

INTER-PROVINCIAL ISSUES OF INTEREST

Kim G. C. Moody, FCA, TEP, Timothy W. Clarke, B.A., M.A., LLB, and Lisa Handfield CGA, LLB, LLM¹

I. INTRODUCTION

Comparing prices is a hobby of many shoppers and this may be equally true when it comes to paying taxes as many individuals, corporations and trusts alike “shop” jurisdictions for the lowest rate. Despite equalization payments amongst the provinces, the provinces do not appear to be able to provide equivalent services to their residents at similar levels of taxation. While the varying costs of providing provincial services may be due to the presence or absence of other revenues, such as royalties, or the number and dispersion of their residents, the bottom line remains – there is significant variation amongst provincial taxation rates.

Due to advancements in technology, society today is undergoing a future shock²– a structural change which can sometimes be overwhelming. With this change comes almost seamless mobility of capital which may allow entities to shift wealth to lower tax jurisdictions. Arguably, advances in technology increase mobility of labour as well; for instance, thousands of workers from across the country commute to Alberta’s oil sands for work. Given this increased mobility of capital and labour, rate “shopping” amongst provinces becomes easier.

This paper will consider a number of inter-provincial issues, beginning with a review of the legislative framework under which provincial income for individuals, trusts and corporations are levied as well as the tests for residency. A variety of inter-provincial plans are then discussed as well as recent case law. The paper concludes with some comments on the general anti-avoidance rule (the “GAAR”).

II. LIABILITY FOR TAXATION

Individuals, trusts and corporations are liable for tax in Canada on their worldwide income pursuant to subsection 2(1) of the *Income Tax Act* (Canada)³ (the “Act”) if they are resident in Canada during the period. The occurrence of residence in Canada provides the basis for the jurisdiction to tax and thus creates the liability for taxation of a person.⁴ In addition to being liable for taxes under the Act, individuals, trusts and corporations are liable for taxation on a provincial basis as levied by the various provincial tax acts. Provincial taxation is generally levied on a similar basis, that of residency.

Non-residents of Canada are taxable on income from an office or employment pursuant to section 115 of the Act and Regulation⁵ 2602 will impute this income to the province(s) in which the duties thereof were performed. Similarly, a non-resident corporation will be taxable on its Canadian source income under section 115 of the Act. Non-resident corporations may also be subject to the “branch tax” pursuant to Part XIV of the Act, which generally will be applied to Canadian-source business income and related taxable capital gains. Non-residents are also taxable if they carry on business in Canada or dispose of taxable Canadian property. Withholding tax is applicable to interest, rents, royalties, dividends and management fees paid or credited to non-resident persons. Similarly, as a general principle, business income is taxed in the province where it is derived.

III. CONSTITUTIONAL FRAMEWORK FOR PROVINCIAL INCOME TAX

1. The Federal and Provincial Taxing Power

Under subsection 91(3) of the *Constitution Act, 1867*⁶ (the “Constitution”), Parliament has unlimited power to impose any mode or system of taxation. Unlike the provinces, there is no qualitative or territorial limit to Parliament’s authority to impose taxes. While the provinces are limited, Parliament may impose any form of direct or indirect taxation inside or outside Canada.⁷

The province’s powers of taxation are limited to raising revenue for provincial purposes by means of direct taxation within the province under subsection 92(2) of the Constitution. The words “raising of a revenue for provincial purposes” have been given little significance by the courts, specifically the phrase puts no functional limit on the purposes for which a province may raise taxes.⁸ In other words, the provinces have the power to tax individuals based on residence, domicile, employment, or carrying on business in the province as long as the connection to the province is substantial.⁹

2. Direct Taxation

The requirements that taxes be “direct” and “within the Province” are of legal ambit. The courts¹⁰ have adopted John Stuart Mill’s distinction between direct and indirect taxation:

A direct tax is one which is demanded from the very person who it is intended or desired should pay it.

Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another.¹¹

While this distinction appears clear, it is not an easy concept to apply in the context of modern taxation statutes. Indeed, although a tax imposed upon the net income of a corporation carrying on business will usually be passed on to its customers, such a tax has been ruled to be direct.¹² An individual cannot pass on an income tax levied on employment income therefore it is a direct tax.¹³ The distinction between a direct and indirect tax lies in the “general tendencies of the tax and the common understandings of man as to those tendencies,”¹⁴ meaning if the general tendency is for the tax to be passed to another person, the tax is indirect, if not, it is direct.

Most modes of taxation have now been classified as direct or indirect but there remains differences in the proper approach to classification. It has been held by Justice La Forest of the Supreme Court of Canada that when a tax falls within an established “direct” category, then the Mill’s “passing-on” test should not be applied, but instead the tax or any variant is presumed to be direct.¹⁵ However, Justice Iacobucci of the Supreme Court of Canada disagreed maintaining that the Mill’s test should be applied to each new tax whether it is a variant of a predecessor tax or not.

3. “Within the Province”

Subsection 92(2) of the Constitution restricts the provinces to levying direct taxation “within the province”. The Supreme Court of Canada held in *Rex v. Cotton*¹⁶ that for a provincial tax to be valid the “subject” of taxation must be within the province. Succeeding cases held that for the purposes of the provincial taxing power, the subject matter of a tax pertains to “persons, property, transactions or benefits” within the province.¹⁷ Specifically, the Supreme Court of Canada in *Dunne c. Quebec (Sous-ministre du Revenu)*¹⁸ discusses what connection to the province is required for the province to be able to levy provincial income tax. The Court noted that subsection 92(2) of the Constitution is construed broadly and with flexibility to include the “power to tax residents of the province...[and also to] tax property, businesses and transactions within the province”.¹⁹

4. The “Extra-Provincial Facts” Doctrine

The wording of subsection 92(2) of the Constitution contemplates the imposition of a tax on provincial residents as they are undeniably “within the province”. Further, the Privy Council ruled in *Bank of Toronto v. Lambe*²⁰ (“*Lambe*”) that Quebec could tax “any person found within the province”, therefore the tax in question was properly levied because the taxpayer carried on business in the province even though it was not resident there.

This case is notable because the Court held that the tax could be computed with reference to paid up capital outside Quebec thus establishing the right of a province to impose a tax on a person found within the province but computed with reference to “extra-provincial facts”.²¹ In other words, the province may impose an income tax on its residents even on income earned outside the province²² where the quantum of such tax is measured by extra-provincial attributes.²³

In *Manitoba v. Air Canada*²⁴ (“*Air Canada*”) the Supreme Court of Canada ruled that a retail sales tax on liquor sales on through-flights over Manitoba and on short term layovers on the way to destinations outside the province was *ultra vires* because the aircraft did not have a “situs” within the province. There must be a substantial or at least more than a nominal presence in the province to provide a basis for imposing a tax. In contrast, in *Air Canada v. Minister of Revenue et al.*²⁵ the Ontario Court of Appeal ruled that Ontario could tax jet fuel that was purchased and primarily consumed outside the province by Air Canada and Canadian Airlines merely because it was physically transferred to the aircraft in Ontario. The court ruled that the refueling transactions were “within the province” and therefore the tax was within the provincial power.

It is difficult to determine where to draw the line between the concept of “nominal presence” in the province for flyovers and layovers, and the more substantial concept of transactional nexus which applied to fueling transactions. Given that provinces may impose a tax on residents based on extra-provincial facts and on non-residents undertaking transactions within the province, there appears to be no constitutional impediment to two or more provinces taxing the same income, hence the need for an interprovincial income allocation formula.

5. The “Agreeing Province” System of Provincial Income Taxation

Before the provincial “Tax Rental Agreements”²⁶ were struck in 1941, the broadly framed provincial taxing power resulted in a maze of overlapping federal, provincial, and municipal income taxes.

In 1962 some provinces entered into tax collection agreements with the federal government which were designed to, among other things lessen the possibility of double provincial taxation arising from the “extra-provincial facts” doctrine. Under the original agreements the federal government undertook to administer and collect provincial tax without charge if the provinces agreed to:

- impose a single rate of tax calculated as a percentage of basic federal tax;
- compute taxable income in accordance with the federal Act;
- impose personal income tax only on those individuals who are resident in the province on December 31; and
- compute taxable income earned in a province by a corporation in accordance with the interprovincial allocation formula contained in the Act and Regulations (also to avoid double taxation).

Over time, the “tax on tax” formula was relaxed to allow the provinces flexibility to impose tax at varying rates on taxable income. If a province agreed to compute taxable income under the Act and allocate that taxable income among provinces under the formula in the Regulations, it was free to impose any tax rate it wished.

6. Federal-Provincial Fiscal Arrangements Act

The federal and provincial income tax arrangements are governed by the *Federal-Provincial Fiscal Arrangements Act*²⁷ (the “FPFAA”). Specifically, the federal government levies tax on behalf of the provinces through a series of tax collection agreements (“TCA”)²⁸ which are provided for under the FPFAA. The federal government has TCA with all of the provinces, except Quebec,²⁹ for the collection of personal income taxes. For ease of administration, the TCA requires that provincial income taxes to be levied on the same basis as federal income taxes meaning that the provinces are required to use the federal definition of “taxable income”. However, the provincial income tax may be calculated using a tax on income method which calculates provincial income tax payable by individuals as a percentage of their taxable income. This method of calculating provincial taxes payable allows the provinces to set their own tax rates and determine which non-refundable tax credits they will offer.

With respect to the taxation of individuals, the federal government currently gives an abatement of 13.5 percentage points of its personal income tax pursuant to the FPFAA to allow room for the provinces to impose taxation.³⁰ The federal government also cedes 1.0 percentage point of its corporate income tax under the FPFAA. Technically speaking, a tax abatement is deemed to be a payment of tax made on December 31 as per Regulation 6401.

The legality of the TCA were challenged in *Gendis Inc. v. Canada*³¹ where the corporation, Gendis, undertook a corporate reorganization that allowed the corporate group to utilize the differences between section 85 of the Act and a parallel rollover provision in the *Quebec Taxation Act*³² (the “QTA”) to avoid provincial tax liability in respect of a sale of property which resulted in a capital gain (the “Quebec Shuffle”). Subsequent to the Quebec Shuffle, Gendis was assessed under the Manitoba provincial tax legislation that was passed retroactively to target such transactions. Gendis argued, not that the legislation was invalid, but that the application of the legislation to the transaction in question was invalid on the basis that the specific provision in the Manitoba legislation³³ could not be enforced as it was not a tax collected on the federal income basis as stipulated by the TCA. The Manitoba Court of Appeal held that the Canada Revenue Agency (the “CRA”) had the ability to collect and transmit taxes and such ability was not strictly limited to the terms of the TCA as there was an ongoing agency relationship of consensual administrative delegation, thus the Minister of National Revenue (the “Minister”) could validly levy an assessment under the Manitoba legislation in this circumstance against the corporation.

Quebec has never been an agreeing province and consequently it computes personal and corporate taxable income and tax under its own legislation and administers and collects tax without the federal government’s assistance. Several of the more elaborate interprovincial tax plans were designed to exploit the lack of integration between the provincial tax regimes for agreeing and non-agreeing provinces.

From time to time Ontario has been a non-agreeing province for corporate tax purposes but has now entered into a TCA with the federal government. With the exception of Quebec and Alberta (for corporate income tax only) all of the provinces and territories are now agreeing provinces for personal and corporate income tax. Consequently, the opportunities for exploiting the lack of integration between provincial tax regimes are dwindling but it is still possible based on the Alberta Court of Appeal’s decisions in *The Queen v. Husky Energy Inc.*³⁴ (“Husky”) and *The Queen v. Canada Safeway Limited*³⁵ (“Canada Safeway”) and (described below) to shift income to provinces with lower rates of taxation.

