THE LEGACY OF CROWN FOREST INDUSTRIES: LIABLE TO TAX—CAUSE OR EFFECT?

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It is for me sometimes surprising that it has been about 17 years since the Supreme Court of Canada decided *Crown Forest Industries*.[1] Partly, this is because it is sometimes surprising to me that I have been in practice for that long. But it is also surprising to me that the central question in the case, the proper interpretation of the phrase "liable to tax by reason of residence . . . or a criterion of a similar nature," which sets out the test for treaty residence in almost all of Canada's income tax conventions,[2] continues to be debated by Canadian courts with respect to some of its most fundamental aspects. These include the question whether the test requires that a particular type or degree of taxation (sometimes described as "worldwide" or "comprehensive" taxation) be applicable to the tested person under the relevant foreign tax laws. The judicial debate in Canada surrounding this question is the focus of this paper.[3]

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[1] *The Queen v. Crown Forest Industries Ltd et al.*, 95 DTC 5389 (SCC).

[2] See, for example, Canada's income tax convention with the United Arab Emirates, which entered into force in 2004, and which uses the usual formulation to define residents of Canada but a different formulation to define residents of the UAE, the latter being indifferent to tax liability.

[3] This paper reflects only this one part of the presentation made with Shawn D. Porter on May 19, 2011 at the annual seminar of the International Fiscal Association (Canadian Branch). Our presentation's theme was Emerging Issues in Tax Treaties. We covered a number of topics in addition to the focus of this paper—including various interpretations and applications of the "active trade or business" test in paragraph XXIX A(3) of the Canada-US income tax convention ("the US treaty"), and the relationship between certain domestic anti-avoidance provisions and treaty provisions granting benefits as well as "saving clause" provisions that may override such benefits in certain circumstances. Shawn's current position (director of the Tax Legislation Division, Tax Policy Branch, Department of Finance) makes it inconvenient for him to elaborate on his discussion of the "active trade or business" test, and the question of treaty benefits remains before the courts with Couzin Taylor LLP as counsel (on the Crown's appeal from *Sommerer v. The Queen*, 2011 DTC 1162 (TCC)), making it inconvenient for me to elaborate on that.

CROWN FOREST INDUSTRIES

The basic facts in *Crown Forest Industries* are well known. In brief, a Bahamian subsidiary within a multinational group of companies was receiving barge rental payments from a Canadian subsidiary within the same group. These payments were subject to non-resident withholding taxes under part XIII of the Income Tax Act.[4] The Bahamian company had its only management office in the United States, and thus took the position that it was resident in the United States for the purposes of the Canada-US income tax convention, even though it was not a "domestic corporation" for US tax purposes, and even though it enjoyed a special exemption from US taxation on its income from shipping activities. If the taxpayer were a US resident, it would have been entitled to a reduced rate of withholding tax, at 10 percent rather than 25 percent.

As we know, the Supreme Court reversed the lower courts and concluded that the Bahamian company was not resident in the United States for the purposes of the US treaty. What remains unclear, apparently, is exactly why. What exactly is the test, and why exactly did this particular company fail that test? Knowing the answers to these two questions is essential to applying the test in other circumstances, although it may not be sufficient, since additional considerations may be relevant in other circumstances.

The implications of *Crown Forest Industries* have been debated extensively, both in Canada and other countries.[5] This is not that surprising, given that the reasons for judgment include certain ambiguous and possibly even inconsistent statements.

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[4] Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.

