Trust through dividends and share redemptions. The Beneficiaries made a written request for distribution from the trust and received capital distributions. In its 2008 tax return, Discovery Trust paid provincial tax on the basis that it was resident in Alberta. The Minister of National Revenue reassessed the trust on the basis that it was not resident in Alberta, but rather in Newfoundland, as central management and control of the trust was exercised in Newfoundland.

The Minister asserted that the Beneficiaries directed RT in all decisions concerning the management and control of the trust, and that RT performed administrative tasks associated with the operation of the trust, such as signing documents, holding share certificates and making necessary deposits and withdrawals, as instructed by the Beneficiaries.

The Court examined each action taken by RT as Trustee, and found that its role was consistent with common trust relationships and commercial reality. While RT consulted with the Beneficiaries on each important transaction, such informed consent by RT was not equivalent to the Trustee submitting to the direction of the Beneficiaries. Moreover, approving a Beneficiary's request is not the same as giving up management and control of the trust.

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1 2012 SCC 14 (Supreme Court of Canada).
2 *Ibid*, paragraph 14.
3 2015 NLTD(G)86 (Supreme Court of Newfoundland and Labrador, Trial Division).

With respect to the Minister's assumption that consultation here amounted to a delegation of the Trustee's authority, the Court stated the following:

> "Independence of the Trustee is maintained by its review of the transaction, acquiring explanation sufficient that an informed decision can be made, ensuring the decision has no negative consequence and is in the best interests of the Beneficiaries. In these consent requests the record disclosed that Royal Trust carried out this independent function as Trustee." [4]

Interestingly, the Court also noted that the Minister's investigation was predicated on the family having an improper motive, *i.e.* moving the residence of the trust from Newfoundland to Alberta had only one purpose, namely tax avoidance. In this regard, the Court reached the following conclusion:

> "There is no question that the investigation was detailed. Documentation was effectively scrutinized as was appropriate. Notwithstanding, I do not have confidence that the discernment of the information by which the inferences were made supporting the Minister's position were not impacted by the overreaching negative view of the motive for minimization of tax. I have to conclude that improper motive entered into the discernment process and compromised in an apparent manner the integrity of an independent rationale for the findings upon which the reassessment could be based." [5]

In contrast, the Court in *Roy D. Boettger (Trustee) and Nancy Smith Spousal Trust v. Québec Revenue Agency* ("**Boettger**") held that the trust in question was resident in Québec, where the Settlor and Beneficiary were resident, and not in Alberta, where the Trustee was resident.[6]

In 2002, the Settlor, Jean-Pierre Gibeault, implemented an estate freeze of his valuable Québec corporation, Cetco Capital Inc. ("**Cetco**"), whereby he exchanged his common shares for fixed value, Class B redeemable shares. The Settlor settled a spousal trust in favour of his wife, Nancy Smith, ("**NS Trust**"), appointing Roy Boettger, a lawyer in Alberta, as the Trustee. He contributed some Class B shares as a gift and sold some other Class B shares for a promissory note from the NS Trust. The Class B shares were redeemed by Cetco, resulting in a deemed dividend. The NS Trust filed its 2002 tax return on the basis that the dividend would be taxed at the Alberta rate, thus benefiting from a 9% reduction in provincial tax when compared with the comparable Québec rate.

The Québec Revenue Agency reassessed the NS Trust on the basis that central management and control of the trust was exercised by the Settlor from Québec, and not by the Trustee from Alberta. At the inception of the Court's analysis of the residence of the NS Trust, it makes the following revealing statement:

> "The evidence shows that the trust NS was created for tax reasons in order to benefit from the reduced Alberta tax rates." [7]

The Court goes on to describe the testimony of one of the tax advisers to the Settlor and Cetco in Québec:

> "During his testimony Daniel Lachapelle, certified accountant, head of taxation at Raymond Chabot Grant Thornton, confirms that the objective pursued by the various transactions was to recover the refundable tax on hand as dividends in the company Cetco and benefit from the rate of taxation of Alberta (the Alberta rate 24.1% while Québec is 32.8%).

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4 *Ibid*, Paragraph 41.
5 *Ibid*, Paragraph 69.
6 2015 QCCQ7517. (The case is currently reported in French, and so any errors in translation to English are entirely mine.)
7 *Ibid*, Paragraph 66.

> The creation of the trust NS is part of the tax project. Trust NS creates no economic activity in Alberta, no company operates and has no employees. It is established in order to hold the shares of Cetco and realize the project developed in Montréal by Jean-Pierre Gibeault's advisors." [8]

The Court found that the powers of the Trustee under the trust deed were limited in their scope and the Trustee's duties were very specific, for example the proceeds from the deemed dividend were required to be paid out to the Beneficiary. Moreover, the Alberta lawyer was only chosen to be the Trustee because he was a resident of Alberta.

Most significantly, it also held that the provisions dealing with a Protector were fatal to the NS Trust. Section 4.5 of the trust deed conferred upon the Protector the power to remove a Trustee. Paragraph 4.6(f) provided that if no Protector was appointed, then the Settlor would have the authority to fill the role of the Protector. Here there was no Protector named in the trust deed, and so the Settlor, Jean-Pierre Gibeault, had "*de facto*" control of the NS Trust.

Finally, the Court concluded that the authority granted to the Alberta Trustee was inadequate to confer central management and control on that person, as follows:

> "The mission of the trustee is not to manage the assets of the trust NS and to grow but rather passively hold the shares and follow instructions developed in the project dictated by the... lawyers and accountants…and defined in the trust deed." [9]

While it is difficult to reconcile these two cases, there are some lessons to be gleaned from the reports. First, the substance of who exercises central management and control of the trust must follow the customary procedures and commercial practises in favour of the trustee acting with independence. Second, the settlor of a trust must recognize the trade-off between giving up control and benefitting from the conferral of sufficient independent powers on the trustee to defeat an argument that the settlor has, in fact, never given up control. Finally, the documents and correspondence reflecting the planning and implementation of a trust arrangement should be carefully crafted to be consistent with the usual non-tax purposes (such as estate planning) as well as the tax purposes for establishing the trust.

[8] *Ibid*, Paragraphs 72 and 73.
[9] *Ibid*, Paragraph 82.