IV. RESIDENCE

1. Residence Defined

The Act does not define the term “residence” but merely deems some individuals who meet certain criteria to be considered residents of Canada.³⁶ Subsection 250(3) of the Act extends the meaning of the word “resident” to include a person who is “ordinarily resident” in a particular place.

Looking to common law principles, the leading case on the meaning of residency is *Thomson v. Minister of National Revenue*³⁷ where Justice Rand of the Supreme Court of Canada defined “resident” and “ordinarily resident” as follows:

It is important only to ascertain the spatial bounds within which [one] spends his life or to which is ordered or customary living is related. Ordinary residence can best be appreciated by considering its antithesis, occasional or casual or deviatory residence. The latter would seem clearly to be not only temporary in time and exceptional in circumstance, but also accompanied by a sense of transitoriness and of return.³⁸

Similarly Justice Kerwin of this Court defined “resident” to mean to “dwell permanently or for a considerable time, to have one’s settled or usual abode, to live, in or at a particular place”.³⁹ The Court noted that every person has at all times a residence for purposes of income tax legislation.⁴⁰ In short, the determination of where a person is resident is a fact driven inquiry.⁴¹

2. Provincial Residence Case Law

A series of older decisions of the Tax Review Board (the “TRB”) have considered where a person is resident in a provincial context. In *Gray v. Minister of National Revenue*,⁴² the individual stated his province of residence as New Brunswick as that was where he was physically present on the last day of each year, however, the individual actually lived in Quebec and only travelled to New Brunswick for holidays. As to be expected, it was held that the individual was resident in Quebec. In *Hoyt v. Minister of National Revenue*⁴³ an individual argued that because he was not present in the province of New Brunswick on the last day of the taxation year that he was not subject to provincial taxation in New Brunswick. The TRB noted that an individual needs to be resident in a second location before it can be assumed that the individual is not resident in the place where he was resident immediately prior.

Similarly, in *Park v. Minister of National Revenue*,⁴⁴ the individual was on sabbatical in another country and advanced the argument that while he was a resident of Canada, he was not a resident of Newfoundland. The TRB noted that while it is “conceivable for a person to be resident in Canada but not resident in a particular province in Canada”,⁴⁵ this individual was in fact resident in Newfoundland even though he was temporarily domiciled abroad.

V. PROVINCIAL TAXATION OF INDIVIDUALS

The phrase “income earned in the year in a province” is defined in subsection 120(4) of the Act to mean an amount determined under rules prescribed for the purpose by Regulations made on the recommendation of the Minister of Finance. Regulation 2601(1) states that if an individual resides in a particular province on the last day of the taxation year and has no income for the taxation year from a business with a permanent establishment outside the province, the individual’s income earned in the taxation year in the particular province is the individual’s income for the taxation year.

Generally speaking, an individual’s taxation year will end on the last day of the calendar year. For purposes of simplicity, the provinces have agreed to tax individuals, excepting business income of an individual, based on where the individual is resident on the last day of the taxation year.⁴⁶

Dual residency arises where an individual can be said to be resident in more than one province on the last day of the taxation year. Regulation 2607 will deem the individual to have resided on that day only in that province which may reasonably be regarded as his or her principal place of residence. The determination of a principal place of residence will be dependent on the strength of residential ties including where the individual has a permanent residence, where the individual’s dependents reside, where the individual works, and where his or her day-to-day activities occur.

While many provinces have lowered the rate of taxation over the last several years, the fact remains that Alberta has favourable rates, particularly for high income individuals and trusts as well as for corporations. The following chart details the applicable rates of taxation for individuals and trusts.

| Jurisdiction | 2013 combined top marginal rates | | | | | |
|-------------------------|----------------------------------|-------------------|----------------|--------------------|----------------------|---------------|
| | Tax on income top rate percent | Provincial surtax | Regular income | Eligible dividends | Ineligible dividends | Capital gains |
| Federal | 29.00% | | 29.00% | 19.29% | 19.58% | 14.50% |
| British Columbia | 14.70% | | 43.70% | 25.78% | 33.71% | 21.85% |
| Alberta | 10.00% | | 39.00% | 19.29% | 27.71% | 19.50% |
| Saskatchewan | 15.00% | | 44.00% | 24.81% | 33.33% | 22.00% |
| Manitoba | 17.40% | | 46.40% | 32.26% | 39.15% | 23.20% |
| Ontario | 13.16% | 20% / 36% | 49.53% | 33.85% | 36.47% | 24.77% |
| Quebec | 25.75% | | 49.97% | 35.22% | 38.54% | 24.99% |
| New Brunswick | 16.07% | | 45.07% | 24.91% | 33.05% | 22.54% |
| Nova Scotia | 21.00% | | 50.00% | 36.06% | 36.21% | 25.00% |
| Prince Edward Island | 16.70% | 10% | 47.37% | 28.70% | 38.56% | 23.69% |
| Newfoundland & Labrador | 13.30% | | 42.30% | 22.47% | 29.96% | 21.15% |
| Yukon | 12.76% | 5% | 42.40% | 19.29% | 30.40% | 21.20% |
| Northwest Territories | 14.05% | | 43.05% | 22.81% | 29.65% | 21.53% |
| Nunavut | 11.50% | | 40.50% | 27.56% | 28.96% | 20.25% |

VI. TRUSTS

1. The Trust Relationship

There is no statutory definition of what constitutes a trust in the Act as this is a matter of trust law; however, the Act defines a number of trust concepts. A trust is a legal relationship, not a legal entity, between the following persons: settlor(s), trustee(s), and beneficiary(ies). A settlor(s) conveys property or an interest therein to the trustee who holds the same for the benefit of the beneficiary(ies). While the trustee may have legal title to the property, they do not have any right of enjoyment as they are simply holding the property to eventually pass it to the beneficiary(ies), thus there is a separation between legal and beneficial ownership of the property. It is “probably most exact to say that the trust is a property-holding or a property-holding and administration device”.⁴⁷

Principles of trust law date back at least nine centuries.⁴⁸ Under the common law of trusts, the only person with a continuing obligation towards the trust is the trustee. Furthermore, at common law, trustees are fiduciaries and thus owe a fiduciary duty to act in the best interests of the beneficiaries. Over time, courts of equity have clarified the fiduciary duties of the trustee to include the duty to act in an even-handed manner, to act as prudent businesspeople, to act personally, to be loyal, and to be accountable to the beneficiaries.⁴⁹

Under the common law, the beneficiaries are not considered to have direct ownership of the trust property but instead such persons have a chose in action, which is the right of a beneficiary to demand that the trustee carry out the terms of the trust according to the trust indenture. A person beneficially interested in a trust may sue the trustee(s) for breach of trust if such person(s) act capriciously or contrary to the trust indenture.

Subsection 108(1) of the Act defines a beneficiary to include a person beneficially interested in the trust. Subsection 248(25) of the Act defines “beneficially interested” to include a person that has a right, whether immediate or future, whether absolute or contingent, and/or whether conditional on or subject to the exercise of any discretion by any person as a beneficiary under a trust to receive any of the income or capital of the particular trust directly or indirectly through one or more partnerships or trusts.

Pursuant to subsection 248(1) of the Act, the definition of “trust” expressed in subsection 104(1) of the Act is adopted, and such definition states that a reference to a trust or estate shall, unless the context otherwise requires, be read as a reference to include a trustee or other legal representative having control of the trust property. Subsection 248(3) of the Act deems certain relationships recognized under civil law to be a trust for purposes of the Act including an usufruct and a right of use or habitation. An *inter vivos* trust is defined by subsection 108(1) of the Act as a trust other than a testamentary trust. In simple terms, subsection 108(1) of the Act defines a testamentary trust as one that arose on and as a consequence of the death of an individual.

While the trust is not a legal entity; the Act creates a fiction whereby it taxes the property of a trust as if were an individual pursuant to subsection 104(2) of the Act.⁵⁰ Interestingly, although the property of the trust is taxed as if it were an individual, the trust itself operates as a conduit under several provisions of the Act, whereby the trust is allowed to essentially flow-through taxable dividends, non-taxable dividends and taxable capital gains.⁵¹ As an aside, the trust itself appears to be taxed as an entity under section 128.1 of the Act for purposes of immigration and emigration.

2. Validity of a Trust

While most practitioners are familiar with the three certainties under trust law, intention, object and subject matter, there also needs to be a *bona fide* transfer of property to the trust, in other words, a valid gift:

...it is clear that no gift takes place under English or Canadian law unless both a present intention to give exists and delivery in the form appropriate to the property in question has taken place.⁵²

Subparagraph 108(1)(b)(ii) of the definition of “settlor” under the Act contemplates that a trust can be settled by a person and their spouse jointly if the property gifted to the trust was previously joint property of that person and their spouse.

As noted in *Antle v. The Queen*,⁵³ (“*Antle*”) a case involving an off-shore trust designed to take advantage of the lower rate of taxation in Barbados through “treaty shopping”, ensuring a trust is properly constituted is critical to an effective tax planning strategy:

With certainty of intention and certainty of subject matter in question and, more significantly, no actual transfer of shares, there is no properly constituted trust: the Trust never came into existence. This conclusion emphasizes how important it is, in implementing strategies with no purpose other than avoidance of tax, that meticulous and scrupulous regard be had to timing and execution....In short, if you are going to play the avoidance game, it is not enough to have brilliant strategy, you must have brilliant execution.⁵⁴

With respect to certainty of intention, both the Tax Court of Canada and the Federal Court of Appeal⁵⁵ held that one could look beyond the trust indenture itself and look to the broader facts and circumstances surrounding the constitution of the trust, thus that certainty of intention was a subjective determination. Certainty of intention in *Twinsectra Limited v. Yardley and Others* was held to be objective by the House of Lords, specifically whether a trust is created depends on the construction of the trust indenture alone.⁵⁶ It is an open question whether the Canadian Courts intended to change the standard of inquiry into the certainty of intention criteria.

Further, as noted by the Tax Court of Canada, it was impossible in *Antle* for the share certificate to have been properly gifted, both in terms of intention to gift and physical delivery of the gift, as the corporation was a private corporation and thus had a physical share certificate which at the time of the settlement of the trust was pledged as security to another corporation.

When it comes to taxation of trusts, the issues become more complex as the provinces regulate property and trust issues under the powers given to them under the Constitution. In *Edgar Estate v. M.N.R.*⁵⁷ it was held that revenue authorities must accept decisions of competent provincial courts on matters within their jurisdiction that may alter property rights, in other words, tax legislation applies only to the legal relationships after provincial law has determined the nature of these relationships.

The superior court of the province has jurisdiction over the validity of a trust and thus the ability to determine where a trust is resident. In a recent case from the Alberta Court of Queen's Bench, *Sheila Holmes Spousal Trust v. Canada*,⁵⁸ the Court refused to exercise its jurisdiction to make a declaration in relation to trusts as there was no evidence of litigation between the third parties and the trustee and no evidence of litigation between the trustee and settlor with respect to the validity of the trust.

The Court felt that the real issue at hand was a tax matter. Query whether the Tax Court of Canada is the proper forum for a determination of the validity of a trust when the provinces have been given control over property rights under the Constitution.

