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STEP Canada Tax Technical Committee

The Queen v. Sommerer, 2012 FCA 207

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In one of the most important decisions dealing with subsection 75(2) of the *Income Tax Act* (Canada) (the "Act"), the Federal Court of Appeal has handed the taxpayer in the *Sommerer* decision (the "Taxpayer") an unequivocal victory. The decision has also provided insightful comments regarding subsection 75(2) and treaty interpretation.

While there were a myriad of issues raised and dealt with at the trial level (*Sommerer*, 2011 TCC 212), there were essentially only two issues before the Court of Appeal:

1. Did subsection 75(2) of the Act apply to attribute to the Taxpayer capital gains realized by an Austrian private foundation?

2. If subsection 75(2) did apply, could the Taxpayer claim relief under Article XIII (5) of the *Canada-Austria Income Tax Convention* (the "Treaty")?

The Taxpayer and his family were Canadian residents. In 1996, the Taxpayer's father, a non-resident of Canada, created an Austrian private foundation (the "Foundation") pursuant to the *Austrian Private Foundations Act* (the "APFA"). The Taxpayer, his wife and children were named as beneficiaries of the Foundation.

The Taxpayer sold shares (which constituted taxable Canadian property) of two different Canadian corporations to the Foundation in 1996 and 1998 respectively at fair market value. The Foundation then sold the shares of both companies, realizing capital gains on both sales. The Minister reassessed the Taxpayer for the capital gains on the shares on the basis that the Foundation was a trust to which subsection 75(2) applied to attribute the gains to the Taxpayer.

The Taxpayer's appeal to the Tax Court of Canada was successful. Key to the trial decision were the following findings:

1. The Foundation was not a trust, but was rather a corporation that was acting as trustee of a trust which held the shares for the benefit of the beneficiaries of the Foundation.

2. Subsection 75(2) did not apply to attribute the capital gains to the Taxpayer because subsection 75(2) does not apply to sales of property by a beneficiary to a trust, but rather only applies to a settlor of the trust and subsequent contributors who are akin to a settlor.

3. Even if subsection 75(2) were to apply to the Foundation, the Taxpayer would be able to claim relief against double taxation under Article XIII (5) of the Treaty.

The Federal Court of Appeal only had to address the second and third issues because the Crown did not challenge the trial judge's finding that a trust relationship was created and instead appealed only the findings regarding the application of subsection 75(2) and the Treaty. Despite there being no need for the Federal Court of Appeal to rule on whether a trust had been established, a good portion of the Court's reasoning was spent considering the nature of a foundation created under the APFA and the Court stated in unequivocal terms that it doubted whether the Foundation held its property in trust for the Taxpayer. If the issue had been raised in argument, it seems likely that the Court would have concluded that no trust existed, which would have negated the need to consider subsection 75(2) at all. However, the Court proceeded with its analysis on the assumption that a trust in fact existed.

The Court agreed with the trial judge that subsection 75(2) cannot apply to a beneficiary of a trust who transfers property to the trust by means of a genuine sale and that only a settlor or a subsequent contributor who could be seen as a settlor can be "the person" for purposes of subsection 75(2). This is a clear rebuff of CRA's practice of interpreting subsection 75(2) very broadly. Taken together with the conclusion in the *Howson*, 2007 DTC 141(TCC) decision that genuine loans are not caught by subsection 75(2), tax advisors have gained some helpful guidelines for trust-tax planning.

The Court went on to consider whether Article XIII (5) of the Treaty would provide relief from Canadian tax, even if subsection 75(2) were to apply in the circumstances to attribute the gain from the non-resident vendor to the Taxpayer. In general terms, Article XIII (5) provides that gains from the alienation of property are taxable only in the country where the alienator is resident. Although obiter, this portion of the judgment endorsed the trial judge's approach to treaty interpretation in finding that the Treaty provided relief from Canadian tax on the disposition of the shares by a non-resident alienator, even if subsection 75(2) would otherwise apply to attribute the gains to a Canadian resident. The Crown had argued that, although Article XIII of the Treaty prevented Canada from taxing the alienator (i.e. the Foundation as trustee of the trust), it did not prevent Canada from taxing the Taxpayer on the attributed gains. The Court rejected the Crown's position and found that the meaning of double taxation in a treaty could include economic double taxation (as would occur by virtue of the application of a domestic attribution rule). Whether or not a particular treaty would provide protection against economic double taxation must be determined on the basis of an interpretation of the particular treaty in question. As Canada had specifically reserved the right in the Treaty (in Article XXXVIII) to tax income attributed to its residents pursuant to section 91 of the Act, and no such reservation had been included in Article XIII, the Court found that the Treaty precluded Canada from taxing the Taxpayer on the attributed capital gains.

The case is an important decision for STEP advisors. It provides clear and important commentary on the purpose and application of 75(2) as well as treaty interpretation and the interaction between domestic tax provisions and treaty provisions.

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