Federal Court of Appeal  Cour d'appel fédérale

**Date: 20120713**

**Docket: A-188-11**

**Citation: 2012 FCA 207**

**CORAM:** **BLAIS C.J.**
**LÉTOURNEAU J.A.**
**SHARLOW J.A.**

**BETWEEN:**

**HER MAJESTY THE QUEEN**

**Appellant**

**and**

**PETER SOMMERER**

**Respondent**

Heard at Ottawa, Ontario, on May 9, 2012.

Judgment delivered at Ottawa, Ontario, on July 13, 2012.

REASONS FOR JUDGMENT BY: SHARLOW J.A.

CONCURRED IN BY: BLAIS C.J.
LÉTOURNEAU J.A.

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## REASONS FOR JUDGMENT

**SHARLOW J.A.**

[1] The respondent Peter Sommerer was assessed under the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) for the years 1996 to 2000 to include in his income, pursuant to subsection 75(2) of the *Income Tax Act*, the taxable portion of capital gains realized by an Austrian private foundation on the sale of corporate shares it had purchased from Mr. Sommerer. An appeal by Mr. Sommerer to the Tax Court of Canada was successful (2011 TCC 212). Justice Campbell Miller concluded that subsection 75(2) of the *Income Tax Act* did not apply to the facts of this case and even if it did, Article XIII (5) of the *Canada-Austria Income Tax Convention, 1980*, S.C. 1980-81-82-83, c. 44, Part II, precludes Canada from taxing in the hands of Mr. Sommerer any gain realized by the

Austrian private foundation. The Crown has appealed that judgment. For the reasons that follow, I would dismiss the appeal.

Background

[2] This case arises from certain transactions in the years 1996 to 1998 involving Peter Sommerer and the Sommerer Privatstiftung (the "Sommerer Private Foundation"), a private foundation established by Peter's father, Herbert Sommerer, on October 3, 1996 under a statute of the Republic of Austria entitled "*Privatstiftungsgesetz*" (the "Austrian *Private Foundations Act*").

[3] In lengthy and cogent reasons, Justice Miller resolved a number of factual and legal issues that are no longer in dispute between the parties. The facts that are relevant to the issues in this appeal are few and are set out below under the heading "Facts". The facts are best understood in the light of the relevant Austrian law, summarized in the next section.

Austrian private foundations

[4] The record contains a copy of the Austrian *Private Foundations Act* as enacted in German, and an English translation. The English translation is appended to Justice Miller's reasons. Two witnesses, Dr. Hellwig Torggler and Dr. Willibald Plesser, gave evidence about the law of Austria relating to the Austrian *Private Foundations Act*. They agree on the principles of Austrian law that I consider relevant to this appeal.

[5] A private foundation is created under the Austrian *Private Foundations Act* by a "Stifter" (translated as "founder"). There may be more than one founder. However, a person cannot become a founder by contributing to an existing private foundation.

[6] A private foundation is established when a founding deed is accepted for filing in the Austrian Register of Corporations. The founding deed must be executed by the founder or founders, it must be notarized, and it must contain the information required by the Austrian *Private Foundations Act*. Among the required information is proof that the founder or founders have endowed the private foundation with money in at least the amount required by the Austrian *Private Foundations Act*. In 1996, the required endowment was 1,000,000 Austrian shillings, then equal to approximately $126,000. The required information also includes the name and address of the founder or founders, the name of the private foundation, its purpose, its intended duration, and the address of its head office, which must be in Austria.

[7] An Austrian private foundation is a juridical person, in the same category in Austrian law as a corporation. It has its own legal personality and the legal capacity to own property in its own right, which it holds and manages for the purposes stated in its constating documents.

[8] A private foundation may be established for any lawful purpose, including a charitable purpose or any purpose for the benefit of the public at large, or it may be established for the purpose of benefitting designated persons, such as the members of a family. Generally, a private foundation

may engage in investment activities that are consistent with its purposes, but it may not engage in commercial activities other than as a secondary activity, assume the management of a commercial corporation, or be registered as the personally liable shareholder of a partnership or an incorporated commercial company.

[9] A private foundation must have a "Stiftungsvorstand" (translated sometimes as "board of directors" and sometimes as "executive board" – in these reasons I use the term "board"). The board is responsible for conducting the affairs of the private foundation. Each member of the board must perform his or her responsibilities frugally and with the prudence of a conscientious manager.

[10] There must be at least three members of the board of a private foundation. The initial board is appointed by the founder or founders. Their successors are named as specified in the founding deed or a supplementary deed. A beneficiary, the spouse of a beneficiary, or a person related to a beneficiary within a specified degree cannot be a member of the board, and neither can any corporation. Two of the members of the board must have permanent residence in Austria.