3. Sham Trusts

Justice Estey of the Supreme Court of Canada defined "sham" in *Stuart Investments Limited v. The Queen*⁵⁹ as "the element of deceit, which is the heart and core of a sham".⁶⁰ In *Continental Bank of Canada et al. v. The Queen*,⁶¹ Justice Bowman of the Tax Court of Canada ruled that the form of legally binding relationships cannot be ignored and when a sham exists, the necessary corollary is that there is a different legal relationship behind the legal façade. Simply put, if the purported legal relationships are binding and are not a cloak to disguise another type of legal relationship, they are not a sham. Generally speaking, a common intention between the parties is required for a sham to exist, but reckless indifference will be taken to constitute the necessary intention. As noted in *A. v. A. and St. Georges Trustees Limited*⁶² ("A. v. A.") the burden of proving a sham rests with the party asserting there is a sham.⁶³

The Court in *A. v. A.* noted that a transaction cannot be genuine for one purpose and a sham for another purpose:

...I do not see how, considering the nature of a sham, a transaction can be a sham for one purpose but not for another. A transaction is either genuine or it is a sham. If it is genuine, then in principle the function of the court is simply to ascertain its legal nature and effect and enforce it accordingly. If it is a sham, then it is in principle ineffective, indeed void, according to Arden LJ in *Hitch v. Stone*...So, for example, a transaction cannot be genuine as between a husband and the Revenue whilst being at the same a sham as between him and his wife.⁶⁴

If a trust is not a sham for general law purposes, it cannot be a sham solely for tax purposes. Even if one or more clauses in the trust indenture are ruled to be invalid or unenforceable, such clauses may generally be severed from the balance of the trust indenture and as such do not affect the validity or enforceability of the trust. A validity constituted trust cannot subsequently become a sham:

It seems to me that as a matter of principle a trust which is not initially a sham cannot subsequently become a sham...Once a trust has been properly constituted, typically by the vesting of the trust property in the trustee(s) and by the execution of the deed setting out the trusts upon which the trust property is to be held by the trustee(s), the property cannot lose its character as trust property save in accordance with the terms of the trust itself, for example, by being paid to or applied for the benefit of a beneficiary in accordance with the terms of the trust deed. Any other application of the trust property is simply and necessarily a breach of trust; nothing less and nothing more.⁶⁵

Given the restrictive views of sham in the United Kingdom and elsewhere, in the view of the authors, it will be difficult for the Minister to successfully argue sham with respect to inter-provincial planning structures involving a trust.

4. Spouse Trusts

There are a number of ways a property can be transferred to a trust on a tax-deferred basis, including qualifying transfers under subsections 73(1), 73(1.01) and 73(1.02) of the Act and qualifying dispositions under subsection 107.4(1) of the Act. With respect to transfers *inter vivos*, an individual can transfer assets to a trust for their exclusive benefit using a self-benefit trust pursuant to subparagraph 73(1.02)(b)(ii) of the Act or alternatively an alter ego trust if the individual has attained sixty-five years of age pursuant to the combined definition in subsection 248(1) and paragraph 104(4)(a) of the Act.

An individual may also transfer property to a trust to benefit themselves and their spouse or common-law partner (collectively referred to as a “spouse”) using a joint conjugal trust on an *inter vivos* basis. An individual can transfer property to a trust to benefit their spouse alone using a post-1971 conjugal trust (referred to as a “spouse trust”) on both an *inter vivos* and testamentary basis.⁶⁶ As with any “rollover” provision, the transferee acquires the property at the transferor’s cost base so as to create a tax-deferral until there is a subsequent disposition of the property.

Property can be transferred to a spouse trust on a tax-deferred basis if the following conditions are met⁶⁷:

1. both the transferor spouse and the trustees are resident in Canada at the time of the transfer;
 2. only the spouse is entitled to the income during his/her lifetime;
 3. no one other than the spouse can obtain the use of the income or capital during his/her lifetime;
- and
4. an election⁶⁸ out of the rollover has not been made.

If there was intention to create a spouse trust, but for some reason the terms of the trust do not meet the requisite conditions in section 73 of the Act, the CRA may consider the spouse trust to be defective and the transfer of property to have occurred on a fully taxable basis. It may be possible to seek rectification from the superior court of the province. Rectification is a process whereby parties to an agreement, including a trust arrangement, can ask the court for an order retroactively amending the trust indenture to accord with the parties’ true intentions which were incorrectly recorded in the trust indenture.

It is best practice to state in the recitals of the trust indenture itself the intention that the trust be a spousal trust pursuant to the provisions of the Act. It is not uncommon for a trust indenture to accidentally provide for some capital to be available to other beneficiaries during the lifetime of the spouse rather than providing for a proper gift-over. If such a situation occurs, the authors recommend seeking rectification immediately upon the discovery of the provision in the trust indenture.

5. Residency⁶⁹

Given that the trust obligations are enforceable by the beneficiaries against the trustee(s), the residence of the trustee should, in the view of the authors, always have some relevance in determining the residence of the trust. The Carter Commission addressed the question of trust residency opining that such residency should be determined primarily by reference to the residence of the trustee.⁷⁰ Interestingly, the Carter Commission also noted that a trust should be resident in Canada if it carries on business in Canada or if substantially all of the trust property is located within Canada.⁷¹

Justice Woods of the Tax Court of Canada in *Garron Family Trust v. The Queen*⁷² (“*Garron*”) notes the often-quoted passage from *DeBeers Consolidated Mines Limited v. Howe*.⁷³ as justification for adopting the central management and control (“CMC”) test to determine the residency of a trust:

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. An individual may be of foreign nationality, and yet reside in the United Kingdom. So may a company.

The Courts, in essence, adopted the corporate CMC test for determining the residence of a trust, with such modifications as are appropriate in the trust context. The CMC test is a fact driven inquiry. While the trustees have *de jure* control of the trust, it is possible, as it is in the corporate context, for another person (perhaps the settlor) to have *de facto* control of the trust.

It is important to note that Justice Woods of the Tax Court of Canada concluded that a trust can be resident in a jurisdiction other than the place where the trustee resides if the trustee does not make decisions or is dictated to by the beneficiaries.⁷⁴ Further, Justice Woods held that more than outsider influence is needed to shift residence away from the jurisdiction where *de jure* control is exercised.⁷⁵

A number of problematic facts were present in *Garron* including the following:

- that the trustee had agreed from the outset that it would defer to the recommendations of Mr. Dunin and Mr. Garron⁷⁶;
- internal memoranda were present and such documents gave the trustee a more limited role than the trust indenture;
- St. Michael, the trust company, was an arm of Pricewaterhouse Coopers and it is questionable what expertise the trustee had;
- the trusts did not have an investment strategy which is not what is expected of an experienced professional trustee;⁷⁷
- the trust had a protector who could replace the trustee at any time; and
- the adult beneficiaries, as a group, could replace the protector at any time.

These factors, amongst others, led the Tax Court of Canada to conclude that Mr. Garron, a beneficiary of the trust and family patriarch, was the person who exercised *de facto* control of the trust and thus the central management and control of the trust resided in Canada where Mr. Garron lived.

The Federal Court of Appeal⁷⁸ echoed the decision of the Tax Court of Canada stating:

However, there is a line to be drawn. On one side of the line are recommendations, even strong ones, by the beneficiaries to the trustee, leaving the trustee free to decide how to exercise the powers and discretions under the trust. In that case, the trustee is still managing and controlling the trust. On the other side of the line the beneficiaries are really exercising the powers and discretions under the trust, managing and controlling the trusts, and displacing the appointed trustee.

Again, it appears that the starting point for residency of a trust is the residence of the trustee(s) or the place where the trustees meet to exercise their fiduciary duties (i.e. where *de jure* control resides), but the test for residence can shift, if it appears that someone other than the trustee has *de facto* control of the trust, to the place where the *de facto* control resides or where it is exercised.

As an aside, changes to the Act in 2001 may have opened the door for the Courts to find that the CMC test is appropriate, in some circumstances, to determine residency. Prior to 2001, subsection 104(1) of the Act read that a reference to a trust shall “be read...as a reference to a trustee” meaning that the Courts may have had no choice but to look to the residency of the trustee to determine the residence of the trust. In 2001, subsection 104(1) of the Act was modified to read that a reference to a trust shall “include” a reference to a trustee.

6. British Columbia Provincial Legislation

Many trust indentures contain a governing law clause which expressly states that the trust will be resident in a particular jurisdiction. It is important to note that British Columbia passed legislation, *The Conflict of Laws Rules for Trusts Act*,⁷⁹ (the “Trusts Act”) which specifically deals with the residence of a trust. Section 3 of the Trusts Act states that the law that governs a trust is the law chosen by the settlor either expressly or by implication. Section 6 of the Trusts Act states that the residence of a trust is the place where the administration of the trust is carried out or is principally carried out. This legislation clearly imposes a test similar to that of CMC. In *Wenngatz v. 371431 Alberta Ltd.*,⁸⁰ an application related to the doctrine of *forum non conveniens*, the British Columbia Supreme Court applied the Trusts Act and held that the trust in question was intended to be governed by Alberta law as indicated by the settlor.

British Columbia has also passed the *International Trusts Act*⁸¹ whereby the *Hague Convention on the Law Applicable to Trusts and their Recognition* (the “Convention”) is adopted in section 1. Article 6 of the Convention states that a trustee shall be governed by the law chosen by the settlor and such choice may be express or implied. Article 7 of the Convention states that a trust shall be governed by the law to which it is most closely connected, if no applicable law has been chosen.

Specifically, in ascertaining the most closely connected law, consideration is given to the place of administration of the trust designated by the settlor, the situs of the assets of the trust; the place of residence or business of the trustee; and the objects of the trust and the places where they are to be fulfilled. Article 8 of the Convention states that the law specified by Article 6 or 7 shall govern the validity of the trust, its construction, its effects and the administration of the trust.

In *Chan v. Chan*,⁸² the British Columbia Supreme Court noted Articles 6 and 8 of the Convention and held that there was no substantial connection to the province for an *inter vivos* trust that was settled under the laws of Nauru.

Both the Trusts Act and the Convention, as adopted by the *International Trusts Act*,⁸³ will likely complicate the question of trust residency for tax purposes.

VII. CORPORATIONS

1. Residency

There are a number of deeming provisions in section 250 of the Act which state that in certain circumstances a corporation shall be resident in Canada.⁸⁴ A corporation may also be resident in Canada under the common law if the CMC of the corporation resides in Canada. There are no provisions in the Act determining provincial residency of corporations.

CMC is a concept adopted by the Canadian courts from jurisprudence of the United Kingdom. In short, the CMC test is applicable to corporations that have been incorporated outside of Canada but have *de facto* management from Canada. CMC is based primarily on where the director's meetings are held but also considers the residency of the directors, assuming that the directors are responsible for the major decisions of the corporation. If the power of directors is usurped by a unanimous shareholder agreement, as provided for by corporate law, then the residency of the shareholders is of relevance in determining the CMC of the corporation.

Similar to *Garron*, external factors in how a company actually operated were considered by the United Kingdom First Tier Tribunal in *Laerstate BV v. Revenue & Customs*⁸⁵ and the CMC test was applied. This case held that the Dutch-incorporated company whose board of directors met in the Netherlands was actually resident in the United Kingdom as the company had a United Kingdom resident director who acted alone from the other director in negotiating a share investment from within the United Kingdom. This same director continued to “control” the company even after his formal resignation. While the other director signed resolutions, his actions were held not to suffice for actual management. The Court described a scale of behaviour from directors mindlessly signing documents without knowing their content to directors having awareness of what they are signing but are unable or do not determine if such actions are in the company’s best interests to directors who have sufficient information to make and do make informed decisions.

