Supreme Court denies equitable relief for tax mistakes

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What you need to know

In an 8-1 decision, the Supreme Court of Canada (SCC) dismissed the availability of equitable rescission to avoid unanticipated adverse tax consequences, even where such consequences were the direct result of the taxpayers' reliance on long-accepted guidance from the Canada Revenue Agency (CRA). The SCC also effectively barred taxpayers from seeking other equitable relief options for tax-related errors, except in very narrow circumstances.

Rectification and rescission are both equitable remedies. Rectification corrects errors in the implementation of an agreement and puts parties to an agreement into the position they intended when entering the agreement. Rescission effectively unwinds agreements; returning the parties to the position they would have been in had the agreement never been entered into.

The decision in *Canada (Attorney General) v Collins Family Trust* (*Collins*), released on June 17, 2022, follows the principles the SCC espoused in *Canada (Attorney General) v Fairmont Hotels Inc.* (*Fairmont*) and *Jean Coutu Group (PJC) Inc. v Canada (Attorney General)* (*Jean Coutu*), both of which denied the availability of rectification for tax-related errors.

In those cases, the SCC held that rectification could not apply to correct unintended tax consequences and could only apply where an agreement was improperly recorded or implemented. In *Collins*, the SCC considered the availability of rescission.

Background

Collins is the result of companion petitions to the British Columbia Supreme Court (BCSC) for equitable rescission by two discretionary trusts. The petitioners, Collins Family Trust and Cochran Family Trust (the trusts), had virtually identical facts – both requested the rescission of a series of transactions that ultimately resulted in the payment of dividends by corporations to the trusts in 2008 and 2009.

The accepted objective of the transactions at issue was to protect the assets of an operating company from creditors without incurring tax liability. Both creating creditor protection and ensuring no tax was payable on the transaction, were determined to be equally important objectives. Both transactions were completed in compliance with, and their effectiveness depended on, a longstanding and widely accepted CRA interpretation of subsection 75(2) of the *Income Tax Act* (ITA).

The transactions involved incorporating a holding company that purchased shares in an operating company and the settlement of a family trust, which had the holding company as a beneficiary. Holding company loaned funds to the trust to allow the trust to purchase the operating company shares from holding company. Operating company paid dividends to the trust, which were attributed to holding company pursuant to subsection 75(2) of the ITA. Holding company, in turn, claimed a deduction under subsection 112(1) of the ITA in respect of the dividends. At the time of the transactions, a published CRA interpretation provided that the attribution rules in subsection 75(2) applied to property held by a trust, irrespective of the manner by which the trust acquired the property (i.e., through sale, gift or settlement).

In *Sommerer v R.,* (*Sommerer*), a case heard subsequent to the implementation of the transactions at issue in *Collins*, the Tax Court of Canada (TCC) held that the CRA's interpretation was incorrect. In *Sommerer*, the TCC held that the attribution rule in subsection 75(2) only applied where the trust acquired the property from the settlor by way of gift or settlement, and could not apply where the property was purchased by the trust. *Sommerer* was affirmed on appeal in *Sommerer v. R*, 2012 FCA 207. After *Sommerer* was released, the CRA reassessed the trusts for the 2008 and 2009 year to include the dividend payments in the trusts' income.

The lower court decisions

In order to avoid the payment of unexpected assessed tax, the trusts petitioned to the BCSC to rescind the series of transactions leading to the dividend payments. The trusts relied on the British Columbia Court of Appeal (BCCA) decision in *Re Pallen Trust* (*Pallen*) in which rescission was granted in virtually identical circumstances.

The BCSC interpreted *Fairmont* and *Jean Coutu* to have broad application, restricting the availability of equitable relief generally for tax mistakes and noted, in obiter, that such a broad application of this restriction seriously undermined *Pallen*. However, as *Pallen* had not been specifically overturned or considered, the BCSC determined that it was bound by it until such time as consideration was taken up by a higher court. As such, the BCSC granted the trusts rescission.

On appeal, the BCCA affirmed the rescission remedy granted by the BCSC. In doing so, the BCCA confirmed that *Pallen* remained a binding precedent on both the facts and the law. Further, the BCCA held that neither *Fairmont* nor *Jean Coutu* undermined the principles applied in *Pallen,* interpreting those decisions to be of strict application to applications for rectification. The BCCA differentiated rectification and rescission on the basis that each remedy is applied on its own distinct legal test, and held that *Fairmont* and *Jean Coutu* did not override the legal test for rescission.

The Supreme Court decision

In *Collins,* the majority of the SCC allowed the appeal, dismissing the trusts' petitions and effectively shutting the door on equitable rescission for tax planning mistakes in Canada, with narrow potential exceptions. The SCC referred to the foundational principle that equitable relief is intended to alleviate results that necessitate relief as a matter of conscience and greater fairness. The SCC held that this foundational principle limits any availability of equitable relief for tax mistakes. As in *Fairmont* and *Jean Coutu*, the SCC reiterated that there is nothing unconscionable or unfair in the ordinary operation of tax statutes to transactions freely agreed to. Instead, the SCC opined that any remedy available to taxpayers in circumstances like those faced by the trusts lies with Parliament, not a court of equity.

Importantly, the SCC viewed this case as one related to the "ordinary operation of a tax statute" and noted that while equitable rescission may be available in cases of mistake, it could not operate to avoid unintended tax consequences. The SCC made it clear that it does not consider reliance on the CRA's interpretation of the tax statute a sufficiently significant mistake going to a fact or law so central to the transaction as to justify equitable relief. Further, the SCC determined there was no unfairness in the application of the ITA because the CRA is bound to apply the ITA strictly and in accordance with the most recent court decisions.

As a result of *Collins*, equitable relief is now largely unavailable to Canadian taxpayers facing unintended tax consequences of prior tax planning. Taxpayers will be subject to tax "based on what they actually agreed to do and did, and not what they could have done or later wished they had done."

The SCC acknowledged two narrow circumstances where equitable relief might still be available if there is appropriate evidence:

1. Where the agreement was not agreed on freely; and
2. Where the written record failed to fully record the original agreement.

Strong evidence on one or both of these points will be required for a court to grant rescission in the face of the SCC's forceful guidance in *Collins*.

The combined effect of *Fairmont*, *Coutu,* and *Collins* is a clear limitation on equitable relief for tax-related mistakes. However, this trilogy does not provide increased certainty for taxpayers. In fact, it is quite the opposite – it results in greater uncertainty since CRA guidance cannot be relied on, an increased tax compliance burden and expense for taxpayers who will be forced to seek professional advice and more civil claims against the tax advisors who provide such advice.

If you have further questions about this denial of equitable relief, reach out to your BLG lawyer, the authors of this piece, or a member of BLG's Tax Group.

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