

Getting it Right: The Remedy of Rectification in Canadian Tax Law

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In Canadian tax law, the tax consequences of a contract generally flow from its legal effect. Legal relationships are recharacterized for tax purposes only in certain situations. As a result, where there is an error in a contract, that error may lead to unintended tax consequences even where it is contrary to the parties' intentions. Taxpayers faced with unexpected Canadian tax liabilities in such circumstances have turned to rectification as a potential remedy.

The equitable doctrine of rectification, like its equivalent in civil law, is intended to address situations where parties have agreed on the terms of a contract, but through inadvertence, the contract does not reflect those terms. This remedy was originally available 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, a trend had developed in Canadian tax cases towards a more flexible approach to rectification that would give effect to the common or continuing intention of the parties. In particular, relief would be granted in situations where the parties' written agreement correctly recorded the intended terms of a contract or transaction, but did not achieve their desired tax result.

The Supreme Court of Canada recently released its much-awaited decisions in *Canada (Attorney General) v. Fairmont Hotels Inc.*¹ and *Jean Coutu Group (PJC) Inc. v. Canada (Attorney General)*.² These two decisions have clarified the scope of rectification in Canada, with significant implications for tax planning as well as commercial cases. In both decisions, the 7-2 majority of the Supreme Court held that rectification will be limited to circumstances where the parties had a prior agreement that was not recorded correctly in the written instrument(s) governing their legal relationships.

Following the decisions in Fairmont and PJC, rectification may still be available in cases involving unexpected tax liabilities, provided the circumstances warrant it. The majority in Fairmont provided the following guidance on when the remedy 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

¹ 2016 SCC 56 ("Fairmont").

² 2016 SCC 55 ("PJC").

accurately record the agreement; and that the instrument, if rectified, would carry out the parties' prior agreement."³

In dissent, Justices Abella and Côté observed that the majority's approach would have the effect of unduly narrowing the scope of the doctrine. Allowing the tax authority to profit from legitimate tax planning errors, when its own rights have not been prejudiced in any way, would amount to unjust enrichment. The minority emphasized that taxpayers are entitled to structure their affairs in a way that minimizes their tax burden, and that "the tax authorities are not entitled to play 'Gotcha' any more than would any other third party who did not rely to its detriment on the mistake."⁴

In contrast, Justice Brown for the majority was clear that "rectification is not equity's version of a mulligan."⁵ Courts rectify instruments which do not correctly record agreements. Courts do not modify an instrument merely because a party has discovered that its operation generates an adverse and unplanned tax liability. In other words, rectification requires more than a common or continuing intention that a contract or transaction be tax-neutral, and will not be permitted if it would amount to retroactive tax planning.

The companion judgment to *Fairmont*, PJC, is a civil law case that originated from Québec. Although the term "rectification" is used in 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, which requires that "[t]he common intention of the parties rather than adherence to the literal meaning of the words shall be sought in interpreting a contract." In this regard, the Code distinguishes between the actual agreement between the parties and the means by which they expressed that agreement.

The central implication of PJC is its confirmation, echoed in *Fairmont*, that common law and civil law rectification should generally produce consistent outcomes. Despite the differences in the underlying law, common law cases should have persuasive value in Québec, and vice versa.

The rulings in *Fairmont* and PJC highlight the need for meticulous drafting that fully and contemporaneously documents the parties' intentions. These rulings also underscore the importance of comprehensive tax planning that sets out not only the intended tax result, but also the steps and relationships required to obtain it. To this end, parties to a contract or transaction should consider creating records with more detailed information that memorialize their intentions, noting both *what* they intend to achieve and *how* they intend to achieve it.

³ *Fairmont*, para 38.

⁴ *Fairmont*, para 84.

⁵ *Fairmont*, para 39.