[11] A private foundation, except one established for the benefit of the public at large, must have at least one "Begünstigter", a person to whom the property of the private foundation may be distributed at the discretion of the board subject to the terms of the founding deed of the private foundation or a supplementary deed. The founding deed must either designate that person (or persons), or stipulate how and by whom they will be designated. The word "Begünstigter" is

translated as "beneficiary", but since the law of Austria does not recognize common law trusts, it should not be inferred that a "Begünstigter", as such, necessarily has all the legal rights of the beneficiary of a common law trust.

[12] The founding deed may permit the designation of a beneficiary or beneficiaries in a supplementary deed executed by the founder or founders, or it may permit the designation of a beneficiary or beneficiaries by a "Stelle" (an organ of the private foundation created by the founder or founders for that purpose), failing which the board may designate the beneficiary or beneficiaries. A supplementary deed is a separate notarized document that is not necessarily required to be filed with the Austrian Register of Corporations. If a supplementary deed is not required to be filed, its contents do not become publicly available information.

[13] The founding deed or a supplementary deed may also name a "Letzbegünstigter" (translated as "ultimate beneficiary"). An ultimate beneficiary is a person who is entitled to receive the property of the private foundation upon its revocation or dissolution, after the creditors of the private foundation have been satisfied. There may be more than one ultimate beneficiary. If a private foundation is dissolved and no ultimate beneficiary has been named, the assets of the private foundation become the property of the Republic of Austria.

[14] A private foundation must have a "Stiftungsprüfer" (translated as "auditor"). It may, and in some circumstances must, have an "Aufsichtsrat" (translated as "supervisory board"). It may also

have other organs established for specified purposes, including a "Beirat" (translated as "advisory board") to advise the board. However, an advisory board cannot replace the board or exercise any of its functions. The existence of an advisory board does not relieve the board of its legal obligation to manage the affairs of the private foundation in accordance with its stated purposes, or affect the legal standard of care imposed on members of the board.

[15] The dissolution of an Austrian private foundation may occur in a number of ways, including upon a resolution of the board, but not by a resolution of any other organ or the beneficiaries. There are circumstances in which the board must pass a dissolution resolution. If the right of revocation has been reserved by the founder or founders, the board must pass a dissolution resolution upon receiving notice of the revocation. The board must pass a dissolution resolution upon the achievement of the private foundation's purposes, upon a determination that its purposes are no longer achievable, upon the occurrence of an event that is stipulated in the founding deed to require dissolution or, in the case of a private foundation established for a fixed term, upon the expiry of the term. In the case of a non-charitable private foundation whose major purpose is for the benefit of individuals, a dissolution resolution must be passed when the private foundation has lasted for 100 years, unless all ultimate beneficiaries resolve unanimously that it should continue for another period not exceeding 100 years at a time.

[16] The founding deed of a private foundation may be amended by the founder or founders only if that right has been reserved. If an amendment is required but cannot be made because no such

right has been reserved, or because the founder or founders are unable to act, the board may make any amendments necessary to achieve the purpose of the private foundation, subject to the approval of the court. An amendment to the founding deed is made by a supplementary deed, and becomes effective only when the supplementary deed is accepted for filing in the Austrian Register of Corporations.

[17] A beneficiary or an ultimate beneficiary, as such, has no right to exercise any authority vested in the board, or to manage or have a say in the management of the private foundation's affairs or in the exercise of any discretion as to the distribution of property to the beneficiaries. The legal rights of a beneficiary or ultimate beneficiary are limited to obtaining information about the affairs of the private foundation, and asking the court to take steps to ensure that the terms of the founding deed and any supplementary deeds are respected. As well, each beneficiary and ultimate beneficiary has a specific statutory right to apply to the court for dissolution of the private foundation if an event has occurred that makes dissolution mandatory and the board has not passed a dissolution resolution, or if the board has passed a dissolution resolution when no event requiring dissolution has occurred.

[18] In this appeal, the Austrian tax treatment of a private foundation is not relevant, but as it is mentioned by Justice Miller in his reasons, I will summarize the evidence presented on that point. An Austrian private foundation generally is subject to the same income tax law as other Austrian corporations, but it may be exempted from Austrian income tax if it files certain information with

the tax authorities, including a supplementary deed naming the beneficiaries. However, a private foundation is not exempt from Austrian income tax on "Spekulationsgeschäfte" (translated as "speculative transactions"), including a gain on the sale of corporate securities within one year of its acquisition, or a gain on the sale of real property within ten years of its acquisition. Thus, a private foundation can and is intended to provide limited shelter from Austrian income tax with respect to income from the use or disposition of its property. Generally, a distribution of the property of a private foundation is subject to Austrian income tax in the hands of the beneficiary who receives it, unless the beneficiary is entitled to an exemption (for example, under an international income tax convention). The private foundation may be obliged to withhold tax from the distribution and remit it to the tax authorities to be applied against the tax liability of the beneficiary.

