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## Rectification of Tax Mistakes Versus Retroactive Tax Laws: Reconciling Competing Visions of the Rule of Law

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### PRÉCIS

Cet article examine le conflit potentiel entre le droit des provinces de déterminer les droits de propriété, y compris le droit de rectification en *equity*, et le droit du gouvernement fédéral de promulguer une législation fiscale avec effet rétroactif. Il soulève une question hypothétique : Est-ce que la rectification constitue la solution appropriée à l'« injustice » d'une législation rétroactive visant les contribuables qui conçoivent et planifient leurs opérations en vue de réduire l'impôt à payer ou d'éviter d'avoir à en payer?

L'article étudie la tendance vers l'élargissement judiciaire des recours en rectification dans les causes fiscales, ainsi que les perspectives d'un appui sur la primauté du droit pour déterminer si, et quand, une rectification serait appropriée. Les auteurs concluent que, dans certaines circonstances, un tribunal provincial pourrait et devrait rectifier un plan fiscal afin de contrer les effets d'un impôt rétroactif qui ne vise pas la planification fiscale abusive, comme la hausse d'impôt proposée par Québec (proposition qui a ensuite été retirée) et qui visait les contribuables ayant des revenus élevés.

### ABSTRACT

This article examines the potential conflict between the right of the provinces to determine property rights, including the equitable right of rectification, and the federal government's right to enact retroactive tax legislation. It poses a hypothetical question: Does rectification provide the appropriate remedy for the "unfairness" of retroactive legislation to taxpayers who intend and plan their transactions to minimize or avoid tax?

The article reviews the trend toward the judicial broadening of rectification remedies in tax cases, as well as perspectives on reliance on the rule of law to determine if and when rectification would be appropriate. The authors conclude that, in certain circumstances, a provincial court could and should rectify a tax plan to counter the

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effects of a retroactive tax that does not target abusive tax planning, such as Quebec's proposed (and subsequently withdrawn) tax increase aimed at high income earners.

**KEYWORDS:** INCOME TAXES ■ COURTS ■ RECTIFICATION ■ RETROACTIVE ■ EQUITY ■ RULE OF LAW

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## INTRODUCTION

In the past decade, the equitable remedy of rectification<sup>1</sup> has emerged as a powerful tool to redo tax transactions in Canada. Rectification orders, issued by provincial superior courts, now far exceed a mere correction of inadvertent drafting mistakes and often have significant tax consequences. Courts have broadened the remedy to accept that taxpayers should be able to seek a rectification order to amend documents<sup>2</sup> in circumstances where they can demonstrate that the transaction as intended would

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1 Traditionally rectification is applied to written instruments. If by mistake the terms of a written instrument do not accord with the true intention of the parties to an agreement, equity allows the instrument to be rectified to accord with that intention. The four requirements for rectification are a prior agreement, a common intention, a final document that did not properly record the intention of the parties, and a common or mutual mistake: *Armstrong v. Armstrong* (1978), 22 OR (2d) 223 (HC). In this article, “rectification refers to a legally effective retroactive change to, or annulment of, a transaction or event, or the way in which it was (by reason of the effect of the contractual or other legal factors involved) effectuated or done, all with a view to changing the related tax effects”: Nathan Boidman, Nicolas X. Cloutier, and Edwin G. Kroft, “Breaking Bad: ‘Remediation’ and Tax Plans Gone Wrong—Judicial Attitudes” (2010) vol. 58, special supp. *Canadian Tax Journal* 141-48, at 142. In some legal jurisdictions, such as the United States, the term “reformation” is sometimes used instead of rectification.

2 Taxpayers may in some circumstances remedy a transaction by way of corporate resolution without seeking a rectification order. See, for example, *Twomey v. The Queen*, 2012 TCC 310, where Pizzitelli J opined that a rectification order would be unnecessary to correct a directors’ resolution with respect to the issuance of shares, contra *Winclare Management Services Ltd. v. Canada (Attorney General)*, 2009 CanLII 18234 (ONSC). In *Winclare*, the court was persuaded

not have triggered unwanted tax consequences. The judicial orders are considered binding on revenue authorities insofar as they determine property rights.<sup>3</sup>

On the other hand, Canadian federal courts accept that retroactive tax (and other) laws are generally constitutionally permissible.<sup>4</sup> As a result of the doctrine of parliamentary supremacy, tax laws can be given a retroactive effect that trumps a taxpayer's earlier reliance on the laws that were in place when the taxpayer engaged in tax planning. A consequence of retroactive tax legislation can be an increase in a taxpayer's tax liability—despite the taxpayer's clear intention and honest and reasonable attempt to engage in tax planning to avoid this result.

One outcome is a clash of judicial perspectives: provincial courts and their vision of an equitable rule of rectification versus federal law (as interpreted by the Tax Court, the Federal Court of Appeal, and the Supreme Court of Canada) and the view that tax laws can have a retroactive effect. Both are “rules of law,” but of course the provincial view arguably undermines the federal view, since tax law applies after private-law rights have been determined by the province.<sup>5</sup> Is this an acceptably “fair” outcome? Does rectification provide the appropriate remedy for the “unfairness” of retroactive legislation to taxpayers who intend and plan their transactions to minimize or avoid tax?<sup>6</sup>

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that a formal judgment for rectification was required because the actions of taxpayers through a corrective directors' resolution to alter a previous event retroactively was not sufficient.

Matlow J commented, *ibid.*, at paragraph 13, “It is unfortunate that no statutory authority presently exists that would have enabled the CRA [Canada Revenue Agency] or its Minister to intervene in this case in the interests of justice without first requiring this merely formal but costly application to be made.”

3 See *Dale v. Canada*, [1977] 3 FC 235 (FCA).

4 The most recent pronouncement by the Supreme Court of Canada on this issue was the 2005 case of *Imperial Tobacco*, where the court employed language almost definitively ousting the possibility of successfully challenging retroactive legislation on the basis of the rule of law. Ultimately, the court spoke of “[t]he absence of a general requirement of legislative prospectivity” and held that “retrospectivity and retroactivity do not generally engage constitutional concerns”: *British Columbia v. Imperial Tobacco Canada Ltd.*, 2005 SCC 49, at paragraphs 71-72.

5 We will not discuss in this article whether it is appropriate for a superior court to grant rectification when and if the order interferes with the jurisdiction of a specialized tribunal or another court. Tax matters are within the exclusive jurisdiction of the Tax Court of Canada and the federal courts. In *Orman v. Marnat Inc.*, 2012 ONSC 549, the Ontario Superior Court refused to dismiss the rectification application on the basis of jurisdiction. Notwithstanding that decision, case law supports jurisdiction as a valid ground for denying rectification. See, for example, *GLP NT Corp. v. Canada (Attorney General)*, 2003 CanLII 41554 (ONSC). As a result, if the taxpayer confined its arguments to the administrative tax reassessment procedures, it would have to challenge the reassessments via an appeal to the Tax Court of Canada (section 169 of the Income Tax Act), and it is questionable whether a provincial court would grant rectification. Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”).

6 For an interesting discussion of whether retroactive legislation erodes the reliability of the law in the eyes of taxpayers, see John Prebble, Rebecca Prebble, and Catherine Vilder Smith, “Retrospective Legislation: Reliance, the Public Interest, Principles of Interpretation and the Special Case of Anti-Avoidance Legislation” (2006) 22:1 *New Zealand Universities Law Review* 271-99.

This article examines this question and the jurisprudence with respect to rectification orders and retroactive legislation in Canada. The analysis suggests that the equitable remedy of rectification—as well as broader categories of the law of mistake—might be deployed by taxpayers (through provincial court orders) to redress the impact of retroactive tax laws when they intrude on a taxpayer's reasonable expectations and do not target tax planning that is perceived to be abusive.<sup>7</sup> Perhaps in anticipation of such a challenge, when the Quebec Taxation Act was amended retroactively to May 9, 2006, the amendment also provided that no rectification orders would be respected that would avoid the imposition of Quebec tax under the new amendment.<sup>8</sup>

The matter is particularly topical in light of recent events, as well as developments in the case law. Consider, for example, the now-withdrawn proposal by the Quebec government to retroactively tax high income earners within the province. Under the earlier proposal, individuals with income over \$130,000 would be subject to retroactive tax rate increases.<sup>9</sup> The result for an individual in Quebec who gifted her cottage property, thus generating additional taxable income, was that she could be subject to the higher retroactive marginal tax rates. Could she seek equitable relief to set aside the gift (in this case rescission) on the basis that she had made a mistake

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7 This view is consistent with the recent observation that, given that the normative power of the rule of law constrains the actions of Parliament “only in the sense that they must comply with the legislated requirements as to manner and form (that is, the procedures by which legislation is to be enacted, amended and repealed),” there should be a compensating notion that taxpayers can effectively also ignore the rule of law (aided by a court) by rewriting their contracts on a retroactive basis with effect as against third parties. See Boidman et al., *supra* note 1, at 145-46. Note that while we focus in this article on federal income tax laws and their potential retroactive effect, retroactive tax laws in other areas, such as Canada's federal consumption tax (the goods and services tax), have been identified as a major area of concern. See Muhammad Abbas and Arthur J. Cockfield, “Canada,” in Thomas Ecker, Michael Lang, and Ine Lejeune, eds., *The Future of Indirect Taxation: Recent Trends in VAT and GST Systems Around the World* (The Hague: Kluwer Law International, 2012), chapter 4, at 109 and 111.

