Case Commentary – Canada (Attorney General) v. *Fairmont* Hotels Inc. 2016 SCC 56 ("*Fairmont*") Released December 9, 2016

SCC Overrules *Juliar*

Comment by J. Andre Rachert, Cook Roberts LLP dated December 12, 2016

In common law the doctrine of rectification operates to correct mistakes in transactions that produce unintended or adverse results. Since 2000, *Juliar v. A.G. (Canada (2000), 50 OR (3d) 728 ONT. CA)* ("***Juliar***"), has been the leading case on tax rectification in Canada.

In a 7/2 decision the Supreme Court of Canada ("SCC") has overruled the *Juliar* decision. Justice Brown wrote the majority decision for the SCC. The ultimate result is perhaps not so surprising when one considers that Justice Brown denied a rectification application while he was an Alberta Queens Bench judge. In *Graymar Equipment (2008) v. Canada (AG), 2014 ABQB 154* Justice Brown stated:

> *Juliar* sits uneasily with Supreme Court's direction in *Performance Industries* and *Shaffron* that rectification is granted to restore a transaction to its original purpose and not to avoid an unintended effect. While, therefore rectification is available in order to avoid a tax disadvantage which the parties had originally transacted to avoid, it is not available to avoid an unintended tax disadvantage which the parties had not anticipated at the time of transacting.

The *Fairmont* decision narrows the circumstances where equitable rectification will be granted. In summary the rules for rectification are likely modified as follows:

1. Showing a common, continuing, definite, and ascertainable intention to pursue a transaction in a tax-neutral manner is no longer the threshold for granting rectification.
2. Additionally, the parties must (a) clearly identify the precise mechanism by which they intended to achieve tax neutrality; and, (b) how that mechanism was mistakenly transcribed in a document.

The addition of step 2 (a) & (b) will have the effect of raising the threshold and, perhaps, frustrating the purpose of the remedy.

Background

The SCC spends much of the *Fairmont* decision dismantling the *Juliar* decision. It makes sense to review the *Juliar* decision prior to discussing the *Fairmont* decision.

In *Juliar* shares in a private corporation were transferred by parents to their daughters and their daughter's husbands on a tax deferred basis. One of the daughters and her husband decided to transfer the shares to a holding company. The couple used tax advisors to set up the original exchange. An advisor mistakenly assumed that the transferred shares had a significant cost base. Therefore the consideration for the shares transferred included shares and a promissory note. The transaction triggered the application of section 84.1 of the *Income Tax Act* (the "**ITA**") because no tax had been paid by the parents on the transfer of the shares to the daughters.

In the rectification application the positions of the Attorney General and the *Juliar* show a distinct contrast that was played out again in the *Fairmont* decision, but with a distinctly different result.

The position of the parties in *Juliar* can be distilled as follows:

1. The Crown's position was that the documents executed by the Juliars (on the advice of their advisors) did exactly what they were supposed to do. The documents caused the transfer of shares into a holding company. The Juliars always intended for the shares to be transferred to the holding company. There was no mistake to correct.

2. The Juliar's position was that their intent was to effect the transaction on a tax neutral basis. That tax neutral result was available. An advisor misunderstood the facts. If that tax advisor had understood the facts correctly the transaction would have taken place on the tax neutral basis; a promissory note would not have been issued.

Of course, the positions of both parties in *Juliar* are correct. The documents did exactly what they set out to do. Shares were transferred into a holding company. However, it is also correct that the intent was to conduct that transaction on a tax-free basis. The unintended result was that tax was triggered.

The Ontario Court of Appeal took the position that the true intention of the Juliars was to transfer the shares into the holding company on a tax neutral basis or not at all. That intention was thwarted by the advisors erroneous understanding of the facts. In result, the Court of Appeal rejected the Attorney General's argument that the purpose of the transaction was met by the transfer of shares into the holding company.

After the *Juliar* decision rectification applications in tax matters became more common place. The general structure of the application has followed a similar theme.

1. A taxpayer consults with an advisor and undertakes a transaction on the advice on the understanding that the tax result will be neutral.
2. The proposed result is achievable under the ITA.

3. Either as a result of a misunderstanding of the law (for example claiming a capital dividend on eligible capital property before corporate year-end) or a misunderstanding of the facts (like *Juliar*) the result is not achieved and tax is payable.
4. The rectification changes the result in a way that meets the intentions of the taxpayer.
5. The amended transaction would have been used but for the mistake by the advisor.