Facts

[19] At all times material to this appeal, Peter Sommerer was resident in Canada. It is not alleged that he was resident in Austria or in any other country during the relevant period.

[20] Herbert Sommerer, the father of Peter Sommerer, executed the founding deed of the Sommerer Private Foundation on October 3, 1996. On the same date, he endowed the Sommerer Private Foundation with 1,000,000 Austrian shillings. The founding deed was registered with the Austrian Register of Corporations. The founding deed names three individuals unrelated to the Sommerer family as the initial members of the board.

[21] The purpose of the Sommerer Private Foundation as set out in its founding deed is as follows (translated from German):

> The purpose of the foundation is to promote the interests of those individuals indicated in the supplementary deed from the income generated by the foundation funds.
>
> Engaging in investment activities, in particular the purchase of shares on credit, is also in line with this purpose.
>
> Beneficiaries and those who may become beneficiaries based on the purpose of the foundation have no legal claim to grants from the foundation.

[22] On October 4, 1996, Herbert Sommerer executed the supplementary deed referred to in the first paragraph quoted above. The beneficiaries are named in section 2 of that supplementary deed. It reads as follows (translated from German):

> The beneficiaries are Mr. Peter Sommerer, his wife, Mrs. Dawn Elizabeth Sommerer, as well as the children from their marriage, but only as of their eighteenth birthday and, in the event of their death, their offspring, provided they are resident in Austria.

[23] Dr. Torggler interpreted this provision to mean that the named persons are only potential beneficiaries unless and until they become resident in Austria. Dr. Plesser agreed. Justice Miller also agreed, and his conclusion on this point is not challenged in this appeal. Thus, the fact that Peter Sommerer was resident in Canada in October of 1996 means that he was not then eligible to receive a distribution as beneficiary, but he could become eligible by becoming resident in Austria.

[24] Under the October 4, 1996 supplementary deed, Peter Sommerer and his spouse are also named as the ultimate beneficiaries of the Sommerer Private Foundation. The provision naming them as ultimate beneficiaries contains no condition as to their place of residence.

[25] In the founding deed, Herbert Sommerer reserved the right to revoke the private foundation. He also reserved the right to amend the founding deed with the consent of the advisory board. The October 4, 1996 supplementary deed establishes an advisory board consisting of the founder (Herbert Sommerer) and the two oldest beneficiaries. It apparently was intended that Peter Sommerer and his spouse would be members of the advisory board, although technically that would be impossible unless they became resident in Austria.

[26] According to the English translation of the October 4, 1996 supplementary deed, the advisory board "shall advise the [board] in determining grants to beneficiaries and has the right to supervise the activities of the [board]." The supplementary deed also provides that it (that is, the supplementary deed) may be "revoked by the [board] with unanimous approval by the advisory board, and all items may be modified or supplemented."

[27] Dr. Torggler and Dr. Plesser did not agree on whether, as a matter of Austrian law, the advisory board was validly created on October 4, 1996 as an organ of the Sommerer Private Foundation. However, it seems to me that none of the issues in this appeal turn on that point.

[28] A supplementary deed executed in January of 1999 changed the residence requirement for beneficiaries and ultimate beneficiaries. The result of the amendment is that the persons named in the October 4, 1996 supplementary deed as beneficiaries or ultimate beneficiaries are entitled to receive distributions of property of the private foundation or distributions on dissolution, as the case may be, if they are resident in any country designated by the advisory board except Canada. As Peter Sommerer was still resident in Canada at that time, he was not then eligible to receive any distributions, but that would change if he ceased to be resident in Canada and became resident in another country designated by the advisory board. Another supplementary deed executed in 1999 removed the supervisory role of the advisory board.

[29] Despite the residence requirement for beneficiaries as it existed between October of 1996 and January of 1999 that might have precluded Peter Sommerer from being a member of the advisory board during that period, the record contains a significant body of evidence indicating that Peter Sommerer was present at most if not all meetings of the board of the Sommerer Private Foundation, and offered his advice on the transactions that gave rise to this case. In my view, the fact that Peter Sommerer offered advice to the board is not relevant to any of the issues on appeal, whether or not he did so as a member of the advisory board.

[30] On October 4, 1996, Peter Sommerer sold to the Sommerer Private Foundation 1,770,000 shares of Vienna Systems Corporation (the "Vienna shares") for their fair market value of $1,177,050 (66.5¢ per share). The Sommerer Private Foundation paid $117,705 of the purchase

price on the date of the agreement and was legally obliged to pay the remainder at a later date, with interest. The sale was unconditional. The cash portion of the purchase price was paid using part of the initial endowment from Herbert Sommerer (paragraphs 67 and 88 of Justice Miller's reasons).