8 The amendment was in respect of the notorious “Quebec truffle” (see *infra* note 98). The effect of such a provincial law would obviously not bind courts in other provinces. The federal government could begin to similarly try to insulate its own retroactive laws from rectification orders by provincial courts. As discussed in this article, provincial courts normally have the power to render decisions concerning private-law transactions that take place within the province, and federal legislation may not have the jurisdiction to limit powers of rectification. A discussion of how these potential conflicts in federal-provincial constitutional law could play out is beyond the scope of this article.

9 On September 22, 2012, the newly elected Quebec government proposed to increase the tax rates for incomes above \$130,000 a year; the proposal was slated to be retroactive to January 1, 2012. After significant political opposition, the government abandoned the retroactive aspects of the tax hikes. See “Retroactive Tax Hike Is Indefensible,” editorial, *Montreal Gazette*, September 27, 2012; and “The PQ's Retroactive Tax on Affluence Is Damaging and Unfair,” editorial, *Globe and Mail*, September 27, 2012.

concerning the tax liability associated with the cottage transfer?<sup>10</sup> Could she seek rectification of the transaction in favour of an instalment sale that would leave her taxable income below the proposed high income earner threshold? While the Quebec proposal involved provincial rather than federal taxation, and was subsequently abandoned, in this article we discuss whether rectification could have been used to defeat the impact of this sort of retroactive tax law. We also touch on rectification in the context of the potential liability that may fall on personal representatives as a result of retroactive legislation—in particular, the proposed retroactive provisions in the federal non-resident trust rules, initially introduced in 1999, reintroduced in a notice of ways and means motion tabled in October 2012, and since enacted as law.<sup>11</sup>

The discussion that follows is divided into four parts. Part one begins by setting out some of the judicial perspectives and tax policy concerns surrounding rectification remedies, and shows how courts have developed different views on rectification in tax cases and non-tax cases. In particular, provincial courts have broadened rectification in tax cases to the point where they accept that contracts can be rewritten to give effect to a taxpayer's intention to avoid taxes, irrespective of potential revenue losses to the fisc.

Part two of the article presents various perspectives on retroactive tax laws and shows how, despite fairness and rule-of-law concerns, Canadian federal courts accept retroactive tax legislation that trumps the earlier honest and reasonable intentions of taxpayers, in large part to guard against real or potential revenue losses.

Part three explores doctrinal limits on the use of rectification remedies to challenge retroactive tax laws, as well as the question of whether provincial courts would or should make rectification orders to counter retroactive tax legislation.

Part four concludes that rectification remedies, as well as the law of mistaken assumptions more generally, could be deployed to limit the impact of retroactive tax laws to situations that focus on inhibiting abusive, potentially “GAARable”<sup>12</sup> tax planning that leads to undue revenue losses, as well as situations where taxpayers did not hold an honest and reasonable belief that their earlier tax-planning efforts complied with all relevant tax laws. We conclude, therefore, that rectification could have been used to reduce the impact of the Quebec government's earlier proposal to retroactively tax high income earners within the province.

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10 *Winclare*, supra note 2.

11 Bill C-48, Technical Tax Amendments Act, 2012, SC 2013, c. 34; royal assent June 26, 2013. Bill C-48, as passed, closely follows the provisions in the October 2012 notice of ways and means motion (Canada, Department of Finance, Notice of Ways and Means Motion To Amend the Income Tax Act, the Excise Tax Act and Related Legislation, October 24, 2012). For further discussion, see infra note 87 and the related text.

12 That is, tax planning that may be subject to challenge under the general anti-avoidance rule (GAAR) in section 245 of the Act.

## THE BROADENING OF RECTIFICATION ORDERS IN TAX MATTERS

### The Juliar Case

In law, rectification is a form of equitable relief, available for judicial correction of an instrument or contract that, by an error in writing, does not reflect or is not consistent with the true intentions of the parties. Since rectification restores a truth to an instrument's expression, it acts in time from the point of formation of the instrument forward. A frequently cited version of the general principle that is often quoted in Canadian cases is found in *Snell's Equity*:

There will be cases where the terms of the instrument do not accord with the true agreement between the parties: a term may have been omitted, or an unwanted term included, or a term may be expressed in the wrong way. *In such cases, equity has the power to reform, or rectify, that instrument so as to make it accord with the true agreement. What is rectified is not a mistake in the transaction itself, but a mistake in the way in which that transaction has been expressed in writing.* "Courts of Equity do not rectify contracts; they may and do rectify instruments purporting to have been made in pursuance of the terms of the contract."<sup>13</sup>

Until recently, there were few cases in Canada in which the matter of rectification was considered in a tax-related transaction, and in those cases, the application for rectification met with little success. In fact, by the mid-1990s the arguments against rectification in tax matters were reasonably well settled.<sup>14</sup> As stated by the Ontario Court of Justice in *Bramco*,

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13 John McGhee, ed., *Snell's Equity*, 31st ed. (London: Thomson Sweet & Maxwell, 2005), at 332 (emphasis added), quoting from *Mackenzie v. Coulson* (1869) LR 8 Eq. 368, at 375. This principle was cited, for example, in *Juliar*, infra notes 16 and 21, and *Snow White Productions*, infra note 26.

14 The arguments against the use of rectification in a tax context were identified in a 1994 decision of the Ontario Court of Justice (General Division), Commercial List, 771225 *Ontario Inc. v. Bramco Holdings Co.* (1994), 17 OR (3d) 571 (Gen. Div.), and debated in the appeal court's decision in the same matter: (1995), 21 OR (3d) 739 (CA). In a corporate reorganization undertaken to secure an income tax advantage, a land transfer tax liability of \$1.7 million on a purchase of land was triggered, rather than the liability of \$84,745 that the parties had intended. A rectification order was sought to substitute a different purchaser. The Ontario Court of Justice dismissed the application. The court did not consider that the remedy of rectification could allow a corporation not initially intended to be a party to the transaction to be substituted for the originally intended party. The Ontario Court of Appeal also dismissed the appeal. The majority referred to the "well-known rule that equity and tax laws are 'strangers' and that in taxing statutes there is no room for equity" (*ibid.*, at 742, citing *Mendel v. MNR*, 65 DTC 114, at 122 (TAB)). The majority further observed (*ibid.*) that granting equitable relief to avoid an unanticipated tax disadvantage under the provincial Land Transfer Tax Act "as the direct result of a deliberate decision . . . to obtain a tax advantage under the [federal] *Income Tax Act* . . . would fly in the face of a long line of authority based upon the need for finality and consistency in matters of taxation."

[a]lthough the court would like to be able to assist those who suffer as a consequence of a mistake, particularly where the result is a windfall to the taxing authority, a court of equity may only grant the relief of rectification in very limited circumstances.<sup>15</sup>

The 2000 decision in *Juliar*<sup>16</sup> has changed all that and clearly demonstrates the full power of equity, as wielded by provincial courts, to rectify transactions to remedy unintended tax results. In *Juliar*, a rectification order was issued to unravel a transaction in order to remedy tax results unintended by the parties, notwithstanding that the transaction was a tax-avoidance transaction.<sup>17</sup>

On the facts, one might sympathize with the taxpayers in *Juliar*. A husband and his wife transferred their shares in a holding company to a second corporation in return for a promissory note. The plan was to effect the transfer without immediate tax liability. Instead, the transaction as structured triggered an immediate and unintended deemed dividend. The taxpayers applied to the Ontario Superior Court of Justice for an order rectifying the transaction to transform it into a tax-free exchange of shares. The rectification order was granted on the basis that the taxpayers had a primary intention from the outset that the transaction would not trigger any immediate income tax consequences and that in order to accomplish this intention, a share-for-share transaction was necessary.<sup>18</sup> The court rectified the corporate resolutions of both corporations to substitute shares for the promissory note that was originally issued. On appeal, the Ontario Court of Appeal also accepted that the taxpayers had a common and continuing intention from the outset to transfer shares without immediate tax, and failed to implement the plan because of a mistake of fact.<sup>19</sup> Leave to appeal to the Supreme Court of Canada was denied without reasons. Of particular interest is the manner in which the issue was framed by the Supreme Court, in part as follows:

Trial judge permitting rectification of corporate transaction so as to avoid liability for immediate payment of income tax—Court of Appeal affirming decision—*Whether Court of Appeal erred in extending principles of rectification by permitting agreement to be rewritten not because agreement incorrectly set down terms of contract, but because consequences of arrangement were undesirable.*<sup>20</sup>

15 *Bramco*, supra note 14 (Gen. Div.), at paragraph 47.

