



# The Residence Of Trusts - A Warning

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**I**n my earlier article “Tax Planning for Gifts and Bequests from Foreign Relatives”, published in the February 2012 issue, I discussed the use of offshore trusts.

Since then, a decision of the Supreme Court of Canada has had a very significant impact on the trust landscape in Canada. It affects all trusts, both offshore trusts and domestic trusts. Anyone who settles a trust, or is a major beneficiary of a trust, must consider this decision very carefully, and take its consequences into account.

## The Supreme Court Decision

The Supreme Court handed down its decision on April 12, 2012, confirming the decision of two lower courts. The case was *Fundy Settlement v. Canada*, also known as *Garron and St. Michael Trust Corporation*.

For many years, a corporation has been held to be resident for tax purposes in the place of the corporation’s “mind and management” or “central management and control”, which is not necessarily its jurisdiction of incorporation. The mind and management was usually held to be where the directors of the corporation held their board meetings at which their decisions were made. In cases where some other person actually directed the corporation, and his or her actions were merely ratified by the board, the corporation was held to be resident where that person was resident.

However, in the past a trust was generally considered to be resident where the trustee was resident. This was supported by a 1978 decision of the Federal Court Trial Division (*Thibodeau Family Trust*). The Supreme Court, in its recent decision, decided to apply to the residence of trusts the same principles that determine the residence of corporations, as explained above.

The Supreme Court confirmed the decisions of two lower Courts, holding that two Barbados trusts were

resident in Canada, not in Barbados, on the basis that a trust is resident where its central management and control is exercised. The Barbados trustee was held to be exercising only administrative functions, while the mind and management of the trusts was in Canada. The principal beneficiaries, who were Canadian residents, gave direct instructions to the investment advisors of the trusts.

## Consequences and Suggestions

While this decision related to the residence of an offshore trust, it has serious implications for domestic trusts. If the beneficiaries of a trust, or even third parties, give “directions” to the trustee, they may be held to be effectively managing the trust. This would make the trust resident in the jurisdiction where the beneficiaries or third parties are resident, not where the trustee is resident. If the trustee is merely providing administrative services to the trust, as was held to be the fact in the *Fundy Settlement* case, that could have very serious and unfortunate tax consequences.

An offshore trust may have a trustee resident in a low- or no-tax jurisdiction. Until now, the Canadian tax authorities have usually accepted that such a trust is resident in that offshore jurisdiction. Now, if Canadian residents are actively participating in the management of the trust, the trust will be held to be a Canadian resident and consequently subject to Canadian taxation on its worldwide income.

In the past, trusts earning income in high tax provinces, such as Ontario, have often been settled using a trustee resident in a lower tax province, such as Alberta. The beneficiaries of such a trust are typically resident in the high tax province. Significant tax savings were possible. However, the principal beneficiaries often participated actively in the management of the trust, giving the trustee “directions” in respect of such important matters as what investments the trustee should buy or sell and which

beneficiaries should receive distributions of income or capital.

It may be possible to avoid future problems by “educating” the beneficiaries and attempting to ensure that, in future, it is clear from the records that the trustee is the “mind and management” of the trust. To this end, frequent “advice” or “suggestions” by the beneficiaries must be avoided. If such “suggestions” are always followed by the trustee, this may be seized upon by the tax authorities as evidence that the “suggestions” are really “directions”, with the unfortunate consequence that, for tax purposes, the trust will be held to be resident where the beneficiaries are resident.

Documentation of the trustee’s decisions will become increasingly important. Correspondence and emails between the trustee and the beneficiaries may be scrutinized by the Canadian tax authorities. The authorities are entitled to demand that such emails be produced, except where they involve obtaining legal advice from a practising lawyer.

The qualifications of a trustee now become a key factor. Does the trustee have the expertise, technical know-how and ability to manage the trust? Does he or she know how to handle the beneficiaries, to avoid the risk of their

taking action which would result in the beneficiaries being held to manage the trust?

As a result of the Supreme Court decision, the Canadian tax authorities may look back at past years of a trust that are still open for assessment (typically the past 3-4 years in most cases). They will search for evidence to permit them to assert that the trustee was not managing the trust, but was merely providing administrative services. In that case, they will claim that the trust is resident in the jurisdiction of those individuals (often the principal beneficiaries) who are providing the “mind and management” of the trust. Nothing can be done to change the past!

This article may serve to warn individuals involved with a trust, whether as trustee or as beneficiary, of the risk. Professional advice should be sought. If it would be difficult to prevent the beneficiaries or third parties from continuing to “manage” the trust, terminating the trust must be considered.

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