[31] In December of 1997, the Sommerer Private Foundation sold 216,666 of the Vienna shares for $4.50 per share to three individuals unrelated to the Sommerer family, realizing a capital gain. In December of 1998, the Sommerer Private Foundation sold the remaining Vienna shares to Nokia Corporation for $9.00 per share, realizing a further capital gain.

[32] In April of 1998, Peter Sommerer sold to the Sommerer Private Foundation, unconditionally, 57,143 shares of Cambrian Systems Corporation (the "Cambrian shares") for $100,000 (approximately $1.75 per share). In December of 1998, the Sommerer Private Foundation sold the Cambrian shares to Northern Telecom Limited for $14.97 (US) per share, plus a further $4.12 (US) per share conditional on certain milestones being met in 1999. That sale resulted in another capital gain for the Sommerer Private Foundation.

[33] The Minister took the position that the capital gains realized by the Sommerer Private Foundation on the sale of the Vienna shares and the Cambrian shares were attributable to Peter Sommerer pursuant to subsection 75(2) of the *Income Tax Act*. For reasons that are not relevant to any issues raised in this appeal, putting that conclusion into effect required income tax reassessments for the years 1996 to 2000. As mentioned above, those reassessments were successfully appealed to the Tax Court of Canada, and the Crown now appeals to this Court.

Analysis

(A) Introduction to subsection 75(2)

[34] Broadly speaking, subsection 75(2) is intended to ensure that a taxpayer cannot avoid the income tax consequences of the use or disposition of property by transferring it in trust to another person while retaining a right of reversion in respect of the property or property for which it may be substituted, or retaining the right to direct the disposition of the property or substituted property. Subsection 75(2) operates by attributing any income or loss from the use of trust property, and any gain or capital loss on the disposition of trust property, to the person from whom the property, or property for which it was substituted, was received by the trust.

[35] Subsection 75(2) reads as follows:

| | |
|---|---|
| **75.** (2) Where, by a trust created in any manner whatever since 1934, property is held on condition | **75.** (2) Lorsque, en vertu d'une fiducie créée de quelque façon que ce soit depuis 1934, des biens sont détenus à condition : |
| (*a*) that it or property substituted therefor may | *a*) soit que ces derniers ou des biens qui leur sont substitués puissent : |
| (i) revert to the person from whom the property or property for which it was substituted was directly or indirectly received (in this subsection referred to as "the person"), or | (i) ou bien revenir à la personne dont les biens ou les biens qui leur sont substitués ont été reçus directement ou indirectement (appelée « la personne » au présent paragraphe), |
| (ii) pass to persons to be determined by the person at a time subsequent to the creation of the trust, or | (ii) ou bien être transportés à des personnes devant être désignées par la personne après la création de la fiducie; |
| (*b*) that, during the existence of the person, the property shall not be | *b*) soit que, pendant l'existence de la personne, il ne soit disposé des |

| | |
|---|---|
| disposed of except with the person's consent or in accordance with the person's direction, | biens qu'avec son consentement ou suivant ses instructions, |
| any income or loss from the property or from property substituted for the property, and any taxable capital gain or allowable capital loss from the disposition of the property or of property substituted for the property, shall, during the existence of the person while the person is resident in Canada, be deemed to be income or a loss, as the case may be, or a taxable capital gain or allowable capital loss, as the case may be, of the person. | tout revenu ou toute perte résultant des biens ou de biens y substitués, ou tout gain en capital imposable ou toute perte en capital déductible provenant de la disposition des biens ou de biens y substitués, est réputé, durant l'existence de la personne et pendant qu'elle réside au Canada, être un revenu ou une perte, selon le cas, ou un gain en capital imposable ou une perte en capital déductible, selon le cas, de la personne. |

(B) The French version of subsection 75(2)

[36] There was some debate in this case as to whether the French version of subsection 75(2) of the *Income Tax Act* and the English version say the same thing, whether the French version contains a drafting error (evidenced by some obviously unintended effects), and whether the apparent differences between the English and French versions have any bearing on the issues in this case. These issues are discussed by Justice Miller in paragraphs 95 to 102 of his reasons. He found the differences between the English and French versions to be of no consequence to the issues in this case, and I agree. I mention this point only to urge the Crown to consider whether there is a drafting error in the French version of subsection 75(2), and if so to initiate corrective steps. If there is an error in that provision, the same error or a similar error may be present in a number of other provisions of the *Income Tax Act* mentioned in the submissions made in this case.

(C) Is there a trust?