The key in many rectification applications has been the advisors in question drawing attention to their own errors. The evidence of the advisors is a key in most applications. Indeed, in applications where an advisors mistake was not a driving force in a transaction rectifications have been unsuccessful (see: *Kanji v. Attorney General of Canada, 2013, ONSC 781*).

Fairmont

The facts in *Fairmont* are reasonably complex and some aspects of the historical tax planning are not discussed in detail. The essential facts are that *Fairmont* was involved in the financing of the purchase of two hotels in the United States by Legacy Hotels REIT ("**Legacy**"), a real estate investment trust in which *Fairmont* held a minority interest. *Fairmont* participated in a financing arrangement with Legacy in order to obtain the management contracts for the US hotels. Legacy was concerned about a potential foreign exchange tax liability. It undertook reciprocal loan arrangements that included *Fairmont* with the intention of achieving tax neutrality on any foreign exchange fluctuations.

Fairmont was purchased in 2006. The concern was that the acquisition would trigger foreign exchange gains, but the offsetting losses would be denied. Fairmont, Legacy and their advisors devised a modified plan that would allow Fairmont to realize its gains and losses in 2006. That plan did not have the same protective effect on subsidiaries of Fairmont that had been involved in the reciprocal loan arrangements. The 2006 plan was not implemented.

In 2007 Legacy had an opportunity to sell the US hotels. It requested that Fairmont terminate the reciprocal loan agreements. This was done on an urgent basis. Fairmont complied with Legacy's request by redeeming its shares in its subsidiaries. The result was an unanticipated tax liability discovered in a subsequent CRA audit.

The Court application was a request to reverse the share redemptions and replace them with loans from the subsidiaries to Fairmont. Although not explicitly stated in the SCC decision my assumption is that the proceeds from the share redemption were to be applied to the repayment of the loan to Legacy. Fairmont's Vice President of tax agreed to the redemption of the shares on the misunderstanding that the original plan had been implemented and there was tax neutrality on the dividend. Instead, the result was a taxable gain resulting from foreign exchange gains.

It is apparent from the Ontario Supreme Court decision that there were a number of complex transactions being undertaken by Fairmont at the time of the redemption of the subsidiary shares. It is also apparent that Fairmont and Legacy had retained very competent advisors to assist them in implementing tax efficient cross-border tax plans.

The Position of the Parties in a Rectification

Fairmont said that their intent from 2002 forward was to use the loan transactions to ensure a balancing of gains and losses resulting from currency fluctuations. That intention continued even after the change in control of Fairmont in 2006.

The Attorney General took the position that the rectification request to reverse the dividends and replace those dividends with intercorporate loans was not part of any plan at any time and was only proposed after the CRA audit disclosed the problem. The Attorney General said that replacing share redemptions with loans was obvious retroactive tax planning. The mistake was not that *Fairmont*'s directors inaccurately recorded what *Fairmont* intended in the director's resolutions. *Fairmont*'s mistake was that it failed to develop a plan to avoid capital gains until after the shares had already been redeemed. Rectification should not be used to sanction a new plan *Fairmont* wishes it had implemented in 2007.

There was no evidence of a historical intention to use intercorporate loans by the subsidiaries to *Fairmont* as a strategy to avoid triggering the foreign exchange gains. The evidence indicated that everyone acknowledged that the purchase of Fairmont had created a problem, but that there was time to deal with the problem. The sale of the Washington hotels was an unforeseen event.

Fairmont and it's advisors were concerned with triggering gains and losses and potential denial of losses pursuant to subsection 40(3.6) of the ITA. That provision denies losses where shares are disposed of to affiliated companies. The subsidiaries were affiliated with each other and Fairmont.

The Supreme Court was left with transactions that on the one hand did exactly what they were supposed to do. The director's resolutions redeemed the shares. On the other hand the share redemption triggered the exact event that the reciprocal loan arrangements were created to prevent.

At paragraph 39 of the SCC decision Justice Brown states "rectification is not equities version of a mulligan." I assume that that statement will be quoted *ad nauseam* when courts now deny rectification applications. It also leaves no doubt about the position of the majority in the Supreme Court.

Dismantling Juliar

Justice Brown spends several paragraphs dismantling the reasoning in *Juliar*. It suffices to say *Juliar's* value as a precedent is neutered. At paragraph 16 Justice Brown states "in my respectful view, however, *Juliar* is irreconcilable with this Court's juris prudence with narrowly confined circumstances to which this Court has restricted the availability of rectification."