2. The Corporate Allocation Formula

The corporate tax rates in Alberta are some of the lowest in the country as detailed by the following table:

| 2013 Combined Federal and Provincial Income Tax Rates (CCRT) | | | | |
|--|--|-------------------|--------------------------------|-----------------------|
| Jurisdiction | Business Income (applies in excess of SBD) | Investment Income | Small Business Deduction (SBD) | Small Business Income |
| Federal | 15.00% | 34.67% | \$500,000 | 11.00% |
| British Columbia | 25.75% | 45.42% | \$500,000 | 13.50% |
| Alberta | 25.00% | 44.67% | \$500,000 | 14.00% |
| Saskatchewan | 27.00% | 46.67% | \$500,000 | 13.00% |
| Manitoba | 27.00% | 46.67% | \$400,000 | 11.00% |
| Ontario | 26.50% | 46.17% | \$500,000 | 15.50% |
| Quebec | 26.90% | 46.57% | \$500,000 | 19.00% |
| New Brunswick | 26.00% | 45.67% | \$500,000 | 15.50% |
| Nova Scotia | 31.00% | 50.67% | \$400,000 | 14.50% |
| Prince Edward Island | 31.00% | 50.67% | \$500,000 | 14.63% |
| Newfoundland & Labrador | 29.00% | 48.67% | \$500,000 | 15.00% |
| Yukon | 30.00% | 49.67% | \$500,000 | 15.00% |
| Northwest Territories | 26.50% | 46.17% | \$500,000 | 15.00% |
| Nunavut | 27.00% | 46.67% | \$500,000 | 15.00% |

Income of a corporation (and of an individual earning business income) is allocated between provinces in which the corporation has permanent establishments based on the formula set out in Regulations 400 to 415.

3. Permanent Establishments

Regulation 400(2) defines a permanent establishment (a “PE”) to mean a fixed place of business of the corporation and includes amongst other things an office, a branch, a mine, an oil well, a farm, a timberland, a factory, a workshop and a warehouse. The meaning of an office, a branch, a mine, an oil well, a farm, a timberland, a factory, a workshop and a warehouse are relatively clear. The justiciable issues turn on the meaning of “fixed places”, “business” or “general authority to contract”.

The existence of a PE is a question of fact. To have a PE, a corporation must have a business but one may usually rely upon the fact that a corporation is presumed to carry on business.⁸⁶ Where a corporation carries on business through an employee or agent established in a particular place who has general authority to contract for his employer or principal, the corporation is deemed to have a permanent establishment in that place.⁸⁷

For the purpose of interprovincial planning it will be important to ensure that the corporation has a PE in the target jurisdiction and does not have a PE in the original jurisdiction. Setting up a PE is not difficult in most situations as one can easily open an office in the desired jurisdiction. Having said this, a registered office or records office for legal purposes appears not to be sufficient for the purpose of this definition.⁸⁸ Moreover, the establishment must not be temporary as permanent means a stable establishment, not one of a temporary or tentative character.⁸⁹ Since a corporation carries on business where its CMC exists,⁹⁰ it will have a PE where its directors and officers meet and reside.

4. The Allocation Formula

The allocation formula is set out in Regulation 402. Where a corporation has a PE in one province and in no other province, all of its taxable income is allocated to that province.⁹¹ Where a corporation has no PE in a particular province, none of its taxable income is allocated to that province.⁹²

Where a corporation has a PE in more than one province its taxable income attributable to each province is 50 percent of the aggregate of:

- a) gross revenue attributable to a particular provincial permanent establishment divided by total gross revenue of the corporation

and

b) salaries and wages paid to employees attributable to that provincial permanent establishment divided by the total salaries and wages of the corporation,

multiplied by the corporation's taxable income computed under the Act.

Where gross revenue of the corporation is nil, the allocation is based on the salaries and wages paid to employees of the PE divided by the total salaries and wages. Where the salaries and wages of the corporation are nil, the formula is based on the gross revenue reasonably attributable to the PE divided by total gross revenue.⁹³

For the purpose of the corporate allocation formula, "gross revenue" does not include interest on bonds, debentures or mortgages, dividends on shares of capital stock, or rentals or royalties from property that is not used in connection with the principal business operations of the corporation.⁹⁴

The definition of "gross revenue" contained in subsection 248(1) of the Act excludes amounts received on account of capital therefore capital gains and recaptured depreciation form no part of the allocation formula. The exclusion of capital gains from the definition of gross revenue presents a planning opportunity to allocate capital gains between provinces using appropriate measures to manipulate gross revenue and salaries and wages (which include director's fees) which are attributed to a particular PE.

5. Provincial Quasi Competent Authorities

Before 1995, the CRA, Ontario and Alberta established the Tri-Party Review Allocation Committee (the "TRAC") to deal with interprovincial corporate income allocation issues. Among agreeing provinces the CRA deals with the allocation of corporate taxable income under Regulation 400. TRAC was necessary to deal with allocation issues amongst non-agreeing provinces and agreeing provinces.

In answer to a question directed to the CRA at the 2002 Association de Planification Fiscale et Financiere convention⁹⁵ (the “APFF”) the CRA described TRAC as follows:

In May 1995, the Parties signed a memorandum of understanding establishing procedures and guidelines for resolving any dispute pertaining to the double taxation resulting from the allocation of income earned in a province by a corporation. This memorandum also provides a mechanism for identifying situations in which potential disputes may occur. The TRAC sits twice a year. Although Revenu Quebec is not obliged to follow these procedures and guidelines, we think [the] department adheres to them voluntarily as do the other parties to the memorandum. Over the years, the collaboration among the participants in the TRAC meetings has always been excellent.

In the answer to the question posed at the APFF – regarding double taxation resulting from a reassessment reallocating income to Quebec after corporation’s taxation years in other provinces become statute-barred, the CRA stated that under the Memorandum of Understanding (the “MOU”) no province is to propose a reassessment based on a reallocation of taxable income earned in a province where the taxation year is statute-barred or will be statute-barred within 120 days except where the assessing authority is alleging fraud or misleading statements by the corporation. The MOU also deals with procedures for filing waivers to avoid the possibility of provincial double taxation.

During the Tax Executives Institute liaison meeting on December 6, 2006 the CRA was to describe the provincial income adjustment (the “PIA”) process “from beginning to end” the CRA responded by stating that:

- the CRA will conduct a PIA audit every time it performs a compliance audit of a corporation reporting multiple PEs in Canada where at least one PE is in an agreeing province;
- once a potential adjustment is identified, the taxpayer is notified and asked to provide representations;
- the file is then referred to non-agreeing provinces for comment;
- the audit report is prepared taking the taxpayer’s representation and the non-agreeing province’s comments into consideration;
- processing the reassessment is postponed until the file has gone through a resolutions process as agreed between the CRA and the non-agreeing province and once a written agreement has been achieved the adjustments are formally proposed to the taxpayer – a process which is designed to ensure the taxpayer is not double taxed; and

- while the decision made by TRAC is communicated to the taxpayer, its deliberations are not made public.

Quebec later became a signatory to the interprovincial allocation review process which became known as the Allocation Review Committee (the “ARC”) as disclosed in Technical News No. 41 dated December 23, 2009.⁹⁶

The technical news publication disclosed ARC’s position on:

- whether interest earned on various financial instruments constitutes gross revenue for the purposes of the allocation formula (it doesn’t for the most part);
- when the use of substantial machinery and equipment results in a permanent establishment (after 30 consecutive days or 90 accumulated days in 12 months); and
- the allocation of leasing revenue among provinces (to the PE in which the leased property is being employed for the most part).

Beginning in 2010 the CRA began issuing “interprovincial income allocation newsletters” which presumably disclose the ARC’s policies on the allocation formula. The first three newsletters issued in 2010 dealt with the same issues discussed in the above noted Technical News and the fourth newsletter dealt with the inclusion of taxable benefits in calculating an employee’s reportable salaries and wages for the purposes of the allocation formula.

We have been advised by Wayne Adams, a former CRA attendee at the committee’s meetings (now the Director of Membership Development and Community Relations with the Canadian Tax Foundation) that the ARC’s primary mandate is to resolve interpretation disagreements with respect to Regulation 400 but there would have been conversations on avoidance arrangements such as “Quebec Truffles”, “Quebec Shuffles” and “Ontario Shuffles” which were intended to achieve a complete elimination of taxation at the provincial level. Conversations about these structures may occur at the ARC level. Similar conversations could conceptually occur at the Joint International Tax Shelter Information Centre, where information on international tax avoidance schemes can be shared between tax administrations. Resolution of potential domestic double taxation attributable to these schemes would be a low priority. Among agreeing provinces there is no need to resort to the ARC because the CRA simply makes the allocations.

VIII. INTER-PROVINCIAL PLANNING⁹⁷

1. Move

The obvious, but not particularly practical, tax planning strategy is to move to a jurisdiction with a lower rate of overall taxation. In an inter-provincial context, this strategy may be attractive to individuals who expect to receive a large capital gain or dividend, as provincial residency on the last day of the taxation year is determinative for purposes of provincial taxation with respect to passive forms of income. It will be imperative that the individual sever their residential ties⁹⁸ with their former province before the end of the taxation year in order to be properly considered a resident of the new province.

2. Rollover Assets to a Trust

A number of plans involve transferring capital assets with pregnant gains on a rollover basis to a spousal, joint partner, alter ego or self-benefit trust which is properly resident in Alberta. It is important to avoid subsection 75(2) of the Act when such assets are transferred to a trust. If the individual who resides in British Columbia undertook this strategy prior to disposing of the capital asset then when the capital asset is disposed of the capital gains will be taxed at the lower Alberta rates.

As with any planning strategy involving a trust, it is important to ensure that the trust is properly constituted meaning that the three certainties and a gift of property are present (as discussed in detail above). Further, in order to avoid the application of subsection 75(2) of the Act, a third party who is not related to the trustee(s) and beneficiary(ies) should settle the trust. In the view of the authors, the best practice is to settle a trust with a silver coin which is kept in a safe deposit box. While a trust can be settled with any property, one must exercise caution when using Canadian currency as an accidental distribution of these funds and/or the property substituted therefore may inadvertently terminate the trust by operation of law if the distribution results in the trust having no property.

Subsection 75(2) of the Act applies when property may revert to a settlor or if the settlor has control over the trust. Subsection 75(2) of the Act is broadly worded and in addition, uses the word “may” which means that even if there is only a mere possibility of a scenario where property could pass to the settlor, even though if scenario is unlikely, the trust will be subject to subsection 75(2) of the Act. If subsection 75(2) of the Act applies to a trust then subsection 107(4.1) of the Act states that subsection 107(2) of the Act cannot apply to the trust.

Subsection 107(2) of the Act allows property of the trust to be distributed to most capital beneficiaries of the Trust on a tax-deferred basis meaning that the distribution of the trust property to a capital beneficiary will not be a taxable disposition. If subsection 75(2) applies to a trust, then it is possible under the exception in paragraph 107(4.1)(c) of the Act, to distribute property of the trust to the person from whom the property was received.

3. Loan to a Trust

One plan involves loaning property to a trust resident in Alberta. The rules in subsection 75(2) of the Act need to be considered but generally speaking they should not be applicable if the loan is genuine. In other words, there needs to be an actual loan agreement, not a mere transfer of property, and such loan needs to bear interest at the prescribed rate⁹⁹ to avoid the application of subsection 56(4.1) of the Act.

The wording of subsection 75(2) of the Act refers only to property held on specific conditions which means that a loan to a trust should not run afoul of this provision since such analysis of whether property is held on these conditions should be independent of how the trust acquired the property.

