There’s No Place Like Home:
The Courts’ Recent Overhaul of the Test for Offshore Trust Residence and Alternative Modes of Determining the Residence of Trusts

By: Aaron Grinhaus

May 5, 2012
# Table of Contents

I. Pay no Attention to the Man Behind the Curtain .............................................1

II. The Yellow Brick Road to an Elusive Doctrine................................................. 4
   a. Bringer Down the House.............................................................................. 5
   b. Ding-Dong, Distinction Dead .................................................................... 8
   c. Toto, We’re Not in Barbados Anymore.....................................................12
   d. Lost in the Woods....................................................................................16

III. How We Got to Oz.........................................................................................19
   a. Life Before the Tornado............................................................................19
   b. Statutes and Cases and Holes, Oh My.......................................................20
   c. There’s No Place Like Home....................................................................22

IV. Finding the Emerald City: Tracing Beneficial Ownership of Trust Property for Tax Enforcement ................................................................. 26

V. End of the Road..............................................................................................28

Bibliography........................................................................................................33
I. Pay no Attention to the Man Behind the Curtain

It can be said with great confidence that the Duke of Westminster, of the famous case in which the British House of Lords created the principle that one can arrange his or her affairs in the most tax efficient manner within the confines of the law, is resting peacefully these days.\(^1\)

There would be no reason for him to roll in his grave when our most innovative and pragmatic legal, accounting and business minds have contrived structures that thwart assessment by the Canada Revenue Agency (the “CRA”), stretch the boundaries of loosely or ill-defined terms and concepts, and in some cases redefine the role of certain entities and concepts known to the law.

The “Westminster Principle” exists now as a coin-return mechanism in a vending machine does: the law is inserted into the machine, the private sector finds a loophole, and it gets rejected back to Parliament to find a way to close the hole. The only problem is that there is no actual coin returned; the money stays with the taxpayer and the government suffers a revenue loss. This is largely attributable to the way certain structures have been used, particularly those involving trusts, to circumvent funds and redistribute them amongst various individuals for the purposes of minimizing, splitting and deferring taxable income.

Let’s start with the basics: a trust is not an individual. A trust is not a corporation. A trust is not a separate legal entity. In fact, it has been opined that:

‘[T]he trust’ cannot be defined. It can only be described. That means you can point to its characteristics or elements, but you cannot put into a sentence what it is. ...Its compass straddles the substantive and the remedial. As a remedy the character of the common law remedial trust is controversial. As to the substantive it is ambivalent. Is the emphasis upon the property that is administered for the other, or the obligations of the one with regard to property and the ability of the other to enforce the performance of those obligations?\(^2\)

\(^1\) Commissioners of Inland Revenue v. Duke of Westminster (1936), [1936] A.C. 1 (H.L.)
To tax a “trust” is therefore a fallacy as it is not a person, individual or entity, and it does not own or hold property. Property is beneficially owned by the beneficiaries and controlled by the trustees. It shouldn’t even be a separate taxpayer as it exists in name only, representing a relationship between property owning individuals. It is not even an “it”.

The conversion of the word “trust” from an adjective describing a relationship into a noun has created an “entity” out of what is in essence the characterization of property beneficially owned by one or more people, known as the beneficiaries and controlled by another group known as the trustees, as created by the original owner known as the settlor. At some point along the path that the Duke blazed for us eight decades ago the use and definition of the trust relationship, much like the distinction between beneficial and controlling ownership, was muddied and skewed to the point that the courts have now been so diverted in their analyses that they are now struggling in the mire of attempting to define where the relationship is resident. Further confounding this analysis is the statutory insistence that a trust itself be considered resident in a particular jurisdiction without specifying just how this is to be determined.³

The most recent authority expounding the test for determining this paradoxical question analogizes a trust, which it presumes is an entity of sorts, to a corporation.⁴ This type of analysis loses sight of the basic principles underlying the trust relationship, accepts it as a separate entity in law, and creates problems of enforcement when it comes to assessment for income tax purposes. The smoke and mirrors game of representing trusts as separate entities has for too long kept the courts focussed on the giant smoky effigy of the Wizard of Oz who controls the assets, whilst effectively concealing the “man behind the curtain”, the beneficial owner of the property

---

³ See e.g. Income Tax Act, R.S.C. 1985, (5th Supp) c.1, s. 94(1)(c)(i) [the “Act”].
⁴ Garron Family Trust v. The Queen, 2009 TCC 450.
held in trust: the beneficiary. It is the opinion of this author that, given the problems inherent in jurisdiction and enforcement, and the ambiguities evident in attempting to assign residency to a relationship structure composed of multiple individuals, the focus should be on determining the location and residency of the taxable properties held in trust, and that trust properties should be deemed resident in the jurisdiction in which the beneficiaries reside in order to reconcile the principle of beneficial ownership with the basic principles of equity, neutrality and simplicity of the tax law.

The purpose of this paper is to trace the jurisprudential development of trusts in Canada and demonstrate how the common-law has deviated from the definition of what an inter-vivos trust really is: a relationship, not an entity. The paper will examine how other common-law jurisdictions conduct this analysis and illustrate how the Canadian courts have facilitated the bastardization of the traditional definition of trusts, resulting in their self-created struggle with the threshold question of residency.

The author will also conduct a brief survey of the current state of the law of the residency of trusts in Canada. It should be noted that the *Income Tax Act* (the “Act”)

5 does not address the issue of where a trust is resident, if for no better reason than the fact that a relationship need not have a defined residency, only do the individuals engaged in that relationship who benefit from taxable property. The author will also examine competing theories and problems created as a result of the judicial struggle to define residency for trusts, and will demonstrate the issues that arise in tax assessment, adjudication and enforcement, and how determining the residency of the beneficiaries is the optimal way to reconcile these issues.

---

Although there are issues and potential problems with basing the residency of taxable trust properties on the residency of the beneficiaries, these issues will be discussed and juxtaposed with the alternative methods of dealing with the taxation of trusts and the current problems which cause the circumvention, nullification or even unenforceability of tax assessment attempts by the CRA.