Prior to setting out the proper test for a rectification the SCC clarified the meaning of "common continuing intention" and "the standard of proof" required in a rectification.

With respect to common continuing intent *Fairmont* had argued that it was unnecessary for them to prove a prior agreement concerning the specific terms which were sought to be rectified. In this case, *Fairmont*'s common continuing intent was conduct its business in a way that would avoid triggering tax. This should be sufficient for grounds for a rectification.

Not surprisingly Justice Brown finds that proposition wanting. Justice Brown states that the Court does not engage in speculative exercises. Furthermore, where an instrument recording an agreed upon course of action is a subject of a rectification application the parties seeking rectification must identify terms which were omitted or recorded incorrectly and which are sufficiently precise to constitute the terms of an enforceable agreement.

If at this time it is not clear how much detail is required. Certainly, there would not be too much argument that a general statement that a party intends to neutralize currency exchange capital gains is not a magic spell that would allow the parties to undertake any corrective measure they want.

Regardless, Justice Brown's reasoning could be taken to mean that in a rectification the evidence must be so clear that the Court is not required to engage in any sort of reasoning.

Regarding evidence, the Court reiterates the statement made in *F.H. v. MacDougal 2008 SCC 53* that at common law the standard of proof is on a balance of probabilities. For some reason further commentary is required. Justice Brown calls for sufficiently cogent evidence that will allow the Court to revise the terms of a written agreement that has been endorsed by the parties seeking a rectification. To paraphrase, if an applicant wants to change an executed document, there must be strong evidence that the documents were not recorded correctly. I am not sure what the SCC is driving at with the comments on evidence. Perhaps there is an insinuation that lower courts have not been sufficiently scrutinizing the evidence.

Summary of the Law

To summarize the Court rejects the notion of a common continuing intention. The Court says (at paragraph 38) that rectification is an *equitable* remedy designed to correct errors in recording of terms in written legal instruments. Where the error is said to result from a common mistake rectification is available where the Court is satisfied that on a balance of probabilities of the following.

1. There was a prior agreement whose terms are definite and ascertainable;
2. The agreement was still in effect at the time the instrument was executed;
3. The instrument fails to accurately record the agreement; and
4. The instrument, if rectified, would carry out the party's prior agreement.

On this basis, the SCC rejects the rectification application that had been granted by the Ontario Supreme Court and the Ontario Court of Appeal. More specifically *Fairmont*'s application is rejected because Fairmont, in 2006, only intended to address the unhedged position of *Fairmont*'s subsidiaries in a way that would be tax and accounting neutral. It had no specific plan how it would do that and no plan was undertaken (at paragraph 39).

The result of the decision is that the basis for rectifications has been narrowed in scope. The requirement that the parties seeking the rectification must show an ascertainable intention to pursue a transaction in a tax neutral basis is now insufficient. Based on the reasoning of Justice Brown the parties must clearly identify the precise mechanism by which they intended to achieve tax neutrality and how that mechanism was mistakenly transcribed in the documents. The result is that the doctrine of rectification, if as narrow as indicated, has largely been nullified.

Justice Abella, writing for the minority, summarises the state of the law based on the reasoning of the majority as follows:

> [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.

The Facts and Equities in *Fairmont* and *Juliar*

The Department of Justice and CRA do not foolishly appeal cases with bad fact patterns. If one compares the facts in *Juliar* to the facts of *Fairmont* it is fairly easy to conclude that the equities differ in each case.

In *Juliar* the impugned transaction was part of a fairly routine type of estate planning transaction. Certainly, the structuring of such transactions is not simple, however; transfers of shares into private corporations are fairly commonplace. It was fairly easy for the Ontario Supreme Court and Ontario Court of Appeal to draw the conclusion that the plan to transfer shares into the holding company had been undertaken on the basis that it is usually undertaken; so that no tax would be triggered.

Occasionally, tax advisors will advise their clients that it might make sense to transfer shares into a corporation and trigger a capital gain. Usually, this occurs where those taxpayers have tax losses that can be used to offset the tax liability that is triggered from such a transfer. There was no evidence in *Juliar* that the Juliar's meant to do anything other than transfer their shares into their holding company on a tax free basis.

In comparison, the tax plan in *Fairmont* appeared to be ever evolving. As well, there was likely a platoon of tax specialists reviewing the various transactions and putting together the *Fairmont* plan. The sale of *Fairmont* triggered a change in ownership and control of the company with unanticipated downstream effects. From the facts it appears that the concerns about inadvertently triggering capital gains arose from the possibility that offsetting capital losses would not be allowed because of the application of subsection 40(3.6) of the ITA. In *Fairmont* the plan was originally to do nothing. However, the sale of the Washington state hotels by Legacy meant that the loans attached to the hotels had to be paid out. The SCC said that there was an inchoate tax plan regarding how to deal with the currency exchange gains and losses the facts support that conclusion.