In *Howson v. The Queen*¹⁰⁰ the Tax Court of Canada was asked to consider whether the funds advanced to a trust were in fact by way of loan so as to avoid the application of subsection 75(2) of the Act. In this case there were a number of transactions designed to take advantage of the five-year tax holiday upon immigration. The Court held:

It stands to reason that a *bona fide* loan is, on its face, not subject to reversion by the terms of the Trust.

It returns to the lender by operation of the loan itself and the law of creditor rights.¹⁰¹

The Court ruled that the funds were loaned despite that the loan was not documented until a few years later as the Court considered the testimony of the parties involved and the financial statements of the trust which recorded the monies as a loan.

Subsection 56(4.1) of the Act is an attribution rule which applies to interest free or low interest loans between persons considered not to be at arm's length where such loans have income splitting as one of their main purposes. Attribution is a concept whereby the legal income of one person is considered as if it were the income of another person and is taxed in the latter's hands on principles of economic fairness. Pursuant to subsection 56(4.2) of the Act a loan at the prescribed rate will be excepted from the attribution rule in subsection 56(4.1) of the Act.

The trust will be taxed on the property income at favourable Alberta rates while the interest income paid by the trust, generally at the prescribed rate, will be deductible by the trust. The tax savings arise from the differential between the lower rate of taxation on the income as the interest income and deduction should off-set each other.

A variation of this plan involves designating trust income and taxable capital gains under subsections 104(13.1) and 104(13.2) of the Act, respectively, to be taxed at the trust level despite that such amounts are actually distributed to a beneficiary. This strategy is particularly effective where the trust has available losses or where the trust's beneficiary is in a higher tax bracket due to being resident in a higher tax rate province. Designating income under subsection 104(13.1) of the Act means that the amounts paid to a beneficiary are, for the purposes of subsections 104(13) and 105(2) of the Act, deemed not to have been paid out of the income of the trust and not paid to a beneficiary for their benefit.¹⁰² Amounts properly designated under subsection 104(13.1) of the Act should not be taxable by the beneficiary pursuant to paragraph 12(1)(m) of the Act and should avoid the attribution rule in subsection 56(4.1) of the Act especially if the wording of subsection 104(13.1) of the Act is assumed to encompass only the relevant sections of the Act.¹⁰³ Specifically, subsection 104(13.1) of the Act states that such a designation is "for the purposes of subsections 104(13) and 105(2) of the Act" and such wording is assumed to encompass all other potentially relevant sections of the Act.

4. Dividend Refund Planning

In short, this plan involves stripping refundable dividend tax on hand ("RDTOH") from a private corporation by reorganizing its capital so that the shareholder may roll high-low redeemable preferred shares to a properly formed trust resident in Alberta. The corporation then pays a dividend sufficient to recover the RDTOH leaving the trust to pay tax at Alberta rates on the accompanying dividends.

The benefit of dividend strategies are the lower combined federal-provincial rate of tax which is applicable in Alberta on dividends that we are assuming are paid to an individual subject to tax at the top marginal rate. An arm's length third party should form the trust in Alberta. If the individual is using an alter ego or joint conjugal trust, it is recommended that the individual not be a trustee of the trust to ensure subsection 75(2) of the Act is not applicable to the trust.

If the individual has not attained sixty-five years of age, caution should be had to the provisions of subparagraph 73(1.02)(b)(ii) of the Act that requires that there be no change in beneficial ownership of property transferred to a trust. It is arguable whether restricting an individual's ability to receive capital of the trust has resulted in a change of beneficial ownership of the private corporation shares transferred to the trust.

If the individual has attained sixty-five years of age, an alter ego trust or joint conjugal trust will need to contain the provision that the settlor be entitled to the capital of the trust during their lifetime. One option to address this problem is to initially structure the trust as required but then have the individual disclaim or release their right to receive the corporation's shares or property substituted therefor. It is generally thought that having someone disclaim or release their right for no consideration should not have adverse tax consequences. There is a risk posed by subparagraph 69(1)(b)(iii) of the Act which states that an individual who makes a disposition to a trust that does not result in a change of beneficial ownership will be deemed to have received proceeds of disposition therefor equal to the fair market value ("FMV"). Given that the disclaimer or release of the property is not to a trust, as the trust already owns such property, it is unlikely that subparagraph 69(1)(b)(iii) of the Act could apply.

A more significant risk may be posed by the fact that a disclaimer or release of a capital interest in an alter ego (or joint conjugal trust) for an individual over the age of sixty-five may render such a trust invalid as one of the conditions of these trusts is that no one other than the individual can be entitled to receive the capital of the trust until after the individual's death (or death of the last-to-die spouse).

Query whether this risk is changed if the trust has other capital property and there is only a disclaimer or release of the capital interest in the corporation's shares. If there is a risk that the trust will fail, such a strategy will completely undermine the tax savings (and applicable probate avoidance objectives,) behind the inception of the trust.¹⁰⁴

The income from the dividend can be taxed in the trust and such income can be kept in the trust as a form of savings. Alternatively, as noted above, the dividend income could be subject to a designation under subsection 104(13.1) of the Act whereby such income is actually paid to a beneficiary of the trust but the income is taxed in the trust. By designating the dividend income under subsection 104(13.1) of the Act, it is possible for an individual resident in British Columbia to receive the dividend free of British Columbia provincial tax.

If the trust is a spousal trust, one must be cognizant of the attribution rule contained in section 74.1 of the Act. Section 74.1 of the Act is aimed at preventing income splitting which is designed to take advantage of progressive income tax rates. Section 74.1 operates to attribute income back to an individual who transferred or lent property to another individual so as to prevent such income splitting. If an election is made under subsection 104(13.1) of the Act, as noted above, section 74.1 should not be applicable to the dividend income.¹⁰⁵

Subsection 129(1.2) of the Act, an anti-avoidance rule, should also be considered. The intention of subsection 129(1.2) appears to be to catch dividends where a private corporation generates a dividend refund but there is no tax on the dividends themselves as they are paid to a person who is otherwise exempt from tax (i.e. pursuant to section 149 of the Act). The wording of subsection 129(1.2) of the Act is broad applying where a dividend is paid on a share of the capital stock of a corporation and such share was acquired in a transaction or series of transactions where one of the main purposes was to enable the corporation to obtain a dividend refund. Subsection 129(1.2) of the Act operates to deem the dividend to not be a taxable dividend, thus a dividend refund cannot be generated. It has been noted that the position of the CRA appears to be that subsection 129(1.2) of the Act is not intended to interfere with the integration mechanism and is targeted at transactions where the dividend recipient is a tax-exempt person.¹⁰⁶

5. Variation of Dividend Refund Planning on Death

A variation of the dividend refund planning strategy, noted above, occurs where an individual holds retractable preferred shares of a private corporation (which she received as part of an estate freeze) and transfers these shares to an alter ego trust, which then causes a retraction of the preferred shares and then elects under subsection 104(13.1) of the Act to have the resulting deemed dividend treated as income of the trust. If the trust is an alter ego trust consider the risk to having the individual receive the proceeds of redemption of the shares in light of subsection 75(2) of the Act.

One option is to have the individual sell the shares of the corporation to the trust at FMV as this may allow the individual to secure both a reduction in her exposure to tax at death and her ability to get the economic benefit of the share redemptions.¹⁰⁷ A FMV sale would result in the individual receiving a promissory note in respect of the unpaid purchase price. It is possible, but unlikely in the view of the authors, that subsection 75(2) of the Act would be applicable to attribute trust income to the individual on the basis of the promissory note.¹⁰⁸ The Federal Court of Appeal held in *R. v. Sommerer*¹⁰⁹ that subsection 75(2) of the Act did not apply to a beneficiary of a trust who transferred property to the trust by way of a genuine sale.¹¹⁰ A FMV transfer of the shares to the trust is a qualifying transfer pursuant to subsection 73(1.01) of the Act.

If the transfer of the corporate shares is to a spousal trust, as opposed to an alter ego trust, subsection 74.4(2) of the Act should be considered. Subsection 74.4(2) of the Act is an attribution provision that is applicable where an individual transfers or loans property, including indirectly through a trust, to a corporation and one of the main purposes of the transfer or loan may reasonably be considered to be to reduce the income of the individual and to benefit another individual who is a designated person (i.e. the spouse). Subsection 74.5(9) of the Act deems a transfer or loan to a trust under which another individual is beneficially interested to be deemed for purposes of section 74.4 of the Act to be transferred or lent to the other individual. Unfortunately, the relieving provisions of subsection 74.4(4) of the Act are not available in this situation as the other spouse is entitled to receive the trust's income.

6. Transferring the Permanent Establishment of a Holding Corporation

Tax savings can be created by simply transferring the PE of a holding corporation to a lower rate province. Directors of the holding corporation would resign and directors resident in the lower rate province would be appointed. This plan can be nicely combined with the RDTOH plan noted above.

7. Capital Gains

This strategy intends to transfer assets with a pregnant capital gain to a trust properly resident in Alberta. Before the sale of shares by an individual resident in British Columbia with a large capital gain, this individual could transfer these shares to a spouse trust resident in Alberta because once the shares are sold by the trust and a designation is made under subsection 104(13.2) of the Act, the tax will be levied at the trust's tax rate in Alberta which is lower. This strategy may not work where the transfer is to an alter ego trust because of the rules in subparagraph 73(1.01)(c)(ii) and subsection 75(2) of the Act.

8. Management Fee Planning

This plan involves restructuring a private corporation's organizational structure by creating two trusts, one business trust in a high rate province which will provide management services to the corporation, and a second trust in a low rate province. The second trust will be the sole beneficiary of the first business trust. The business trust will then deduct salaries paid to owner-managers of the corporation and allocate its net management services profits to its beneficiary, the personal trust in the low rate province. The corporation can deduct reasonable management fees paid to the business trust.

9. Consulting Fee Planning

A variation of the above strategy may be effective where an individual provides consulting services and there are no restrictions (i.e. provincial license requirements) that would prevent such services from being offered through a trust or if the individual can provide such services under applicable regulations by being an employee of the trust. If the individual is resident in British Columbia, the services would be provided through a trust that is also resident in British Columbia. The beneficiary of the British Columbia trust would be a trust properly resident in Alberta to whom the net consulting revenues would be paid to. In other words, the consulting revenues would then be taxed in the hands of the beneficiary (i.e. the Alberta trust). The income would circulate back to the individual as a distribution of capital from the Alberta trust. Income received by the Alberta trust should be property income and therefore not subject to allocation back to any PE located in British Columbia.¹¹¹

As with any strategy involving multiple trusts, care should be taken to avoid the application of tax under Part XII.2 of the Act. Part XII.2 of the Act applies to impose a special tax on trusts earning “designated income” and will apply to a beneficiary resident in Canada if that person is a “designated beneficiary”.

While the scope and the specifics of Part XII.2 of the Act are beyond the scope of this paper, it is important to note that Part XII.2 could be applicable and where such provision apply, a trust that would otherwise be able to claim a deduction from income under subsection 104(6) of the Act will instead pay tax on that income, thus there is double taxation of the same income, once in the British Columbia trust and once in the Alberta trust.

10. Transferring Assets to a Corporation

Individuals may roll assets which earn investment income to a corporation that only has a PE in a low rate province on a tax-deferred basis pursuant to subsection 85(1) of the Act. As such, the investment income will then be subject to lower tax rates. It is important that there is not also a PE in the jurisdiction of the individual which is in the higher rate province.

