The Queen v Sommerer, 2012 FCA 207

Does Subsection 75(2) of the ITA Apply to a bona fide Sale by a Beneficiary to a Trust at FMV?

[SEE COMMENT BELOW RE BUDGET 2013 THAT ADDRESSES THIS CASE]

The Queen v Sommerer, 2012 FCA 207

This was an appeal from the decision of the TCC in 2011 TCC 212. At issue were two questions:

- Whether subsection 75(2) applies to attribute income or gains to a person who sold property at FMV to a trust of whom the vendor was a (potential) beneficiary or ultimate beneficiary)?
- Whether the Income Tax convention article applicable to the sale of property did not apply to a person whose liability to tax arose as a result of an attribution rule, despite the fact that the economic vendor was able to take advantage of the provision to avoid Canadian taxation?

The FCA concluded that subsection 75(2) applies to attribute gains and income back to a person, other than a person who sells property to a trust at FMV, being the same person that gave or donated the property to the trust and who has the right of control or reversion, and that attribution rules could not deny the benefit of a provision in a tax convention absent a reservation from the application of the provision applicable to the circumstances.

The taxpayer was at all relevant times a resident of Canada. The taxpayer's father set up an Austrian private foundation, which included as beneficiary the taxpayer. However, under the terms of the foundation, the taxpayer was not eligible to receive disbursements until and unless he became an Austrian citizen (and later a citizen of a country other than Canada).

On October 4, 1996, the taxpayer sold shares of a corporation to the foundation at FMV, for cash and a promissory note. The sale was unconditional. In December 1997 the foundation sold some of the shares to unrelated parties and realised a capital gain on the sale, and sold the remainder of the shares again to an unrelated party realizing a capital gain. The taxpayer also sold in 1998 shares of another corporation to the foundation at FMV, which were later sold by the foundation at a higher price.

The minister reassessed the taxpayer on the basis that the capital gains realised by the foundation were attributable to the taxpayer pursuant to subsection 75(2) of the ITA.

The Court stated that subsection 75(2) is there to ensure that a taxpayer cannot avoid the income tax consequences of use or disposition of property by means of transfer in trust to another person while retaining a right of reversion in respect of that property or substituted property, or while retaining a right to direct the disposition of the property or substituted property. This is achieved by attributing the income and loss from the property or substituted property to the person the trust received the property from.

Subsection 75(2) reads as follows:

> **75. (2)** Where, by a trust created in any manner whatever since 1934, property is held on condition
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> (a) that it or property substituted therefor may
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> (i) revert to the person from whom the property or property for which it was substituted was directly or indirectly received (in this subsection referred to as “the person”), or
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> (ii) pass to persons to be determined by the person at a time subsequent to the creation of the trust, or
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> (b) that, during the existence of the person, the property shall not be disposed of except with the person’s consent or in accordance with the person’s direction,
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> any income or loss from the property or from property substituted for the property, and any taxable capital gain or allowable capital loss from the disposition of the property or of property substituted for the property, shall, during the existence of the person while the person is resident in Canada, be deemed to be income or a loss, as the case may be, or a taxable capital gain or allowable capital loss, as the case may be, of the person.

The FCA noted that the Austrian private foundation is not a trust as understood at common law, though it may achieve much of the same ends. This, however, does not mean that the establishment and endowment of the foundation was the settlement of a trust. An Austrian private foundation is a legal person capable of holding and dealing with property in its own right. Even if it could be said that the property was held in trust by the foundation, the rights of the beneficiaries did not arise until the fulfilment of the conditions. There was nothing in the constating documents or otherwise to indicate that the right of the private foundation was constrained by any legal or equitable obligations analogous to those of a common law trustee. The court used analogies between a corporation and its relationship to shareholders, as compared with an Austrian private foundation, to support the conclusion that "[n]othing 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".

The FCA, however, proceeded on the assumption (based on the trial judge's findings that were not challenged on appeal) that a trust was settled.

