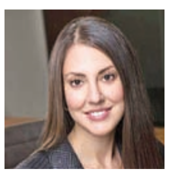
Focus TAX LAW

KMLMTZ66 / ISTOCKPHOTO.COM

Offshore motivations

Decision is first to clarify rules for ‘tax haven’ hedge fund investments



Jennifer Leve

The recent Tax Court of Canada decision, *Gerbro Holdings Company v. Canada* 2016 TCC 173, is the first judgment to consider the offshore investment fund (OIF) rules in a situation involving a Canadian taxpayer's investment in hedge funds that are located in low-tax jurisdictions.

The decision is of interest since it lends clarity to the application of the OIF rules, and in particular, to what constitutes a “main purpose,” as compared to an “ancillary purpose” when determining a taxpayer's motive in obtaining a tax benefit.

In general, the OIF rules are anti-avoidance rules to discourage taxpayers from investing in investment funds outside Canada in order to reduce or defer Canadian tax. When the OIF rules apply, the taxpayer must include in their income an amount equal to the product of the deemed cost of the investment multiplied by a specified interest rate (currently 1 per cent), plus a *notional* amount of 2 per cent, for a total of 3 per cent. This imputed amount will be included in income net of any actual income the taxpayer receives from the investment (but not capital gains), and will be added to the cost of the investment so double taxation is limited when the investment is ultimately sold.

In this case, Gerbro was a holding company of a wealthy Canadian family whose sole shareholder was a spousal trust with a substantial inheritance. Gerbro used independent money managers to manage the investments of the spousal trust during the lifetime of the surviving spouse, and its investment portfolio included five hedge funds based in low-tax jurisdictions. The minister assessed the taxpayer and applied the OIF rules for the years in dispute to include imputed income under the OIF rules. Gerbro appealed.

Two tests determine if the OIF rules apply: (1) does the interest in the non-resident entity derive its value primarily from “portfolio investments,” and (2) does the taxpayer satisfy the “Motive Test” (i.e., is one of the main reasons for making the investment in the fund to obtain a tax benefit)?

On the first question, the Tax Court said the investments were portfolio investments since they did not exercise significant influence or control over the property invested in, consistent with the ordinary commercial meaning of the term.

In order to meet the Motive Test under OIF rules, one of the main purposes for making the investment must be to obtain a tax benefit, which can include a deferral of Canadian income tax. The Tax Court held that this test was not met. While tax motivations were part of Gerbro's decision-making process, the Tax Court found this was not one of the main reasons for the investments. Instead, a compelling set of business reasons, along with the reputations of the investment fund managers, were held to be the dominant reasons for investing.

The Tax Court laid out four reasons for Gerbro's investment in the offshore funds, referring to Gerbro's own investment guidelines which supported an overarching bona fide commercial reason for investing:

1. To obtain good returns;
2. To reduce the overall volatility of its portfolio;
3. To invest with trustworthy individuals; and
4. To hold liquid investments.

As well, the Tax Court acknowledged the risk and liquidity needs of the taxpayer, given that the sur-

Test, Page 12

Focus TAX LAW

SCC takes restrictive approach to rectification

Scott Rollwagen

ERHUI1979 / ISTOCKPHOTO.COM

On Dec. 9, 2016, the Supreme Court of Canada released two companion decisions concerning when a court will step in to assist parties who have mistakenly structured transactions that trigger unanticipated and unwanted tax consequences.

In *Canada (Attorney General) v. Fairmont Hotels Inc.* 2016 SCC 56, the court considered the scope of the common law and equitable principles of rectification. A companion decision, *Jean Coutu Group (PJC) Inc. v. Canada (Attorney General)* 2016 SCC 55, considered the corresponding principles under Quebec law.

In each case, the court took a restrictive approach to rectification, severely restricting its availability to those circumstances where the parties actually intended to execute a specific transaction that differs from the one they in fact executed.

Fairmont Hotels concerned the termination of a financing arrangement between Fairmont and Legacy Hotels REIT that was intended to operate on a tax-neutral basis.

The financing arrangement exposed Fairmont to tax liability on account of foreign exchange fluctuations because the financing was in U.S. dollars. To hedge this risk, reciprocal offsetting loan transactions were entered into between two Fairmont subsidiaries and Legacy Hotels. The tax-neutrality of the financing was later put into jeopardy by a subsequent takeover of Fairmont. To preserve the tax neutrality of the financing for Fairmont, a plan was effected to hedge Fairmont's exposure to foreign exchange fluctuations. This plan, however, deferred protecting the subsidiaries' exposure to be dealt with later. Critically, there was no specific plan as to how this goal would be accomplished.