The Equities

The equities in *Fairmont* differ from the equities in the vast majority of rectification applications.

Most rectification applications involve small private corporations, estates or trusts where the tax advisor has made a mistake in implementing a plan that would normally be uncontroversial. The equities for allowing rectification are easier to see in the *Juliar* decision then they are in the *Fairmont* decision. *Fairmont* has a fairly bad set of facts and a platoon of tax advisors who cannot show the Supreme Court a concrete plan to deal with the unintended tax result. In *Juliar* it was pretty easy to say "this is what we were trying to do." Most tax advisors would be familiar with the *Juliar* type of planning. The same cannot be said for the complex planning in *Fairmont*.

On the facts in *Juliar* the overarching plan remained the same. The *Juliar*'s wanted to transfer shares they held personally into a corporation on a tax neutral basis. They relied on an advisor who put together a plan that was based on a faulty understanding of the facts. In other words, there was a mistake. Certainly, there was not a mistake in the recording of the instruments. There was a mistake in the premise by which the instruments were created.

Tax rectifications present a unique problem for the Courts. In most rectification applications the only concerned parties are the parties to the document that is the subject of the rectification application. A judge can be reasonably comfortable that a document did not accord with the intention of the parties where both of the parties are stating that is the case (mutual mistake). In circumstances where the application for rectification is brought on by one party and opposed by another (unilateral mistake) the Court has an opportunity to weigh the evidence put forward by the parties to sift out the true intention of the parties. It would not be too difficult for a Court to exercise its equitable jurisdiction to amend a home purchase document that erroneously listed the sale price as $1 rather than $1 million, even without background supporting documents.

Rectification applications become more complicated tax planning transactions for the following reasons.

1. There is an absence of hard bargaining prior to the execution of documents.
2. The transaction may be undertaken for multiple reasons, including, tax efficiency.
3. The party opposing the rectification, the CRA, has not relied on the transaction to its detriment.
4. It is axiomatic that taxpayers have a desire to minimize their tax burden. That desire is not equivalent to “a continuing, definite, and ascertainable intention.”

If a general statement of intent were sufficient in an application taxpayers would never really have to engage competent advisors to prepare their transactions for them. After the *Juliar* decision one might have expected an onslaught of rectification applications if finding a more tax efficient result was all that was required in a rectification application. Certainly, there have been more rectification applications after *Juliar.* However, the success of many applications reflects the complexity of the ITA and not a lackadaisical attitude towards compliance.

The other equitable issue in tax rectifications is that the Receiver General is receiving tax revenue that it should not receive. Historically, third parties who had relied on a transaction would be given notice of the rectification application.

Arguably, the CRA is such a party. There is a tax result that flows from the mistake that the CRA is statutorily obligated to pursue. However, it is also equally true that if the transaction had been completed correctly the CRA often would have no tax to collect at all. The CRA is not an interested party in the same way that the subsequent purchaser of a home that had originally been purchased for $1 is interested in an application to reverse the initial transaction.

In *Juliar* the Ontario Court of Appeal took issue with the Attorney General's narrow position on rectification finding that rectification applications should not be denied just because they will deny a windfall of tax revenue to the government. Justice Brown says that the tax windfall result is not relevant in the analysis.

Summary

The Court in *Juliar* acted to exercise its equitable jurisdiction. There was no doubt that there was a mistake in the understanding of the facts. That is only one step removed from the preparation of the document that would allow the shares to be transferred into the holding company on a tax free basis.

However, if I am reading the decision in *Fairmont* correctly, and I hope I'm not, that kind of mistake is insufficient to allow for a grant of a rectification application. The *Juliar*'s would only succeed if the instructions were to specifically transfer the shares into the holding company on a share for share exchange and the documents had recorded the transaction as a share and promissory note exchange. In the circumstances rectifications are reduced to clerical errors.

The Near Future

There are undoubtedly a number of rectification applications before superior courts throughout the country. Those applications have been predicated upon the law set out in *Juliar*. Undoubtedly some of those applications will now be withdrawn. The remainder will be pushed forward and taxpayers will have an opportunity to see how the lower courts interpret the Supreme Court's ruling on the scope of the remedy.