Supreme Court of Canada clarifies the remedy of rectification in Canadian tax cases

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The Supreme Court's decisions in *Fairmont* and *Jean Coutu* (*PJC*)

On December 9, 2016, the Supreme Court of Canada released two much-awaited decisions in *Fairmont* [1] and in *PJC* [2] that clarified the scope of the remedy of rectification in Canada, with broad implications for tax planning as well as commercial cases.

The equitable doctrine of rectification, like its equivalent in the civil law, is intended to address situations where parties have agreed on contractual terms, but through inadvertence, their written contract does not reflect these terms. The doctrine of rectification originally applied only where there was clear evidence that the parties had agreed to specific terms that were not recorded in a written agreement.

In recent years, there has been a trend in Canadian tax cases towards a more flexible approach to rectification that gives effect to the continuing specific intention of the parties. In particular, rectification has been granted to remedy a situation where the parties' written agreement correctly recorded the intended terms of a transaction or series of transactions, but did not achieve the parties' desired tax result. Rectification was granted because the agreement as recorded did not carry out the parties' continuing intention to undertake a transaction on a particular tax basis, even though it correctly recorded the legal relationships that the parties intended.

In both *Fairmont* and *PJC*, the 7-2 majority of the Supreme Court found that rectification is limited to circumstances where the parties had a prior agreement that was not recorded correctly in the written instrument(s) governing their legal relationships. The line of cases that suggested a broader approach to rectification was overruled.

Equitable doctrine of rectification

Historically, rectification in common law jurisdictions was granted in limited circumstances where the parties had reached a prior agreement, but the document(s) evidencing the contract did not reflect the terms of this agreement.[3] In 1953, Lord Denning held that "in order to get rectification it is necessary to show that the parties were in complete agreement on the terms of their contract, but by an error wrote them down wrongly."[4]

By the year 2000, the requirements for obtaining rectification in the Canadian tax context were interpreted in a somewhat more flexible manner.

The *Juliar* approach

In Canadian tax law, tax consequences generally flow from the legal effect of the governing documents. Legal relationships are recharacterized for tax purposes only in certain situations.[5] As a result, where there is an error in a legal document, that error may lead to unintended tax consequences even where it is contrary to the intention of the parties.

Taxpayers who faced an unexpected Canadian tax liability as a result of certain errors have turned to rectification as a potential remedy.

Juliar [6] was the cornerstone of Canadian tax-related rectification decisions. The Ontario Superior Court in *Juliar* did not require that the party seeking rectification must have determined the precise mechanics or terms by which the party would realize its desired outcome.[7] It was sufficient in *Juliar* that the parties had a common and continuing intention to carry out a transfer of property without creating a tax liability on the transfer of the property. After the Ontario Court of Appeal upheld this decision, the Supreme Court refused leave to appeal.

Following *Juliar*, some courts granted rectification in tax-related cases where the parties had created the legal relationships that they intended to create, but the tax result arising from the legal relationships was unexpected and clearly not intended by the parties.

Performance Industries and *Shafron*

Following its refusal to hear *Juliar* in 2000, the Supreme Court heard two rectification cases that arose in a non-tax context in common law provinces. In *Performance Industries* (2002) [8] and *Shafron* (2009),[9] the Supreme Court focused on whether or not written agreements reflected the exact terms to which the parties had previously agreed.[10]

Fairmont resolves tension between the *Performance Industries* approach and the *Juliar* approach

The *Juliar* line of cases was not consistently followed, particularly outside of Ontario. While some commentators suggested that the *Juliar* concept of rectification (as applied in the lower courts' decision in *Fairmont*) cast too wide a net for rectification,[11] others viewed the *Juliar* framework as correct, and argued that the criticisms levied against that approach were exaggerated or unfounded.[12]

Fairmont [13] arose in this context. Upon hearing the applicant's request for rectification, the Ontario Superior Court and the Ontario Court of Appeal followed the approach set out in *Juliar*, and granted rectification on the basis that the parties had a common and continuing intention to hedge currency risk on a tax neutral basis, and had originally determined that their intention would be frustrated if share redemptions took place. Share redemptions were, nevertheless, mistakenly carried out. The lower courts allowed the parties to substitute loans in place of the share redemptions in order to achieve Fairmont's tax-neutral hedging objective. In contrast, the Supreme Court allowed the Attorney General's appeal, and agreed that a mere general intention to carry out transactions on a "tax neutral" basis was not sufficient to entitle the parties to rectification. The majority of the Supreme Court agreed that the Ontario Court of Appeal erred in applying the *Juliar* threshold for rectification, and instead applied the higher threshold set out in the *Performance Industries* and *Shafron* decisions.

Takeaways from *Fairmont*

Rectification may still be available to remedy unexpected tax liabilities, provided the circumstances warrant rectification under the traditional equitable rectification doctrine. The majority in *Fairmont* provided the following guidance on when rectification may be granted:

Where the error is said to result from a mistake common to both or all parties to the agreement, rectification is available upon the court being satisfied that, on a balance of probabilities, there was a prior agreement whose terms are definite and ascertainable; that the agreement was still in effect at the time the instrument was executed; that the instrument fails to accurately record the agreement; and that the instrument, if rectified, would carry out the parties' prior agreement.[14]

On a go-forward basis, the Court's ruling underscores the importance of careful and considered legal drafting that documents the parties' intentions. The decision also underscores the importance of comprehensive tax planning that sets out not only the intended result, but also concrete legal steps and relationships required to obtain the result that are agreed to by the parties.

