CCH
Tax Notes – August
<u>Sale to Trust not hit by “Reversionary Trust” Rules</u>

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 are 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 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 par 34.]

Until recently, cases centering on the provision were relatively infrequent. That trend was changed starting in 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 where subsection 75(2) has been in issue include *Garron* and *Labow*).

Sommerer involved a non-resident father (Herbert) who set up an Austrian foundation in the mid-90’s. 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 - relevant to the appeal - are 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 FMV, were property which 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 lengthly analysis, the rationale articulated by the appeals court is also straight forward: 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., because it would lead to double-tax on the same gain. As a result, the appeal 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 par. 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 FMV), stipulating that the terms of the existing trust apply except that, if the painting is still held by the trust in ten years' time, the painting would revert to Jack. If the trust sells the painting five years later, the Federal Court of Appeal 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 above example, the Federal Court of Appeal concludes that subsection 75(2) applies to Jack, but he is not the original contributor to the trust, nor does the FCA 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 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 case of 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 75(2) – that the reversionary trust rules could be triggered if the contributor has 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 to 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 Federal Court of Appeal, "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) – not to lead to outcomes that are "absurd and could not have been intended by Parliament" (pars 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 common sense interpretation of its provisions, which manage to minimize "absurd" results. To me, that's what the Federal Court of Appeal's decision is all about.

<u>Other Issues</u>

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 focuses 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 pars. 41 and 42) that:

> ". . . 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 Federal Court of Appeal agreed with the Tax Court of Canada's conclusion that, even if subsection 75(2) were to apply, this 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 was of the view 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.

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[1] The FCA noted that: "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 par. 52.

[2] See, for example, "Is a Family Trust Vulnerable to the CRA? More Warning Signs: Subsections 75(2)–107(4.1)", by the author, *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 Document No. 2008-0292061E5 and earlier Technicals (including Document No. 2003-0050671E5 and 2004-0086921C6), e.g., the policy would not apply where the trust expressly requires the contributor's consent.