16 *Attorney General of Canada v. Juliar et al.*, (2000) 50 OR (3d) 728 (CA).

17 Tax avoidance in this context means tax planning to reduce or avoid tax liability within the framework of acceptable tax policy. In some jurisdictions, it is referred to as mitigation.

18 Cameron J found on the evidence “that the Juliars had a common and continuing intention from the outset to transfer their half interest in the business of Juliar Holdings and to do so ‘on a basis which would not attract immediate liability for income tax on the transaction.’” *Juliar*, supra note 16, at paragraph 19.

19 In dismissing the appeal by the Crown, the Ontario Court of Appeal relied on the principles set out in *Re Sloccock’s Will Trust*, [1979] 1 All ER 358 (Ch. D.). See infra note 48 and the related text.

20 *AG of Canada v. Juliar*, [2000] SCCA no. 621, dismissing leave to appeal, May 24 2001 (emphasis added).

The crucial finding in *Juliar* was that the true agreement between the parties was that the transaction would take place *in a manner* that would not attract immediate liability for tax. The Ontario Superior Court of Justice noted that

[t]he intention to postpone or avoid tax on the transaction was not formed as a result of the assessment by Revenue Canada. It was an intended and fundamental aspect of the transaction from its inception. The purpose of the tax avoidance and maintaining the assets of the business determined the form of the transaction. The Juliars expected no other effect.<sup>21</sup>

### The Post-Juliar Cases

The *Juliar* decision was a welcome gift to taxpayers and an immediate concern for revenue authorities.<sup>22</sup> Predictably, the rapid transition in Canada from virtually no rectification orders in tax matters to the use of the equitable doctrine to, in effect, rewrite fiscal history has been swift. Many taxpayers have since relied on the *Juliar* decision to secure provincial court judgments to correct tax documents and tax plans with unintended tax consequences, whether immediate or in the future.<sup>23</sup>

In *Razzaq Holdings*, an error was made in the reorganization documents that resulted in some erroneous share transfers.<sup>24</sup> In granting the rectification order, the court considered the *Juliar* decision and stated that

[t]he basis of the rectification order [in *Juliar*] was that the result of the transaction was not what the taxpayers had intended as it was shown that they had always intended to transfer their shares without triggering any tax.<sup>25</sup>

Similarly in *Snow White Productions*,<sup>26</sup> the Supreme Court of British Columbia accepted the principles and reasons set out in *Juliar* to order retroactive rectification of agreements so as to conform to the parties' primary intention that certain tax consequences be achieved. In the court's view, the facts of the case justified this result. When Snow White Productions Inc. applied for a film tax credit, the claim was denied because the company did not have ownership of the film copyright or a direct contract with the copyright holder as required under the applicable legislation. The court accepted the tax consequences as being not merely incident to the agreement but at the core of the intention underpinning the original agreement.<sup>27</sup>

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21 *Re Juliar et al. v. Attorney General of Canada* (2000), 46 OR (3d) 104, at paragraph 48 (SC).

22 See, for example, Canada Revenue Agency, *Income Tax Technical News* no. 22, January 11, 2002.

23 See, for example, *McPeake*, *infra* note 31 and the related text.

24 *Re Razzaq Holdings Ltd.*, 2000 BCSC 1829.

25 *Ibid.*, at paragraph 18.

26 *Snow White Productions Inc. v. PMP Entertainment Inc. et al.*, 2004 BCSC 604.

27 The court stated (*ibid.*, at paragraph 24), "I find that it was always the common intention of the parties to obtain the legitimate fiscal advantage of the benefits under the *Income Tax Act* (Canada) and the *Income Tax Act* (British Columbia) which accrue to an 'eligible production corporation' in a position to receive an 'accredited film or video production certificate.'"

Provincial superior courts have continued to expand the scope of the remedy and to reduce the evidence necessary to show the required intent. An excellent example is the 2011 decision in *S & D International*.<sup>28</sup> In that case, the shares of a corporation were owned by three businessmen and their wives. Several errors occurred. First, in order to protect the spouses from a securities commission investigation, the corporation agreed to buy the shares from each spouse for \$1,864,778.75. The agreement provided that the corporation could pay the purchase price by transferring land of the same value. The shareholders believed that the fair market value of the land was equal to the cost base for tax purposes. Then all of the land, and not just the land required for the share purchase, was transferred to the wives. The corporation was assessed on the basis that it had disposed of the land at its fair market value of \$25,063,038, and the wives were assessed for deemed dividends. The parties compounded their tax difficulties by executing a cancellation agreement and transferring the land back to the corporation, triggering additional tax liability on the disposition.

The Alberta Court of Queen's Bench exercised its equitable jurisdiction to reduce the consideration given to the wives under the initial transfer agreement, finding that there was a fundamental mistake as to the tax effect of the transactions (that is, it granted rectification). The court also inferred that the parties would have done something else had they been aware of the adverse tax consequences of their documented transaction. In so finding, the judge stated:

I thus think it is artificial to interpret *Juliar* as requiring that the parties demonstrate that the mistake was a "primary and continuing objective of the applicants from the inception of the transaction." That circumstance might make the case for equitable relief stronger, but is not a pre-condition to the court granting equitable relief if it had been necessary to achieve a just result.<sup>29</sup>

The court also granted rescission with respect to the cancellation agreement. According to the court,

[t]he Applicants were clearly mistaken as to the effect of that transaction, not its basic nature, who the parties were or what the subject matter was. That is sufficient to trigger equitable jurisdiction.<sup>30</sup>

28 *S & D International Group Inc. v. Canada (Attorney General)*, 2011 ABQB 230.

29 *Ibid.*, at paragraph 83. In the same paragraph, the court states, "I hesitate to place the same strictures around equitable remedies for mistake as there are for common law mistake. Under common law mistake, a party is *entitled* to a legal remedy in the appropriate circumstances. Equitable relief is always discretionary."

30 *Ibid.*, at paragraph 106. The court found that rescission was not necessary to address the mistakes made in closing the transaction. These could be addressed in a rectification order that substituted cash for the land initially transferred to the spouses.

Perhaps the most far-reaching decision to date on rectification orders affecting tax matters is the 2012 decision of the British Columbia Supreme Court in *McPeake*.<sup>31</sup> This decision also provides an excellent summary of the principles that appear to underlie the remedy in Canada in tax cases.

In *McPeake*, Mr. McPeake established a family trust to distribute the benefits of his property (shares in a software company) to family members as beneficiaries. The trust was used as a vehicle to avoid payment of tax on capital gains. This end was to be achieved by distributing the trust income to the beneficiaries, who in turn were entitled to use the then \$500,000 capital gains deduction. It became clear that the plan would fail when the trust was reassessed almost a decade later and an overlooked attribution rule was cited by the Canada Revenue Agency (CRA). An application was sought to rectify the trust document by removing the compromising clauses. In the end, not one but two rectification orders were granted to prevent the unintended tax consequences.

The court's key findings in relation to the law of rectification can be summarized as follows:

- Rectification is a remedy within the equitable jurisdiction of a superior court.<sup>32</sup>
- The remedy is restorative, not “retroactive”: it aligns the documents with the true underlying intentions and does not change the essence of the agreement between contracting parties.<sup>33</sup>
- Rectification operates to correct the documents from inception. “Since rectification restores a truth to an instrument’s expression, it acts, in time, from the point of instrument formation onward.”<sup>34</sup>
- The onus is on the party seeking rectification to prove that the written instruments do not reflect the true agreement of the parties and “that the aspects to be rectified are mistakes that obstruct the true intentions behind the document’s formation.”<sup>35</sup> Moreover, the intention underlying the document must

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31 *McPeake v. Canada (Attorney General)*, 2012 BCSC 132.

32 The court stated (*ibid.*, at paragraph 16), “Rectification is an equitable remedy that courts may apply to various legal documents that stand as instruments expressing intended legal relations. Rectifiable documents can include contracts (*Performance Industries Ltd. v. Sylvan Lake Golf & Tennis Club Ltd.*, . . .), land deeds (*771225 Ontario Inc. v. Bramco Holdings Co.* . . .), documents relating to corporate transactions (*Juliar v. Canada (Attorney General)* . . .), and trust deeds (*Rose v. Rose* . . .).”

33 “[Rectification] is to restore the parties to their original bargain, not to rectify a belatedly recognized error of judgment by one party or the other.” *McPeake*, *supra* note 31, at paragraph 16, quoting *Performance Industries Ltd. v. Sylvan Lake Golf & Tennis Club Ltd.*, 2002 SCC 19, at paragraph 31.

34 *McPeake*, *supra* note 31, at paragraph 16.