[37] The Crown argued in the Tax Court that the Sommerer Private Foundation is a trust. Peter Sommerer argued that it is a corporation. Justice Miller concluded that it is a corporation that holds its property in trust for Peter Sommerer and the other named beneficiaries. He went on to conclude that subsection 75(2) of the *Income Tax Act* does not apply to attribute to Peter Sommerer the capital gains realized by the Sommerer Private Foundation on the sale of the Vienna shares and the Cambrian shares. He held in the alternative that Article XIII (5) of the *Canada-Austria Income Tax Convention* precludes Canada from taxing Peter Sommerer on the capital gains realized by the Sommerer Private Foundation.

[38] The Crown's appeal assumes that Justice Miller was correct when he concluded that the Sommerer Private Foundation holds its property in trust. The Crown challenges only Justice Miller's conclusions on the application of subsection 75(2) of the *Income Tax Act* and Article XIII (5) of the *Canada-Austria Income Tax Convention*. Peter Sommerer does not agree that the Sommerer Private Foundation holds its property in trust, but as respondent in this appeal he has chosen not to argue that point. He has concentrated instead on defending Justice Miller's conclusions on the application of subsection 75(2) of the *Income Tax Act* and Article XIII (5) of the *Canada-Austria Income Tax Convention*. Because of the manner in which this appeal was argued, the proposition that the Sommerer Private Foundation holds its property in trust was not the subject of submissions, and I will express no final opinion on whether it is correct. However, I will say that in my view, it is a doubtful proposition.

[39] According to the undisputed evidence of Dr. Torggler, the law of Austria does not recognize trusts as understood in Canadian law. However, it is evident that as a practical matter (and putting aside for the moment any income tax considerations), Herbert Sommerer may well have achieved many of the objectives that could have been achieved in a common law jurisdiction by settling a trust for Peter Sommerer, his spouse and their children. He did so by creating and endowing the Sommerer Private Foundation under the Austrian *Private Foundations Act* and naming Peter Sommerer, his spouse, and their children as beneficiaries and ultimate beneficiaries. But that does not mean as a matter of law that the creation and endowment of the Sommerer Private Foundation was the settlement of a trust, or that a trust existed or came into existence when the Sommerer Private Foundation bought the Vienna shares or the Cambrian shares from Peter Sommerer.

[40] As mentioned above, an Austrian private foundation is a juridical person with the legal capacity to own property in its own right and to deal with its property on its own account. The legal right of an Austrian private foundation to deal with its own property is the same as the legal right of a Canadian corporation to deal with its own property. That is so despite the fact that the board of an Austrian private foundation must manage its affairs in furtherance of the purposes stipulated in its constating documents. The board of directors of a corporation is similarly constrained, in the sense that it must manage the affairs of the corporation in its best interests, subject to any terms and conditions in its constating documents.

[41] A corporation does not hold its property in trust for its shareholders or members, except to the extent that a trust deed or an analogous legal instrument imposes the legal and equitable

obligations of a trustee on the corporation with respect to specific corporate property. Assuming it is theoretically possible for an Austrian private foundation to hold its property in trust (that is, subject to conditions that are analogous to the legal and equitable obligations of a trustee in a common law jurisdiction), that possibility cannot be realized unless those conditions are formally established. Nothing in the constating documents of the Sommerer Private Foundation or the law of Austria, as reflected in the record of this case, supports the conclusion that the right of the Sommerer Private Foundation to deal with its property is constrained by any legal or equitable obligations analogous to those of a common law trustee.

[42] Looking at the situation from another point of view, a shareholder or member of a corporation, as such, is not the beneficial owner of any property or the corporation, and has no legal or equitable claim to the corporate property (unless such a claim arises upon the declaration by the board of directors of a dividend, or when the dissolution of the corporation is imminent). Unless and until such an event occurs, a shareholder or member has only an inchoate right to receive distributions of corporate property from time to time at the discretion of the board of directors, and to share in the distribution of the corporate property upon its dissolution. The same can be said of the interest of a beneficiary or an ultimate beneficiary in the property of an Austrian private foundation. Nothing in the Austrian *Private Foundations Act* or the constating documents of the Sommerer Private Foundation gives Peter Sommerer a legal or equitable claim to the corporate property that is different from that of a shareholder or member of a corporation.

[43] For these reasons, I doubt that the Sommerer Private Foundation holds any of its property in trust for Peter Sommerer. However, in the remainder of these reasons I set aside my doubts about whether the Sommerer Private Foundation holds its property in trust, and I assume without deciding that in October of 1996 when Herbert Sommerer created the Sommerer Private Foundation and endowed it with the equivalent of $126,000, he settled a trust for the benefit of Peter Sommerer, his spouse and their children, with the Sommerer Private Foundation as trustee.