II. The Yellow Brick Road to an Elusive Doctrine

No concept in law can be said to have stretched the bounds of the synergistic workings of the common law and equity such as the doctrine of the trust relationship as it has developed. Indeed, the idea of a trust has been described as “the greatest and most distinctive achievement performed by Englishmen in the field of jurisprudence”.\(^6\) The flexibility and malleability of the idea, which developed over eight centuries of British common law jurisprudence, has been praised in modern literature as “an institution that has grown pragmatically”.\(^7\) This pragmatism is demonstrated by the courts of equity having carved out multitudinous exceptions to circumvent any barriers created by the statutory or common law, which frequently rose up to occlude its use, in a myriad of creative and novel ways.

As equity developed alongside, but superior to, the common law before the two courts were merged into one, the two streams of law were amalgamated to form an elusive doctrine that could hardly be characterized as one that bore predictable and well-defined boundaries. Since “equity” is the court’s ability to deviate from statute or established common-law principles, a “great achievement” in equity, as the trust idea was described by Maitland\(^8\), is in fact an


\(^8\) *Selected Essays*, supra note 6.
excessive deviation from the will of the legislature and the doctrine of *stare decisis*.

Nevertheless, the basic elements remained constant, namely that they evidence “a relationship based on property control and property enjoyment between two persons, the trustee who controls and the beneficiary who enjoys.” Given that there have developed various types of, or uses for, trust relationships, it is difficult to pin down one comprehensive definition that goes further than the roles of the key players. This is likely why the courts ended up adopting a test bespoke for corporations despite the glaring differences between a papered relationship and the bringing into existence of an entity.

The focus of this paper will not be on how the concept of the trust was developed throughout history; instead, the author will focus on how the development of the trust law resulted in a misapprehension of the determination of its residency for the purposes of determining its taxable income.

### a. Bringing Down the House

As the tornado carried Dorothy Gale’s house away into a strange new world, so did the courts carry away the trust concept, dropping it into a new world where it became analogous to a corporation and thus a separate person under the law. The most significant case in which the issue was raised in Canada was *Thibodeau*. In *Thibodeau*, the Minister of National Revenue (the “Minister”) assessed the income tax returns of a discretionary family trust as a result of taxes payable due to capital gains. The trust was settled in 1968, and at the time was administered by two trustees, both Canadian residents. In 1970 one of the Canadian trustees resigned and the remaining trustee transferred the assets of the trust to Bermuda and appointed

---


10 *Thibodeau Family Trust v. The Queen*, (1978) 78 DTC 6376.
two Bermuda residents as trustees, resulting in three trustees being charged with administering the trust. While the Canadian resident trustee offered financial advice and suggestions, a majority of the three trustees was required to crystallize any investment or activity. The consent of the Bermuda trustees was not automatic and in certain cases that consent was not obtained.11

In 1972 the Minister assessed the trust for taxes on the basis that it was a Canadian resident, or in the alternative, a dual resident of Canada and Bermuda. The Federal Court heard the case on appeal and held, *inter alia*, that the trust was in fact resident in Bermuda and therefore not subject to assessment. In coming to this decision the court considered, as presented by the parties, the corporate test of residency established in two British cases: *De Beers*12 and *Unit Construction*13.

In *De Beers*, a diamond trading company had its office registered and incorporated in South Africa in order to operate and coordinate its mining and distributing business. The directors of the corporation were resident in both South Africa and England, though the majority of the directors resided in London and were required to be consulted on, or in some cases approve, major decisions and expenditures. The British court held that the corporation, for tax purposes, was resident in England, holding that:

In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. 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 ... and the real business is carried on where the central management and control actually abides.14

---

14 *De Beers*, supra note 12 (emphasis added).
Here the court focussed on where *de facto* control is, and the court in *Unit Construction* solidified this concept. In *Unit Construction*, the British court affirmed the “central management and control” test where wholly-owned African subsidiaries of a British corporation were deemed to be resident in England when it was determined that, even though the constating documents of the subsidiaries explicitly forbade management and control by foreign directors, *de facto* control was being exercised by individuals resident in the UK.\(^\text{15}\) In reasoning the court’s holding, Viscount Simonds wrote:

> Nothing can be more factual and concrete than the acts of management which enable a court to find as a fact that central management and control is exercised in one country or another. It does not in any way alter their character that, in greater or less degree, they are irregular or unauthorised or unlawful. The business is not the less managed in London because it ought to be managed in Kenya. Its residence is determined by the solid facts, not by the terms of its constitution however imperative.\(^\text{16}\)

In other words, when ascertaining the residency of a corporation, the court must look to the facts subjective to the circumstances in order to declare definitive residency. While a subjective analysis was adopted by the court in *Thibodeau*, the court stopped short of analogizing “the corporation” with the trust relationship.

After considering *De Beers* and *Unit Construction*, the court in *Thibodeau* held that, in order to determine the residency of a trust, all the facts must be analyzed in a subjective light. After reviewing and considering the corporate test for residency the court expounded the following common-law test for determining the residency of a trust:

---

\(^{15}\) *Unit Construction Co., LTD. v. Bullock (Inspector of Taxes)*, [1959] 3 All ER 831.

