OFFSHORE INVESTMENT FUND PROPERTY RULES CLARIFIED BY THE TAX COURT

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The recent decision of the Tax Court of Canada in *Gerbro Holdings Company v. The Queen* ("***Gerbro***")[1] is the first judgment to consider the application of the offshore investment fund property rules (the "**OIFP Rules**") contained in section 94.1 of the *Income Tax Act* (Canada) (the "**Tax Act**") to interests in investment funds based in what have traditionally been viewed as "tax-havens".[2] The decision, a win for the taxpayer, held that tax considerations were not "one of the main reasons" motivating the taxpayer to invest in, and hold shares of, the offshore investment funds at issue. Therefore, the OIFP Rules were found not to apply to the taxpayer.

Background

The OIFP Rules are anti-avoidance rules intended to discourage taxpayers from investing in investment funds situated outside of Canada in order to reduce or defer their liabilities for Canadian tax. In highly simplified terms, the OIFP Rules apply where:

1. a taxpayer acquires an interest ("**Offshore Property**") in a foreign entity (other than a "controlled foreign affiliate"),
2. the investment can reasonably be considered to derive its value, directly or indirectly, principally from certain "portfolio investments" of the foreign entity (or any other non-resident person) (the "**Portfolio Test**"), and
3. it may reasonable be concluded that one of the main reasons for the taxpayer investing in the Offshore Property was to derive a benefit from portfolio investments in such a manner that the taxes, if any, on the income, profits and gains from such portfolio investments for any particular year are significantly less than the tax that would have been payable under Part I of the Tax Act if the income, profit and gains had been earned directly by the taxpayer (the "**Motive Test**").

Where the OIFP Rules apply in respect of a taxpayer's Offshore Property, the taxpayer is essentially required to include an amount in its income equal to the product of the deemed cost of the Offshore Property multiplied by a specified interest rate (currently, a prescribed interest rate[3] plus 2%), less any amount of income (but not capital gains) otherwise recognized by the taxpayer from the Offshore Property. This deemed income accrual gets added to the tax cost of the Offshore Property. The effect of this income inclusion is two-fold: it accelerates the recognition of income in respect of the Offshore Property, and it converts some gains that would otherwise be treated as capital gains (only half of which are subject to tax) into ordinary income.

The *Gerbro* Case

In *Gerbro*, the taxpayer, Gerbro Holdings Company ("**GHC**"), was a holding company that was wholly owned by a spousal trust established for the benefit of Marjorie Bronfman (the "**Spousal Trust**"). GHC was tasked with investing the capital and income of the Spousal Trust during Ms. Bronfman's lifetime. At issue was whether the OIFP Rules applied during the relevant taxation years to GHC's holdings of interests in five hedge funds based in the Cayman Islands, the Netherlands Antilles and the British Virgin Islands (collectively, the "**Hedge Funds**"). The Hedge Funds used a variety of active, alternative trading strategies, including long and short equity trading, fixed income trading, commodities trading, and derivatives transactions, to earn income and capture capital appreciation.

In applying the OIFP Rules, the Tax Court identified two key questions that needed to be addressed.

First, the Court inquired whether the underlying investments of the Hedge Funds were "portfolio investments" such that the Portfolio Test embedded within the OIFP Rules was satisfied. The taxpayer argued that a "portfolio investment" did not include assets used to derive income from an active business. Since the Hedge Funds engaged, directly or indirectly, in active trading strategies, the taxpayer reasoned that the underlying assets of the Hedge Funds were inventory used in an active investment business and should not be considered to be "portfolio investments". The Court rejected this argument, concluding that a "portfolio investment" entails an investment in which the investor is not able to exercise significant control or influence over the property invested in, consistent with what the Court concluded was the ordinary commercial meaning of the term[4]. On that basis, the Court concluded that GHC's interests in the Hedge Funds satisfied the Portfolio Test.

Second, the Court went on to analyze the motivations of GHC for investing in the Hedge Funds. In this regard, the Court held that the taxpayer's investments in the Hedge Funds did not satisfy the Motive Test within the OIFP Rules. While the Court found that tax considerations were one of the reasons motivating GHC's investment in the Hedge Funds, they were not one of the *main reasons* for such investments. Rather, the Court held that "compelling business reasons and the [Hedge Funds] managers' reputations were Gerbro's dominant reasons for investing". In particular, the Court found, as a factual matter, that GHC's reasons for investing in the Hedge Funds were:

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.

Given that the last three reasons stood totally independent of any possible tax considerations, the Court concluded that, while obtaining a tax benefit (which would presumably affect the after-tax return of the investments) may have been a reason for investing in the Hedge Funds, it was less important than the commercial reasons for the investments and was, therefore, not a "main reason".