(D) Does subsection 75(2) apply?

[44] The Sommerer Private Foundation used part of the money it received from Herbert Sommerer as an endowment to pay Peter Sommerer part of the purchase price of the Vienna shares. The Sommerer Private Foundation later sold the shares and realized a capital gain. The position of the Crown is that subsection 75(2) applies to attribute that capital gain to Peter Sommerer.

[45] I reproduce here the parts of subsection 75(2) upon which the Crown relies:

| | |
|---|---|
| **75.** (2) Where, by a trust created in any manner whatever since 1934, property is held on condition | **75.** (2) Lorsque, en vertu d'une fiducie créée de quelque façon que ce soit depuis 1934, des biens sont détenus à condition : |
| (*a*) that it or property substituted therefor may | *a*) soit que ces derniers ou des biens qui leur sont substitués puissent : |
| (i) revert to the person from whom the property or property for which it was substituted was … received (in this subsection referred to as "the person"), … | (i) ou bien revenir à la personne dont les biens ou les biens qui leur sont substitués ont été reçus […] (appelée « la personne » au présent paragraphe), […] |
| … any taxable capital gain … from the disposition of the property … shall, | […] tout gain en capital imposable […] de la disposition des biens […] est |

| | |
|---|---|
| during the existence of the person while the person is resident in Canada, be deemed to be … a taxable capital gain … of the person. | réputé, durant l'existence de la personne et pendant qu'elle réside au Canada, être […] un gain en capital imposable […] de la personne. |

[46] This provision must be read together with paragraph 248(5)(*a*) of the *Income Tax Act*, which provides, broadly speaking, that for the purposes of most provisions of the *Income Tax Act*, the notion of the substitution of property contemplates any number of substitutions. It reads in relevant part as follows:

| | |
|---|---|
| (5) For the purposes of this Act …, | 5) Pour l'application de la présente loi […]: |
| (*a*) where a person has disposed of or exchanged a particular property and acquired other property in substitution therefor and subsequently, by one or more further transactions, has effected one or more further substitutions, the property acquired by any such transaction shall be deemed to have been substituted for the particular property…. | *a*) lorsqu'une personne dispose d'un bien donné ou l'échange et acquiert un autre bien en remplacement et que par la suite, par une ou plusieurs autres opérations, elle effectue une ou plusieurs autres substitutions, le bien acquis par cette opération est réputé substitué au bien donné […] |

[47] The Crown argues that subsection 75(2) applies to this case because when Peter Sommerer sold the Vienna shares to the Sommerer Private Foundation in October of 1996, it was possible under the constating documents of the Sommerer Private Foundation that the Vienna shares or property substituted for them (including the proceeds of their sale, any property that might be acquired with the proceeds of their sale, and so on), might one day be distributed to Peter Sommerer as a beneficiary or an ultimate beneficiary. I agree that Peter Sommerer may one day be entitled to a

distribution from the Sommerer Private Foundation of property that, by virtue of paragraph 248(5)(*a*), would be property substituted for the Vienna shares. However, Justice Miller found that to be an insufficient basis for the application of subsection 75(2). I agree.

[48] Subsection 75(2) must be interpreted and applied to give effect to its language, read in its proper context and with a view to giving effect to its intended purpose. As mentioned above, subsection 75(2) generally is intended to ensure that a taxpayer cannot avoid the income tax consequences of the use or disposition of property by transferring it to another person in trust while retaining a right of reversion or a right of disposition with respect to the property or property for which it may be substituted. A common example of the application of subsection 75(2) is the settlement of a trust where the settlor is also a beneficiary with an immediate or contingent right to a distribution of the trust property. In that situation, and in many other situations contemplated by paragraphs 75(2)(a) and (b), subsection 75(2) achieves its intended purpose.

[49] In this case, the Crown contends that the application of subsection 75(2) applies also in respect of property that has been *purchased* by a trustee from a beneficiary at fair market value and held subject to the terms of the trust. In my view, to interpret subsection 75(2) so that it could apply to a beneficiary in respect of property that the trust acquired from the beneficiary in a *bona fide* sale transaction leads to outcomes that are absurd and could not have been intended by Parliament.

[50] A series of examples will illustrate this point. (For the sake of simplicity, assume that to the extent the trust in these examples earns any income from the use of its property, the income is

distributed to the beneficiaries on a current basis, so that no property of the trust represents retained income or property substituted for retained income.)

[51] An individual, Mary, settles a $10,000 trust for her children, naming them all as beneficiaries who are to share equally in all distributions of property of the trust, and naming herself as the sole beneficiary in the event that all of the children predecease her. In this case, subsection 75(2) would apply to attribute to Mary all of the income and losses of the trust from the use of its property, and all of the capital gains and losses realized by the trust on the disposition of its property (during her lifetime as long as she is resident in Canada).