35 *Ibid.*, at paragraph 17.

be more than a general intention, and “what constitutes sufficient specificity of intention varies by context.”<sup>36</sup>

- Tax avoidance is legal and may be supported by rectification.<sup>37</sup>

The court in *McPeake* found that there was sufficient evidence to show a specific intention (one that existed when the deed was created and that had continued) to avoid payment of tax on capital gains from the sale of shares by maximizing the capital gains deduction to the beneficiaries. Following the reasoning in *Juliar*, the court held that the desired tax consequences were not incidental to the trust’s formation but were the reason therefor.

The post-*Juliar* decisions demonstrate that if the intention of the parties is to put into effect a transaction that avoids tax, yet the parties by some error fail to do that, rectification may be the most appropriate and effective remedy available. Several courts have also confirmed that intention can be inferred from the evidence.<sup>38</sup> Perhaps most importantly, provincial court judges have now been unequivocal in their view that a mistake as to the effect of a transaction is sufficient to engage the equitable jurisdiction of the court.<sup>39</sup>

Not surprisingly, there appear to be few limits as to when orders will be granted in tax cases provided that the requisite intention is found.<sup>40</sup> The notable exception is that the remedy cannot be used for retroactive tax planning.<sup>41</sup> In the *Stone’s Jewellery*

36 Ibid., at paragraph 18.

37 Ibid., at paragraph 25. The court also reviewed the two lines of authority in Ontario in which courts reached divergent results on petitions for rectification. In *Bramco*, supra note 14, rectification was denied because the superior court failed to find sufficient specific intention to avoid a land transfer tax, a kind of tax that the applicant had not even contemplated at the transaction’s inception, because at the time of purchase she had focused solely on the avoidance of income tax. In contrast, rectification was ordered in *Juliar*, supra note 16, because the evidence showed a specific intention on the part of the applicants to avoid capital gains tax. Despite the differences in outcome, the court noted that the Ontario courts accepted that rectification could be legitimately used to achieve “tax avoidance”: the divergence of the courts hinged not on the tax avoidance itself, but on whether a specific intention to avoid tax was proved to exist at the transaction’s inception.

38 See *Juliar*, supra note 16; see also *McPeake*, supra note 31. Notwithstanding, the best and most reliable evidence in support of an application for rectification to establish the intention of the parties to avoid or take advantage of a particular tax provision is clearly written evidence existing contemporaneously with the time at which the contract or instrument is created.

39 *S & D International*, supra note 28, at paragraph 106.

40 In *Binder v. Saffron Rouge Inc.* (2008), 89 OR (3d) 54 (SC), the Ontario Superior Court of Justice concluded that there had been no common or continuing intention between the parties to obtain the tax benefits sought. In that case, the applicants were shareholders of Saffron Rouge Inc. (“Saffron”). Saffron had issued preferred shares to non-resident investors, causing the company to lose its status as a Canadian-controlled private company under the Income Tax Act. This in turn caused the shareholders to lose their capital gains exemption.

41 *Orman*, supra note 5, at paragraph 47.

decision, rectification was also denied, but for the reason that it did not provide an appropriate remedy.<sup>42</sup> Rescission of the contract or a finding that it was void ab initio at common law was necessary to give effect to the intention of the parties. The facts and the court's reasons are outlined below.

In *Stone's Jewellery*, the parties transferred land to four individuals and later to a corporation in transactions that they believed would be tax-deferred. With respect to the transfer to the corporation, the court held that it did not "have the power to direct that the 2006 Transfer proceed on a tax free basis . . . in accordance with the parties' intentions."<sup>43</sup> Similarly, rectification was not available to the four individuals with respect to the earlier transaction since the court was "not being asked to rectify the transaction back to its intended form, but to undo the transaction."<sup>44</sup> Instead, the court applied the common-law doctrine of mistake as it applied to contracts, and found that the transfer to the corporation was void ab initio because it was carried out under the mistaken belief of all the parties that it could be effected on a rollover basis; additionally, the earlier transaction also was void ab initio because it had proceeded on the basis of an (implicit) assumption by the parties that it would not have adverse tax consequences. In the court's view, the mistake was "as to the effect of the transaction itself and not merely as to its consequences or the advantages to be gained by entering into it."<sup>45</sup> Strekaf J was clear in her decision that had the contract not been void ab initio, she would have been prepared to exercise her equitable discretion to rescind the transfer agreement to the corporation as well as the initial transfer to the four individuals.

Strekaf J quoted with approval Fridman on *The Law of Contract* with respect to the court's equitable discretion to grant rescission:

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42 *Stone's Jewellery Ltd. v. Arora*, 2009 ABQB 656. Another recent example where a rectification order was refused but declaratory relief was provided instead involved a Ponzi scheme. In *Orman*, supra note 5, the two individuals seeking relief were victims who claimed that they had unnecessarily paid income tax on funds received and reported as income. They took the position that the uncovering of the fraud revealed that amounts previously reported as interest payments were actually return of capital, and that payments to them were corporate loans rather than bonuses. They sought an order to rectify the respondents' corporate records to reflect the actual nature of the payments. The court's reasoning in rejecting the claim for rectification provides a useful framework for considering the use of the remedy in tax cases. "Rectification is concerned with mistakes in recording the parties' intent or purpose in their written documents. It is designed to ensure that the parties' documents express the parties' purpose at the time the documents were finalized. In this case, at the time the documents were finalized (reporting income), they correctly expressed the parties' intention: rectification is not available to correct what is a mistake in the underlying purpose that was accurately expressed in the parties' documents. Rectification is not available to correct erroneous assumptions or beliefs as to what was intended." *Ibid.*, at paragraph 63.

43 *Stone's Jewellery*, supra note 42, at paragraph 45.

44 *Ibid.*, at paragraph 68.

45 *Ibid.*, at paragraph 50, quoting from *Gibbon v. Mitchell*, [1990] 1 WLR 1304 (Ch. D.).

The jurisdiction of the courts to grant rescission of a contract on equitable grounds, which involves a restoration of the parties to their original rights and property, extends beyond the situations and circumstances in which, at common law, a party, acting unilaterally, can treat the contract as a legal nullity, and then pursue such common-law remedies as may be available. Although there is a degree of overlap between the common-law right to rescind for fraud, and the equitable jurisdiction of the court to grant rescission of a contract which has been entered into as a consequence of a false representation or some other fraud, the equitable power to order rescission is wider in scope. Indeed, the limits of this jurisdiction have not been fixed. Wherever a court considers, on general equitable grounds, that a contract should not be allowed to stand, and that the request by one party that it be annulled and avoided should be granted, the court has the power to do so. A court of equity can do what is “practically just.”<sup>46</sup>

### Rectification in Non-Tax Cases

As discussed above, the rectification orders in the tax cases under review were made by provincial superior court judges. The analysis reveals that the key principles applied in the *Juliar* decision and relied on by later courts in granting equitable relief are developing differently from the principles relied on when the remedy was provided by the Supreme Court of Canada in post-*Juliar* non-tax cases.

In *Juliar*, the Ontario Court of Appeal relied on the following principles from *Slococ Will's Trust*<sup>47</sup> in dismissing the Crown's appeal:

The true principles governing these matters I conceive to be as follows. (1) The court has a discretion to rectify where it is satisfied that the document does not carry out the intention of the parties. This is the basic principle. (2) Parties are entitled to enter into any transaction which is legal, and, in particular, are entitled to arrange their affairs to avoid payment of tax if they legitimately can. . . . (3) If a mistake is made in a document legitimately designed to avoid the payment of tax, there is no reason why it should not be corrected . . . to enable the parties to obtain a legitimate fiscal advantage which it was their common intention to obtain at the time of the execution of the document.<sup>48</sup>

The Supreme Court of Canada cited very different principles in the two non-tax cases since *Juliar*. In *Shafron*,<sup>49</sup> a 2009 application, the court prefaced its analysis of rectification with the following quotation from Lord Denning in *Frederick E. Rose (London) Ltd.*:

46 G.H.L. Fridman, *The Law of Contract*, 5th ed. (Toronto: Thomson Carswell, 2006), at 812, quoted in *Stone's Jewellery*, supra note 42, at paragraph 29.

47 Supra note 19, at 363.

48 *Juliar*, supra note 16, at paragraph 33.

49 *Shafron v. KRG Insurance Brokers (Western) Inc.*, 2009 SCC 6. At issue was the wording of a restrictive covenant in an employment contract between Shafron and KRG Insurance Brokers—specifically, the interpretation of the ambiguous phrase “Metropolitan City of Vancouver.” The Supreme Court denied rectification to cure the ambiguity on the basis that there was no evidence that the parties had agreed to anything other than the term found in the agreement, notwithstanding its ambiguity or vagueness.