[5] An electronic search of "Crown Forest" in a database containing only publications of the Canadian Tax Foundation returned no less than 820 hits. Reference may be made, in particular, to Judith M. Woods, "Recent Jurisprudence," *Report of Proceedings of Forty-Fifth Tax Conference*, 1993 Conference Report (Toronto: Canadian Tax Foundation, 1994), 48:1-22; Allan R. Lanthier, "Treaty Residence" (1994) 2:1 *Canadian Tax Highlights* 4; Allan R. Lanthier, "Crown Forest Tumbles" (1995) 3:7 *Canadian Tax Highlights* 52; Firoz Ahmed, "Selected Issues Related to the 1995 Foreign Affiliate Amendments," International Tax Planning feature (1995) 43:6 *Canadian Tax Journal* 2142-67; Stephen R. Richardson and James W. Welkoff, "The Interpretation of Tax Conventions in Canada" (1995) 43:5 *Canadian Tax Journal* 1759-91; David A. Ward, "Canada's Tax Treaties" (1995) 43:5 *Canadian Tax Journal* 1719-58; Larry F. Chapman, "Emerging Tax Issues: Treaty Interpretation and Crown Forest Industries Ltd., Income of Financing Affiliates and the New FAPI Rules, Formation of Financing Affiliates by Non-Resident-Owned Canadian Companies," in *Report of Proceedings of Forty-Seventh Tax Conference*, 1995 Conference Report (Toronto: Canadian Tax Foundation, 1996), 6:1-29; Allan R. Lanthier, "Exemption Extinguished?" (1996) 4:12 *Canadian Tax Highlights* 92; David A. Ward et al., "A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on Crown Forest Industries" (1996) 44:2 *Canadian Tax Journal* 408-24; François Vincent, "Crown Forest Industries: The OECD Model Tax Convention as an Interpretive Tool for Canada's Tax Conventions" (1996) 44:1 *Canadian Tax Journal* 38-58, at 57; W. Gordon Williamson, "New Developments Affecting International Corporate Finance," in *Current Issues in Corporate Finance*, 1997 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1998), 15:1-25; Robert Couzin and Stephen S. Ruby, "The Impact of Recent

The court began its analysis with an examination of the test from a textual perspective, and then proceeded to a more purposive perspective—all with a view to achieving the "paramount goal," described as being "to find the meaning of the words in question."[6] From a textual perspective, the court stated:

> [23] At this stage of the analysis, the primary question to ask is *why* Norsk is liable to pay tax in the United States. If its liability is *rooted* in the fact that "it is engaged in a trade or business effectively connected with the U.S.," then it would seem that Norsk is not a "resident" of the United States under Article IV since "engaged in a trade or business" is *not* listed as a factor to trigger residency under that article. The only way residency could be found in such a situation would be to determine "engaged in a trade or business" to be a "similar criterion" under Article IV. On the other hand, if Norsk's tax liability in the U.S. *emanates from the fact* that its "place of management" is in the U.S., then it would appear, *prima facie*, that Norsk could satisfy the residency requirements under Article IV, since "place of management" is a sufficient condition of residence. [Emphasis added.]

On the basis of these statements, one might posit that the court held that the test turns on a determination of the *cause* of the tested person's liability, not the *nature or extent or effect* of that liability, under the relevant foreign tax law.[7] That is, the court stated that the primary question to ask is *why* the tested person is liable to pay tax—not *in what way* or *to what extent* the tested person is liable to pay tax.

Cases," in *Report of Proceedings of Fiftieth Tax Conference*, 1998 Conference Report (Toronto: Canadian Tax Foundation, 1999), 52:1-32; Elie Roth, "Canadian Taxation of Non-Resident Trusts: A Critical Review of Section 94 of the Income Tax Act" (2004) 52:2 *Canadian Tax Journal* 329-427; Tani Vithlani, "The Application of Treaty Benefits to Partnerships: Characterization of a Foreign Entity," Corporate Tax Planning feature (2004) 52:1 *Canadian Tax Journal* 294-314; Paul Hickey, "Tax Treaty Residence" (2007) 15:4 *Canadian Tax Highlights* 2-3; Marc Darmo and Angelo Nikolakakis, "The New Rules on Limitation on Benefits and Fiscally Transparent Entities," in *Report of Proceedings of Sixty-First Tax Conference*, 2009 Tax Conference (Toronto: Canadian Tax Foundation, 2010), 26:1-59; Angelo Nikolakakis, "The Unthinkable Anathema of Double Non-Taxation: The Relevance and Implications of Foreign Tax Considerations in the Context of Applying GAAR" (2010) 58, special supplement *Canadian Tax Journal* 243-301; David A. Ward and Stephen S. Ruby, "Tax Treaty Cases, 1965-2008" (2010) 58, special supplement *Canadian Tax Journal* 111-26; and Matias Milet, "Hybrid Foreign Entities, Uncertain Domestic Categories: Treaty Interpretation Beyond Familiar Boundaries" (2011) 59:1 *Canadian Tax Journal* 25-57.