[52] Now a complication is added. One of Mary's children, Jack, donates a painting to the trust, stipulating that it is to be held subject to the existing terms of the trust except that if the painting is still held by the trust in ten years time, the painting would revert to Jack. The trust sells the painting five years later, realizing a capital gain on the sale. The capital gain is attributed to Jack pursuant to subsection 75(2) because it was realized on the disposition of property that the trust acquired from Jack subject to the terms of the existing trust, and also subject to the condition that the property could revert to him. It is important to observe that, because the painting was donated to the trust by Jack and the trust gave nothing to Jack in return, it cannot be said that the painting is property substituted for any property that the trust received from Mary, so there could be no attribution to Mary of any gain on the sale of the painting, or any income or gains associated with property substituted for the painting.

[53] Now suppose that Jack, instead of donating the painting to the trust, sells it to the trust for its fair market value with no conditions attached. The painting is sold by the trust at a time when Jack is the only child of Mary still alive. The trust realizes a capital gain on the sale. At that point, either Mary or Jack could become entitled to receive all of the property of the trust, depending upon which of them dies first.

[54] Under the conventional understanding of subsection 75(2), the painting would be considered property substituted for money that the trust received from Mary. That is because all of the property of the trust can be traced, through the substituted property rule, to whatever property Mary donated to the trust when it was settled. Because the painting and any property substituted for the painting could revert to Mary, subsection 75(2) would apply to attribute to Mary the capital gain on the sale of the painting. However, if the Crown's interpretation is correct, it would be equally valid to say that because the trust received the painting from Jack when the terms of the trust were such that the painting could revert to him, subsection 75(2) attributes to Jack the capital gain on the sale of the painting.

[55] Thus, under the Crown's interpretation of subsection 75(2), the same capital gain is attributed simultaneously to Mary and Jack. That cannot be. Nothing in subsection 75(2) contemplates an outcome involving the attribution of the same gain to more than one person. This double application of subsection 75(2) cannot be avoided by a discretionary use of subsection 75(2), because it is not a discretionary provision. It applies automatically to every situation it describes.

[56] For the same reason, it is no answer to say that in this particular case, subsection 75(2) could never apply to Herbert Sommerer, the "settlor" of the trust, because he is not a resident of Canada. Again, because subsection 75(2) applies automatically to every situation it describes, it is not acceptable to adopt one interpretation for transactions involving only residents of Canada, and a different interpretation for transactions involving residents of other countries.

[57] I conclude that the Crown's proposed interpretation is wrong because it is based on the incorrect premise that subsection 75(2) can apply to a beneficiary of a trust who transfers property to the trust by means of a genuine sale. Justice Miller reached the same conclusion through a comprehensive application of the principles of statutory interpretation to specific words and phrases in subsection 75(2). His main conclusion is stated succinctly at paragraph 91 of his reasons:

> … once properly unravelled and viewed grammatically and logically, the only interpretation is that only a settlor, or a subsequent contributor who could be seen as a settlor, can be the "the person" for purposes of subsection 75(2) of the *Act*.

[58] It remains only to apply this conclusion to the present case. The Sommerer Private Foundation purchased the Vienna shares from Peter Sommerer using money from the original endowment from Herbert Sommerer. Peter Sommerer has not endowed the Sommerer Private Foundation with any other money or property. Therefore, subsection 75(2) cannot apply to attribute any income or gains of the Sommerer Private Foundation to Peter Sommerer.

[59] That is a sufficient basis for dismissing this appeal. However, since Justice Miller dealt with Article XIII (5) of the *Canada-Austria Income Tax Convention*, I will comment on that issue as well.

(E) Does the *Canada-Austria Income Tax Convention* apply?

[60] Justice Miller concluded that if subsection 75(2) were to apply to attribute to Peter Sommerer the capital gain realized by the Sommerer Private Foundation on the sale of the shares it purchased from Peter Sommerer, Canada nevertheless is precluded by Article XIII (5) of the *Canada-Austria Income Tax Convention* from taxing the gain in his hands.

[61] Article XIII (5) of the *Canada-Austria Income Tax Convention* reads as follows:

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| 5. Gains from the alienation of any property, other than those mentioned in paragraphs (1), (2), (3) and (4) shall be taxable only in the Contracting State of which the alienator is a resident. | 5. Les gains provenant de l'aliénation de tous biens autres que ceux qui sont mentionnés aux paragraphes 1, 2, 3 et 4 ne sont imposables que dans l'État contractant dont le cédant est un résident. |

[62] Justice Miller reasoned that the gain in issue falls squarely within the language of Article XIII (5). After considering the relevant principles of the interpretation of income tax conventions and the commentaries of the Organization for Economic Cooperation and Development (the "OECD"), he found nothing in the context of the *Canada-Austria Income Tax Convention* to suggest that Article XIII (5) was not intended to apply literally.