The Crown's argument was that because its possible under the constating documents for the property of the foundation to someday be distributed to the taxpayer as beneficiary or ultimate beneficiary, subsection 75(2) applies. The FCA agreed that this is true, but this itself is insufficient for the subsection to apply. The FCA stated that:

> 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. As mentioned above, subsection 75(2) generally is intended to ensure that a taxpayer cannot avoid the income tax consequences of the use or disposition of property by transferring it to another person in trust while retaining a right of reversion or a right of disposition with respect to the property or property for which it may be substituted. A common example of the application of subsection 75(2) is the settlement of a trust where the settlor is also a beneficiary with an immediate or contingent right to a distribution of the trust property. In that situation, and in many other situations contemplated by paragraphs 75(2)(a) and (b), subsection 75(2) achieves its intended purpose.

The crown argued that the subsection also applies in respect of property that has been purchased by a trustee form a beneficiary at FMV, and held subject to the terms of the trust. The court disagreed and said that to include bona fide sale transactions under the purview of subsection 75(2) would lead to absurd results, which the court highlighted through the use of examples (paras 51-55).

The court concluded that the Crown's interpretation is wrong because " it is based on the incorrect premise that subsection 75(2) can apply to a beneficiary of a trust who transfers property to the trust by means of a genuine sale." Referring to the TCC decision, the FCA agreed that "once properly unravelled and viewed grammatically and logically, the only interpretation is that only a settlor, or a subsequent contributor who could be seen as a settlor, can be the "the person" for purposes of subsection 75(2) of the Act". In this case, because the taxpayer did not contribute any property to the trust (if one existed) nothing can be attributed back to him by subsection 75(2).

The FCA also dealt with the finding of the TCC that even if subsection 75(2) applied, the income was not subject to tax in Canada pursuant to Article XIII(5) of the Canada-Austria Income Tax Convention, which provides that " Gains from the alienation of any property, other than those mentioned in paragraphs (1), (2), (3) and (4) shall be taxable only in the Contracting State of which the alienator is a resident." The Crown argue that this provision did not apply to the alienation of the shares at issue, because the taxpayer's income tax liability arose as a result of the attribution rules in 75(2) and not as a result of the alienation. Both the TCC and the FCA rejected this argument as being inconsistent with the words of the convention, since other provisions provided reservations allowing the taxation of attributed gains while this provision did not.

COMMENT

From Budget 2013 (Economic Action Plan 2013) Annex 2

Non-Resident Trusts

The *Income Tax Act* contains rules designed to prevent the use by taxpayers of non-resident trusts to avoid Canadian tax. If a person resident in Canada contributes property to a non-resident trust, rules (the deemed residence rules) may apply to treat the non-resident trust as resident in Canada.

Another rule (the trust attribution rule) may apply to attribute to a Canadian resident taxpayer the income from property held by a trust, including a non-resident trust, if the property is held by the trust in circumstances that grant effective ownership of the property to the taxpayer. Specifically, the trust attribution rule may apply in respect of property held by a trust on condition that:

- the property can revert to the taxpayer; or
- the taxpayer has influence over the trust's dealings in respect of the property.

A related rule prevents a tax-deferred distribution of property from a trust where property of the trust is, or has been, subject to the trust attribution rule.

The interpretation of the trust attribution rule in a recent decision of the Federal Court of Appeal (*The Queen v. Sommerer*, 2012 FCA 207) was not in accordance with the intended tax policy. In particular, the Court held that the trust attribution rule did not apply, in the particular circumstances of the case, to property received by a non-resident trust in exchange for fair market value consideration.

To respond to the decision in *Sommerer* and to protect the integrity of the tax rules that apply where a Canadian-resident taxpayer maintains effective ownership over property held by a non-resident trust, Budget 2013 proposes to amend the deemed residence rules to apply if a trust holds property on conditions that grant effective ownership of the property (as described above in the context of the trust attribution rule) to such a taxpayer. In these circumstances, any transfer or loan of the property (regardless of the consideration exchanged) made directly or indirectly by the Canadian resident taxpayer will be treated as a transfer or loan of restricted property (as defined in the tax rules) by the taxpayer. As a result, the Canadian resident taxpayer will generally be treated as having made a contribution to the trust and the deemed residence rules will apply to the trust. As well, the rule described above with respect to trust distributions will be extended to apply to the trust.

To clarify the application of the tax rules that apply to non-resident trusts, Budget 2013 also proposes to restrict the application of the trust attribution rule so that it applies only in respect of property held by a trust that is resident in Canada (determined without regard to the deemed residence rules).

This measure will apply to taxation years that end on or after Budget Day.

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