\(^{16}\) ibid. at 834.
The facts of this case for selecting as the criteria to propound such a formula are: 1) that the majority of the Trustees of the Trust are and were at all material times resident in Bermuda; (2) that the trust document of constitution permitted a majority decision on all matters of Trustees’ discretion; (3) that ... the majority shareholder ... did not control the shares held by the Trust ... (4) that the residency of the Trust in the main was in Bermuda at all material times; (5) that some of the beneficiaries resided ... in the United States; (Canada was their residence during the other times); and (6) that the ... Trust did not ... carry on business in Canada.17

Gibson, J., in explaining the reasons for the holding in *Thibodeau*, valiantly resisted adopting the tests in *De Beers* and *Unit Construction* by distinguishing corporations from trusts in a unique way:

The judicial formula for this respecting a corporation, in my view, cannot apply to trustees because trustees cannot delegate any of their authority to co-trustees. A trustee cannot adopt a ‘policy of masterly inactivity’ ... and on the evidence, none of the trustees did adopt such a policy.18

Although the court did not adopt the “central management and control” test in this case, it is here that the slippery-slope down to first analogizing, and subsequently equating, trusts with corporations began as a result of the weak distinction upon which the court relied. The final nail in the coffin came with *Garron*19, a case which is currently in the process of appeal to the SCC (the “SCC”).20

b. Ding-Dong, Distinction Dead

In the early 1990s, a series of events was triggered whereby an innocent, commonplace, and carefully crafted estate planning transaction resulted in a court battle that ultimately killed the distinction between corporations and trusts in the most fundamental sense: the nature of the ownership of property. When a corporation holds property it holds both legal and beneficial title; in a trust relationship these are divided amongst the trustees and beneficiaries, respectively. In

---

17 (1978) 78 DTC 6376 at 6386.
1992, Myron Garron incorporated a holding company (the “Original Holdco”) which was used to hold shares in two Canadian operating companies. By 1996 the shares in the Original Holdco were held 50% by Andrew Dunin, Mr. Garron’s business partner, and the other 50% by Mr Garron, his wife and their family trust. Mr. And Mrs. Garron, both Canadian residents, were trustees of the trust and their children and grandchildren were the beneficiaries. In 1998 the structure was reorganized so that any growth value of the shares would not be subject to Canadian tax upon disposition. In order to effect this structure an estate freeze was executed and a new organizational structure involving holding companies and trusts was contrived.

As is common among estate freezes, the common shares that were being held by the Original Holdco were exchanged for three new types of shares: two types of frozen shares and a new class of common. The frozen shares would remain in Canada in the hands of Mr. Garron and Mr. Dunin or their related holding entities while the shares with growth value would accumulate equity in an offshore holding company. In this case the vehicles that were chosen to hold the growth shares offshore were corporations controlled by two discretionary trusts settled for the benefit of Mr. Garron and his family and Mr. Dunin and his family, respectively. The offshore jurisdiction that they chose was Barbados due to the tax treaty that exists between Canada and Barbados to avoid double taxation (the “Treaty”).

A Barbados company, St. Michael’s Trust Corp. (the “Trustee”), was engaged to act as trustee for both trusts, which respectively controlled the two corporations that held the growth shares of the Original Holdco. The court accepted the following findings of fact, inter alia, which defined the relationship between the trustee and the respective beneficiaries of the trusts:

---

a. Under the terms of the trust indentures, Mr. Garron and Mr. Dunin and their respective spouses alone could replace the protector, who in turn could replace the trustee, if the trustee acted against their wishes.

b. The limited role of [the Trustee] was understood by all parties at the outset. In particular, it was understood that [the Trustee] would have no decision making role in relation to the sale of the Trusts’ interests ... [and] that decisions of that nature would be made by Mr. Garron and Mr. Dunin and implemented by [the Trustee] under their direction.

c. The Trusts used the same investment advisers as the beneficiaries. This allowed the beneficiaries to deal directly with the Trusts’ financial advisers and directly control the Trusts’ investment activity without the involvement of [the Trustee].

d. The tax advisers to Mr. Garron and Mr. Dunin were also used for the Trusts and when acting for the Trusts were directed by Mr. Garron and Mr. Dunin.

e. There is no documentary evidence that [the Trustee] took an active role in managing the Trusts ....

...

1. [Directors of the Trustee corporation] were required to ratify actions proposed to be taken or taken by the Trusts, but there is no evidence that they had much substantive information about the transactions, which tends to support the proposition that they knew that the role of [the Trustee] was intended to be limited to administrative matters.22

Thus the trust relationship operated and the reorganized structure endured.

With the reorganized structure in place the operating companies successfully continued to do business and subsequently began entertaining offers for sale. In 2000 a deal was struck for the shares which comprised the controlling stake of the operating companies in exchange for a mixture of cash and shares of the purchaser’s parent corporation. The sale of the shares held by the Garron and Dunin Trusts resulted in capital gains of approximately $217 million and $240 million, respectively. At the time the Canadian tax on capital gains was 2/3. The Minister rejected the claims for an exemption based on the Treaty and litigation ensued.

22 2010 FCA 309 at para. 66.
Below are two diagrams which illustrate the facts described above:

On appeal to the Tax Court of Canada (the “TCC”), the court upheld the assessment. Justice Judith Woods, a former tax partner at McCarthy Tétrault, was handed a question borne of a gap in the law that had to be filled. The Treaty stated that:

---

23 2009 TCC 450.
For the purposes of this Agreement, the term “resident of a Contracting State” means any person who, under the law of that State, is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. The terms “resident of Canada” and “resident of Barbados” shall be construed accordingly.24

As a result, the next step was to determine residence, which was left to the law of the governing jurisdictions. Unfortunately, neither jurisdiction had settled tests for the residency of a trust. The court determined that “[i]n light of the [Treaty] definition, each of the Trusts is a ‘resident of Canada’ for purposes of the Treaty if it is liable to taxation in Canada by virtue of residence or by one of the other listed criteria,”25 leaving it to the courts to determine such residence. It is rare, but inspiring, when these moments arise in the courts: a crossroads where a judge has the opportunity to exercise her wisdom and powers of interpretation by deciding whether to embrace the ancient legal canon of stare decisis by analyzing the nature of the legal relationships involved, or by engaging the more Orwellian methodology of doublespeak. Justice Woods chose the latter.

c. Toto, We’re Not in Barbados Anymore

Justice Woods began her analysis by dispelling the Thibodeau test entirely, bringing an entirely new meaning to the old adage: Trust takes years to build…but seconds to shatter. Although handed down from the Federal Court, apparently it had no weighted authority in the TCC. With one fell swoop Justice Woods’ statement both discarded what was obviously a subjective test analysis for determining the residency of a trust and re-wrote the decision of the Federal Court: “[i]t is clear from the reasons in Thibodeau that the judge did not purport to state a general test of trust residence. The decision was intended to be limited to the particular facts of

---

24 Ibid. at para. 104 [citing the Treaty, Article IV(1)].
25 Ibid. at para. 105.
the case ...”²⁶ She then went on to re-write Justice Gibson’s rationale in *Thibodeau* for not using the “central management and control” test by simply saying “[i]f the above comment [discounting the use of the central management and control test] is intended to be applicable in all cases, regardless of the particular facts and circumstances, I respectfully cannot agree with it.”²⁷ She gave little additional explanation and focussed on merely one aspect of the test: the residence of the trustees. Now with the deadwood swept out of the way Justice Woods was able to pave a new, divergent path.

