JUNE 21, 2022

Canada's Top Court Decides Against Equitable Rescission in *Collins Family Trust*

Authors: Marie-France Dompierre, Stephen Ruby, Connor Hasegawa and Michael H. Lubetsky

"Equity has no place here," held the Supreme Court of Canada in its 8-1 decision in *Canada (Attorney General) v Collins Family Trust (Collins)*, 2022 SCC 26, on June 17. Reversing the decisions of the British Columbia courts below, Collins holds that the equitable remedy of rescission – whereby a court declares a contract, gift or other act null because it was entered into under a material misapprehension by one or more of the parties – is not available when the misapprehension relates to its tax consequences. Rather, *Collins* stands for the principle that in every circumstance "taxpayers should be taxed...on what they actually agreed to do and did, and not what they could have done or later wished they had done."

This decision means that Canadian taxpayers in the common law provinces have lost a long-standing and important remedy against having to pay unnecessary and unfairly onerous taxes due to misunderstandings in the way the increasingly complex and often incomprehensible provisions of the *Income Tax Act* (ITA) apply. *Collins* has also created a stark rift between the common law provinces and Québec, whose *Civil Code of Québec* allows a court, on the application of a party, to "annul" a contract based on an "error," including a misunderstanding of its tax consequences – a procedure that the Supreme Court of Canada endorsed in *Quebec (Agence du revenu) v Services Environnementaux AES inc.* (*AES*), 2013 SCC 65, and has not repudiated since.

As a result of *Collins*, taxpayers engaging in transactions need to be extra vigilant to ensure that their tax planning is executed thoroughly and that its implementation conforms exactly to the tax planning. Last-minute changes to transactions – even if seemingly innocuous – can precipitate significant adverse consequences and should be reviewed carefully before being put into effect.

The brief majority decision in *Collins* also contains broad, categorical statements about how the Minister of National Revenue lacks any discretion in administering and enforcing the ITA. Given that the ITA expressly confers a great deal of discretion upon the Minister, these statements are inexact as general propositions and, if taken literally, could call into question the power of the Minister to enter into binding settlement agreements with taxpayers regarding their fiscal obligations – a power that has been recognized as essential to the proper functioning of the tax system. One can only hope that the *obiter dictum* in *Collins* is read in its context and not given a life of its own.

Background

In *Collins*, two separate companies retained an accounting firm to advise on two similar plans to protect corporate assets from future creditors without creating additional tax liability. Each plan involved the creation of a family trust and the incorporation of a holding company as the trust's beneficiary. The holding company lent funds to the trust to purchase the shares of the operating company at fair market value, after which the operating company paid dividends to the trust.

According to the Canada Revenue Agency's (CRA's) published guidance at the time, as well as the general understanding among tax practitioners, subsection 75(2) of the ITA (to which all sections referred to in this bulletin apply) would attribute the dividends paid to the trust to the holding company. As intercorporate dividends, no tax would be payable because of the deduction available at subsection 112(1).

However, a few years after these transactions occurred, the Tax Court of Canada held in *Sommerer v The Queen* (2011 TCC 212, affirmed 2012 FCA 207) that contrary to the CRA's published positions, subsection 75(2) does not apply when a trust purchases shares for fair market value as opposed to these shares being gifted or settled. The CRA – even while appealing *Sommerer* to the Federal Court of

Appeal – initiated an audit and subsequently issued reassessments that retroactively disallowed the attribution of the dividends to the holding companies and taxed the dividends in the hands of the trusts.

Both trusts applied for the rescinding of transactions leading to and including the payment of the dividends on the grounds that the transactions were entered into on the basis of a fundamental misapprehension of their expected tax consequences. The trusts were successful before the British Columbia Supreme Court as well as the British Columbia Court of Appeal, which had granted rescission in a substantially identical case a few years earlier (*Re Pallen Trust*, 2014 BCSC 305, affirmed 2015 BCCA 222).

Our Insights

Loss of an Important Remedy Against Unjust and Onerous Taxation

Collins sets out a broad principle that taxpayers should not be permitted to engage in "retroactive tax planning" and that the prohibition against retroactive tax planning precludes "*any* equitable remedy by which it might be achieved, including rescission" (para 7). The Court goes on to explain that a taxpayer is barred "from resorting to equity in order to undo or alter or in any way modify a concluded transaction or its documentation to avoid a tax liability arising from the ordinary operation of a tax statute" (para 22).