IX. HUSKY AND CANADA SAFEWAY

1. Introduction

On March 7, 2013, the Supreme Court of Canada dismissed the Crown's leave applications in *Husky*¹¹² and *Canada Safeway*¹¹³ thus preserving the ability of taxpayers to undertake interprovincial tax planning to reduce or eliminate provincial tax without offending the provincial GAAR. The Alberta GAAR is similar to that of most other provinces and very similar or in some cases, identical to the GAAR under the Act.

Husky and *Canada Safeway* considered the deductibility of interest payments under paragraph 20(1)(c) of the Act and the Alberta GAAR in respect of payments to corporations subject to the Ontario *Corporations Tax Act*¹¹⁴ (the "OCTA") under the now well-known "Finco" or "Ontario Shuffle" strategy. In essence this strategy took advantage of an anomaly in the OCTA exempting property income earned by a company incorporated offshore but having a PE in Ontario (a so-called "subsection 2(2)" corporation). The transaction involved performing a reorganization to finance Alberta operations using funds borrowed from the Ontario corporation. Finco then paid its interest income back up the corporate chain by way of incorporate dividends without being taxed by virtue of the deduction available in section 112 of the Act.

2. *Husky*

The Minister of Finance for the Government of Alberta reassessed the Husky corporations on the basis that in some cases the corporations did not comply with the technical requirements of the relevant Alberta tax provisions and that the reorganizations resulted in abusive avoidance pursuant to the Alberta GAAR.

Specifically, Alberta reassessed:

1. to deny the interest deduction claimed pursuant to paragraph 20(1)(c) of the Act
2. to deny the section 112 deduction available in the Act on a dividend paid from the financing corporation; and
3. to include interest in the Alberta resident corporation under paragraph 12(1)(c) of the Act which formerly applied to the Husky finance corporations having PEs in Alberta.

On interest deductibility, the Alberta Court of Queen's Bench held Husky had complied with the technicalities of paragraph 20(1)(c) of the Act and that it was not an abuse for the taxpayer to refinance the operations.

The Crown admitted that the dividends technically qualified for the deduction in section 112 of the Act but argued the section's purpose is to prevent multiple levels of taxation as income passes through a chain of corporations but should only be allowed if the income has been taxed at least once. Because Ontario did not impose tax on the financing corporation, it was argued the provincial GAAR was properly applied to deny the deduction under section 112 of the Act up the chain.

The Court disagreed ruling that the purpose of Section 112 of the Act was to avoid multiple taxation not to ensure income was taxed at least once:

The simple answer is that tax avoidance by itself is not abuse. I echo the words in *Shell* as cited in *Canada Trustco*. If there is nothing in the statutes preventing it, taxpayers may rely in a sophisticated structure of financing to minimize the tax payable. Operations refinanced its business and took advantage of a difference in provincial taxing policy. There is nothing abusive in that.¹¹⁵

On appeal the Alberta Court of Appeal rejected the Crown's argument with respect to section 112 of the Act noting that nothing in the language of that section supports the view that Parliament intended to permit the deduction of inter-corporate dividends only if the underlying stream of income was taxable. Alberta was free to alter the language of its counterpart to section 112 of the Act if it wished to prohibit inter-corporate dividend deductions when the underlying income stream was not taxed, but it did not do so.

The Court's ruling on the interest deduction/inclusion issue is highly germane to interprovincial planning. The Alberta Court of Appeal clearly rejected the Crown's silo approach to provincial taxation thus affirming the provinces' rights to set their own tax policy and a taxpayer's right to seek to minimize provincial tax by exploiting the differences in those policies:

Here, the borrowers used the funds to run their businesses. Based on these cases, it would be a stretch to find abusive avoidance simply because a taxpayer took the benefit of another province's advantageous tax treatment. That proposition lies at the heart of Alberta's position and cannot be accepted. It is difficult to see how, therefore, these transactions could be considered abusive simply because the lender received more favourable tax treatment in another Canadian province. This is especially so since differing provincial tax policies are a fundamental part of the Canadian federation.¹¹⁶

The Court also acknowledged that it is not abusive to exploit legislative gaps or “loopholes” in the tax law without offending the Alberta GAAR, but side-stepped the Crown’s argument that “exploiting the lack of alignment between federal and provincial tax acts” can be abusive avoidance preferring to focus on whether the provisions in question were abused rather than on the larger scheme of provincial taxation:

More generally, Alberta relies on *OGT Holdings Ltd. c. Quebec (Sous-ministre du Revenu)*, 2009 QCCA 191, 2009 D.T.C. 5048 (Fr.) (Que. C.A.) to contend that it “can be abusive avoidance” to exploit the lack of alignment between provincial and federal tax acts: para 103 Factum. Of course, the determinative issue is whether there was abusive avoidance on these facts, and I conclude otherwise. Therefore, I need not decide the general point raised by Alberta.¹¹⁷

The Court then appeared to reject the Crown’s argument nonetheless:

The constitutional reality of Canada is that each level of government has taxation authority. Provinces are free to fully adopt the federal system, and some have done so. Alberta and Ontario have not. Each case of alleged abuse must be carefully assessed in the context of Supreme Court law.¹¹⁸

In refusing to follow *OGT Holdings Ltd. v. Quebec*¹¹⁹ (“OGT”), a case involving the now obsolete outbound “Quebec shuffle” which involved an interprovincial rollover under section 518 of the QTA¹²⁰ (the Quebec equivalent of subsection 85(1) of the Act),¹²¹ the Alberta Courts have clearly rejected the proposition that exploiting the lack of alignment between the federal agreeing province and non-agreeing province regimes is abusive. One must focus on the use of the provisions in question, not the larger scheme of provincial tax avoidance.

3. *Canada Safeway*

It is evident from the *Canada Safeway* decision of the Court of the Queen’s bench of Alberta that the Court does not agree with the Quebec Court’s conclusion in *OGT* that the presence or absence of tax liability in another province is relevant to whether the transaction was abusive. In *Canada Safeway* the Alberta tax authorities allowed the interest deduction when the lender was a related Alberta resident corporation but denied it when the lender became an Ontario resident that was not subject to tax on the interest income. The Court held that liability for tax in another province is irrelevant.¹²²

In rejecting the Crown's argument the Alberta Court of Appeal picked up a similar theme as *Husky* in relation to whether the interest deduction should be disallowed under the Alberta GAAR. For the taxability of another taxpayer to be relevant, there must be clear language in the statute.¹²³

The approach to interprovincial planning by the Alberta Courts in *Husky* and *Canada Safeway* on the one hand and the Quebec Courts in *OGT* is strikingly different. In Alberta taxability of a resident taxpayer does not depend upon the taxability of another non-resident taxpayer, whereas in Quebec it appears to be so dependent.

In any event, it is clear that the Alberta Court of Appeal was not inclined to affirm the Crown's arguments that income cannot be shifted between provinces to capitalize on exemptions or lower tax rates. The Supreme Court of Canada refused the Crown's leave applications, interprovincial rate shopping is not abusive.

4. *MIL*

The results in *Husky* and *Canada Safeway* echo the outcome in *MIL (Investments) S.A. v. R.* ("*MIL*")¹²⁴ where Justice Bell rejected the Minister's assertion that "treaty shopping" constituted an abuse of the Canada-Luxembourg Tax Treaty preferring to analyze whether the taxpayer abused the particular provisions of the treaty that were relied upon to obtain the tax benefit:

In written argument, Respondent's counsel argued that "treaty shopping" is an abuse of bilateral tax conventions and that this is recognized by the Supreme Court of Canada. In oral argument, the following passage from *Crown Forest Industries Ltd. v. R.*, [1995] 2 S.C.R. 802 (S.C.C.) at page 825, was quoted to establish that if the Supreme Court had access to section 245, it would have used that section to deny a benefit from "treaty shopping":

It seems to me that both Norsk and the respondent are seeking to minimize their tax liability by picking and choosing the international tax regimes most immediately beneficial to them. Although there is nothing improper with such behavior, I certainly believe that it is not to be encouraged or promoted by judicial interpretation of existing agreements.

I do not agree that Justice Iacobucci's *obiter dicta* can be used to establish a prima facie finding of abuse arising from the choice of the most beneficial treaty. There is nothing inherently proper or improper with selecting one foreign regime over another. Respondent's counsel was correct in arguing that the selection of a low tax jurisdiction may speak persuasively as evidence of a tax purpose for an alleged avoidance transaction, but the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive. It is the *use* of the selected treaty that must be examined.

In reasons comprising only nine paragraphs, the Federal Court of Appeal dismissed the Minister's appeal thereby rejecting the notion that double non-taxation is inherently abusive:

To the extent that the appellant argues that the Tax Treaty should not be interpreted so as to permit double non-taxation, the issue raised by GAAR is the incidence of Canadian taxation, not the foregoing of revenues by the Luxembourg fiscal authorities.

Based on *Husky*, *Canada Safeway* and *MIL* there is no reason in principle why interprovincial rate shopping and double interprovincial non-taxation should be abusive if the transactions giving rise to the tax benefit do not abuse the statutory provisions upon which they rely.

X. INTER-LEASING, INC.

The *Inter-Leasing, Inc.*¹²⁵ ("*Inter-Leasing*") decision deals with the inclusion side of the Ontario Finco strategy. Inter-Leasing was the Ontario lender within the Precision Drilling group whose parent, Precision Drilling Corporation who is a large supplier to the oil and gas industry and whose shares were listed on the TSX and NYSE. The group undertook a reorganization which resulted in \$519,000,000.00 being converted from non-interest bearing to interest bearing debt ultimately owing to Inter-Leasing under four "specialty debts" which were held in the British Virgin Islands, Inter-Leasing's place of incorporation.

Having been incorporated in a jurisdiction outside Canada but with a PE in Ontario, *Inter-Leasing* was a so-called "2(2) corporation" and thus such corporation was liable to tax in Ontario only on specifically enumerated sources of income. In Inter-Leasing's case the interest income (\$271,756,874.00 from 2001 to 2004) was only taxable if it was "income from a business carried on in Canada".

The Minister assessed tax and interest of \$55 million on the basis that the income was from a business, but if not the Ontario GAAR applied to deny the exemption.

Inter-Leasing contended that a taxpayer who earns interest income passively from only four debt instruments is not carrying on a business in relation to that interest. The magnitude of the debts or interest earned is irrelevant. Extensive business-like intervention or activity is required to convert property income into business income. *Inter-Leasing* argued that the interest income it earned was “quintessentially” income from property.

Ontario argued (and the Court agreed) that the issues under the legislation and jurisprudence were:

- 1) whether *Inter-Leasing* carried on a business in Canada; and
- 2) if so, whether the interest was an integral part of that business.

Income from investments is generally considered to be property income rather than income from a business subject to two exceptions: where the investments constitute an integral part of the taxpayer’s business activities; or where the activities associated with the generation of interest income are in and of themselves a business. Since the investment activities carried on by the taxpayer were minimal the case turned on whether the investments constituted an integral part of the taxpayer’s business activities.

The Court relied upon *Ensite v. The Queen*¹²⁶ as authority for the proposition that investments constitute an integral part of a business if they are “employed and risked” therein. Having found that there was little or no risk, the Court held that how the debts were employed engaged “a broad analysis of what *Inter-Leasing* was doing”.