Justice Woods then began to rationalize the use of the “central management and control” test with an attempted reconciliation of the corporation with the trust:

Although there are significant differences between the legal nature of a trust and corporation, from the point of view of determining tax residence, the characteristics are quite similar. The function of each is, at a basic level, the management of property.²⁸ In fact this is not the case, and the simplistic analogy drawn here disregards the fundamental differences between the two concepts. The SCC has recognized that a corporation is not merely created for the management of property, but instead for the protection of individuals engaged in risk, for their own personal gain:

The very purpose of a corporation is to separate out conduct and pocketbook, to allow some to contribute capital and share in profit, and to allow others to contribute work, generally for a fixed return. Vicarious liability is a recognition of that fact.²⁹ On the other hand, a trust is the opposite: it is designed to minimize risk by those who do not stand to gain anything: “[a] trust is an equitable obligation binding a person (called a trustee) to

---

deal with property owned by him ... for the benefit of persons ... anyone of whom may enforce the obligation.”30 Given this distinction, one cannot simply analogize these two vehicles as being for the “management of property”, and even if they were, the mode by which this management would occur differs on an axiomatic level.

Further to this point is the intent of the legislature in its characterization of a trust, as is reflected in the Act. Section 104 of the Act defines a trust as a person, not a corporation:

Taxed as individual

A trust shall, for the purposes of this Act, and without affecting the liability of the trustee or legal representative for that person’s own income tax, be deemed to be in respect of the trust property an individual...31

Justice Woods then continued to justify her holding by saying that “adopting a similar test of residence for trusts and corporations promotes the important principles of consistency, predictability and fairness in the application of tax law.”32 Creating a test in itself does achieve these goals; however, the courts have long recognized that tax law policies are based on equity, simplicity and neutrality in the administration of the tax system.33 As will be discussed in greater detail below, the burden that the “central management and control” test places on the courts and the taxing authority outweighs any benefit that this test lends to administrative certainty.

Justice Woods further reasoned that “[t]he development of a test of trust residence in Canada has been left by Parliament to the courts.”34 Although the legislation is quiet on this

31 R.S.C., 1985, c. 1 (5th Supp.), s. 104(2).
32 2009 TCC 450 at para.160.
34 2009 TCC 450 at para.161.
point, it does give hints as to the intent of the legislature. Section 94(1)(a) of the Act states as follows:

94. (1) Where,
(a) at any time in a taxation year of a trust that is not resident in Canada or that, but for paragraph 94(1)(c), would not be so resident, a person beneficially interested in the trust (in this section referred to as a "beneficiary") was
(i) a person resident in Canada, ... and
(b) at any time in or before the taxation year of the trust,
(i) the trust ... has ... acquired property, directly or indirectly in any manner whatever, from
(A) a particular person who
(I) was the beneficiary referred to in paragraph 94(1)(a), was related to that beneficiary or was the uncle, aunt, nephew or niece of that beneficiary, ...
the following rules apply for that taxation year of the trust: ... 35

As will be discussed in greater detail below, section 94 of the Act provides an important guidepost indicating that the location of the beneficiary and the location of the property are important factors in determining the applicability of the Canadian tax law rules to foreign trusts.

On appeal the Federal Court of Appeal (the "FCA") substantially adopted Justice Woods’ reasoning. 36 The courts recognized the lack of precedent; however, they did not explore the source of the "central management and control" test and why that became the test for the residency of a corporation.

It should also be noted that the Minister broadly argued that this type of structure, which involved "treaty shopping" for the most preferential tax jurisdiction, violates of the General Anti-Avoidance Rule ("GAAR"). 37 Once again affirming the Westminster Principle, the court

35 R.S.C., 1985, c. 1 (5th Supp.), s. 94(1).
36 2010 FCA 309 at para. 51.
37 RSC 1985, c 1 (5th Supp), s. 245.
affirmed that this type of activity is an instrument readily available in the tool-box of the tax planner:

[The application of the GAAR] turns on whether the series of transactions that resulted in the Trusts becoming entitled to the treaty exemption in the face of section 94 is a misuse or abuse of the Barbados Tax Treaty. Justice Woods said no. I agree. ... If the residence of the Trusts is to be determined on the basis of the residence of [the Trustee] ... then the Trusts have not avoided section 94. On the contrary, they have fallen squarely into it.\(^{38}\)

With its affirmation of the TCC’s holding the new test became law, and was subsequently affirmed by the SCC.\(^{39}\)

\[\textbf{d. Lost in the Woods}\]

There has been very little published in the way of a critique of Justice Woods’ test as promulgated in \textit{Garron} and upheld by the FCA, partially because the decision is a relatively recent one, but also because would-be commentators are likely holding their pens in abeyance in anticipation of the SCC’s ruling on appeal. It remains to be seen how the SCC will treat the lower court holdings and so the law as it stands right now, in addition to any transactions which require this test as guidance for potential tax liability, are in limbo until such determination is made. Although commentary is limited there have been a few attempts to summarize, and comment on, the holdings in the \textit{Garron} cases.

