

Supreme Court of Canada rules in favour of taxpayers in Québec 'rectification' cases

November 28, 2013

In brief

Rectification cases are of interest to the tax community because the truth is, whether we like to acknowledge it or not, mistakes happen. Sometimes the only solution is to attempt to rectify the legal steps. At common law, rectification is an equitable remedy that may be available through the superior courts of the common law provinces. When a court rectifies the steps in a transaction, the steps as rectified become the steps that were legally taken. In Québec, the Civil Code of Québec (CCQ) governs private law and until now, it was not clear to what extent rectification or a similar remedy was available in Québec. Some argued that the only remedy available to address unintended tax consequences resulting from a transaction was to have it nullified pursuant to the rules in the CCQ. This meant that in Québec a provincial court would not (some say *could* not) correct a transaction that might be corrected in another province.

This changed in 2011 when the Québec Court of Appeal (QCCA) decided in two separate cases (*Agence du Revenu du Québec v. Services Environnementaux AES Inc., et al.* and *Agence du Revenu du Québec v. Jean Riopel, et al.*) to correct contractual documents that did not reflect the intentions of the parties.¹

Both cases were appealed to the Supreme Court of Canada (SCC) and were heard together by the SCC on November 8, 2012. The SCC released its decision on November 28, 2013, clarifying that the civil law did afford a remedy that was the equivalent of rectification of a contract.

In detail

Background

The QCCA decisions marked a shift in the interpretation of the CCQ. As a result, many tax practitioners have been eagerly awaiting the SCC's pronouncement on the availability of rectification in Québec.

The QCCA held that the courts have the power in Québec civil law to correct acts in order to

give effect to the parties' true common intentions on the basis of article 1425 of the CCQ. Article 1425 of the CCQ provides that the common intention of the parties rather than adherence to the literal meaning of the words shall be sought in interpreting a contract.

The QCCA further held that there is no need to import the common law doctrine of

rectification into Québec's civil law.

The leading common law case on rectification in the tax

1. *Agence du Revenu du Québec (formerly the Deputy Minister of Revenue of Québec) v. Services Environnementaux AES Inc., et al.*, 2009 QCCS 790; aff'd. 2011 QCCA 394; aff'd. 2013 SCC 65; *Agence du Revenu du Québec v. Jean Riopel, et al.*, 2010 QCCS 1576; rev'd. 2011 QCCA 954; aff'd. 2013 SCC 65.

context is *Juliar v. Canada (Attorney General)*, a decision of the Ontario Superior Court of Justice that was subsequently affirmed by the Ontario Court of Appeal (leave to appeal to the SCC was denied). In that case, the Court rectified corporate resolutions and other corporate actions to substitute shares for promissory notes that had been given as consideration for the sale of shares, in order to reflect the taxpayers' common intentions to implement certain transactions without attracting income tax liability.²

The facts of the two cases that were appealed from the QCCA to the SCC are summarized below.

Services Environnementaux AES Inc.

In the first case, the taxpayers AES Inc. and its subsidiary, Centre technologique AES Inc., entered into a reorganization governed by section 86 of the *Income Tax Act* (and the equivalent provision of the Québec *Taxation Act* for Québec tax purposes). The parties mistakenly believed that the adjusted cost base (ACB) of the shares was \$1,217,029, an error that was attributed to AES's advisors. Based on that error, the transactions entered into with respect to the share sale resulted in AES Inc. receiving a promissory note in the amount of \$1,217,028 in the reorganization steps. Later, upon AES Inc. receiving a Notice of Reassessment that added a taxable capital gain of \$840,770 to its taxable income, the parties discovered their mistake (i.e. that the ACB of the shares was in fact only \$96,001). The parties took steps to replace the promissory note that had been issued

with a new note in the amount of \$95,000 and preferred shares for the rest of the original note amount. They then presented a motion in the Québec Superior Court (QCCS) for rectification of the written documents for the reorganization on the basis that article 1425 of the CCQ entitled the QCCS to give effect to the parties' true intentions. The motion was granted. The QCCS's decision was affirmed by the QCCA.

Riopel

In the second case, Mr. Riopel and his wife, Ms. Archambault, sought to amalgamate two corporations. Mr. Riopel was the sole shareholder of one of the amalgamating corporations and held a 60% interest in the second corporation. Ms. Archambault held the remaining 40% interest in the second corporation. The husband and wife intended that Mr. Riopel would be the sole shareholder of the amalgamated corporation. They agreed with their advisors that the reorganization would be effected without any immediate tax consequences to them and that in order to effect the tax planning, Ms. Archambault's shares would be transferred to her husband's corporation prior to the amalgamation.