Rectification is concerned with contracts and documents, *not with intentions*. In order to get rectification it is necessary to show that the parties were in complete agreement on the terms of their contract, but by an error wrote them down wrongly; and in this regard, in order to ascertain the terms of their contract, you do not look into the inner minds of the parties—into their intentions—any more than you do in the formation of any other contract.<sup>50</sup>

The court then went on to cite with approval the criteria set out by the Supreme Court in *Performance Industries*<sup>51</sup> (the other non-tax-related decision):

(1) the existence and content of the inconsistent prior oral agreement; (2) that the party seeking to uphold the terms of the written agreement knew or ought to have known about the lack of correspondence between the written document and the oral agreement, in circumstances amounting to fraud or the equivalent of fraud; and (3) “the precise form” in which the written instrument can be made to express the prior intention.<sup>52</sup>

The court in *Shafron* concluded that there was “no indication that the parties agreed on something and then mistakenly included something else in the written contract. Rather, they used an ambiguous term in the written contract.”<sup>53</sup>

While provincial courts pay lip service to the two Supreme Court decisions and the principles on which they rely, the same courts appear quick to distinguish those decisions. For example, the British Columbia Supreme Court considered the Supreme Court of Canada’s view in *Shafron* in a tax-related case, *Fraser Valley Refrigeration*.<sup>54</sup> The Crown argued that *Shafron* had changed the law of rectification in Canada with respect to intention. The BC court disagreed:

In *Shafron* rectification was not available because the plaintiff was attempting to resolve a contractual ambiguity, in circumstances where the parties had not expressed intention,

50 *Frederick E. Rose (London) Ltd. v. William H. Pim Jnr & Co.*, [1953] 2 QB 450 (CA) (emphasis added) (quoted in *Shafron*, supra note 49, at paragraph 52).

51 *Performance Industries*, supra note 33. In that case, at paragraph 31, the Supreme Court summarized the rectification remedy as follows: “Rectification is an equitable remedy whose purpose is to prevent a written document from being used as an engine of fraud or misconduct ‘equivalent to fraud.’ The traditional rule was to permit rectification only for mutual mistake, but rectification is now available for unilateral mistake (as here), provided certain demanding preconditions are met. Insofar as they are relevant to this appeal, these preconditions can be summarized as follows. Rectification is predicated on the existence of a prior oral contract whose terms are definite and ascertainable. The plaintiff must establish that the terms agreed to orally were not written down properly. The error may be fraudulent, or it may be innocent. What is essential is that at the time of execution of the written document the defendant knew or ought to have known of the error and the plaintiff did not. Moreover, the attempt of the defendant to rely on the erroneous written document must amount to ‘fraud or the equivalent of fraud.’”

52 *Shafron*, supra note 49, at paragraph 53, citing *Performance Industries*, supra note 33, at paragraphs 37-40.

53 *Shafron*, supra note 49, at paragraph 57.

54 *Fraser Valley Refrigeration, Re*, 2009 BCSC 848.

thus there was no mutuality of intent or agreement as to the actual meaning of the ambiguous term. . . . *Shafron* does not mean that intention is irrelevant to rectification cases. . . . In my view, the *Shafron* decision did not change the law of rectification.<sup>55</sup>

The judge went on to add:

In tax cases rectification is granted to rectify documents that are inconsistent with the expressed and agreed tax intent of the parties to a contract. Intent is relevant, because where intent is common and continuing it forms a part of the true agreement between the parties to a contract.<sup>56</sup>

So while the Supreme Court of Canada appears to be taking a cautious and narrow approach, citing earlier judicial comments that “[t]he power of rectification must be used with great caution,”<sup>57</sup> the provincial courts seem fully prepared to grant rectification “once the Court is satisfied that the true agreement between the parties (which is based on the transaction not attracting or at least minimizing income tax) is frustrated.”<sup>58</sup>

Courts have delineated the scope and applicability of rectification remedies in circumstances other than tax cases. For instance, an order for rectification will not be granted where it would harm the interests of an innocent third party.<sup>59</sup> In addition, undue delay or subsequent affirmation of the written agreement can provide the basis for denying rectification orders. Moreover, in the recent pronouncement on rectification in *Performance Industries*, the Supreme Court of Canada held that the conduct of the adversely affected party (normally the plaintiff) can be taken into account in determining whether it is just to provide equitable relief.<sup>60</sup> As discussed

55 Ibid., at paragraphs 39-40.

56 Ibid., at paragraph 41.

57 *Shafron*, supra note 49, at paragraph 56, quoting *Hart v. Boutillier* (1916), 56 DLR 620, at 630 (SCC).

58 *Di Battista v. 874687 Ontario Inc.* (2005), 80 OR (3d) 136, at paragraph 6 (SC).

59 See *Wise et al. v. Axford et al.*, [1954] OWN 822 (CA). Who is the affected third party if rectification is granted? In the tax-related cases, both parties to the contract or arrangement for which rectification is sought are generally in agreement, or at least not in disagreement, about the remedy being sought—namely, tax relief. The party often in disagreement in the tax cases is the fisc.

60 *Performance Industries*, supra note 33. In this case, the defendant argued that the plaintiff should be denied relief because he did not carefully read the written agreement prior to signing it. The court indicated that, while the plaintiff’s actions should be scrutinized, his want of due diligence could not serve as a defence to rectification in this case. One could argue that, in a rectification case that seeks to address retroactive tax laws, the innocent third party is the government, which is solely interested in collecting revenue from the transaction. The rectification cases, however, scrutinize whether a private bargain should be set aside or modified, and traditionally courts scrutinize only the actions of the parties to the bargain, and so might ignore the interests of third parties such as governments.

later in this article, when interpreting the impact of retroactive tax legislation, courts should similarly scrutinize whether a particular taxpayer seeking equitable relief had an honest and reasonable reliance on earlier tax laws when he or she engaged in tax planning.

### Summary

On the basis of the prior analysis, two things are obvious. First, case law is developing independently in tax-driven rectification applications. In all of the decisions since *Juliar*, the courts have been willing to grant the remedy beyond the narrow circumstances envisaged by the Supreme Court of Canada in non-tax cases. Second, the trend in Canada appears to be toward broadening the grounds for equitable relief within the tax cases. At least two provincial court judges have indicated that they would not have followed the often cited decision in *Bramco*,<sup>61</sup> where the court would not grant rectification to relieve the taxpayers of the land transfer tax payable as a result of a tax-planned transfer. According to the court, rectification was denied because income tax but not land transfer tax was contemplated at the time of the transaction.

What is also of interest in these cases, starting with *Juliar*, is the court's attitude toward the fisc. In *Juliar* and subsequent cases, the courts have cited with approval the statement from *Sloccock Wills Trust* that "[i]t would not be a correct exercise of the discretion in such circumstances to refuse rectification *merely because the Crown would thereby be deprived of an accidental and unexpected windfall*."<sup>62</sup> Provincial court judges also appear in many of the decisions to be at best ambivalent to the interests of the fisc<sup>63</sup> and its right to be added as an interested party to a rectification application.<sup>64</sup>

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61 *Supra* note 14 (leave to Appeal to the Supreme Court of Canada was dismissed without reasons November 2, 1995).

62 *Juliar*, *supra* note 21, at paragraph 37 (emphasis added), quoting from *Sloccock Wills Trust*, *supra* note 19, at 363. Also see, for example, *Re: Prospera Credit Union (Matter of)*, 2002 BCSC 1806, at paragraph 2: "Customs and Revenue Agency's interest will not be affected other than losing an unexpected windfall by the orders sought."

63 In *Orman*, *supra* note 5, where the taxpayers seeking rectification were the victims of a Ponzi scheme, the judge referred to the parties to the sought-after rectification order as Messrs. Orman and Freed, and to the government as "the Taxman." The latter form of reference leaves little doubt as to the court's orientation and the likelihood of a favourable outcome for the taxpayers. The court's wording is also in stark contrast to other tax decisions where the fisc is generally referred to as "the respondent," "the Minister," or "the Canada Revenue Agency" represented by the attorney general of Canada.

64 See the comments in *Stone's Jewellery*, *supra* note 42, where the CRA opposed an application for rectification in respect of a transaction that resulted in an assessment of more than \$6 million in income taxes. In her reasons for judgment, Strefak J stated (*ibid.*, at paragraph 74) "there is no evidence that any third parties who were not involved in the original transaction would be prejudiced." This may come as a surprise to the CRA.

The one clear judicial limitation on the remedy of rectification is that it should not be used for retroactive tax planning.<sup>65</sup> There should be no question of retroactive tax planning where a document is amended merely to reflect the original intention of the parties. Does the answer change if rectification is used to correct an error in a transaction itself? On the basis of the *Juliar* decision, it appears not.<sup>66</sup>

## PERSPECTIVES ON RETROACTIVE TAX LAWS

### The Rule of Law and Retroactive Tax Laws

The preceding discussion focused on Canadian judicial perspectives on the equitable remedy of rectification; this part of the article broadens the inquiry to consider how another Canadian judicial perspective on retroactive tax laws<sup>67</sup> deals with taxpayers' reasonable expectations within the context of perspectives on the rule of law.

The rule of law is considered to be among the most important aspects of a democratic society.<sup>68</sup> A number of different elements, including principles of certainty and predictability, constitute the rule of law. Friedrich Hayek described the rule of law as follows:

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65 *McPeake*, supra note 31.