One such article commented on the original TCC holding shortly after it was handed down from the bench, speculating on how the holding will be treated on appeal.\(^{40}\) The authors discussed the holding and its departure from the established \textit{Thibodeau} test and Interpretation

\(^{38}\) 2010 FCA 309 at para. 89-90.
\(^{40}\) Jack Bernstein and Barbara Worndl, “Resident Trust and No Trust” (2009) 17:10 Canadian Tax Highlights (Canadian Tax Foundation) 1.
Bulletin 447\[^1\]; however, their concluding statements raise important doubts with respect to the applicability of the test to other fact scenarios:

It is interesting that the court in Garron chose to embrace the corporate test for residence because, it said, in determining residence for a trust or corporation the relevant function at the core of each case is the management of property, which the trustee in that case failed to perform. A different conclusion might have been reached in Garron if the trustee had been more involved in the investment of the sale proceeds.\[^2\]

This observation suggests that, had the trustee duly exercised its duties in Barbados there would be no need for the application of a new test. As a result the analysis focussed on the location of the beneficiary who had \textit{de facto} control of the assets.

Another scholarly critique of the holding in Garron targeted the faulty analogy comparing corporations to trusts as entities, and adopted the position that Thibodeau was a more preferable test than the one which trumped it in Garron.\[^3\] In a wholesale lambasting of Justice Woods’ reasoning, the author pointed out the fundamental fallacies inherent in applying the corporate test to that of a trust:

A central management and control test to determine residency is appropriate for a corporation but not appropriate for a trust. A trust is not an entity, it is a legal relationship. ... Woods J. opined in Garron the Parliament had left it to the courts to determine the test for the residency of a trust. It could be argued that if Parliament had wanted the residency of a trust determined on the same basis as a corporation, it could have done so since the decision of Thibodeau.\[^4\]

The author continues to clarify the main derogations in the Garron decision:

\[^1\] Canada Revenue Agency, Interpretation Bulletin IT-447, “Residence of a Trust or Estate” (30 May 1980).
\[^2\] “Resident Trust and No Trust”, supra note 39 at1.
\[^4\] \textit{Ibid.}, at p. 241.
It is only in tax law that we treat a trust as not being a ‘trust’ but as an individual. ... The Garron decision ignores the trustee’s duties and obligations to the beneficiaries and looks straight to control – that the trustees are not permitted to have a passive role. ... A settler can assign any role to a trustee and this may include a passive role. It shouldn’t matter if a trustee’s role is passive because the nature of a trustee’s role is to carry out its fiduciary obligations to the beneficiaries.\(^\text{45}\)

This argument stresses the fundamental elements of a trust, thus illustrating that analogy cannot properly be made to a corporate entity.

Furthermore, as one author points out, there are many options available for the courts and the legislature to consider:

Tax rule writers can choose, in determining how to assign the status of residency to a trust, from among the following factors or criteria — place of formation, governing law, settlor, beneficiaries, location of assets, the trustees ... management and administration by the trustees .... Whether the TCC and FCA view respecting the law of residency and the facts in Garron are appropriate is a question that the SCC will address .... [as well as] to what extent [the SCC will] consider totally different approaches ...\(^\text{46}\)

It remains to be seen whether the SCC will adopt the lower courts’ rulings and entrench the new test into Canadian jurisprudence, or whether it will take its own approach, as it has done in previous cases, overturning all the lower courts and substituting its own holding in their place.\(^\text{47}\)

In its decision the SCC did not give due consideration to the principles on which these competing common-law tests have been developed, and instead dismissed the issue by stating that “[w]hile there is a dearth of judicial authority on the question of the residency of a trust, the residency of a

\(^{45}\)Ibid., at p. 241 (emphasis added).


\(^{47}\)See, e.g., Ludco Enterprises Ltd. v. Canada, [2001] 2 SCR 1082 (overturning the Minister’s reassessment, the TCC and the FCA, all of which were concurrent).
corporation has been determined to be where its central management and control actually abides.”\textsuperscript{48}

III. How We Got to Oz

a. Life Before the Tornado

Life was a lot simpler in 1906 before trusts were being used in the complex cross-border transactions in which they are used today. It was more common at that time to use corporations for such structures, and so the focus of tax planning and jurisprudential analysis was on the corporation; in fact, Canadian tax law did not address non-resident trusts until 1972, “[t]he objective of these provisions [being] to prevent the tax-free accumulation of income on capital contributed to a non-resident trust by a taxpayer resident in Canada for the benefit of a Canadian-resident beneficiary.”\textsuperscript{49} “Central management and control” has given certainty to the tax courts for over a century in determining the residency of corporations. In 1906 the British House of Lords, in giving its reasons for the holding in \textit{De Beers}, explained why “central management and control” was important:

An individual may be of foreign nationality, and yet reside in the United Kingdom. So may a company. Otherwise it might have its chief seat of management and its centre of trading in England \textbf{under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad.}\textsuperscript{50}

This same passage was cited by the court in \textit{Garron}, only the most relevant portion, that which explains why central management and control is important, was disregarded.\textsuperscript{51} In basic terms: the location of central management and control is the place where the corporation derives its main

\textsuperscript{48} 2012 SCC 14 at para. 8.
\textsuperscript{50} \textit{De Beers Consolidated Mines v. Howe (Surveyor of Taxes)}, [1906] A.C. 455 at 458 (emphasis added).
\textsuperscript{51} 2010 FCA 309 at para. 54.
benefits: namely protection of the law for the peaceful administration of business. In a trust relationship, those benefitting are not the people who are running the business; instead, they are the beneficial owners of, and recipient of any gain derived, trust properties: the beneficiaries. This oft overlooked rationale is the justification for why the “central management and control” test is inapplicable in the case of trusts, which do not operate the way corporations do as separate entities within the legal system. The result was the creation of an “entity” which was borne of the misappropriation of common-law concepts characterizing a relationship that was never intended to act as a separate entity.

b. Statutes and Cases and Holes, Oh My

It is curious to consider how and why trust law is so under-developed in the statutory law and jurisprudence given its ever-increasing use in the discretionary context. Intuitively it would behove the legislature to focus on plugging any leaks in the tax law, taxes being its main source of revenue. Nevertheless, the trust relationship is increasingly being integrated into roll-overs under sections 51, 85 and 86 of the Act, estate freezes and corporate reorganizations, in order to minimize, defer and split tax liability so as to reduce or eliminate as much taxable income as possible. Re. Relevant to this paper are the ways in which trusts are integrated into offshore or foreign structures, and furthermore, how the legislature and government agencies have struggled to address this.