But rather than merely looking at the passive nature of the taxpayer’s operations, the Court considered it appropriate to consider its “core function and purpose” within the Precision group of corporations. In finding that its purpose was “to reduce the after tax cost of capital for companies within the group”, the Court concluded that it was carrying on business in Canada:

Inter-Leasing’s *raison d’être* and principle (sic) function and purpose was to assist the Precision Group in attempting to legitimately reduce the after-tax cost of capital for companies within the Precision Group. It had no other object or activity to speak of. Even their investment in McMaster LP was a part of that enterprise. *Inter-Leasing*’s role was fundamental and critical to the accomplishment of an ongoing joint venture with the other companies in the Precision Group. That being the true nature of *Inter-Leasing*’s business, the transactions that it entered into, coupled with the subsequent administration and routing of the interest income earned, are core activities and ought to be considered income from a business in Canada.¹²⁷

Assuming “reducing the after-tax cost of capital” means undertaking the Finco tax reduction strategy the Court appears to be saying that the tax strategy constitutes a business in and of itself. However, the Federal Court of Appeal has ruled in *Moloney v. The Queen*¹²⁸ that the reduction of tax cannot be a business:

While it is trite law that a taxpayer may so arrange his business as to attract the least possible tax (see *Duke of Westminster's case*. (1936) A.C. 1), it is equally clear in our view that the reduction of his own tax cannot by itself be a taxpayer's business for the purpose of the *Income Tax Act*, R.S.C. 1952, c. 148 (am. S.C. 1970-71-72, c. 63) (the “Act”). To put the matter another way, for an activity to qualify as a “business” the expenses of which are deductible under paragraph 18(1)(a) it must not only be one engaged in by the taxpayer with a reasonable expectation of profit, but that profit must be anticipated to flow from the activity itself rather than exclusively from the provisions of the taxing statute.¹²⁹

In *Inter-Leasing* the Court went on to consider, in *obiter*, whether the GAAR would otherwise apply if the income was from property. The case appears to break new ground by stating that the “2(2) provision” was a “charging provision” whose purpose was to “define the tax base as broadly as possible in order to generate tax revenue”. And given that all of the other GAAR cases considered deductions or exemptions (whose purposes may be to promote certain taxpayer choices the government wants to encourage), involving a charging provision “may require a new approach”. The Court mused that it would be difficult to find that a tax benefit resulting from an avoidance transaction dealing with a charging provision would ever be consistent with the object and purpose of such a provision”

As a consequence, it will be very difficult to find that any “tax benefit” resulting from an “avoidance transaction” is consistent with the “object, spirit or purpose” of this category of legislator that will afford refuge for the taxpayer under the third part of the meeting the onus of establishing that such tax avoidance is inconsistent with the object and purpose of the particular legislative provision in issue. When it comes to charging provisions the object and purpose is to raise revenue, rather than promoting certain taxpayer choices the government wants to encourage.¹³⁰

This reasoning is questionable as the purpose of a charging provision is not necessarily to “define the tax base as broadly as possible in order to generate tax revenue”. Arguably the purpose of such provision is to define the tax base precisely in accordance with its terms. The Ontario government chose to tax corporations incorporated in Canada on their worldwide income pursuant to the ss.2(1) whereas corporations incorporated outside Canada were only taxable on specifically enumerated sources of income pursuant to ss. 2) provision. If the government wished to define the tax base as broadly as possible it could have made ss.2(2) corporations taxable on their worldwide income from all sources. Thus the premise of the Court’s “new approach” is not supported by the legislation itself.

It is a stretch to suggest that a taxpayer could not undertake a tax plan to avoid a charging provision without abusing it. For example, non-resident employees are taxable only if they perform their duties in Canada under subsection 2(3) and section 115 of the Act. If the Court’s conclusions regarding charging provisions in Inter-Leasing are correct, and if such an employee persuades his employer to move his employment duties across the line to the State of Washington, he would be committing an act of abusive tax avoidance because the object and purpose of subsection 2(2) and section 115 of the Act is to “define the tax base as broadly as possible to generate revenue”. In the authors’ view, the Court’s abuse analysis is too broad and may not survive an appeal should one be launched.

XI. SIMILARITIES AND DIFFERENCES IN PROVINCIAL GAAR LEGISLATION

1. British Columbia GAAR

The British Columbia GAAR defines a “tax benefit” to mean:

- (a) a reduction, avoidance or deferral of tax, or of another amount, payable under this Act, or
- (b) an increase in a refund of tax, or of another amount, under this Act.¹³¹

The “tax benefit” is limited to a reduction/avoidance of tax imposed only under the *British Columbia Income Tax Act*¹³² (the “BCITA”). Interestingly, the obvious limitation in the BCITA is similar to that of the QTA where its scope appears to be restricted to abuses/misuses of the Act itself and the accompanying regulations.

Another distinction between the legislation in British Columbia and the other provinces with respect to the GAAR is found in the definition of an abusive transaction. The British Columbia GAAR abuse provision contains language similar to that used in the Act before it was amended retroactively in 2005 where it applied only to abuses of the Act itself:

For greater certainty, subsection (2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.

The Tax Court of Canada in *Rousseau-Houle v. R.*¹³³ held that a transaction which abused the federal regulations but not the Act itself was not caught by the GAAR as it read at that time:

It is clear, then, that, when Parliament wishes to refer to both the Act and the Regulations, it says so explicitly. In subsection 245(4) of the Act, it did not do so. In my opinion, in interpreting the words “this Act...read as a whole” in this subsection one must limit oneself to the provisions of the Act and not take the provisions of the Regulations into account.

With the exception of British Columbia, the provinces have adopted language similar to the wording of the amended GAAR provision in the Act. For example the GAAR in the *Alberta Corporate Tax Act*¹³⁴ reads as follows:

Subsection (2) applies to a transaction only if it may reasonably be considered that the transaction

- (a) would, if this Act were read without reference to this section, result, directly or indirectly, in a misuse of the provision of any one or more of
 - (i) this Act or the regulations
 - (ii) the Income Tax Regulations (Canada) as they apply for the purposes of this Act,
 - (iii) the Income Tax Application Rules (Canada) as they apply for the purposes of this Act,
 - (iv) a tax treaty, or
 - (v) any other Act or regulation of any other jurisdiction that is relevant in computing tax or any other amount payable by or refundable to a person under this Act or in determining any amount that is relevant for the purposes of that computation,
- or
- (b) would result directly or indirectly in any abuse having regard to the provisions referred to in clause (a), other than this section, read as a whole.

Based on the principles laid down in *Husky*, *Canada Safeway* and *MIL*, a transaction that does not abuse any provision of the BC ITA or regulations but somehow abuses the QTA or the federal Regulations would appear not to be caught by the British Columbia GAAR. But a similar transaction would be caught by the Alberta GAAR.

2. Quebec GAAR

In 2009, after having enacted retroactive legislation to defeat the “Quebec Truffle” strategy in 2006, Quebec amended its GAAR legislation to put an end to what it perceived as aggressive tax planning schemes. In addition to broadening the definition of abusive transactions the legislation calls for:

- i. mandatory early disclosure of transactions where the advisor is entitled to a contingent fee or is subject to a confidentiality clause by the taxpayer (and the tax benefits in question are over certain thresholds) – failures to disclose are punishable by fines and the suspension of the normal reassessment period until disclosure has been made; and
- ii. an extension of the normal reassessment period from three and four years to six and seven years; and the application of penalties to taxpayers and promoters where the GAAR applies except where the transaction was disclosed or the taxpayer or promoter can make out a due diligence defense.

The imposition of penalties for transactions that are subject to the Quebec GAAR has been criticized because if the GAAR applies the taxpayer has otherwise complied with the law. Further, a taxpayer cannot self-assess under the GAAR.

Indeed, strict liability penalties assessed in relation to the withholding tax in *Cophthorne Holdings Ltd. v. R*¹³⁵ were reversed by the Tax Court of Canada because, but for the application of the federal GAAR, there was no obligation to withhold and remit and the taxpayer could not self-assess for withholding tax under the GAAR by virtue of subsection 245(7) of the Act:

It is only because of the application of GAAR that the liability to pay the withholding tax arises. The question therefore is whether the Appellant becomes liable to pay a penalty under subsection 227(8) when it was not technically required to withhold tax under the relevant provisions of the Act. I do not think that a GAAR assessment can give rise to penalties for non-compliance with the technical sections of the Act. First, the GAAR is not a penalty provision.

If a transaction, or series of transactions, runs afoul of GAAR, the remedy specified in subsection 245(2) is that tax consequences will be determined that are reasonable in the circumstances in order to deny a tax benefit that would otherwise result from the transaction. Subsection 245(2) does not indicate that a successful GAAR assessment will cure the deficiency in the scheme of the Act but merely that the tax benefit resulting from the technical application of the section will be denied.

Second, there is nothing in the GAAR provisions that would allow a taxpayer to self-assess on the basis that GAAR applies...

This aspect of the Tax Court of Canada's decision was not appealed to the Federal Court of Appeal so the principle stands. Thus it remains to be seen if penalties imposed on taxpayers under the Quebec GAAR will pass muster in the courts.

Different considerations may apply to a promoter as the "no self-assessing under GAAR" rule does not apply. With respect to the due diligence defense Justice Bowman of the Tax Court of Canada in *Wong v. The Queen*¹³⁶ that:

... due diligence is nothing more than the degree of care that a reasonable person would take to ensure compliance with the Act. It does not require perfection or infallibility.

Sophisticated avoidance transactions that are subject to the GAAR are always carefully crafted to comply with the law thus it would not be difficult for a promoter to demonstrate that he or she took reasonable care to comply with the tax law. And while the promotion of a transaction that has already been ruled by the courts to be subject to a GAAR may justify the imposition of penalties, it will be difficult for Revenu du Quebec to defend a Quebec GAAR penalty imposed in respect of a transaction that breaks new ground.

XII. CONCLUSION

Justice Bell in *MIL Investments S.A. v. The Queen*¹³⁷ gave comments to the effect that there is nothing inherently abusive about international “treaty shopping”¹³⁸. Essentially, Justice Bell was saying that the treaty provisions themselves must be examined closely to see if there is misuse or abuse as misuse or abuse is not simply determined by the fact that a person relied on the different tax rates of the jurisdictions. Similarly, in the inter-provincial planning context, the Alberta Court of Appeal agrees, as noted in *Husky* and *Canada Safeway*, that there is nothing inherently abusive about shifting income amongst jurisdictions or “rate shopping”. These decisions leave open many inter-provincial planning opportunities.

1 Timothy W. Clarke is Of Counsel to Moodys Gartner Tax Law LLP. Kim G. C. Moody is the Director of Canadian Tax Advisory at Moodys Gartner Tax Law LLP. Lisa Handfield is a Tax Lawyer at Moodys Gartner Tax Law LLP

2 A reference to the book titled *Future Shock* by Alvin Toffler.

3 All references are to the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), as amended, unless otherwise stated.

4 A person is defined in subsection 248(1) to include a corporation and an individual. A trust is taxed as an individual pursuant to subsection 104(1).

5 *Income Tax Regulations*, CRC, c. 945.

6 30 & 31 Vict., c. 3.

7 Hogg, *Constitutional Law of Canada*, 5th ed. (“Hogg”), Carswell at pages 31-32.

8 See Hogg, *supra*, at page 31-3, *Dow v. Black* (1875) L.R. (PC) and *Re Employment and Social Insurance Act* [1936] SCR 427 at page 434.

9 Hogg, *supra*, at page 25-10.

10 See *Bank of Toronto v. Lambe* (“*Lambe*”) (1887) 12 App. Cas. 575 and the many Canadian tax cases that cite it.

11 *Principles of Political Economy* (1848), Book V, chapter 3.