66 Indeed, it was by focusing the *Juliar* analysis not on whether the parties in fact intended and in fact accomplished a share-for-debt exchange (with albeit unexpected tax consequences), but on whether the parties intended to avoid or defer tax and carried out a transaction that in fact accomplished avoidance or deferral of tax, that the Court of Appeal was able to justify rectification in the circumstances presented in the case. For a good discussion of this issue, see generally Bruce S. Russell and Karen D. Stillwell, "Aspects of Fixing Mistakes in Tax Context: Rectification and Due Diligence," in *2009 Atlantic Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2009), 1-46.

67 There are two main categories of what is sometimes referred to as "retroactive legislation": (1) laws that operate upon existing rights to alter them from the date of enactment; and (2) laws that provide that as of a past date, the law will be taken to mean what it was not—in other words, legislation that operates as of a time prior to its enactment. In the context of this discussion, we distinguish between these two categories and rely on the distinction made by E.A. Driedger in "Statutes: Retroactive Retrospective Reflections" (1978) 56:2 *Canadian Bar Review* 264-78, at 268-69. Thus, for the purposes of this article, we consider retroactive legislation to mean legislation that operates as of a time prior to its enactment. In contrast, retrospective legislation operates for the future only. It is prospective, but it imposes new results in respect of a past event. A retroactive statute changes the law from what it was; a retrospective statute changes the law from what it otherwise would be with respect to a prior event. A number of tax and non-tax courts rely on this distinction. See, for example, *Epiciers Unis Metro-Richelieu Inc. Division "Econogros" v. Collin*, 2004 SCC 59, and *Gibralt Capital Corporation v. The Queen*, 2002 DTC 1601 (TCC). See also the discussion in note 75, *infra*.

68 The Supreme Court of Canada has written that the rule of law is a "fundamental postulate of our constitutional structure" that lies "at the root of our system of government." See *Imperial Tobacco*, supra note 4, at paragraph 57, citing *Roncarelli v. Duplessis*, [1959] SCR 121, at 142, and *Reference re Secession of Quebec*, [1998] 2 SCR 217, at paragraph 70. In *Imperial Tobacco* (supra note 4, at paragraph 61), the court cited supporting views that a breach of the rule of law does not lead to invalidity.

[The rule of law] means that government in all of its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one's individual affairs on the basis of this knowledge.<sup>69</sup>

Other legal philosophers such as Joseph Raz, H.L.A. Hart, and Lon Fuller, have identified similar, interrelated concepts in describing the rule of law, such as clarity, publicity, and prospectivity.<sup>70</sup> Other observers have also sometimes questioned the desirability of retroactive tax laws on grounds that include fairness and the rule of law.<sup>71</sup>

For these reasons, within the Canadian legal system there is a presumption against retroactive legislation; under this view, legislation is deemed to generally become effective when it is legislated and remains active until repealed. Edinger<sup>72</sup> traces this presumption to Roman law, along with its subsequent adoption by most western legal systems, including those of the United States, the United Kingdom, Australia, and Canada.

The main rationale for opposing retroactive laws—that they change the rules of the game after the game has been played—was discussed in an 1880 paper by William Pratt Wade:

In all retroactive laws there must be an element of surprise, by which persons whose rights are affected are taken unawares. They are called upon to act in a manner different from what they have been led by the settled state of the law to anticipate. So repugnant is such a system of legislation to our nature sense of justice, that it has been stigmatized as more unreasonable than that adopted by Caligula, who was said to have written his laws in a very small character and hung them upon high pillars, the more effectually to ensnare the people.<sup>73</sup>

## Canadian Judicial Views

Despite this obvious fairness concern, Canadian law is clear that retroactive laws are generally acceptable, and in tax matters they are considered commonplace.<sup>74</sup> In fact, tax laws often have effect from the date of the budgetary announcement, which

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69 F.A. Hayek, *The Road to Serfdom: Text and Documents*, ed. Bruce Caldwell (Chicago: University of Chicago Press, 2007), at 112.

70 For discussion, see Benjamin Alarie, “Retroactivity and the General Anti-Avoidance Rule,” in David G. Duff and Harry Erlichman, eds., *Tax Avoidance in Canada After Canada Trustco and Mathew* (Toronto: Irwin Law, 2007), chapter 8, at 201-2.

71 See “Setting Effective Dates for Tax Legislation: A Rule of Prospectivity,” Note (1970) 84:2 *Harvard Law Review* 436-55.

72 See Elizabeth Edinger, “Retrospectivity in Law” (1995) 29:1 *University of British Columbia Law Review* 5-25.

73 Cited by Edinger, *ibid.*, at 13.

74 See the discussion in note 67, *supra*.

typically far precedes the date on which the legislation is passed.<sup>75</sup> Even when announced in a budget to have immediate effect, retroactive legislation clearly raises the fairness issues identified in the previous section. To many Canadian courts, however, fairness does not appear to be an issue in the context of retroactive legislation.

In its most recent pronouncement on retroactivity, the Supreme Court indicated that “there is no requirement of legislative prospectivity embodied in the rule of law or in any provision of our Constitution.”<sup>76</sup> The court noted that statutes can have retroactive operation when the statute is clear that such effect is intended.<sup>77</sup> The only other limit identified is the one placed on retroactive legislation that implicates an individual’s liberty interest: a retroactive criminal law that sought to impose guilt on an individual in respect of prior conduct would be constitutionally impermissible under the Canadian Charter of Rights and Freedoms.<sup>78</sup>

It could be argued that tax laws bring about potential criminal sanctions and hence a taxpayer’s liberty interest ought to be protected by prohibiting retroactive tax laws. In fact, Canadian courts have previously recognized that an investigation into a taxpayer’s records constitutes a government search that attracts constitutional protections against unreasonable state searches.<sup>79</sup> Moreover, there is a lengthy tradition in political philosophy (often derived from Lockean perspectives) that views

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75 There has been considerable confusion in the use of the term “retroactive” in relation to tax legislation. In *Gustavson Drilling (1964) Ltd. v. Minister of National Revenue*, [1977] 1 SCR 271, an oil company tried to deduct in 1964 drilling expenses incurred prior to 1960. Tax laws passed in 1962 had repealed the right to claim such deductions for tax years following 1962. The majority of the court held that the repealing legislation was not in fact retroactive and that “[n]o one has a vested right to continuance of the law as it stood in the past” (*ibid.*, at 282). The use of the term “retroactive” in this case was what Driedger, *supra* note 67, would describe as “retrospective.”

76 See *Imperial Tobacco*, *supra* note 4, at paragraph 69. But see Geoffrey T. Loomer, “Taxing out of Time: Parliamentary Supremacy and Retroactive Tax Legislation” [2006] no. 1 *British Tax Review* 64–90, at 82 (arguing that some constitutional mechanism should allow the questioning of retroactive tax legislation).

77 *Imperial Tobacco*, *supra* note 4, at paragraph 72. See *Gustavson Drilling*, *supra* note 75.

78 *Imperial Tobacco*, *supra* note 4, at paragraph 69. See the Canadian Charter of Rights and Freedoms, part I of the Constitution Act, 1982, being schedule B to the Canada Act 1982 (UK), 1982, c. 11, section 11(g) (herein referred to as “the Charter”).

79 In addition to state searches for criminal investigation purposes, section 8 of the Charter has also been used to restrict the ability of government officials to seize and disclose tax returns for the purposes of assessing a person’s tax liability. See, for example, *Gernbart v. Canada*, [2000] 2 FC 292 (CA). In addition, retroactive tax legislation may require a government reassessment and scrutiny of a taxpayer’s private financial situation, which may call for protection under section 7 of the Charter—the provision providing for protection of “life, liberty, and security of person.” Section 7 appears to be becoming increasingly important in Charter privacy analysis. See *Ruby v. Canada (Solicitor General)*, 2002 SCC 75, at paragraph 32: “[T]here is an emerging view that the liberty interest in s. 7 of the Charter protects an individual’s right to privacy.” But see *Imperial Tobacco*, *supra* note 4, at paragraph 69 (indicating that section 7 was not engaged by retroactive tax legislation).

state taxation powers—the use of the state’s monopoly of means of violence to relieve a person of part of his or her private property—as among the government’s most intrusive powers.<sup>80</sup>

Canadian tax courts have at times expressed their reservation with respect to applying retroactive tax legislation:

Retroactive legislation, although within the power of Parliament is legal but undesirable. The inappropriateness of reassessing taxpayers who completed transactions in accordance with the law in force at the time of those transactions without any expectation of adverse retroactive effect is self-evident.<sup>81</sup>

To guard against abuse, Canadian courts have also adopted a presumption of minimal retroactivity.<sup>82</sup> For instance, this presumption was expressed in a 1924 Supreme Court of Canada decision:

[W]here an enactment, admittedly retrospective, is expressed in language which leaves the scope of it open to doubt, and according to one construction it imposes retrospectively a new liability, while upon another at least equally admissible, it imposes no such burden, the latter construction is that which ought to be preferred.<sup>83</sup>

As discussed subsequently, the presumption of minimal retroactivity may provide provincial courts with sufficient wiggle room to provide equitable relief when retroactive tax laws increase tax liabilities for taxpayers who honestly and reasonably relied on existing tax laws to guide their tax-planning efforts.