A starting point for this analysis is section 94 of the Act. Without re-citing the section, which has been reproduced in section II(c) above, it addresses how a trust not resident in Canada is to be treated for tax purposes. Of note is the first sentence, which introduces the tax rules

---

52 RSC 1985, c 1 (5th Supp), ss. 51; 85; 86.
53 Ibid., s. 94.
applicable to foreign resident trusts by stating “at any time in a taxation year of a trust that is not resident in Canada ...”, without explaining exactly how residence is to be determined.\textsuperscript{54} It goes on to explain how the residence of the beneficiary will be used to determine whether the trust will be deemed resident in Canada; Professor Vern Krishna explains the test as follows:

A trust that might not otherwise be considered resident in Canada by virtue of the common law tests may, nevertheless, be deemed to be a resident trust for tax purposes. Generally, a non-resident discretionary trust with Canadian resident beneficial interests that acquires property from a Canadian resident is deemed to be resident in Canada.\textsuperscript{55}

The guiding point is that, despite the tests developed by the courts, the legislature has clearly crafted an overriding test based on the location of the property itself and the beneficial interest thereof. Intuitively the intent was to simplify the attachment of any tax liability to the liable assets.

Further guiding us in this analysis are Interpretation Bulletin ("IT") related to the section. Unfortunately the last IT issued on this topic was on May 30, 1980, and stated that:

The residence of a trust ... is a question of fact to be determined according to the circumstances in each case. However, a trust is generally considered to reside where the trustee, executor, administrator, heir or other legal representative ... who manages the trust or controls the trust assets resides.\textsuperscript{56}

Since this test, described in \textit{Thibodeau} was overruled by \textit{Garron}, and IT’s do not have the force of law, we must look to other CRA publications until a new IT is published.

In 2010 the CRA published a “Trust Guide” which provides further guidance with respect to the deemed residence test. It is very explicit that the starting point, and in fact determinative factor, is the “beneficiary test”:

\textsuperscript{54} \textit{Ibid.}, s. 94(1)(a).
\textsuperscript{56} Canada Revenue Agency, Interpretation Bulletin IT-447, “Residence of a Trust or Estate” (30 May 1980).
[A deemed resident trust] is a trust resident in another country, but that is considered resident in Canada for certain tax purposes. Usually, such a trust has received a contribution from a resident or former resident of Canada. A trust is a deemed resident if:

a resident of Canada transferred property to the trust and is either beneficially interested in the trust (for example, as a beneficiary of the trust), or is related to such a person (including an aunt, uncle, nephew, or niece of the beneficiary); or

the beneficiary acquired an interest in the trust by way of purchase or as a gift or inheritance from a Canadian resident who transferred property to the trust.\footnote{Canada Revenue Agency, Tax Guide T4013, “T3- Trust Guide 2010” (publication date unknown).}

The legislation, CRA materials and commentary thereon all point to the beneficiary being the legislature’s intended focus in settling the issue where a trust’s residency is in question. Other common-law jurisdictions have sought to settle this issue in a more proactive approach using their legislative powers to circumvent any litigation borne of ambiguity.

c. There’s No Place Like Home

It may come as some surprise to discover that Canada is unique in its struggle with the question of how trust residency is to be determined as many jurisdictions have settled the issue through legislation. It remains to be seen whether on appeal Garron, before the SCC, will attempt to compare our system to those which have established tests for reaching this determination. In the UK, for example, the case law and statutes have established that the residence of the trustees is what determines the residence of the trust for tax purposes.\footnote{Her Majesty’s Revenue & Customs Trustee Residence Guidance, v.1 (July 2009), online: HM Revenue & Customs <http://www.hmrc.gov.uk/cnr/trustee-res-guidance.pdf> at 2.} The UK legislation creates a very specific test which clearly settles how residence should be determined in the event of ambiguity:
474. Trustees of settlement to be treated as a single and distinct person

(1) For the purposes of the Income Tax Acts (except where the context otherwise requires), the trustees of a settlement are together treated as if they were a single person (distinct from the persons who are the trustees of the settlement from time to time).

...

475. Residence of trustees

(1) This section applies for income tax purposes and explains how to work out, in relation to the trustees of a settlement—

(a) whether or not the single person mentioned in section 474(1) is UK resident, and

(b) whether or not that person is ordinarily UK resident.

...

(6) If at a time a person ("T") who is a trustee of the settlement acts as trustee in the course of a business which T carries on in the United Kingdom through a branch, agency or permanent establishment there, then ... assume that T is UK resident at that time.59

Generally speaking, in the UK the “body of trustees” is used to determine the taxability of the trust assets within the jurisdiction. This is not the case in the United States.

The United States law does not provide a helpful guideline in resolving these issues. If for no better reason, trust law is a collage of state principles which define the basic trust in the jurisprudence of the several jurisdictions. The federal body of codified tax law, chiefly represented by the Internal Revenue Code, does not provide a definition for “trust”, and merely describes its attributes.60 The main residency provision is found at section 7701(a)(30)(E) which states:

The term “United States person” means ...