12 See Hogg, *supra*, at page 31-10 and *Nickel Rim Mines v. AG Ontario* [1966] 1 O.R. 345 (C.A.); affirmed (1967), SCR 270.

13 Hogg, *supra*, at page 31-10.

14 See *Lambe*, *supra*, at page 582.

15 See *Ontario Home Builder's Association v. York Region Board of Education*, (“Ontario Home”) [1966] 2 SCR 929 at paragraph 126-146 per La Forest J. (concurring in the result).

16 (1912), 45 S.C.R. 469], at p. 536.

17 Hogg, *supra*, at 31-24.

18 2007 SCC 19.

19 *Ibid.*, at paragraph 12.

20 See *Lambe*, *supra*.

21 Hogg, *supra*, at 31-24.

22 *Kerr v. Superintendent of Income Tax* [1942] SCR 436.

23 See *British Columbia (Attorney General) v. Ellet Estate*, [1980] 2 S.C.R. 466.

24 [1980] 2 S.C.R. 303.

25 (1966), 28 O.R. (3d) 97.

26 Under which the provinces surrendered their constitutional right to impose personal and corporate income tax and succession duties in exchange for “tax rental payments” from the federal government.

27 R.S.C. 1985, c. F-8.

28 The TCA were implemented in 1962. The federal government assumes the cost of bad debts as well as the cost of administering the TCA and in exchange the federal government is allowed to retain interest and most penalties levied on taxpayers.

29 Residents of Quebec receive an abatement of 16.5 percent of their basic federal tax but are subject to tax at the prevailing rates set by the Quebec government. Quebec taxes its residents under the *Quebec Taxation Act*.

30 In 1977 the federal government lowered its tax rates to create more room for the provinces to levy their tax, thus there was minimal effect on the total amount of income tax payable by an individual.

31 2006 MBCA 58 affirming 2004 MBQB 180.

32 RSQ, c. I-3.

33 Section 53.2 of the Act, CCSM, c I-10.

34 *Infra*, note 115.

35 *Infra*, note 116.

36 See subsection 250(4).

37 [1946] C.T.C. 51.

38 *Ibid.*, at paragraph 49.

39 *Supra*, note 37 at paragraph 2.

40 Supra, note 37 at paragraph 49.

41 The following factors adapted from the more comprehensive list in *Wassick v. Minister of National Revenue*, [1994] 2 C.T.C. 2235, are likely to be relevant to a determination of provincial residence: past and present habits of life; regularity and length of visits in the jurisdiction asserting residence; ties with the jurisdiction; ties elsewhere; permanence or otherwise of purposes of stay, ownership of a dwelling in a province or rental of a dwelling on a long-term basis; residence of spouse, children and other dependent family members in a dwelling maintained by the individual in the province; memberships in churches or synagogues, recreational and social clubs, unions and professional organizations; insurance coverage (general insurance and health care); mailing address; telephone listing; and driver's license.

42 [1978] C.T.C. 3101.

43 [1977] C.T.C. 2401.

44 [1979] C.T.C. 2817.

45 *Ibid.*, at paragraph 6.

46 In a December 18, 2003 letter (CRA document no. 2003-0049244), the Minister of National Revenue states that the provinces intentionally took this arbitrary approach to provincial taxation in an attempt to simplify the determination of tax payable and to avoid unnecessarily complex allocation calculations and stated that any possible increase in revenue from creating, implementing, monitoring and enforcing potential allocation calculations amongst provinces would be negligible.

47 Donovan Waters, "An Overview of the Law of Trusts," in Report of Proceedings of the Fifth Tax Conference, 1998 Conference Report (Toronto: Canadian Tax Foundation, 1998).

48 Catherine A. Brown, "The Taxation of Trusts: Reconciling Fundamental Principles," in *Estates, Trusts & Pensions Journal*, Volume 21, No. 1 October 2001.

49 Jack Bernstein and Barbara Womdl, "Canada's New Test to Determine Trust Residency," *Tax Notes International*, October 5, 2009.

50 It is important to note agency type relationships, such as a bare trust, are not considered to be trusts for purposes of the Act.

51 Subsections 104(19), 104(20) and 104(21) respectively.

52 Donovan W.M. Waters, Mark R. Gillen, and Lionel D. Smith, eds., *Waters Law of Trusts in Canada*, 3d ed. (Toronto: Thomson Carswell, 2005), at page 167.

53 2009 TCC 465.

54 *Ibid.*, at paragraph 58.

55 2010 FCA 280.

56 Jim Cruickshank, "Trusts: Recent Developments," in Report of Proceedings of the Sixty-Second Tax Conference, 2010 Conference Report (Toronto: Canadian Tax Foundation, 2011), 29:1-14.

57 [1974] C.T.C. 2065 (Tax Review Board).

58 2013 ABQB 489.

59 84 D.T.C. 6305.

60 *Ibid.*, at page 6321.

61 94 D.T.C. 1858.

62 [2007] EWHC 99 (High Court of Justice, Family Division), at paragraph 50.

63 *Ibid.*, at paragraph 80.

64 Supra, note 62, at paragraph 43.

65 Supra, note 62, at paragraph 43.

66 Planning with testamentary trusts is beyond the scope of this paper.

67 Property can also be transferred to an ex-spouse/ex-common-law partner in settlement of their rights arising out of the marriage/union pursuant to paragraph 73(1.01)(b).

68 It is possible to elect out of the tax-deferred treatment when a transfer to a spouse otherwise meets the above conditions. There is no specific form for the election. As a caution, subsection 69(1) will apply to the transfer if an individual elects out of the rollover so it is important that such transfer be at fair market value.

69 It is interesting to note that the United States explicitly sets out the criteria for the residence of trusts in sections 7701(a)(30) and 31 of the Internal Revenue Code and Federal regulation 301.7701-7.

70 Jack Bernstein, "Residence of Trusts and Corporations," in *1997 Ontario Tax Conference* (Toronto: Canadian Tax Foundation), 1997, 8:1-53.

71 *Ibid.*

72 2009 TCC 450. *Garron* is a case involving the Barbados freeze tax planning strategy.

73 [1906] A.C. 455.

74 Supra, note 56.

75 *Ibid.*

76 Supra, note 72 at paragraph 194.

77 Supra note 72 at paragraph 245.

78 2010 FCA 309.

79 RSBC 1996, c. 65.

80 2011 BCSC 1630.

81 RSBC 1996, c. 237.

82 2012 BCSC 192.

83 Supra, note 81.

84 Pursuant to subsection 250(4) a corporation incorporated in Canada (including in any province) after April 26, 1965 will be deemed resident in Canada. Corporations incorporated in Canada before April 27, 1965 will be deemed resident in Canada if at any time after such date they were resident in Canada under the common law or carried on business in Canada. A corporation incorporated before April 9, 1959 in Canada will be resident if prior to June 18, 1971 such corporation was a foreign business corporation that was controlled by a corporation resident in Canada during the previous ten year period. A corporation otherwise resident in Canada will not be resident in Canada pursuant to subsection 250(5) if the corporation is considered resident in another jurisdiction under a treaty as such determination will prevail.

85 [2009] UKFTT 209 (TC).

86 *Anderson Logging Co. v. the King, Canadian Marconi Company v. The Queen, Upstream Holdings Incorporated v. MNR 64 DTC 608 (TAB)* and Archived IT-420R3 paragraph 13

87 Other rules apply to the insurance corporations, substantial machinery and equipment and subsidiaries but are beyond the scope of this paper.

88 *MNR v. Tara Exploration and Development Co. Ltd.* 72 DTC 6288 (SCC).

89 *Sunbeam Corporation (Canada) Ltd. v. MNR* 62 DTC 1390.

90 *DeBeers Consolidated Mines, Limited v. Howe* [1906] AC 455 (HL).

91 Subsection 402(1), Regulation 402(4) sets out detailed rules regarding the attribution of gross revenues which are beyond the scope of this paper. For an excellent discussion of these provisions see Claude Auger and Marc-André Bélanger, "Interprovincial Allocation of Income," in *Report of Proceedings of the Fifty-First Tax Conference*, 1999 Conference Report (Toronto: Canadian Tax Foundation, 1999), 10:1-43.

92 Subsection 402(2).

93 Subsection 402(3)(b) and (c).

94 Subsection 402(5).

95 Published as CRA document 2002-015673.

96 Which dealt with the possibility that loss consolidation transaction could shift income among provinces.

97 For an excellent discussion see Craig M. Jones, "Alberta Trust in Tax and Estate Planning," 2002 Prairie Provinces Tax Conference (Toronto: Canadian Tax Foundation), 15:1-30.

98 See note 41.

99 The prescribed rate is currently one percent but is anticipated to increase to two percent on October 1, 2013 although as of the date of writing a formal announcement of the increase in the prescribed rate has not yet been made.

100 2006 TCC 644.

101 *Ibid.*, at paragraph 15.

102 *Supra*, note 98.

103 *Ibid.*

104 *Supra*, note 98.

105 Subsection 56(4.1) and section 74.1 are similar, however, the former applies to a broader group of persons, those who are not at arm's length, whereas section 74.1 applies to a spouse or common-law partner. However, section 74.1 applies to transfer and loans while subsection 56(4.1) only applies to loans, not transfers.

106 *Supra*, note 98 and Technical Interpretation 9217697.

107 *Supra*, note 98.

108 See also Technical Interpretation dated July 17, 2000 where the CRA stated that subparagraph 75(2)(a)(i) would not apply to a bond fide unconditional sale of property even if a portion of the purchase price were unpaid.

109 2012 FCA 207.

110 The CRA recently confirmed at the Society of Trust and Estate Practitioners' 2013 STEP Canada Roundtable that they accept the general proposition in *Sommerer* which is that where property is transferred to a trust by a beneficiary of the trust in return for consideration that constitutes a fair market value, subsection 75(2) will not apply to attribute income in respect of that property to that beneficiary.

111 *Supra*, note 110.

112 2011 ABQB 268 as affirmed by 2012 ABCA 231.

113 2011 ABQB as affirmed by 2012 ABCA 232.

114 R.S.O. 1990, c. C-40.

115 *Supra*, note 112, at paragraph 71.

116 *Ibid.*, at paragraph 49.

117 *Supra*, note 112, at paragraph 57.

118 *Supra*, note 112, at paragraph 59.

119 2006 QCCQ 6328.

120 *Supra*, note 32.

121 The Cour du Quebec and the Quebec Court of Appeal dismissed the appeal of *OGT* ruling that the Quebec rollover provisions were misused as such provisions were used to eliminate, rather than defer, Quebec provincial tax. This transaction resulted in no provincial tax being payable and as such, was considered abusive.

122 *Supra*, note 113, at paragraphs 73 and 74.

123 *Ibid.*, at paragraphs 45 and 46.

124 2006 D.T.C. 3307 (TCC) affirmed 2007 D.T.C. 5437 (FCA).

125 2013 ONSC 2927.

126 [1986] 2 S.C.R. 509.

127 *Supra*, note 125, at paragraph 34.

128 92 DTC 6570.

129 *Ibid.*, at paragraph 1.

130 *Supra*, note 125, at paragraph 43.

131 Section 68.1 of the British Columbia *Income Tax Act*, *infra* note 125.

132 RSBC 1996, c. 215.

133 2006 D.T.C. 3181.

134 RSA 2000, c. A-15.

135 2007 D.T.C. 1230.

136 [1996] G.S.T.C. 73.

137 [2006] T.C.J. No. 362.

138 The Department of Finance is accepting comments until December 31, 2013 on their document "Treaty Shopping – The Problem and Possible Solutions".