### **Rectification Versus Retroactive Tax Laws**

Before proceeding to the next part of the article, which discusses the potential for rectifying arrangements affected by retroactive laws, we pause to consider why provincial courts appear willing to rectify tax mistakes whereas federal courts seem willing to accept the validity of retroactive tax laws, arguably without critically considering the various interests at stake.

On the one hand, provincial courts seem to emphasize business certainty, as well as reinforcement of private rights and reasonable contractual intentions. In addition, these courts seem less deferential to Parliament in that rectification of tax

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80 See, for example, Arthur J. Cockfield, “Income Taxes and Individual Liberty: A Lockean Perspective on Radical Consumption Tax Reform” (2001) 46:1 *South Dakota Law Review* 8-71 (discussing tax policy concerns arising from Locke’s conception of individual liberty and the labour theory of property).

81 See *MIL (Investments) SA v. The Queen*, 2006 TCC 208, at paragraph 30.

82 Alarie, *supra* note 70, at 205.

83 See *Kent v. The King*, [1924] SCR 388, at 397.

mistakes—even if they were made as a result of errors caused by the taxpayers—leads to a circumvention of federal tax laws and results in revenue losses. On the other hand, federal courts downplay concerns surrounding fairness and business certainty in order to promote the overarching goals of legislative supremacy and, in the case of retroactive tax laws, revenue collection. The federal courts also appear to be more accepting of laws that try to inhibit aggressive tax planning.

Both federal and provincial courts appear to be influenced by their own internal logic and their vision of the appropriate role of the rule of law.<sup>84</sup> Interestingly, both analyze this role in the context of federal tax laws; the provincial courts emphasize how equity and reasonable contractual intentions should at times trump federal tax laws, whereas the federal courts appear more willing to ignore honest and reasonable intentions when they clash with the dictates of retroactive tax laws.

The internal reasoning of each approach would be brought together in a clash if a plaintiff tried to rectify an arrangement or agreement that was adversely affected by retroactive tax laws. Consider the following hypothetical situation. Income tax legislation that contains a retroactive provision, such as the proposed non-resident trust rules, is tabled as a notice of ways and means motion. Prior to the enactment of the legislation, the trust is terminated. The trust files its tax returns on the basis of the existing law, not on the basis of the proposed rules. The proposals are eventually enacted with retroactive effect.

According to the CRA, if notice is given (for example, via a notice of ways and means motion) of proposed legislation that will have a retroactive effective date when enacted, and if a legal representative does not file in accordance with the proposed legislation and distributes the taxpayer's property that is under the legal representative's possession or control, the legal representative will be personally liable up to the amount of the distributed property.<sup>85</sup> The reasoning is that the retroactive commencement date of a tax change (relative to its enactment) gives rise to the liability

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84 At this point, we query whether the different court decisions have been influenced by the phenomenon of autopoiesis (where a system is derived from reasoning that is self-referential and recursive). For discussion, see Geraldine Hikaka and John Prebble, *Autopoiesis and General Anti-Avoidance Rules*, Victoria University of Wellington Legal Research Paper no. 31/2011 (Wellington, NZ: Victoria University of Wellington, 2011), at 3 (describing how autopoiesis theory can assist in understanding the nature of income tax law). In this sense, the reasoning of the federal and provincial courts could be described as “operatively closed” since they are both driven by different principles and understandings. Assuming that a plaintiff tries to use rectification to undo the adverse effects of retroactive tax laws, through the judicial system the two autopoietic systems would be able to observe and react to one another in what has been described as a “systems paradigm.”

85 Subsection 159(3) of the Act and the CRA round table presented at the Society of Trust and Estate Practitioners conference, June 2-3, 2011, question 1 ([www.step.ca/pdf/snc2011craRoundtable.pdf](http://www.step.ca/pdf/snc2011craRoundtable.pdf)). This assumes that the personal representative did not or could not obtain a clearance certificate as a result of the open-ended legislative proposals.

before the trust is wound up. Similar logic applies if a corporation that will be affected by retroactive tax legislation is wound up before the legislation is enacted.<sup>86</sup>

In the case described by the CRA, should the personal representative be able to seek a rectification order to correct aspects of the distribution of trust property that led to tax liability for the trust if retroactive legislation affects the final tax result? Surely it was not the intention of the personal representative to face personal tax liability with respect to the trust assets. Sympathies for the trustee—particularly if that person is not a professional trustee—may be further inflamed by the complexities surrounding the non-resident trust rules, the temporal aspects of which have been anything but clear. In fact, six sets of proposals were introduced between 2000 and 2012, with four different retroactive dates.<sup>87</sup> The sixth incarnation was introduced in the March 4, 2010 federal budget, with the effective retroactive date delayed from the originally announced date of 2001 until 2007. This measure, tabled in a notice of ways and means motion on October 24, 2012, has since become law.<sup>88</sup>

The sheer number and complexity of the legislative proposals with respect to non-resident trusts left even the most seasoned tax professionals uncertain for more than a decade about the tax rules applicable to trust property. During this period, many trustees would no doubt have come under pressure from beneficiaries to make distributions or to wind up the trust under the terms of the trust document. More importantly, personal representatives may have taken steps based on the proposals that resulted in more onerous taxation than would apply under the enacted legislation. Is rectification (or rescission) an appropriate remedy for the personal representative in these circumstances if personal liability results from retroactive tax changes or more onerous liability to the trust? A provincial court, deploying its own internal logic related to the post-*Juliar* cases, could agree that rectification is the appropriate remedy.

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86 For an interesting example of a situation where a taxpayer sought to rely on retroactive legislation, see *Edwards v. Canada*, 2012 FCA 330. In *Edwards*, the taxpayer was involved in a charitable donation scheme. In the Tax Court, the taxpayer brought a motion for an adjournment of the hearing pending the enactment of amendments to the Act proposed in Bill C-48 (which are now law: see supra note 11). The amendments, as proposed, would have been retroactive to the date on which they were first announced and may have allowed the taxpayer to claim all or a portion of the denied credit. The Tax Court denied the taxpayer's adjournment request, although the Federal Court of Appeal allowed it pending passage of the proposed amendments.

87 The saga of the non-resident trust provisions began when the proposed rules were announced in the 1999 federal budget. The first version was introduced on June 22, 2000. The Department of Finance announced that it was seeking comments by September 1, 2000; legislation was to be tabled in Parliament in 2000, which was to become effective as of January 1, 2001. A revised draft was released for public comment on August 2, 2001. A third draft was released as a notice of ways and means motion on October 11, 2002 and specified that the rules would have effect for 2003 and subsequent taxation years. A fourth version was tabled on October 30, 2003 as a notice of ways and means motion to take effect for taxation years beginning after 2002. A fifth version was introduced by the minister of finance on November 9, 2006. Bill C-10 was introduced in 2006 and died while it was before the Senate in 2008.

88 See supra note 11.

## USING RECTIFICATION ORDERS TO COUNTER RETROACTIVE TAX LAWS?

In a 2010 article on rectification, Boidman et al. noted:

Where a rectification order is sought as a result of retroactive tax legislation, the doctrine, as an equitable remedy, should be interpreted broadly, should not be constrained by artificial limitations, and should be employed where needed to prevent tax authorities from relying upon written instruments that do not reflect their authors' clear underlying intentions. As indicated in *Amalgamation of Aylwards (1975) Ltd., Re*, at paragraphs 38 and 41, rectification remedies may be applied, in appropriate cases, to "novel situations."<sup>89</sup>

No prior writings appear to have explored this provocative statement. This part of the article takes up the challenge to investigate whether the remedy of rectification—as well as, more generally, the law of mistake—can and should be used to counter the effect of retroactive tax laws. We pose two questions. First, would a provincial court grant a rectification order; and second, should a provincial court grant a rectification order to counter the effects of retroactive tax legislation? We move forward with the debate mindful of the rather colourful language used by Davis J in *Mendel*, asserting that "[i]t is a well-known rule that 'Equity and Income Tax are strangers,'" and that "[i]t is thus well recognized that, in taxing statutes, there is no room for equity."<sup>90</sup>

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89 Boidman et al., *supra* note 1, at 147-48. In *Amalgamation of Aylwards (1975) Ltd., Re* (2001), 16 BLR (3d) 34 (NLSC) (a non-tax decision), the court relied on *Juliar*, *supra* note 16, to change the format used for an amalgamation. The court also retroactively issued new shares. The decision includes the following: "*Juliar v. Canada (Attorney General)* . . . permitting rectification of a corporate transaction so as to accord with an original intent to avoid income tax liability, illustrates that the doctrine of rectification may, in appropriate cases, be employed in *novel situations* in the corporate sphere to ensure that instruments evidencing corporate transactions comport with the real intentions of their creators. . . . In the context of the current case, what is significant about *Juliar* is that the court was prepared to allow rectification *where the mechanism chosen to reach an intended result was mistakenly used*. The parties were allowed effectively to restructure the transaction by using a *different mechanism*, provided of course that the result obtained by the use of the new mechanism was in accordance with the original common intention of the parties. In achieving rectification, the parties were permitted, retroactively, to create new, or modify existing, instruments to achieve their original purpose where the original instruments could not do so as a result of a common mistake, and this was so even though the parties may not have adverted to the appropriateness of the use of the specific mechanism that had originally been mistakenly chosen to effectuate their original intention." *Aylwards*, *supra*, at paragraphs 38 and 41 (emphasis added).