The Court's comment that a taxpayer cannot "resort to equity" to avoid a tax liability in this way is an apparent overstatement given that the Court upheld – in *Canada (Attorney General) v Fairmont Hotels Inc. (Fairmont)* (2016 SCC 56) – that taxpayers can obtain the equitable remedy of rectification when "an agreement between the parties was not correctly recorded in the instrument that became the final expression of their agreement" (*Fairmont*, para 3). *Collins* repeatedly cites *Fairmont* with approval and, indeed, *Collins* goes on to reiterate the principle that when a written document does not record the original intent of the parties, the Court *can* rectify the document so that the parties pay tax in accordance with their original intent, not in accordance with the document (*Collins*, para 23). Post-*Fairmont* Canadian cases have repeatedly granted rectification where taxpayers had set out a specific plan that would have achieved its tax objectives but that was not correctly implemented,[1] and this case law presumably remains valid.

Moreover, the Court's reasoning in *Collins* does not seem to provide for any consideration of the nature or circumstances that have led a taxpayer to enter into a transaction that gives rise to an unforeseen and potentially onerous tax liability. Essentially, *Collins* treats the following scenarios as equivalent from an equitable standpoint:

a. taxpayers who seek to engage in an uncontroversial, non-abusive transaction but face unexpected and entirely preventable taxes due to an oversight in planning (as occurred, for example, in *Pitt v Holt*, discussed below);

b. taxpayers who plan their affairs in accordance with published CRA guidance but are faced with an unforeseen, retroactive change in the law through an unexpected court decision (as has occurred in this case);

c. taxpayers who discover, after completing a transaction, that if they had planned the transaction differently, they would have been able to pay lower taxes for reasons not previously known or even considered; and

d. taxpayers who embark upon an ill-considered, aggressive and abusive tax plan but discover after the fact that their plan was ineffective and therefore seek a "do-over" or, as aptly styled by Justice Brown in *Fairmont*, "equity's version of a mulligan."

These four scenarios raise very different equitable considerations and it is far from obvious that they should be treated the same way. One might reasonably expect that a remedy should be available in the case of scenarios (a) and (b) but perhaps not (c) and certainly not (d).

Tax legislation has become so complex that, even with sophisticated tax advice, it has become a herculean task to comply with filing and reporting obligations while avoiding pitfalls and traps that can lead to double taxation, penalties or other unnecessary tax liabilities. Mistakes are inevitable. And prior to *Collins*, it was generally accepted that the law should allow for the retroactive correction of those mistakes when they result in onerous amounts of additional tax beyond what a taxpayer would normally have to pay when implementing proper, non-abusive tax planning. Following *Collins*, however, such taxpayers (at least in the common law provinces) are now out of luck.

Interprovincial Disparities

Collins has also entrenched a stark divide between Canada's common law provinces and Québec. Under the *Civil Code of Québec*, when a party's consent to a contract is vitiated, the party "has the right to apply for annulment of the contract" provided that it "is acting in good faith and sustains serious injury." Consent can "be vitiated by error, fear or lesion," with error vitiating consent "where it relates to [...] anything that was essential in determining that consent." (arts. 1399, 1400, 1407 and 1420 CCQ). Applying these principles back in 2013, the Supreme Court of Canada unanimously held in *AES* that if the expected tax treatment of a transaction was essential to a party's decision to enter into it, the failure to achieve that tax treatment may constitute an error that vitiates consent and provides grounds for an action in nullity. *AES* was reviewed and confirmed by the Supreme Court in *Fairmont* (as well as its companion decision *Jean Coutu Group (PJC) Inc. v Canada (Attorney General)* (2016 SCC 55)) and apparently remains good law.

It bears noting that in French law, which is considered persuasive in Québec, the failure of a transaction to achieve its intended tax consequences is considered a ground of nullity provided that (other than in the case of gifts) those expected consequences are set out expressly in the transactional documents. This rule, originally devised by the jurisprudence, is now grounded in the recently revised article 1135 of the French Civil Code.

By disallowing the use of equitable remedies in the common law provinces, while upholding the use of an action in nullity in Québec, the Supreme Court has apparently created a significant disparity between Québec and the common law provinces in terms of remedies available to taxpayers who enter into transactions with an incorrect or incomplete understanding of the tax consequences.

International Disparities

Collins has also entrenched a divide between Canada and other common law jurisdictions by expressly rejecting the landmark 2013 decision of the Supreme Court of the United Kingdom in *Pitt v Holt (Pitt)* ([2013] UKSC 26).