6 At paragraph 22.

7 See also paragraph 25, where the court stated as follows: "it must be shown that the liability to taxation operates *by reason of* one of the listed grounds. This connotes the existence of some sort of causal connection or, in the least, some relationship of proximity" (emphasis in original). In paragraph 29, the court also distinguished "*a factor* used in determining its tax liability" from "*the actual grounds* for that tax liability," with a view to determining "the true and immediate basis for tax liability" (emphasis in original). In paragraph 36, the court referred to "the veritable lynch-pin of . . . tax liability," and in paragraph 38 to "the legal basis for . . . tax liability." None of these statements suggests that the nature or effect of the tax liability to which the tested person may be exposed under the applicable foreign tax laws is a relevant consideration.

Thus, having concluded that the *cause* of the tested person's liability under the laws of the United States was the fact of being "engaged in a trade or business" in the United States, and that this was not an enumerated criterion, the court proceeded to determine whether it might be regarded as a "similar criterion." It is in this context that the court's reasons begin to blur the distinction between the *cause* and the *effect* of the tax liability. The court made the following statements:

> [40] I agree with the appellant that the *most similar element* among the enumerated criteria is that, standing alone, they would each constitute a basis on which *states generally* impose *full tax liability* on *world-wide income*: *Klaus Vogel on Double Taxation Conventions* (1991), at pp. 154-59; Joseph Isenbergh, *International Taxation: U.S. Taxation of Foreign Taxpayers and Foreign Income*, vol. I (1990), at pp. 326-27. In this respect, the criteria for determining residence in Article IV, paragraph 1 involve more than simply being liable to taxation on some portion of income (source liability); they *entail being subject to as comprehensive a tax liability as is imposed by a state*. In the United States and Canada, such comprehensive taxation is taxation on world-wide income. However, tax liability for the income effectively connected to a business engaged in the U.S., pursuant to s. 882 of the *Internal Revenue Code*, amounts simply to source liability. Consequently, *the "engaged in a business in the U.S." criterion is not of a similar nature to the enumerated grounds since it is but a basis for source taxation*. [Emphasis added.]

With these statements, the court seemed to put the spotlight on the usual or general effect of a particular criterion, rather than on more intrinsic or qualitative elements, such as whether a criterion relates to the taxpayer's *personal characteristics or connections* with a jurisdiction as opposed to more *commercial and economic connections*. In other words, these comments suggest the relevance of *functional similarity* rather than *qualitative similarity*. Moreover, although these statements are clearly directed at determining the similarity of an unenumerated criterion, they could be interpreted as suggesting that they somehow also qualify tax liability as a function of the enumerated criteria. On the other hand, the references to "states" and "generally" might suggest that these observations were not intended to qualify the criteria, whether enumerated or not, but rather to find a common element among them—namely, that states generally, though not necessarily, use such criteria to ground the imposition of more comprehensive liability, there being many exceptions to this general approach under the laws of many countries.

The court then continued its examination of the matter from a more purposive perspective—with a view to "the intentions of the drafters of the Convention" and "the goals of international taxation treaties."[8] In this regard, the court began by stating its conclusions, as follows:

[8] At paragraph 42 and following.

> I do not believe that Norsk *should be* considered a resident under Article IV of the Convention nor that the designers of the Convention would have envisioned that it ought to benefit from the preferential tax treatment accorded to residents.[9]

The court then proceeded to explain these statements in various respects, including the general proposition that one of the "principal purposes" of the US treaty is to "reduce or eliminate double taxation of income earned by citizens and residents of either country from sources within the other country."[10] The court then made the following, somewhat confusing set of statements:

> [48] In the case at bar, I underscore that there is no need to prevent double taxation because the U.S. has declined to tax Norsk's revenue. Although this does not affect Norsk's tax liability, the effect is still that Norsk is not required to pay any tax in the United States by virtue of the s. 883(a) exemption, this exemption arising by virtue of a reciprocal arrangement between the U.S. and the Bahamas, where Norsk is incorporated. Further, it is unclear whether the specific rental income at issue is even, independent of the exemption, subject to taxation in the U.S. because, pursuant to s. 864(c)(4) of the *Internal Revenue Code*, it might not be considered to be effectively connected with the conduct of Norsk's American trade or business. Allowing Norsk to benefit from the Convention in this case would actually lead to the avoidance of tax on the rental income because the liability for tax asserted by the Canadian authorities would be reduced notwithstanding that the United States chooses not to impose any tax thereon or does not even have the jurisdiction therefor.

