Principles of Rectification in the Canadian Tax Context - Sas Ansari

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Principles of Rectification in the Canadian Tax Context

Canada (AG) v Fairmont Hotels Inc, 2016 SCC 56

In this 7:2 decision of the Supreme Court of Canada, the Court agreed that the test for rectification is not modified in the tax context, but disagreed about the scope of its application (the dissent felt that the majority decision unduly restricted the remedy).

This is an important decision that will cause insurers of tax professionals and tax professionals themselves to re-evaluate the risks of tax planning.

FACTS

This involved a financing arrangement that the parties intended, both at inception and ongoing, to operate on a tax neutral basis. However, unintended tax liability was incurred and the courts below allowed rectification on the basis of the intended tax neutrality.

ANALYSIS

Majority

The majority held that rectification is limited to "cases where the agreement between the parties was not correctly recorded in the instrument that became the final expression of their agreement" and would not be available to undo what are unanticipated effects of that agreement (para 3). Rectification is available to ensure that was intended is actually done, but not to salvage an agreement on the basis of what was hoped to be done. It is a potent remedy to be used with great caution to avoid undermining the confidence in contracts.

The majority held that *Juliar v. Canada (Attorney General)* (1999), 46 O.R. (3d) 104 (S.C.J.), *aff'd* (2000), 50 O.R. (3d) 728 (C.A.), is not reconcilable with the SCC jurisprudence as to rectification, expanding its scope (para 19). As the SCC in *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622, at para. 45 stated that a taxpayer should be taxed on what it actually did not what it could have done or hoped it did (para 23). The majority put an end to taxpayer arguments that the Crown would be unjustly enriched or would obtain a tax windfall (para 24):

[...]Tax consequences, including those which follow an assessment by the CRA, flow from freely chosen legal arrangements, not from the intended or unintended effects of those arrangements, whether upon the taxpayer or upon the public treasury. The proper inquiry is no more into the "windfall" for the public treasury when a taxpayer loses a benefit than it is into the "windfall" for the taxpayer when that taxpayer secures a benefit. The inquiry, rather, is into what the taxpayer agreed to do. *Juliar* erroneously departed from this principle, and in so doing allowed for impermissible retroactive tax planning: *Harvest Operations Corp. v. Canada (Attorney General)*, [2015 ABQB 327](http://incometaxact.ca), [2015] 6 C.T.C. 78, at para. 49

A court may exercise its equitable jurisdiction and grant rectification where the legal instruments do not accord with the agreement they were meant to record (a term was omitted, an unwanted item included, a term incorrectly expressed) (para 12). In other words, "rectification allows a court to achieve correspondence between the parties' agreement and the substance of a legal instrument intended to record that agreement, when there is a discrepancy between the two[, such that its] purpose is to give effect to the parties' true intentions, rather than to an erroneous transcription of those true intentions" (para 12). It is a remedy only available "where a written instrument has incorrectly recorded that parties' antecedent agreement" and is not "concerned with mistakes merely in the making of that antecedent agreement" (para 13). Rectification cannot amend the agreement only the instrument recording the agreement.

Rectification is available for two types of errors.

The first is where both parties suffer from a common mistake that the instrument accurately records their antecedent agreement. The parties must demonstrate (para 14):

- the parties had reached a prior agreement;
- the terms of this prior agreement as definite and ascertainable;
- the agreement was effective when the instruments were executed;
- the instrument(s) fail(s) to record that prior agreement accurately; and
- if rectification is granted, as proposed, the instrument would, in fact, carry out the prior and continuing agreement.

The second is where a mistake claimed is unilateral (the parties disagree as to whether the instrument contains a mistake as to the agreement). In such as case, the following preconditions must be met by the party seeking rectification (para 15):

- the party resisting rectification knew or ought to have known about the mistake; and
- permitting that party to take advantage of the mistake would amount to "fraud or the equivalent of fraud".

Rectification is NOT:

- available to cure a party's error in judgment in entering into an agreement (para 19);
- able to give an outcome or a benefit that, in hindsight, the parties should have agreed to (para 19);
- to be used to amend an agreement, only to align the written recording of the agreement with the actual agreement (para 19);
- there to secure a tax advantage but to ensure the benefits of an agreement entered into but wrongly recorded are obtained (para 21);
- available to avoid unintended or unanticipated tax consequences of an intended agreement (para 21);
- available absent a prior agreement, and requires a continuing intention to enter into that prior agreement at the time the documents are executed (para 28);
- available to correct common mistakes of judgment that frustrate the parties' aspirations or unspecified plans, only common mistakes in recording the intended prior agreement (para 31);
- available unless the party seeking rectification can demonstrate which terms were omitted or incorrectly recorded AND the terms that would correctly record the agreement (para 32);
- there to create an agreement where none is present (para 32);

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Dissent

The difference in opinion between the majority and the dissent was as to the threshold of granting rectification, not when the remedy is available. Also, the dissent was of the opinion that intention does not have to amount to a fully enforceable agreement (para 59), only that it be sufficiently clear and certain so that the courts can correct the error without resorting to speculation about what the parties intended to do (para 60). The dissent would have allowed rectification not only to correct the recording of the agreement but also the implementation of the agreement (para 67).

In short, the dissent was of the opinion that errors in tax planning where, if the tax planning was done properly, the crown would not be prejudiced are a proper area for rectification. The dissent agreed that taxpayers should be taxed on what they did not what they could have done (para 71), but that genuine intention to obtain a tax outcome should allow rectification of errors in recording and implementation (para 72).

The dissent stated:

[43]   I agree that there is no adjustment to the test for rectification if the context is a tax case. With respect, however, I do not agree that the test was not met in this case.

[44]   The doctrine of rectification has many strands. The jurisprudence addresses errors in the transcription and implementation of documents, different types of mistakes, the rights of third parties, and how the remedy applies in various legal contexts. A coherent approach to all of these strands flows from the underlying theory that parties should not be prevented from having their true intentions implemented because of these errors. It is, after all, an equitable remedy that seeks to prevent the unfairness that results from enforcing a mistake, including the unfairness inherent in unjust enrichment and windfalls.

[45]   I see the approach applied by my colleague as unduly narrowing its scope. A common, continuing, definite, and ascertainable intention to pursue a transaction in a tax-neutral manner has usually satisfied the threshold for granting rectification. The additional requirement that the parties clearly identify the precise mechanism by which they intended to achieve tax neutrality, and how that mechanism was mistakenly transcribed in a document, has the effect of raising the threshold and frustrating the purpose of the remedy. It also has the regrettable effect of imposing a narrower remedy in the common law than exists under civil law.

[46]   The Application Judge concluded that the intention of the parties had been mistakenly implemented and that rectification was justified. The Court of Appeal agreed. As do I. Based on the factual findings and the applicable jurisprudence, the threshold has been met. I would dismiss the appeal.

NOTE: With respect to the dissenting members, the parties ought to be able to show how the agreement they entered into fails to record their intended agreement incorrectly AND how the agreement should have recorded it. Where a party cannot show what terms should have been included in the agreement, which should have been excluded, or how the terms included should have been worded, rectification cannot lie.

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