

Update on Rectifications

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Topics to Discuss

1. Introduction:
2. *Fairmont Hotels* case
3. *B.C. Trust* case
4. *Canada Life* case
5. *5551928 Manitoba* case

What is Rectification ?

- Rectification is one of the equitable remedies available to a superior court of a province to relieve against that which is unfair, unconscionable, or unjust
- Rectification has traditionally been considered an equitable remedy that is available to correct a written agreement when the parties were in agreement on the terms of their contract but, by mistake, wrote them down incorrectly
- It is a remedy, however, that may be used in appropriate circumstances to avoid an adverse tax consequence from a completed transaction

The elements that must be proven to obtain a rectification order are as follows:

- The parties had a common intention before making the written instrument alleged to be deficient;
- This common intention continued unchanged at the time the written instrument was executed;
- The written instrument mistakenly did not conform to the prior common intention; and
- The party seeking relief can show the precise form in which the written instrument can be made to express the prior common intention.

Canada (Attorney General) v. Fairmont Hotels Inc.

When is rectification available to avoid adverse tax consequences ?

- Fairmont and two of its Canadian subsidiaries entered into a financing arrangement with a Legacy Hotels REIT to manage two U.S. hotels acquired by Legacy
- The financing was done in U.S. dollars, and to avoid FX exposure, Fairmont entered into a reciprocal U.S. dollar loan with Legacy through its subsidiaries
- When Fairmont was acquired by arm's length investors, Fairmont and its subsidiaries were faced with an FX loss
- Plan proposed whereby Fairmont but not its two subsidiaries would trigger FX gains and losses in the same year – but dealing with the exposure of the two subsidiaries was deferred



Canada (Attorney General) v. Fairmont Hotels Inc. ...cont'd

- When Legacy went to sell the two U.S. hotels, it requested Fairmont to unwind the reciprocal loans, which Fairmont did by redeeming its shares in its subsidiaries
- Unexpectedly, a CRA audit revealed that the redemption triggered taxable gains
- Fairmont sought rectification on the basis that the original intention of Fairmont and its subsidiaries was tax neutrality, and this share redemption resulted in an inadvertent negative tax consequence, contrary to the parties' original intention

Canada (Attorney General) v. Fairmont Hotels Inc. ...cont'd

- The lower courts followed the precedent in *Juliar v. Canada (Attorney General)*, in which the issuance of shares was substituted for debt in order to avoid a taxable deemed dividend, in accordance with the parties' original intention to have a tax-neutral transaction
- However, the Supreme Court of Canada drew back from that extension of the applicable jurisprudence
- The Court rejected tax neutrality as a sufficient basis for rectification
- Rectification is limited to cases where the agreement between the parties was not correctly recorded in the final instrument
- It does not undo unanticipated effects of that agreement; a court cannot change the agreement to salvage what a party hoped to achieve

Canada (Attorney General) v. Fairmont Hotels Inc. ...cont'd

What can we learn from this case ?

- In order to seek equitable relief from unintended tax consequences, the taxpayer must prove the existence of the traditional elements the courts have looked for, namely:
 - The parties had a common intention before making the written instrument alleged to be deficient;
 - This common intention continued unchanged at the time the written instrument was executed;
 - The written instrument mistakenly did not conform to the prior common intention; and
 - The party seeking relief can show the precise form in which the written instrument can be made to express the prior common intention.

BC Trust v. Attorney General for Canada

How do the rectification rules apply to trusts where unintended tax consequences arise ?

- The trustees of a BC trust allocated its income from 2002 to 2011 to an Alberta trust which was a beneficiary, but when audited by the CRA and faced with disallowances, decided not to allocate its income in 2012
- The trustees settled the dispute for the earlier years and applied to Court for rectification to permit the trustees to pass a resolution to allocate the trust's income in 2012 to the Alberta trust

BC Trust v. Attorney General for Canada ...cont'd

- The Crown objected arguing that this would amount to retroactive tax planning, contrary to the principles of *Fairmont Hotels*
- There was no evidence that the Trustees' decision was based on a mistake of any kind, but rather was a result of the Trustees exercise their discretionary powers under the Trust Settlement
- The Court followed *Fairmont Hotels* and held that rectification is not available where the basis for seeking it is a party's wish to amend, not the instrument that records an agreement, but the agreement itself

BC Trust v. Attorney General for Canada ...cont'd

What can we learn from this case ?

- The principles from *Fairmont Hotels* require there to be an existing agreement that has not been properly recorded, and the civil court be an appropriate venue to seek the remedy of rectification to restore the parties to the position they would have been in if the original common intention had been properly implemented
- The Court indicated that the Trustees were free to pass a resolution in respect of the 2012 income allocation and have the Tax Court determine its consequences (whatever that may be)

The Canada Life Insurance Company v. Attorney General of Canada

Can a court grant rectification or another equitable remedy after the restrictions imposed by the Supreme Court in *Fairmont Hotels* ?