These statements are confusing, in particular, because the court observed that the United States had "declined to tax" Norsk pursuant to the "s. 883(a) exemption," but then stated that "this does not affect Norsk's tax liability." This seems to suggest that a person may be considered to be "liable to tax" in a particular jurisdiction even where that jurisdiction "chooses not to impose any tax" on that person. If that is correct, then the test must turn on the *cause* of *potential* tax liability, not on the *actual effect* on the particular tested person. And yet, these statements were made as part of a followup discussion to the court's textual analysis in which the court stated that "the criteria for determining residence in Article IV, paragraph 1 . . . entail being subject to as comprehensive a tax liability as is imposed by a state."[11]

These statements were then followed by a discussion of further "extrinsic materials," certain hypothetical fact patterns, and the significance of the absence from the US treaty of the usual "second sentence" to the first paragraph of such treaty residence articles. (The sentence excludes persons that are liable to tax in the relevant state in respect only of income from sources in that state.) Finally, the court concluded with a point-form summary, including the following statement:

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9 At paragraph 42.

10 At paragraph 46.

11 At paragraph 40.

> The parties to the Convention intended only that persons who were resident in one of the contracting states and liable to tax in one of the contracting states on their "world-wide income" be considered "residents" for purposes of the Convention.[12]

This statement could be interpreted to suggest yet another standard—namely, that the test turns on *both cause and effect*.[13] In other words, this formulation of the test would require not only that the relevant person's tax liability be rooted in or caused by an enumerated or similar criterion, but also that the effect of that causal connection be that the tested person is exposed to comprehensive liability.

SUBSEQUENT JURISPRUDENCE

A review of the jurisprudence since *Crown Forest Industries* suggests that there is considerable disagreement among the lower courts with respect to the articulation and application of the test in a variety of circumstances. In particular, there is the line of cases involving non-resident trusts: *Garron*, *Antle*, and *RCI Trust*.[14] While all of these decisions in their reasoning pay homage to *Crown Forest Industries*, the comments may reflect an inconsistent understanding of that judgment.

Garron, Antle, and RCI Trust

Each of the decisions in *Garron*, *Antle*, and *RCI Trust* involves the treaty residence of certain Barbados trusts with Canadian-resident beneficiaries, in circumstances featuring the disposition of "taxable Canadian property." In each case, the Crown took the position that paragraph 94(1)(c) of the Act was applicable such that the trusts were deemed to be resident in Canada, thereby permitting Canada to tax the gains arising from the dispositions, notwithstanding the Canada-Barbados income tax convention ("the Barbados treaty").

Subject to certain exceptions,[15] paragraph 94(1)(c) of the Act applies to a discretionary trust that would otherwise be a non-resident of Canada where two main categories of conditions are met—namely, where (i) a person beneficially interested in the trust (referred to as a "beneficiary") was a resident of Canada ("the resident beneficiary condition"),[16] and (ii) the trust[17] has[18] acquired property,[19] directly or

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[12] Point 3, at paragraph 68.

[13] See also the reference in paragraph 57 to American Law Institute, *Federal Income Tax Project—International Aspects of United States Income Taxation II—Proposals on United States Income Tax Treaties* (1992), at 127-28, which focuses on both the taxpayer's "personal connection" with the relevant country and the notion that the person must be "fully taxable," in the sense of being fully subject to the relevant country's "plenary taxing jurisdiction."

[14] *Garron et al. v. The Queen*, 2009 DTC 1287 (TCC); aff'd. 2010 DTC 5189 (FCA), on appeal to SCC; *Antle et al. v. The Queen*, 2009 DTC 1305 (TCC); aff'd. 2010 DTC 5172 (FCA); and *MNR v. Morris et al.*, sub nom. *RCI Trust*, 2010 DTC 5013 (FCA); rev'g. 2009 DTC 5127 (FCTD).

[15] See clauses 94(1)(b)(i)(C), (D), and (E).

