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SCC closes another door on equitable relief

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On 17 June 2022, the Supreme Court of Canada (SCC) released its much-anticipated decision in *Attorney General of Canada, et al. v. Collins Family Trust, et al.*, 2022 SCC 26, confirming that the equitable remedy of rescission is not available to remedy adverse tax consequences.

Background

In 2016, the SCC significantly restricted access to rectification, an equitable remedy similar to rescission, where taxpayers sought to correct a mistake that had resulted in unanticipated and adverse tax consequences in *Canada (Attorney General) v. Fairmont Hotels Inc.*, 2016 SCC 56 and *Jean Coutu Group (PJC) Inc. v. Canada (Attorney General),* 2016 SCC 55. The SCC held that in those cases the agreements in issue could not be rectified to avoid the unwanted tax consequences. The SCC stated that rectification was limited to correcting written instruments of the parties that did not reflect their true intentions; if the agreements reflect the transaction that the parties intended, then they should be taxed based on what they actually agreed to do and not on what they could have done or wished they had done. However, the SCC provided that if there is extrinsic evidence that demonstrates that the wording of the parties' legal agreements did not reflect their original intentions, then rectification could still be available.

Building a better working world

Rescission is an equitable remedy, distinct from rectification, that serves to retroactively cancel, annul or set aside a transaction in situations where a mistake was made by the parties that was so serious that it would be unconscionable, unjust or unfair to leave the mistake uncorrected. An order of rescission has the effect of cancelling or unwinding the transaction and restoring the parties to their pre-contractual positions.

While rescission had not been specifically addressed in the 2016 decisions, the SCC has now closed the door on yet another equitable remedy for adverse tax consequences.

Facts

This case involved the implementation of a tax plan, one purpose of which was to protect an operating company's (Opco's) assets from creditors without incurring an income tax liability. The plan took advantage of the attribution rule in subsection 75(2) of the *Income Tax Act*[1] (the Act) and the inter-corporate dividend deduction in subsection 112(1).

In summary, the plan involved the formation of a new holding company (Holdco) and a family trust, with Holdco being a beneficiary of the family trust. Holdco purchased shares of Opco and then sold the shares to the family trust. During the 2008 and 2009 taxation years, Opco paid dividends to the family trust. The dividend income was reported as being attributed by the trust to Holdco by virtue of subsection 75(2), and Holdco claimed a deduction in respect of those dividends under subsection 112(1). As a result, income was moved from Opco to the trust and then attributed to Holdco without any income tax being paid. The trust could then distribute such income to its individual beneficiaries free of tax.

At the time of the plan, it was commonly understood by many tax professionals and by the Canada Revenue Agency (CRA) that the attribution rule in subsection 75(2) applied to a person who transferred property to a trust where the person was also a beneficiary of the trust, regardless of the method of transfer of the property to the trust — whether by sale or gift. Opco's tax plan was partially based on this administrative practice of the CRA at the time.

However, in 2011, the Tax Court of Canada (TCC) adopted a narrower interpretation of subsection 75(2) in *Sommerer*,[2] concluding that the attribution rule did not apply where the property in question was sold to a trust, as opposed to gifted to, or settled on, the trust. The decision in *Sommerer*[3] was affirmed by the Federal Court of Appeal in July 2012. The interpretation of subsection 75(2) in *Sommerer* was contrary to the long-standing administrative position of the CRA.

Following the decision in *Sommerer,* the CRA reassessed the Collins family trust's 2008 and 2009 tax returns on the basis that the dividends paid by Opco to the family trust should have been included in the trust's income and not attributed to Holdco because, based on *Sommerer*, subsection 75(2) did not apply to attribute the dividends to Holdco. The CRA also claimed in the alternative that the general anti-avoidance rule (GAAR) should apply to include the dividends in the trust's income because the transactions enabled the trust to withdraw surplus from Opco without paying tax and were contrary to the overall scheme of the Act.

[1] R.S.C. 1985, c. 1 (5th Supp.), as amended.
[2] *Sommerer v. The Queen*, 2011 TCC 212.
[3] *The Queen v. Sommerer*, 2012 FCA 207.