- In 2007 Canada Life entered into a series of transactions with affiliates, leaving it with FX exposure in connection with USD denominated investment in a limited partnership
- As the CAD increased in value, and facing an exposed FX capital gain, Canada Life entered into a series of transactions to create an FX capital loss to offset the expected capital gain, involving the dissolution of the limited partnership and the transfer of its assets to the partners, including Canada Life

The Canada Life Insurance Company v. Attorney General of Canada

- The CRA rejected the realization of the capital loss on the basis that the automatic rollover rules of subsection 98(5) preclude such a recognition
- At the Superior Court before *Fairmont Hotels* decided, Canada Life obtained its rectification order, which the AG appealed to the Ontario Court of Appeal
- Here the parties agreed that rectification was no longer available, but Canada Life sought to have the Court exercise its inherent jurisdiction in equity and equitable rescission to reverse the steps in the reorganization to achieve the desired capital loss

The Canada Life Insurance Company v. Attorney General of Canada

- The Court held that the relief sought, albeit by a different name, is the very type of correction of an error in the structuring and implementation of a transaction to achieve a particular tax result that the Supreme Court rejected in *Fairmont Hotels*
- Rescission of a contract entered into by mistake requires the parties to establish:
 - The parties were under a common misapprehension as the facts or their respective rights,
 - The misapprehension was fundamental,
 - The party seeking relief was not itself at fault, and
 - One party will be unjustly enriched at the expense of the other party if equitable relief is not granted

The Canada Life Insurance Company v. Attorney General of Canada

- The Court held that none of these requirements was met in this case
- The Court agreed with the AG that Canada Life's objective was to avoid an adverse tax consequence by retroactively changing the facts on which the CRA's assessment was based
- The Court also asserted that what Canada Life was seeking amounted to retroactive tax planning, something precluded by the Supreme Court
- It held that retroactive tax planning includes attempts to change one's affairs so that tax consequences that were intended, but which were prevented by mistake, can be achieved

The Canada Life Insurance Company v. Attorney General of Canada

What can we learn from this case ?

- The principles for granting equitable relief articulated by the Supreme Court in *Fairmont Hotels* extend beyond rectification to any order for equitable relief available to a court based on its inherent jurisdiction
- Tax consequences flow from the transaction the taxpayer undertakes, including the legal relations actually created, and not from its motivations or objectives

5551928 Manitoba Ltd.(Re)

How do the rectification rules apply to capital dividend distributions where unintended tax consequences arise ?

- The corporate taxpayer (“555”) sold a property and realized a capital gain in its 2015 taxation year ending August 31, 2015
- The accountants for 555 advised that an amount of \$184,880 attributable to eligible capital property could be included in the corporation’s capital dividend account and be paid out as a tax-free dividend by December 31, 2015

*5551928 Manitoba Ltd.(Re)...*cont'd

- The directors declared the dividend payable on December 31, 2015 to pay out the entire capital dividend account as a tax-free capital dividend
- The CRA rejected the calculation of the capital dividend account, as the ITA only permits eligible capital property to be included at the end of the taxation year, namely after August 31, 2016
- The CRA assessed 555 a penalty tax for the excessive dividend of 60% times the excessive amount of \$184,789
- 555 applied to the British Columbia Supreme Court for an order rectifying the board's resolution

*5551928 Manitoba Ltd.(Re)...*cont'd

- The Crown argued that 555 did not have evidence to show that there was a prior agreement with definite and ascertainable terms supporting the request for rectification
- The Court disagreed, and held that the direction from 555 to the accountants to determine the maximum amount in the capital dividend account that could be paid out tax-free constituted a definite and ascertainable agreement
- Moreover, the wording of the directors' resolution stated their intention to have the full amount of the dividend be treated as a tax-free capital dividend in payment of the maximum amount available in the capital dividend account
- The only flaw was the error of the accountants

5551928 Manitoba Ltd.(Re)...cont'd

- The Crown sought to have the Court accept the directors' resolution with the precise figure for the capital dividend to be determinative of the issue against 555
- However, the Court held that in doing so, it would be determining an agreement that was inconsistent with the evidence of the directors, the evidence of the accountants and the language of the board's resolution
- In following the principles laid out in *Fairmont Hotels*, the Court held that 555 did not engage in "bold tax planning" that should be discouraged; 555 did not seek to modify the instrument merely because its operation generated an unplanned tax liability; rather the agreement from the outset was only to issue a tax-free capital dividend



*5551928 Manitoba Ltd.(Re)...*cont'd

- The Court also held that there was no evidence the board acted recklessly, failed to take proper due diligence actions; rather, they consulted with reputable accountants concerning a complex provision in the ITA
- Furthermore, the Court was not being asked to wholly rewrite or unwind a complex transaction; rather the proposed rectification simply substitutes the correct figure for the incorrect figure

5551928 Manitoba Ltd.(Re)...cont'd

What can we learn from this case ?

- The basic rules laid out in *Fairmont Hotels* can give rise to a positive rectification order where
 - The instrument in question produces a result which is inconsistent with the evidence of the parties as to their original intention
 - The parties seek to modify an instrument to correct a mistake but not to fashion a new agreement
 - There is no peripheral evidence of the parties engaging in aggressive tax planning or acting recklessly



Questions?



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