[16] This condition is also satisfied where the beneficiary was a corporation or trust with which a person resident in Canada was not dealing at arm's length, or a controlled foreign affiliate of a person resident in Canada.

indirectly in any manner whatever, from a particular person who was the beneficiary referred to in (i), or was related to that beneficiary,[20] and was resident in Canada at any time in the 18-month period before the end of the relevant taxation year of the trust,[21] provided that, in the case of an individual, the person had before the end of that year been resident in Canada for a period of, or periods the total of which is, more than 60 months ("the resident contributor condition").[22] Where these conditions are satisfied, the trust is deemed to be resident in Canada for the purposes of part I of the Act (and certain other purposes),[23] but it is taxable under part I only with respect to a portion of what would normally be the "taxable income" of a resident. Specifically, its deemed "taxable income" would include only its "taxable income earned in Canada" (being the category on which non-residents are normally taxable under part I); a modified formulation of what would be its "foreign accrual property income" (FAPI) if it were a "controlled foreign affiliate" of a person resident in Canada; FAPI attributed to it under subsection 91(1) (plus amounts included under subsection 91(3) and minus deductions under subsection 91(2), (4), or (5)); and amounts included in its income by virtue of section 94.1.

Thus, the cause of such tax liability is ostensibly (deemed) residence, but more fundamentally it is rooted in the satisfaction of the resident beneficiary condition and the resident contributor condition.[24] As for the effect, it is less than comprehensive, but also not exactly limited to income from a source in Canada.

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17 Or a non-resident corporation that would, if the trust were resident in Canada, be a controlled foreign affiliate of the trust.

18 At any time in or before the relevant taxation year of the trust.

19 Other than in prescribed circumstances.

20 Or was the uncle, aunt, nephew, or niece of that beneficiary.

21 Or, in the case of a person who has ceased to exist, was resident in Canada at any time in the 18-month period before the person ceased to exist.

22 This condition can also be satisfied where the property is acquired from a trust or corporation that acquired the property, directly or indirectly in any manner whatever, from a particular person described above with whom it was not dealing at arm's length (see clause 94(1)(b)(i)(B)). In addition, it is a condition under subparagraph 94(1)(b)(ii) that all or any part of the interest of the beneficiary in the trust was acquired directly or indirectly by the beneficiary by way of purchase, or gift, bequest, or inheritance from a person referred to in clause 94(1)(b)(i)(A) or (B), or the exercise of a power of appointment by a person referred to in clause 94(1)(b)(i)(A) or (B).

23 See subparagraph 94(1)(c)(i).

24 In *Crown Forest Industries*, the court specifically rejected the treatment of a factor for a criterion as a criterion. Place of management was a factor (but not the only one) for determining whether Norsk was engaged in a US trade or business, which was the actual criterion. In other words, having a US place of management was not equivalent to, and did not necessarily result in, being engaged in a US trade or business. In contrast, although the device of deemed residence is used under paragraph 94(1)(c), that status is triggered by the satisfaction of the underlying conditions that there be a resident beneficiary and a resident contributor. Arguably, these conditions are the "true basis" for such tax liability, as described in paragraph 29 of *Crown Forest Industries*.

Against that background, it fell to the courts in the decisions referred to above to determine whether such a trust should be regarded as a resident of Canada for the purposes of the Barbados treaty, which included a formulation of the test that is very similar to that considered in *Crown Forest Industries* under the US treaty.[25] In each of these cases, the courts rejected the Crown's position that Canadian residence had been made out for treaty purposes.

In *Garron*, the Tax Court of Canada made the following statements in this regard:

> [315] The essential difficulty that I have with the Minister's position is that Summersby and Fundy are not liable to taxation by virtue of s. 94(1)(c) *in the same way* as trusts resident in Canada under general principles.
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> [316] The *scope of taxation* under s. 94(1)(c) is more *limited*. Basically, it is a scheme that is *source-based*. In essence, the deemed resident provision in s. 94(1)(c) is part of a formula used in determining the tax base. In only a limited sense could it be said that trusts that are liable to taxation under s. 94(1)(c) are taxed by reason of their residence. *It would be more accurate to say that trusts are liable to tax under s. 94(1)(c) because they satisfy the requirements set out in s. 94(1)(a) and (b), namely a beneficiary and contribution test.*
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> [317] The appellants rely on *Crown Forest*. This decision is not dispositive of the issue, in my view, because *Crown Forest* dealt with a different question. Nevertheless, I would agree with the appellants that the Minister's interpretation is not consistent with the approach taken in *Crown Forest*.
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> [318] The following excerpt from the decision suggests that provisions such as Article IV(1) of the Treaty are intended to extend the benefits of a treaty *only where the relevant country "asserts an unlimited right to tax income."* Iacobucci J. states:
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> > The commentaries to the OECD Model Convention as well as academic sources indicate that generally the domestic laws of the contracting states employ residence to apply on "full-tax liability": paragraphs 3 and 8 to the commentary to Article IV; Nathan Boidman, L. Frank Chopin and Alan W. Granwell, "Tax Effects for Canadians of the New U.S. Code and Treaty Residency Rules (Part Two)" (1985), 14 *Tax Mgmt. Intl. J.* 183, at pages 184-85. So, too, does the American Law Institute, *Federal Income Tax Project—International Aspects of U.S. Income Taxation II—Proposals on U.S. Income Tax Treaties*, at pages 127-28:
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> > > Under prevailing practice, a country entering into an income tax treaty extends the benefits of the treaty to a person or entity that is a "resident of (the other) contracting state." "Residence," in turn, is