Despite their intentions, the advisors implementing the transactions reversed the order of the steps and the Articles of Amalgamation were filed without the share transfer having occurred first. When the advisors realized that they had made an error, they tried to correct it without explaining the error to Mr. Riopel and Ms. Archambault. In fact, the couple signed new documents with a view to resolving the problem caused by the faulty tax planning without having

been informed that the initial plan had not been properly implemented. Ms. Archambault received a Notice of Reassessment adding a deemed dividend of \$335,000 to her taxable income, at which time the taxpayers discovered the error and applied to the QCCS to rectify the written instruments.

The QCCS denied the application on the basis that rectification was not an appropriate remedy in the circumstances. In the Court's view, the error could not be rectified under the CCQ since this was a substantive error that affected both the form and substance of the transaction. The Court held that under the CCQ, an error of a substantive nature could only lead to the contract being nullified, which was not the relief that was sought by the taxpayers in this case. The QCCA reversed the decision on the basis that it could rectify the contract so as to give effect to the parties' true intentions, based on the interpretive rule in article 1425 of the CCQ.

SCC's decision

The Agence du Revenu du Québec (ARQ) and the Canada Revenue Agency (CRA) had opposed the taxpayers' motions in each of the cases. At the SCC, the Attorney General of Canada also intervened in both the appeals in support of the ARQ and, in addition to arguing that the concept of rectification does not apply in the civil law context, criticized the common law courts for 'unduly extending the concept of rectification in tax cases', and invited the Court to weigh in on that issue.

In a unanimous decision, written by LeBel J., the SCC found in favour of the taxpayers and dismissed the appeals by the ARQ, although for

2. *Juliar v. Canada (Attorney General)*, 46 OR (3d) 146 (Ont. SCJ); aff'd. 50 OR (3d) 728 (ONCA); leave to appeal to the SCC refused on May 24, 2001.

reasons that differed in part from those of the QCCA, primarily concerning the degree of reliance on article 1425 of the CCQ. According to the SCC approach, the essence of a contract in Québec civil law is an agreement of wills or a meeting of the parties' minds. The contract is distinct from its physical medium, unless there is a requirement for it to be in writing or formalized in some other prescribed manner. If, as in the cases at hand, the agreement of wills was not implemented properly, the parties were free to amend the documents in order to restore the integrity of their original agreement.

The SCC agreed that this might not always be possible if third parties had relied on the erroneous documentation. However, the ARQ and the CRA did not have 'acquired rights' to have an erroneous writing continue to apply. To so find would require the Court to conclude that the revenue agencies became 'special assignees' that were entitled to collect part of the economic proceeds of the transactions, and the Court refused to accord them this status. The SCC confirmed that tax law is accessory to the general law where the tax legislation does not itself recharacterize contractual or economic transactions: 'Tax law applies to transactions governed by, and the nature and legal consequences of which are determined by reference to, the common law or the civil law.'

The SCC found that the correction of the acts resulted from the actual will of the parties and there was no need to rely on a supposed power to correct based on the 'implicit powers' of the Superior Court. The Court's intervention was based on fundamental rules of contract law. Article 1425 still seems to have been

properly invoked, according to the SCC's reasoning, on the basis that the revenue agencies had raised a dispute concerning whether the amendments to the documents were legitimate and necessary to reflect the parties' intentions. Article 1425 was properly used in order to interpret the common intention of the parties and to confirm whether their amended documentation reflected that intention.

The decision makes two final points, which included a 'word of warning'. First, taxpayers should not view the SCC's conclusions as an invitation to engage in 'bold tax planning' on the assumption that it will always be possible to redo their contracts retroactively should that planning fail. An intention to reduce tax liability would not on its own constitute the object of an agreement. Absent a more precise and more clearly defined object, no contract would be formed and article 1425 could not be relied on to justify seeking the common intention of the parties to give effect to that intention despite the words of the writings prepared to record it.

The other comment was for the intervenor, the Attorney General of Canada. The Court declined the latter's invitation to review the line of authorities that has endorsed rectification as a remedy in tax cases. The Court merely stated that the two appeals before it were governed by Québec civil law and were not appropriate cases in which to reconsider the common law remedy of rectification that has developed since the *Juliar* decision.

Broader implications

The decision is a welcome one. It would be an absurd outcome if relief that was available in the rest of

Canada was unavailable to taxpayers who have engaged in transactions governed by Québec civil law. No court has given a 'carte blanche' to taxpayers to engage in retroactive tax planning using a rectification remedy. The decision sensibly recognizes the reality that errors do sometimes occur and that the revenue agencies should not receive a windfall as a result.

Let's talk

For a deeper discussion of how this decision might affect you or your business, please contact:

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