Furthermore, parties should consider creating records that memorialize their intentions, noting both what they intend to achieve and how they intend to achieve it. Such records would include adding more detailed recitals to key agreements, and otherwise creating contemporaneous documentation of what was intended at the time the agreement was entered into.

Civil law rectification – the decision in *PJC*

Fairmont's companion judgment, *PJC*, is a civil law case from Québec. Although the term "rectification" is used in Québec civil law, there is, strictly speaking, no doctrine of rectification in Québec. The Québec civil law remedy is provided by article 1425 of the Civil Code of Québec (CCQ), which requires that "The common intention of the parties rather than adherence to the literal meaning of the words shall be sought in interpreting a contract," thereby distinguishing between the actual agreement between two parties and the means by which they expressed that agreement.

Unlike *Fairmont*, which marked the first Supreme Court decision on rectification in the tax context, *PJC* came just three years after the Supreme Court decided a civil law tax rectification case: *AES*.[15] The *AES* case dealt with two civil law applications for rectification. Both sought to correct mistakes made in the course of implementing structures that, absent those mistakes, would have been tax neutral. Justice LeBel upheld the taxpayers' corrections in a unanimous decision, relying solely on the CCQ rather than importing common law rectification. He noted that in civil law, consensualism is fundamental to the law of contracts and parties are free to correct documents to reflect their common intention, subject to third-party rights. However, he stated that "tax authorities do not have an acquired right to benefit from an error made by the parties to a contract after the parties have corrected the error by mutual consent."[16] Conversely, Justice LeBel found that a common intention to reduce one's tax liability is not enough on its own to support rectification. Ultimately, the evidence supported a common intention in both cases to carry out the tax plans as set out in the rectified contracts, but Justice LeBel strictly limited the precedential value of his decision to the civil law context.

PJC involved a straightforward application of the principles previously set out in *AES*, though unlike *AES* the taxpayer in *PJC* was unsuccessful. The main implication of *PJC* is its

confirmation, echoed in *Fairmont*, that common law and civil law rectification should generally produce consistent outcomes. Despite difference in the underlying law, that principle means that common law cases should have persuasive value in Québec, and vice versa. *PJC* also provides a useful example of a failed rectification, which combined with *AES*, helps to demonstrate where the line should — or at least henceforth will — be drawn.

The full *Fairmont* decision is available at http://scc-csc.lexum.com/scc-csc/scc-csc/en/item/16281/index.do.

The full *PJC* decision is available at http://scc-csc.lexum.com/scc-csc/scc-csc/en/item/16280/index.do.

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[1] *Canada (Attorney General) v. Fairmont Hotels Inc.*, 2016 SCC 56 (*Fairmont*).

[2] *Jean Coutu Group (PJC) Inc. v. Canada (Attorney General)*, 2016 SCC 55 (*PJC*).

[3] *Dynamex Canada Inc. v. Miller* (*Dynamex*), 78 A.C.W.S. (3d) 725, 1998 CarswellNfld 88 at para 23.

[4] *Frederick E. Rose (London) Ltd. v. William H Pim Jnr. & Co.* C.A, as cited in *Dynamex* at para 17.

[5] *Shell Canada Ltd v. R.*, [1999] 3 S.C.R. 622, 1999 CarswellNat 1808 at para 39.

[6] *Juliar v. Canada (Attorney General)*, 1999 CarswellOnt 2970, aff'd by the Ontario Court of Appeal in 50 O.R. (3d) 728, 8 B.L.R. (3d) 167; leave to appeal to SCC refused, [2000] SCCA No 621.

[7] *Fairmont Hotels Inc. v. Canada (Attorney General)*, 2015 ONCA 441, 2015 CarswellOnt 8955 at para 10.

[8] *Performance Industries Ltd. v. Sylvan Lake Golf & Tennis Club Ltd.*, 2002 SCC 19, [2002] 1 SCR 678 (*Performance Industries*).

[9] *Shafron v. KRG Insurance Brokers (Western) Inc.*, 2009 SCC 6, [2009] 1 SCR 157 (*Shafron*).

[10] See, for example, *Performance Industries*, at para 40; *Shafron* at para 57.

[11] See, for example, Bruce S. Russell and Karen D. Stilwell, "Aspects of Fixing Mistakes in Tax Context: Rectification and Due Diligence" 2009 Atlantic Provinces Tax Conference (Halifax: Canadian Tax Foundation, 2009) at 6A:1-46.

[12] See, for example, Jeff Oldewening, Rachel A. Gold, and Chris Sheridan, "Statutory Rectification" in Derek Alty et al, eds, Corporate Tax Planning (2016) 64:1 Canadian Tax Journal 293-325.

[13] 2014 ONSC 7302, 2014 CarswellOnt 17975.

[14] *Fairmont* at para 38.

[15] *Quebec (Agence du revenu) v. Services Environnementaux AES inc.*, [2013] 3 SCR 838, 2013 SCC 65.

[16] *Ibid* at para 52.