Pitt concerned a man who suffered serious head injuries in a traffic accident and received a £1.2-million settlement that was administered by his wife. On the advice of counsel, and with Court approval, the wife settled a discretionary trust to receive the funds. Because, however, the advisers neglected to include a particular clause in the trust deed required under U.K. legislation, the trust faced a large, unanticipated tax liability. Years later, when the error was discovered, the wife sought to have the trust set aside. The Supreme Court of the United Kingdom – based on a review of more than a century of case law – concluded that equitable rescission is available for transactions that produce unexpected and onerous tax consequences due to planning errors and that, on the particular facts of the case, the trust could be set aside.

Pitt has proven influential around the world and has been cited or adopted in support of a variety of propositions in cases from Australia, New Zealand and Hong Kong. By expressly rejecting *Pitt*, however, the Supreme Court of Canada has charted a very different course for the evolution of Canadian common law, to the detriment of Canada's taxpayers.

Ministerial Discretion

Finally, the majority opinion states at paragraphs 25 and 26 that because the Minister of National Revenue has a duty, set out in subsection 220(1), to administer and enforce the ITA, she has no discretion in tax administration and was thus obligated to reassess the trusts following the *Sommerer* decision. With respect, this statement is difficult to reconcile with the express language of the ITA, which confers vast amounts of discretion on the Minister in administering and enforcing the ITA, including the discretion on whether to audit a particular taxpayer (section 231.1 and following) as well as the discretion on whether to reassess a taxpayer who has filed a return and has received an original assessment or notification that no tax is payable (subsection 152(4)).

Presumably, the Court was simply referring to the "*Galway* principle," according to which the Minister must follow the ITA as best as she can when determining how much tax is owed in a particular period and cannot set a person's tax liability in a manner that the fact and the law cannot support. However, the *Galway* principle does not oblige the Minister to audit and reassess any particular taxpayer – even less so retroactively, after a decision is rendered interpreting a provision of the ITA for the first time in contradiction with CRA's published guidance and especially while the Minister appeals this same decision.

In the past, the Minister has sought to rely on subsection 220(1) and her supposed lack of discretion in administering and enforcing the Act to argue that she is not bound by any settlement agreement reached with a taxpayer. This argument was rejected by the Federal Court in *Rosenberg v Canada (National Revenue)* (2016 FC 1376)[2] and the Federal Court of Appeal has since confirmed that settlement agreements reached between taxpayers and the Minister are valid and binding on both parties (see *Canada v CBS Holdings Co.*, 2020 FCA 4). One must hope that the rather inopportune language by the Supreme Court at paragraphs 25 and 26 of *Collins* will not lead to a reconsideration of this settled and welcome case law.

Implications for Taxpayers

By largely closing the door to equitable rescission, *Collins* makes it much harder for taxpayers to correct errors made in determining the tax consequences of a proposed transaction. Perhaps more than ever before, taxpayers should endeavour to avoid such mistakes in the first place by retaining tax counsel to carefully review all aspects of a proposed transaction and ensuring that counsel have sufficient time to do so in light of the ever-increasing size and complexity of tax legislation. Last-minute changes in a closing agenda in particular can potentially precipitate onerous tax consequences, and taxpayers must reserve sufficient time for tax counsel to carefully review such changes.

Alternatively, if time constraints and the nature of a proposed transaction allow, taxpayers should also give greater consideration to obtaining advance tax rulings from the CRA. While rulings are generally not considered enforceable in court, the CRA will usually respect them, and they thus reduce tax uncertainty. Indeed, during the oral hearing of *Collins*, the taxpayers' failure to obtain advance tax rulings was a recurring theme in the Court's questions and, while not discussed in the majority decision, apparently had some influence over the Court's decision-making. This said, obtaining a ruling can be time-consuming, applications are not always successful and any deviation from the plan as set out in the ruling will entitle the CRA to disregard it – all of which limits the effectiveness of the ruling process in reducing tax risk.

[1] Elie Roth, Stephen Ruby and Ryan Wolfe, "Equitable Remedies in Tax Matters: The Elusive Search for Relief," in Pooja Mihailovich and John Sorensen, eds., *Tax Disputes in Canada: The Path Forward* (Toronto: Canadian Tax Foundation, forthcoming).

[2] Davies acted for the taxpayer in *Rosenberg*.

Key Contacts: Marie-France Dompierre and Stephen Ruby