[25] In *Garron*, supra note 14, the courts held that the trusts there in question were resident in Canada under general principles, such that it became academic whether paragraph 94(1)(c) was applicable. Similarly, in *Antle*, ibid., the treaty residence issue became academic because the courts held that the trusts were either simply ineffective or a sham.

> defined in terms of taxing jurisdiction. A person or entity is considered resident in a country *if that country asserts an unlimited right to tax* his or its income—that is, a right *based upon the taxpayer's personal connection* with the country (as opposed to the source of the income or other income- or asset-related factors). The test of residence requires that the person or entity claiming treaty benefits be "*fully taxable*" in the residence country, in the sense of being *fully subject to its plenary taxing jurisdiction*.
>
> Full tax liability is not satisfied in a case where an entity is liable to tax in a jurisdiction only on a part of its income.
>
> [319] It is unlikely that the drafters of the Treaty had in mind including as "residents of a contracting state" persons that are *subject to a more limited scope of taxation* than persons who are resident under general principles. For this reason, I reject the submission of the Minister.[26]
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> [320] In light of this conclusion, it is *not necessary* that I consider whether the reference to "residence" in Article IV(1) can ever include residence determined by *factors other than physical factors*. [Emphasis added.]

On the basis of these statements, it seems that the Tax Court of Canada recognized that the *cause* of the tax liability of paragraph 94(1)(c) trusts is rooted in factors other than physical factors, but explicitly would have decided the matter on the basis that the *effect* is less than comprehensive.

When the matter came before the Federal Court of Appeal, a similar conclusion was reached based on similar reasons:

> [83] *Crown Forest* teaches that the common element of the enumerated criteria in the treaty definition of residence is that each constitutes a basis on which states generally impose full tax liability on world-wide income. It follows that a person who is liable to tax in Canada only on income from a source or sources (source liability), as opposed to its world-wide income from all sources, would not be considered a resident of that state for treaty purposes. Justice Iacobucci, writing for the Court in *Crown Forest*, explained this point as follows at paragraph 40 [citations omitted]: . . .

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[26] It is interesting to note that the court did not consider the implications of article XXX(3) of the Barbados treaty, which excludes certain entities that benefit from preferential treatment under Barbados income tax laws. If it is really fair to conclude that the drafters of the Barbados treaty did not have in mind including as "residents" persons that are subject to a more limited scope of taxation than persons who are resident under general principles, then this exclusion seems to be redundant. Moreover, on November 8, 2011, a protocol was signed to revise the Barbados treaty in various respects, including the absolute exclusion under article XXX(3). Under the revised approach, it seems clear that the envisioned entities (that is, those enjoying preferences under the Barbados International Business Companies Act, the Exempt Insurance Act, the Insurance Act, the International Financial Services Act, the Society With Restricted Liability Act, or the International Trusts Act, or any substantially similar law subsequently enacted) are intended to be regarded as treaty residents, and that they are to be excluded from benefits only under articles VI to XXIV.

> [87] The deemed residence rule in section 94 does not simply deem a foreign trust to be a person resident in Canada. It is substantially limited; it deems a foreign trust to be a person resident in Canada whose taxable income for the year is the total of its taxable income *earned in Canada* for the year, plus "foreign accrual property income" (or FAPI, which essentially consists of certain investment and other passive income, including capital gains, of a foreign corporation that are attributed to a Canadian resident shareholder in certain circumstances). These limitations result in a foreign trust being deemed to be a person resident in Canada, not for all purposes of Part I (which would make it liable to tax on *all of its income*, wherever earned), but only for the purposes of Part I that are relevant to the determination of its Canadian source income and its FAPI. As a practical matter, as the parties agree, that *excludes only foreign active business income*, but it nevertheless falls short of displacing the treaty definition of residence. [Emphasis added.]