(E) any trust if —

(i) a court within the United States is able to exercise primary supervision over the administration of the trust, and

(ii) one or more United States persons have the authority to control all substantial decisions of the trust.61

This section should be taken with a grain of salt. The mixture of state case law and Federal legislation creates a dichotomous classification of discretionary trusts, namely the Grantor and non-Grantor trusts ("Grantor" is synonymous with "Settlor"). As described by one US commentator:

Who is taxable and how that is determined is quite complicated. It is helpful to keep the following in mind. A grantor trust is not taxed as a trust. The owner – generally the grantor – is taxed directly as if the trust did not exist. A non-grantor trust is taxed much like an individual, but is allowed a deduction for amounts distributed to beneficiaries as the beneficiaries are taxable on distributions.62

Given the fragmented nature of the law in this area, the US position is less than helpful in simplifying or providing alternatives to our current tests. Suffice it to say that, regardless of the fragmented nature of the case law, the focus of the test in the federal statute is control. This is unlike Australia, where the focus is on the beneficiary.

The Australian law takes a more rational approach to resolving the problem of identifying the taxable individuals in a trust relationship. Given that the beneficiaries are entitled to any property held by the trust, any undistributed gain that the trust realizes is proportionately attributed, for tax purposes to the beneficiaries.63 The Australian Act provides for the following to ascertain the residence of a trust:

61 Ibid., § 7701(a)(30)(E).
63 Income Tax Assessment Act 1936 (Cth.), s. 97 [the “Australian Act”].
97. Beneficiary not under any legal disability

(1) Subject to Division 6D, where a beneficiary of a trust estate who is not under any legal disability is presently entitled to a share of the income of the trust estate:

(a) the assessable income of the beneficiary shall include:

(i) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia; and

...

(3) Where:

(a) a beneficiary of a trust estate is presently entitled to a share of the income of the trust estate;

(b) the beneficiary is a non-resident at the end of the year of income; and

(c) the beneficiary is:

(i) a body, association, fund or organization the income of which is exempt from tax ...; or

(ii) an organization the income of which is exempt from tax by virtue of a regulation in force under the International Organisations (Privileges and Immunities) Act 1963;

that beneficiary is, for the purposes of the application of this Division in relation to that beneficiary in relation to that year of income, a beneficiary to whom this subsection applies.\(^\text{64}\)

The statute goes on to carve out exceptions for disabled and non-resident beneficiaries which generally place the payment obligations on the trustee, with a credit to the beneficiary.\(^\text{65}\) The author contends that the beneficiary, being the focus of the inquiry for tax liability, is the correct method by which the trust residency analysis should be conducted.

\(^{64}\) *Ibid.*

\(^{65}\) *Ibid.*, s. 98.
IV. Finding the Emerald City: Tracing Beneficial Ownership of Trust Property for Tax Enforcement

As was argued above, the “central management and control” test is specifically tailored to an entity, the corporation, which does not have the same uses, characteristics or aims as the trust relationship. The individuals controlling a corporation are doing so with an aim to risk for the purpose of profit, hiding behind the corporate veil to shield themselves from risk. On the other hand, the trust relationship is quite different: a settler dictates the terms of protection of assets; the trustee manages those assets; the beneficiary reaps any fruits born of those assets. The problem in Garron was that, where the trustee is not de facto in control of the assets held in trust, it cannot be held accountable for the tax liability of the trust. By shifting the focus to control, instead of the assets, a new problem was created: enforcement and accountability.

Enforcement is an important factor in tax assessment. If assets are located offshore or otherwise being held within a foreign jurisdiction, it requires a great deal of circumvention in order to access those assets. If the assets are located within Canada the CRA has virtually unlimited power and unfettered access to assets. Therefore, it is this author’s contention that the focus should be on the location of the beneficiary, as in the Australia example. This will resolve the problem of accounting and enforcement by targeting the beneficial owner of the assets.

It is recognized that a problem arises where the assets are located offshore but the beneficiary is located in Canada. In this regard it is important to recognize the basic fundamental elements of the trust relationship. If a trust is assessed based on the location of the beneficiary, but the beneficiary does not have the assets at its disposal to satisfy the tax liability, the trustee has an obligation to access the trust’s assets for the benefit of the beneficiary. If the trustee does not exercise its obligation to defend the beneficiary against any tax liability of the beneficiary, the
beneficiary would have a claim against the trustee for breaching its fiduciary duty. Thus the burden is shifted to the beneficiary and the trustee, as opposed to the CRA, to ensure that the trust relationship is enforced. This significantly reduces the Crown’s burden and legitimizes the trust relationship, making the system more equitable, neutral and simple.

Furthermore, the “central management and control” test was designed, as was mentioned above, to ensure that corporations pay for the protection they derive from the governing jurisdiction in which they de facto operate.66 Beneficiaries are the ones directly benefitting from the trust property, and it is they who have the right to exercise their beneficial rights to the property. A beneficiary that is resident in Canada benefits from all protections and programs offered by the Canadian government and thus is liable for its fair share of tax. The property and its owner benefit from the protection and laws of the state, and the state can only effectively enforce its collection powers within its jurisdiction against the assets; therefore, it must deem residency where the assets are beneficially held, namely in the jurisdiction in which the beneficiary resides. This further promotes the public policy of retaining tax revenue in Canada by creating a presumption that the beneficiary is liable for Canadian tax and shifting the burden from the CRA.

A seminal principle in Canadian tax legislation is that a Canadian resident is liable to pay tax on its worldwide income.67 There should be no exemption for an individual deriving benefit from trust assets. It is important to remember that as beneficiaries, those individuals are the direct recipients of the trust properties. There is no “separate entity” buffering tax liability as with a corporation. It is all attributable to the individual (or beneficiary corporation). The beneficiary is

---

67 *R.S.C., 1985, c. 1 (5th Supp.),* s. 3.
the beneficial owner of any assets held or produced by a trust, and is the only person entitled to
derive profit or capital gain from the trust; therefore, if the trust accumulates assets, those assets
must be attributed to the beneficiary. The statutory law explicitly recognizes this as an important
factor in determining residence in section 94 of the ITA which is a pellucid indication of the
intent of the legislature. 68 Furthermore, even if it were to be considered a separate entity, section
104 clearly expounds that a trust is to be treated as an individual, not as a corporation. 69