Later, and on an urgent basis, Legacy asked Fairmont to terminate the reciprocal loan arrangements involving the subsidiaries because Legacy wanted to sell the hotels to which the arrangements related. In terminating these arrangements, Fairmont redeemed its shares in its subsidiaries via resolutions passed by the subsidiaries' directors. This redemption triggered an unanticipated tax liability that was discovered in the course of a subsequent audit by the Canada Revenue Agency.

Had the termination of the reciprocal loan arrangements been effected differently by means of loans from the subsidiaries to Fairmont in the same amount as the share redemptions, the tax liability would not have been triggered. Fairmont commenced a court application seeking rectification of its directors resolutions to convert the share redemptions into loans.

> "The inclusion of imprecise terms in an instrument is, on its own, not enough to obtain rectification...
>
> **Scott Rollwagen**
> Lenczner Slaght

Both lower courts concurred in allowing the application for rectification. Following the decision of the Ontario Court of Appeal in *Juliar v. Canada (Attorney General)* [2000] O.J. No. 3706, both courts focused on the overall goal of Fairmont, which was to unwind the reciprocal loan arrangements on a tax-neutral basis. On this analysis, the vehicle of a share redemption reflected a mistake in selecting the means by which that overall goal was to be effected.

The majority in the Supreme Court of Canada found that *Juliar* could not be reconciled with this traditional understanding of rectification. It therefore overruled *Juliar* and re-emphasized that "the party seeking rectification must identify terms which were omitted or recorded incorrectly and which, correctly recorded, are sufficiently precise to constitute the terms of an enforceable agreement. The inclusion of imprecise terms in an instrument is, on its own, not enough to obtain rectification; absent evidence of what the parties had specifically agreed to do, rectification is not available. While imprecision may justify setting aside an instrument, it cannot invite courts to find an agreement where none is present."

Further, while it reaffirmed its prior finding in *F.H. v. McDougall* [2008] 3 S.C.R. 41 that the proof on a balance of probabilities is the only civil standard of proof, the majority stressed that evidence sufficient to establish an antecedent agreement that had been written down incorrectly must be "evidence exhibiting a high degree of clarity, persuasiveness and cogency." Justice Russell Brown disagreed with the dissenting judges' characterization of the governing intention as being the plan to achieve the unwinding of the reciprocal loans on a tax-neutral basis, observing that "the party seeking rectification of an instrument to show not merely an inchoate or otherwise undeveloped 'intent,' but rather the term of an antecedent agreement which was not correctly recorded therein."

As the majority's emphasis on the word "intent" indicates, *Fairmont Hotels* lays bare a disquieting fact about the common law. While the concept of "intention" is ubiquitous, there is little consensus concerning what intention really is. In this, it is easy to confuse intention with motive. "Intention" concerns what a party sets its mind to actually doing. "Motive" concerns a party's reason for doing what it did. Very often the party's intention — its specific and deliberate decision to undertake an act, will yield results that do not conform with the overriding motive. Traditionally, in contract law, what is relevant is a party's intention, not its motive.

Fairmont Hotels and its companion civil law decision *Jean Coutu* reaffirm that rectification is not available to permit parties to go back in time and re-engineer a concluded transaction that they intended to undertake, even though re-engineering the transaction may in hindsight be the only means of achieving the very objective that may have motivated it.

Scott Rollwagen is the research partner at Lenczner Slaght.

Test: Taxpayer supplied significant documentation supporting investment goals

Continued from page 11

viving spouse was elderly and that upon her death the trust assets would be distributed to the various heirs of her deceased husband. The Tax Court accepted that Gerbro would not have been able to replicate the underlying investment strategies of the fund managers, and noted that Gerbro neither established nor artificially manipulated the investment funds in order to obtain preferred tax treatment or deferral.

For these reasons, the Tax Court held that while tax motivations influenced the taxpayer's decision-making, they were ancillary reasons. The Tax Court went on to mention that it was improper to conclude that availability of tax savings should automatically infer this was a main reason for making the investments in the first place, nor should the fact that just because an investment fund is situated in a "tax haven," the Motive Test is met.

So how is a main reason distinguished from an ancillary reason, especially where the reason is undeclared?

The Tax Court pointed out that the Motive Test is not a purely subjective test, but must be objectively reasonable in the circumstances and validated by fact-specific evidence. The more important the reason for investing, the harder it will be to elevate another reason, such as obtaining a tax benefit, to the same level. However, let us remember Gerbro was able to provide the Tax Court with significant documentation supporting its investment goals; an essential takeaway is that taxpayers should carefully document their investment strategies and considerations when making offshore investments.

On Sept. 30, 2016, the Crown filed a notice of appeal challenging both the Tax Court's application of the legal test in determining a taxpayer's main reasons for making an offshore investment, and its factual conclusion that none of Gerbro's main reasons for investing was tax driven. It will be interesting to see whether the Tax Court's decision is upheld at the Federal Court of Appeal.

Jennifer Leve is an associate with Morris Kepes Winters LLP, a Toronto-based tax law boutique.