In brief, the court seems to have concluded that Canadian treaty residence was not made out because the trust's deemed "taxable income" would not include its foreign active business income. This is a sweeping proposition, and quite disconcerting if one considers that numerous jurisdictions, including Canada, exclude or exempt either all or some foreign active business income from the tax base of otherwise fully taxable corporations.[27] This proposition is also much broader than one that would deny treaty residence only to persons liable to tax only on income from a source within the relevant country, since that is not the case where the person is taxable in respect of foreign-source passive income.

Similarly, in *Antle*, the Tax Court of Canada made no material comments with respect to the *cause* of the tax liability of a paragraph 94(1)(c) trust, but rather would have decided the matter based on *effect*, as follows:

> [127] With respect to the argument that the Antle Trust by virtue of subparagraph 94(1)(c)(i) and subsection 2(1) of the Act is liable to tax in Canada as a resident, and therefore, can be treated as such for Treaty purposes, I find the decision in *Crown Forest* is a complete answer to that argument. In addressing a similar provision in the Canada-US Treaty (Article IV), Justice Iacobucci concluded:
>
> > The parties to the convention intended only that persons who are resident in one of the contracting States and liable to tax in one of the contracting States on their "worldwide income" be considered residents for purposes of the convention.
>
> [128] The Respondent correctly pointed out the differences between the facts in *Crown Forest* and the case before me, and the focus in *Crown Forest* was on the term "liability to tax." However, the Supreme Court of Canada's conclusion is inescapable. As the Antle Trust would *not be taxed on its worldwide income*, it falls outside the Court's very clear enunciation of a Canadian resident for Treaty

[27] For example, under subsection 138(2), insurance corporations are not taxable in respect of their foreign life insurance business income.

> purposes. I agree with the Respondent that it would be unusual for a Trust to have income to be taxed outside of Part I, but it would not be impossible. Much more has been written on this and could be written, but I will not do so given my earlier reasoning. I did, however, want to make the parties aware of my conclusions on the residence issue. [Emphasis added.]

When this matter came before the Federal Court of Appeal, the issue was not revisited.

Only in *RCI Trust* was this question decided on the basis of *cause*. More specifically, the Federal Court Trial Division held that the trust was not treaty resident in Canada because it had no physical presence in Canada.

> [37] The Respondent acknowledges that the Barbados Trust is *prima facie* a resident of Barbados. Based on the facts described above, it meets the physical criteria associated with actual residence of the kind described in Article IV, paragraph 1, of the Treaty which speaks of "domicile," "place of management" and "criterion of a similar nature." In my view, similar criteria would include other aspects of *actual physical presence and not more esoteric concepts such as deemed residence*.
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> [38] The question is whether Article 3 of the Treaty allows me to conclude that the Barbados Trust is also a resident of Canada. In my view, such a conclusion is not open to me on the facts of this case because Article IV, paragraph 3, limits the assessment to the provisions of paragraph 1 of the Treaty. This means that a finding of dual *residence must be based on actual physical factors and there are no such factors linking the Barbados Trust to Canada. Accordingly, the Barbados Trust is only resident in Barbados*. [Emphasis added.]

When this matter came before the Federal Court of Appeal, the question again was not revisited, the court having decided the matter on entirely different grounds.

CONCLUSION

Arguably, the comments above could be considered consistent with a view that the test turns on both *cause* and *effect*, with a failure on either being a ground for the denial of treaty residence. However, the Tax Court of Canada and the Federal Court of Appeal have focused more on *effect*, whereas the Federal Court Trial Division has focused more on *cause*. It is submitted that the latter is the more appropriate interpretation, given that the language of the test refers to the "reason" for tax liability, and to a criterion of a similar "nature," as well as the usual presence of the "second sentence." If one were to ask what the "reason" is for the imposition of a particular penalty (which is not to suggest that taxation is penal), one would usually think that the answer lies in a description of what the relevant person did or did not do, not in a determination of the amount or effect of the penalty. There is a difference between the "reason" for a conviction and the sentence then imposed, which can vary.