In supporting its factual findings, the Court cited a number of factors. First, and likely most important to the Court's decision, the terms of the Spousal Trust provided that, on Ms. Bronfman's death, the trust's assets were to be distributed to the various heirs of her husband. Given that Ms. Bronfman was 88 during the relevant taxation years, the Court accepted that the need to minimize volatility and make liquid investments was of paramount importance to the taxpayer's investment strategy and that the investments in the Hedge Funds allowed the Spousal Trust to achieve that goal. Second, the Court accepted the taxpayer's argument that it simply could not replicate the underlying investment strategies of the Hedge Funds without investing in the Hedge Funds. Third, the Court found that the nature of the Hedge Fund industry was that the identity and reputation of fund managers were important to investors. Finally, the Court repeatedly observed that the taxpayer was not involved in establishing the Hedge Funds – it simply invested in whatever shares the funds offered for sale – thus, the Hedge Funds were not artificially manipulated to obtain a tax deferral.[5]

More broadly, the Court provided useful guidance for applying the Motive Test in other cases. The Court acknowledged that the "line between a main reason and a secondary reason is difficult to draw" and that the required analysis is "entirely factual". The Court went on to enunciate the following interpretive principles, which are to be applied when analyzing the facts of a particular case:

1. A taxpayer's reasons for investing can be disclosed or undisclosed, and the fact that a tax-avoidance reason is undisclosed, as is often the case, does not prevent a court from inferring that such a reason existed;
2. There can be more than one main reason for investing in a non-resident entity;
3. The Motive Test is not a sine qua non test under which the Court must conclude that tax avoidance was not a main reason for investing if it is convinced that the taxpayer would have invested notwithstanding the absence of any tax benefit;
4. It is improper to conclude that resulting tax savings automatically lead to the inference that obtaining those tax savings must have been a main reason for investing; and
5. Choosing to invest in a non-resident entity when there was the possibility of investing in another vehicle triggering a larger tax liability is not necessarily determinative of whether a tax benefit was a main reason for investing.

The Court also observed in passing that one "can argue that the more important a reason for investing is, the harder it will be to elevate another reason, such as obtaining a tax deferral benefit, to the same level".

Analysis

Gerbro is important because it is the first case to consider the application of the OIFP Rules to an investment in an offshore investment fund and, therefore, provides some guidance as to how the courts and the Canada Revenue Agency (the "**CRA**") will interpret and apply the rules in the future.

At a minimum, the Court's decision in *Gerbro* confirms that the mere fact that one invests in an investment fund that is situated in a "tax-haven" is not sufficient to satisfy the Motive Test when applying the OIFP Rules. Based on prior jurisprudence dealing with other sections of the Tax Act, this result is not surprising; nevertheless, it is comforting to have the principle confirmed in the context of applying the OIFP Rules.

Perhaps more importantly, the decision in *Gerbro* also stands for the proposition that simply because a taxpayer may have a tax purpose for investing in a particular fund does not necessarily mean that such purpose was one of the "main purposes" for making the investment. If achieving a tax benefit is simply a secondary or ancillary purpose to other, *bona fide* commercial objectives motivating an investment in an offshore fund, it is not "one of the main reasons" for making that investment. This is a helpful conclusion, since it would be unusual for tax considerations to not be at least a factor affecting the investment decisions of a sophisticated investor. Gerbro shows that it is possible to invest in an offshore fund without triggering the OIFP Rules.

That being said, investors should be careful about trying to read too much into the *Gerbro* decision. The Court's decision does not mean that investors in offshore funds no longer need to worry about the OIFP Rules. The application of the OIFP Rules to a particular taxpayer's investment in an offshore fund will be highly sensitive to the particular facts and circumstances motivating the investment in such fund. The facts in *Gerbro* were particularly favourable to the taxpayer, in particular, the Court's conclusion that the taxpayer had to invest in liquid assets with minimal volatility to accommodate the required transactions that would take place following Ms. Bronfman's death. This provided, or at least so the Court concluded, a compelling overriding reason for investing in the Hedge Funds relative to other investments that was unrelated to tax considerations. In different circumstances, similar investments by other investors might not give rise to the same results. Therefore, taxpayers making investments in offshore funds will need to continue to carefully assess whether the OIFP Rules apply to their investments in their particular circumstances. Given the factual nature of the decision in *Gerbro*, it will be interesting to see whether the CRA appeals the decision, or simply tries to distinguish this decision in future cases dealing with the OIFP Rules.

One important take-away from the *Gerbro* case is the importance of taxpayers carefully document their investment strategy and investment considerations when making an investment in an offshore fund. In this case, the taxpayer was able to introduce its investment guidelines, meeting minutes, and internal memoranda outlining the analysis and reasoning motivating its investment in the Hedge Funds, which documentation reinforced the testimony of the taxpayer's president that tax was not a primary driver of its investment strategy. Absent the compelling documentation of the taxpayer's investment strategy, and the institutional knowledge held by its president, it may have been more difficult for the taxpayer to satisfy the Court that tax considerations were not one of the "main reasons" motivating its investments in the Hedge Funds. Investors proposing to make investments in offshore funds on the basis that the OIFP Rules do not apply to them may be well advised to prepare and retain similar supporting documentation in the event that their position is challenged by the CRA.

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1. 2016 TCC 173
2. The only other decision to have considered the OIFP Rules, *Walton v. The Queen*, 98 DTC 1780 (TCC), dealt with a very different fact pattern. As a result, the judgment in *Walton* did not provide much meaningful guidance to investors looking to invest in offshore funds.
3. The prescribed rate is determined by the Canada Revenue Agency on a quarterly basis based on the yield of Government of Canada treasury bills.
4. The Court did acknowledge that this interpretation broke down insofar as it applied to investments in commodities or real estate, but attributed this to sloppy legislative drafting.
5. This stands in sharp contrast to the facts in *Walton, supra* note 2, where the taxpayer's investment in the foreign entity was carefully structured to avoid triggering the controlled foreign affiliate provisions of the Tax Act.

A Cautionary Note