The family trust objected to these reassessments and petitioned the British Columbia Supreme Court (BCSC) for an order to rescind the transactions leading up to and including the payment of the dividends to the family trust, on the basis that a mistake was made.

BCSC decision

At the BCSC, the chambers judge first noted that the facts in the *Collins Family Trust* case were "virtually identical" to the facts in an earlier case, *Pallen Trust*,[4] because both cases involved the same accounting firm and the same tax plan. In *Pallen Trust*, the judge granted rescission on the basis of mistake because in his view, it would be unfair not to do so:

> [57] … A key determinant in this case is the common general understanding as to the operation of s. 75(2) by income tax professionals and CRA as well as my finding that [the] CRA would not have sought to reassess the Trust prior to *Sommerer*. This aspect of the case in my view is what takes the case into the zone of unfairness…[5]

Pallen Trust was subsequently affirmed by the British Columbia Court of Appeal (BCCA).[6]

The chambers judge then went on to consider whether *Pallen Trust* had been overruled by *Fairmont* and *Jean Coutu*, which were decided after *Pallen Trust*. In *Fairmont*, the SCC clarified that rectification was only available to correct a written instrument that incorrectly recorded the agreement that had actually been made by the parties and was not available where the parties' agreement was accurately recorded, but led to an undesirable or otherwise unexpected tax result. The SCC concluded in *Jean Coutu* that a similar civil law remedy was similarly circumscribed.

The chambers judge was of the view that *Fairmont* and *Jean Coutu* were intended to apply to all tax cases generally. He was unable to reconcile why different equitable remedies should have dramatically different outcomes. As a result, he concluded that *Fairmont* and *Jean Coutu* had significantly undermined the precedential value of *Pallen Trust*. Despite this conclusion, the chambers judge nevertheless felt bound by the doctrine of *stare decisis*[7] and, as a result, followed the decision in *Pallen Trust* and granted the order of rescission as requested by the petitioners. The Crown appealed the decision to the BCCA.

[4] *Re Pallen Trust*, 2014 BCSC 305.
[5] *Ibid*.
[6] *Re Pallen Trust*, 2015 BCCA 222.
[7] *Stare decisis* is the legal doctrine that requires lower courts to follow the precedent of higher courts when making their decisions. In this case, the chambers judge felt bound to follow the *Pallen Trust* despite concerns that the SCC decisions in *Fairmont* and *Jean Coutu* undermined the precedential value of *Pallen Trust*.

BCCA decision

On appeal, the BCCA focused on the following three issues:

1. Did *Fairmont* and *Jean Coutu* overturn *Pallen Trust*?

2. If not, can *Pallen Trust* be distinguished from the current case given that a similar tax plan (in *Fiducie Financière Satoma c. La Reine*, 2017 TCC 84) was subsequently found to be abusive tax avoidance, contrary to the GAAR?

3. If *Pallen Trust* was not distinguishable from the current case, was there an adequate alternative remedy available?

First, contrary to the chambers judge's position, the BCCA found that *Fairmont* and *Jean Coutu* did not undermine the principles expressed in *Pallen Trust*. In other words, *Pallen Trust* was still good law. The BCCA found that the chambers judge had interpreted the two SCC cases too broadly. Because rectification and rescission are distinct equitable remedies that serve different purposes and have different effects, the BCCA saw no reason why the two equitable remedies could not have different results. According to the BCCA, rectification was limited to a clear discrepancy between the words of a legal document and the intentions of the parties; it is not concerned with consequences. In contrast, rescission considers consequences to be relevant to the gravity of a mistake. While rectification places the parties in the position that they originally intended (i.e., the achievement of their tax plan), rescission places the parties back to their original position (i.e., their tax plan is abandoned).

Second, the BCCA agreed with the chambers judge that the *Collins Family Trust* case can be distinguished from *Satoma* on two bases — that the shares in *Satoma* were purchased by the trust using funds that had been gifted, and the primary purpose of the transactions in *Satoma* was to avoid the payment of tax, whereas here, the chambers judge had accepted that there were two purposes for the transactions: tax avoidance and creditor protection. As a result, *Pallen Trust* cannot be distinguished from the current case despite *Satoma*.