The negative effects of taxing a beneficiary do not outweigh the simplicity that this test will
engender in enforcement. Three prominent arguments against using the location of the
beneficiary are that a beneficiary may not be equipped with money to pay, with the requisite
information about the assets of the trust required to assess tax liability, or possess the capacity to
deal with the tax consequences. In many cases the beneficiary does not have full access to the
assets of the trust, making the tax liability unduly burdensome. In addition, the beneficiary may
not even have knowledge of the trust or any details of the assets. Finally, the individual may be
benefitting from a trust for the reason that he or she does not have the mental capacity to deal
with his or her own affairs. These issues are easily remedied by remembering that, even though
the location of the beneficiary is being used to determine trust residency, it is still the assets of
the trust which are subject to tax and therefore it remains the obligation of the trustee to ensure
its payment. No new obligation would be created for the beneficiary if the “beneficiary” test
were adopted by the courts; however, the reporting, recording and tax obligations of the trustee
would presumably be more onerous since the trustees would be more accountable to the
beneficiaries in the event of assessment by the Minister, not a detrimental by-product at all.

68 Ibid., s.94.
69 Ibid., s.104.
V. End of the Road

Tax planning and estate structuring have become increasingly prevalent activities amongst corporate and estate lawyers. We have stretched the bounds of the law and our imaginations in creating ever more contrived conduits, deferral structures and attempts to utilize lower tax rates in order to avoid putting money into the Crown’s pocket that could otherwise stay in your client’s. However, we must always remember the two inevitabilities in life: death and taxes. Evidently a trust can help you escape the painful consequences of the former by allowing your assets and wishes to continue posthumously as your wishes may dictate; however, the latter is inescapable, even after you’ve paid your toll across the river Styx.

A trust, a relationship born of a person creating an intention to settle property benefitting one group and controlled by another group for a specific purpose, has long been developed in the common law as a relationship malleable in its use. The pragmatism with which it developed has allowed for flexibility in the transfer and succession of assets. Over the nearly 800 years through which it developed though its character has not changed: that of a relationship, not of an entity; that is, until now.

The paradoxical question of the residency of a trust, and the characterization of a trust as an entity, is infinitely problematic. Trying to attribute the assets of an individual, though the ownership of those assets is divided, to a location which is not the owner of the assets, is the false premise upon which the recent string of cases has based a flawed test for residency. This is why, given the recent decisions and the results thereof, it is the opinion of this author that, given the problems inherent in jurisdiction and enforcement, and the ambiguities evident in attempting to assign residency to a relationship structure composed of multiple individuals, the focus should
be on determining the location and residency of the taxable properties held in trust, and that trust properties should be deemed resident in the jurisdiction in which the beneficiaries reside in order to reconcile the principle of beneficial ownership with the basic principles of equity, neutrality and simplicity of the tax law.

As the world became increasingly globalized the courts brought the test in Thibodeau into existence to reconcile problems unaddressed by the Act. The test which presumed that a trust is resident somewhere, and which based that residence in the location of the trustee survived in Canadian law for over three decades. The court’s analysis of corporate based cases such as De Beers and Unit Construction influenced the later decision in Garron, which fundamentally altered the existing landscape and jolted the non-residency test into question. Garron fully adopted the corporate residency test thus encouraging trusts to be analogized to an entity. The simplicity with which this analysis was undertaken hardly does justice to the unique character of the trust relationship and the fundamental underlying attributes which set it apart from a corporation.

Despite the obvious problems with creating a separate entity from a relationship between individuals, several arguments have surfaced in light of the Garron decision. First, this decision was clearly tailored to one circumstance: where the beneficiaries are really calling the shots, not the trustee. If the test that had endured for over thirty years was to be discarded, it should be demonstrated that various circumstances will be caught by the new test, an analysis which was not substantially undertaken. Second, the judgement was based on the false premise that corporations and trusts are analogous in their primary function of managing property. A corporation’s primary function is to protect its investors from risk in the pursuit of profit; a trust relationship is to expose the trustees to liability in the event that their actions put the assets at
risk. These are practically opposite purposes. Third, the assets of a corporation are ascertainable in the name of the corporation, whereas beneficial title vests in the beneficiary of a trust but is controlled by the trustee. The analysis adopted by the court in Garron focuses the analysis on control as opposed to ownership which is inappropriate in the trust context.

Unfortunately the Act and CRA interpretation documents and bulletins are silent as to the question of where a trust is resident, though there are clues that can guide us. Section 94 of the Act points to the beneficiary; the CRA publications also point to the beneficiary; other jurisdictions have legislative tests that can guide us as well. In the UK they look to the trustee, the US looks to control. Australia looks to the beneficiary and puts statutory obligations on the trustee where a beneficiary is under legal disability. After having reviewed these alternatives, the location of the beneficiary helps resolve the issues inherent in assessment and enforcement.

Basing trust residency on the location of the beneficiary allows the CRA to access the tax-labile assets without having the burden of chasing trustees in foreign jurisdictions. Trustees are under an obligation to ensure that tax liabilities of the trust assets are paid. The beneficiary, being the beneficial owner of any trust property, should be liable for any tax liability resulting from realized increases in the trust property as they are directly attributable to that beneficiary. Finally, any increased obligations resulting from the implementation of this test will fall on the shoulders of the trustees, who will be further accountable to the beneficiaries. It remains to be seen how the SCC will resolve this question based on existing arguments as well as alternatives which exist in other jurisdictions. Until this test is settled, no offshore planning can be conducted with any certainty; therefore in the interim, we should heed the warning of George Harrison in
the Beatles song “Taxman”: “And my advice to those who die, declare the pennies on your eyes!”  

---

Bibliography

**Statutes, Regulations, CRA Publications and Treaties**

8. *Income Tax Assessment Act 1936* (Cth.)

**Case Law**

Secondary Sources


Other Sources

1. George Harrison, Taxman, Performed by The Beatles, Track 1 on the album Revolver (Parlophone:1966).