[63] The Crown argues that even though the gains attributed to Peter Sommerer pursuant to subsection 75(2) are gains from the alienation of property by a person who is resident in Austria, and are thus within the scope of Article XIII (5), the only consequence is that Canada cannot tax the alienator – the Sommerer Private Foundation – on the gain. According to the Crown, Peter Sommerer can obtain no relief from Canadian tax under Article XIII (5) because he is not resident in Austria, and also because the tax in issue is not imposed on the basis that Peter Sommerer is the alienator of the shares, but by the operation of the attribution rule in subsection 75(2).

[64] Justice Miller rejected that argument because he considered it inconsistent with the language of Article XIII (5), and the apparent premise for another provision of the *Canada-Austria Income Tax Convention*, Article XXXVIII (2). In that provision, Canada reserves the right to tax residents of Canada on income and gains attributed to them pursuant to section 91 of the *Income Tax Act* (the foreign accrual property rules). The existence of that reservation suggests that an underlying premise of the *Canada-Austria Income Tax Convention* is that tax on attributed income generally is within its scope. There is no similar reservation relating to the attribution of income and gains under subsection 75(2), which means that Canada has not reserved the right to tax residents of Canada on income and gains attributed to them under subsection 75(2).

[65] The Crown argues that the reservation clause in relation to the attribution of income and gains under the foreign accrual property rules is not necessary but was included only for greater certainty, and that foreign jurisprudence establishes that domestic attribution rules do not conflict with international tax conventions based on the OECD model. However, having reviewed all of the

foreign cases and learned commentary to which the parties referred, I am unable to accept the Crown's argument.

[66] The OECD model conventions, including the *Canada-Austria Income Tax Convention*, generally have two purposes – the avoidance of double taxation and the prevention of fiscal evasion. Article XIII (5) of the *Canada-Austria Income Tax Convention* speaks only to the avoidance of double taxation. "Double taxation" may mean either juridical double taxation (for example, imposing on a person Canadian and foreign tax on the same income) or economic double taxation (for example, imposing Canadian tax on a Canadian taxpayer for the attributed income of a foreign taxpayer, where the economic burden of foreign tax on that income is also borne indirectly by the Canadian taxpayer). By definition, an attribution rule may be expected to result only in economic double taxation.

[67] The Crown's argument requires the interpretation of a specific income tax convention to be approached on the basis of a premise that excludes, from the outset, the notion that the convention is not intended to avoid economic double taxation. That approach was rejected by Justice Miller, correctly in my view. There is considerable merit in the opinion of Klaus Vogel, who says that the meaning of "double taxation" in a particular income tax convention is a matter that must be determined on the basis of an interpretation of that convention (*Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD –, UN –, and US Model Conventions for the Avoidance of Double Taxation on Income and Capital*, 3rd ed. (The Hague: Kluweer Law International, 1997)).

[68] I see no error of law or principle in the conclusion of Justice Miller that Article XIII (5) applies to preclude Canada from taxing Peter Sommerer on the capital gains realized by the Sommerer Private Foundation.

Conclusion

[69] For these reasons, I would dismiss the appeal with costs.

"K. Sharlow"

J.A.

"I agree
Pierre Blais, Chief Justice"

"I agree
Gilles Létourneau J.A."

**FEDERAL COURT OF APPEAL**

**NAMES OF COUNSEL AND SOLICITORS OF RECORD**

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| **DOCKET:** | A-188-11 |
| **STYLE OF CAUSE:** | HER MAJESTY THE QUEEN<br>v. PETER SOMMERER |
| **PLACE OF HEARING:** | Ottawa, Ontario |
| **DATE OF HEARING:** | May 9, 2012 |
| **REASONS FOR JUDGMENT BY:** | SHARLOW J.A. |
| **CONCURRED IN BY:** | **(**BLAIS C.J., LÉTOURNEAU J.A.) |
| **DATED:** | July 13, 2012 |

**APPEARANCES:**

| | |
|---|---|
| Luther P. Chambers<br>Martin Beaudry | FOR THE APPELLANT |
| Roger Taylor<br>Daniel Sandler | FOR THE RESPONDENT |

**SOLICITORS OF RECORD:**

| | |
|---|---|
| Myles J. Kirvan<br>Deputy Attorney General of Canada | FOR THE APPELLANT |
| Couzin Taylor LLP<br>Ottawa, Ontario | FOR THE RESPONDENT |