Third, the BCCA did not find it appropriate to interfere with the chambers judge's exercise of discretion because alternative remedies were not considered to be realistic. Regarding a remission order under section 23 of the *Financial Administration Act*, the BCCA commented that in light of the CRA's position on the trust, it was highly unlikely that the Minister of National Revenue would recommend a remission of tax. The BCCA further commented that because the advisor's advice at the time that it was given accorded with the commonly held view, including by the CRA, of the interpretation subsection 75(2), a negligence claim brought against them would have been unlikely to succeed.

Based on the above, the BCCA concluded that *Pallen Trust* was binding on the *Collins Family Trust* case, on both the facts and the law, and therefore the appeal was dismissed.

SCC decision

In an 8-1 decision, the majority of the SCC allowed the Crown's appeal finding that the lower courts erred in adopting the equitable remedy of rescission:

> [7] [….] Equity has no place here, there being nothing unconscionable or otherwise unfair about the operation of a tax statute on transactions freely undertaken. It follows that the prohibition against retroactive tax planning, as stated in *Fairmont Hotels* and *Jean Coutu*, should be understood broadly, precluding any equitable remedy by which it might be achieved, including rescission.

In concluding that BCCA's determination that equity can alleviate a tax mistake was incompatible with domestic law, the SCC first turned to the limiting fundamental premise of equity, that equity evolved to mitigate the results obtained from the inflexible common law and sought relief for reasons of "conscience" and "greater fairness." The SCC found that adverse tax consequences were outside equity's domain as there was nothing unconscionable or unfair in the ordinary operation of tax statutes to transactions freely agreed upon. The SCC also pointed out that if there was to be a remedy available, "it [would] lie with Parliament, not a court of equity."

Justice Brown, writing for the majority, then turned to the principles of tax law and found that the well-established principle from *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622 — that unless a statute provides otherwise, taxpayers are taxed based on what they agreed to do, and not on what they could have done — cut both ways. In other words (as stated at para. 16(b) of the decision), "while a taxpayer should not be denied a sought-after fiscal objective which they should achieve on the ordinary operation of a tax statute, this proposition also cuts the other way: taxpayers should not be judicially accorded a benefit denied by that same ordinary statutory operation, based solely on what they would have done had they known better."

The majority's conclusions regarding the lack of scope for equity in tax cases were categorical (at para. 22): "The statements of principle … — that tax consequences flow from legal relationships, that taxpayers' liabilities should be governed by the ordinary operation of tax statutes and on what the taxpayer agreed to do, and that legal instruments cannot be modified merely because they generated an adverse tax liability — are categorical, and not restricted to cases where rectification is sought. To be clear: they are of general application, precluding equitable relief altogether when sought to avoid an unintended tax liability that has arisen by the ordinary application of tax statutes to freely agreed upon transactions. There is no room for distinguishing *Fairmont Hotels* or *Jean Coutu* based upon the particular remedy sought."

Implications

Now that the SCC has made it clear that the principles for granting equitable relief articulated in *Fairmont* and *Jean Coutu* extend beyond rectification to rescission as well as to any other equitable relief that may be granted by a court based on its inherent jurisdiction, taxpayers and their advisors must be careful in structuring their transactions — even if relying on the CRA's administrative interpretation of the Act — as they will not get a "mulligan" if a subsequent court case concludes that this interpretation was incorrect. One would hope, however, that where the CRA has provided a taxpayer with an advance tax ruling and thereafter a court subsequently rules in a case involving a different taxpayer that a statutory provision germane to the ruling should be interpreted in a different manner, that the CRA would not seek to revoke the ruling and assess the taxpayer based on the new jurisprudence.

Learn more

For more information, please contact your EY or EY Law advisor or one of the following professionals:

Toronto

Daniel Sandler
+1 416 943 4434 | daniel.sandler@ca.ey.com

Montreal

Marie-Claude Marcil
+1 514 879 8208 | marie-claude.marcil@ca.ey.com

Stephanie Brouillard
+1 514 879 8241 | stephanie.brouillard@ca.ey.com

Calgary

David Robertson
+1 403 206 5474 | david.d.robertson@ca.ey.com

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