In the context of taxation, it seems clear that states often provide very different tax regimes for their various residents, be they natural or artificial persons. These

regimes differ not only on rates, but also on bases. Thus, the proposition that states generally intend to exclude from treaty residence any person that is subjected to taxation on a less than fully comprehensive basis (or even on a basis that is narrower than the most comprehensive basis usually asserted) seems to be unfounded, given the prevailing practices of states. While this may be true in relation to a particular treaty (which would depend on the intentions of the contracting states), it does not seem to be reasonably plausible in the context of the Barbados treaty, whether before or after the recent protocol thereto.

On the question of the similarity of unenumerated criteria, it remains uncertain whether what is relevant is qualitative rather than functional similarity. Interestingly, if what is relevant is functional similarity, then it seems to follow that a person could be regarded as a treaty resident of a particular state by reason of being engaged in a business activity in that state (or on the basis of any other criterion), if the tax laws of that state provide that any person engaged in a business activity in that state (or satisfying the posited criterion) would be liable to comprehensive taxation. Although this result would not quite turn *Crown Forest Industries* on its head, it goes well beyond the usual meaning of the word "nature" and ignores the distinction between *nature* and *effect*. Moreover, such an interpretation would open the door to an unlimited universe of criteria, which seems inappropriate.

While most jurisdictions stay within the boundaries of normal practices—imposing comprehensive taxation only on persons with significant personal rather than merely economic attachments—the Canadian trust rules in paragraph 94(1)(c), as well as the various preferences for other taxpayers applicable under the Act, serve as good reminders that there can be exceptions in either direction. Relatively comprehensive liability can be asserted against persons without significant personal connections, and less than comprehensive liability can be asserted against persons with significant personal connections. If the test turns on both *cause* and *effect*, then both of these categories would be excluded. If the test turns only on *effect*, then many factual residents could be excluded, and factual non-residents could be included. In contrast, if the test turns on *cause*, factual residents (and those with similar personal connections) would tend to be included (subject to more specific exclusions, including under a "second sentence" or even more specific exclusions, like the pre-protocol formulation of article XXX(3) of the Barbados treaty), and factual non-residents (and those without similar personal connections) would tend to be excluded. This treatment seems (to me at least) to be more coherent and consistent with what must have been intended in using this form of test.

This approach would also be more consistent with principles of comity among states, in acknowledging that each is entitled to assert comprehensive taxation against its factual residents (and similar persons—meaning persons with similar factual connections), but equally that each is free to assert less than comprehensive taxation against its factual residents in order to advance its own public policy objectives; restricting each state only from asserting anything but source-based taxation against factual non-residents (and similar persons). Indeed, it would be

surprising (to me) if contracting states had intended to restrict their policy flexibility to such an extent that they would have agreed that their treaty partners would exclude from treaty residence all taxpayers that enjoy any special reduction at all from the usually asserted base (as suggested (wrongly in my view) by the statement in *Antle* (reproduced above on page 2:10) that the trust there in question could not be regarded as Canadian treaty resident because it "would not be taxed on its worldwide income").

Finally, it is submitted that a trust having Canadian-resident beneficiaries and Canadian-resident contributors should not cause the trust to be considered to have significant *personal* connections to Canada, any more than having Canadian shareholders should cause a corporation to be considered to have significant *personal* connections to Canada.[28] It would be surprising (to me at least) if treaty partners generally intended that corporations that are formed and managed within their jurisdictions could be taxed on a comprehensive basis by other jurisdictions by reason of having shareholders in those other jurisdictions. Indeed, under the jurisprudence developing in various countries, it seems that treaties may even prevent the taxation of the resident shareholders of a foreign corporation on an imputation basis, subject to any applicable saving clause.[29] If that is correct, it seems to follow, a fortiori, that the presence of those shareholders should not permit the comprehensive taxation of the corporation, on the asserted theory that the personal connections that the shareholders may have to the relevant country can be equated to or be considered similar to the corporation having such personal connections.

[28] In the trust context, this issue would largely be rendered academic by the proposed addition of section 4.3 of the Income Tax Conventions Interpretation Act, released with the August 27, 2010 legislative proposals to amend the Act and other statutes.

[29] As noted, this question is beyond the scope of this paper.