90 *Mendel*, *supra* note 14, at 122. Davis J quotes in part from Finlay J in *Kliman (HM Inspector of Taxes) v. Winckworth* (1933), 17 TC 569, at 572 (KB): "There is no room, of course, in a taxing Act for equitable considerations, if by 'equity' the Commissioners meant there, as I suppose they did, considerations of what they conceived would effect a just result in all the circumstances. It is, of course, for the legislature and not for the Courts to consider matters of that sort."

## Would a Canadian Court Rectify Contracts Affected by Retroactive Tax Laws?

In several ways, there is an ill fit between the equitable remedy of rectification and its potential application to retroactive tax legislation.

First, traditionally rectification orders generally apply—as does the common law of mistaken assumptions—to mistakes concerning circumstances believed to be in existence at the time the contract is created. The law of frustration, on the other hand, applies to assumptions concerning future circumstances that prove to be incorrect. In other words, when a taxpayer engages in tax planning, he or she relies on current tax laws to generate a hoped-for tax outcome. The documents hence reflect the accurate and true agreement between the taxpayers at the time the transaction was entered into. Retroactive tax laws occur at some future point, and hence the taxpayer did not make a current mistake. Rather, the taxpayer's tax plan was “frustrated” by a subsequent event that is more similar to an act of god (or some other unexpected event) that was difficult for the taxpayer to envisage at the time of entering into the transaction.<sup>91</sup>

The law of mistake (including the equitable remedy of rectification) has developed in a distinct (albeit related) fashion from the law of frustration.<sup>92</sup> Hence, a court might refuse to apply a rectification order surrounding a mistake that arose as a result of a tax-law change that occurred in the future. Alternatively, and as explored by the US District Court in *Neal*, discussed below,<sup>93</sup> since a retroactive law operates

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91 The remedy in the case of retroactive legislation would be to allow the taxpayer either to redo the transaction in such a way as to permit the transaction to occur in a manner that would achieve the desired tax effect, or to unwind the transaction. See *Di Battista*, supra note 58, at paragraphs 6 and 8, where Campbell J makes the following comments: “As set out in *Attorney General of Canada v. Juliar* . . . once the Court is satisfied that the true agreement between the parties (which is based on the transaction not attracting or at least minimizing income tax) is frustrated, rectification may be permitted to reflect the transaction as intended. . . . The Court must (a) make a finding of unintended mistake; (b) exercise discretion which discretion can include, ‘. . . enabl[ing] the parties to obtain a legitimate fiscal advantage which it was their common intention to obtain at the time of the execution of the document.’”

92 It is not our intention to discuss the law of mistake in this article other than in the limited context of pointing out that the doctrine of mistake, like rectification, could have potential application, assuming that a taxpayer enters into a contract with the primary intention and agreement to obtain a specific tax result, but owing to a mistake the tax result is not achieved. For example, many of the cases under discussion involved parties who were not at arm's length and who both anticipated the same beneficial tax outcome. The mistake was common to both parties. The remedy is to void the contract ab initio, and hence the transaction should be unwound. As discussed, a prerequisite for relief as to mistake at common law is that the mistake is as to existing facts or laws. The circumstances in which a contract will be voidable in equity are wider, and the courts “will afford relief in any case where it considers that it would be unfair, unjust or unconscionable not to correct it.” For a useful discussion of these issues, see Terry S. Gill, “The Tax Advisor's Tool Box: Repairing Tax Problems,” in *2005 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2005), 14:1-46, at 14-33.

93 See infra note 100 and the related text.

on a fiction (in that the taxpayer runs afoul of a rule that it is deemed to have come into effect at a past date and hence applies to past behaviour), then similarly the state of affairs and the intentions of the taxpayer can be deemed to have occurred at the time the new retroactive tax law takes effect (a law that was unknown to the parties at the time, so that they were mistaken as to its existence). In this way, the law of mistake might be able to address retroactive tax laws under conventional doctrine, in that it assists parties when they were under a mistaken belief as to what they perceived to be the current state of the law (since it turned out not to be what was assumed at the time of the transaction, owing to the retroactive tax law).

Second, on a related point, it is not clear that a court would accept a taxpayer plaintiff's claim for relief from retroactive tax legislation since the circumstances may not fit within the four traditional requirements for rectification—namely, the existence of a prior agreement, a common intention, a final document that did not properly record the intention of the parties, and a common or mutual mistake.<sup>94</sup> With respect to the third requirement, a court may hold that the final document did indeed reflect the intent of the parties and that it is unreasonable to suggest that the taxpayers could not have foreseen subsequent retroactive tax legislation, since such legislation has been deployed in Canada for many decades.

On the other hand, intention is a key element for rectification in tax cases and can apply retroactively. This is not inconsistent with the Supreme Court of Canada's view of when rectification may be appropriate. In the case of retroactive tax hikes that apply to the general income of individuals, such as that which would have occurred under the now-defunct Quebec proposal, it may be unreasonable to suggest that these individuals should have foreseen this development insofar as Canadian governments have rarely, if ever, deployed these types of retroactive taxes in the past. (For more on this, see the discussion in the next section.) As well, the law of mistake—or more specifically, the law of mistaken assumptions, of which law of rectification forms a part—appears to broadly support relief in many circumstances. Canadian law in this area is often traced to Lord Denning's 1950 decision in *Solle*.<sup>95</sup> In that case, Lord Denning asserted that there was a long line of precedents that permitted contracts to be set aside on some equitable ground:

A contract is also liable in equity to be set aside if the parties were under a common misapprehension either as to facts or as to their relative and respective rights, provided that the misapprehension was fundamental and that the party seeking to set it aside was not himself at fault.<sup>96</sup>

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94 *Armstrong*, supra note 1.

95 *Solle v. Butcher*, [1949] 2 All ER 1107 (CA). Canadian cases that have followed Lord Denning's view include *Toronto Dominion Bank v. Fortin (No. 2)* (1978), 88 DLR (3d) 232 (BCSC).

96 *Solle*, supra note 95, at 1120.

Note, however, that the remedy in these circumstances is one of rescission and not rectification.<sup>97</sup>

Although there are no Canadian decisions that have granted a rectification order to counter retroactive tax legislation, Canadian legislation clearly contemplates the potential impact of rectification on retroactive legislation. For example, to counter the tax leakage caused by the infamous Quebec truffle,<sup>98</sup> the Quebec Taxation Act was amended retroactively to May 9, 2006. The amendment also provided that no rectification orders would be respected.

The analysis in *Juliar* regarding the effect of the transaction and the parties' intentions also raises an important issue. What is the real agreement between the parties for which rectification is sought?<sup>99</sup> If the agreement is to enable a transaction to proceed in a tax-free manner, regardless of how is to be accomplished, the *Juliar* decision is good authority for the proposition that rectification should be granted to achieve that objective. *Juliar* also provides an argument for untangling a transaction that has been negatively affected by retroactive tax legislation.

*Neal*,<sup>100</sup> a US District Court decision, although based on unilateral mistake, also supports an equitable claim for rescission in the case of retroactive legislation. In that case, the plaintiff released her contingent reversionary interests in a trust under gift tax legislation, on the basis of her reasonable belief, following the advice of counsel, that a provision then in effect would exact more onerous tax consequences if she did not do so. Congress retroactively repealed the provision, nunc pro tunc. The outcome was that the plaintiff paid gift tax unnecessarily. She sought an order to rescind the release with a view to a refund of the gift taxes paid.

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97 We note that rectification as an equitable remedy may provide the appropriate relief where rescission will not. The converse is also true. Rectification will not assist the taxpayer if the issue is that a tax election was not filed or if the transaction cannot be restructured. See, for example, *Stone's Jewellery*, supra note 42, where the court could not substitute the needed relief (a rollover), but could either void the transaction at common law on the basis of the doctrine of mistake or rescind the contract in equity. As indicated above, the remedies for mistake can be found in both the common law and equity. If the mistake meets the test under common law, the contract is void. If the mistake meets the test in equity, the contract is voidable.

98 The Quebec truffle was an interprovincial tax-planning arrangement promoted by tax practitioners where the result was that no or minimum provincial income tax was paid. The arrangement was facilitated by an election at the federal level, which in most provinces meant that the election was also effective for provincial tax purposes. Because Quebec collected its own taxes, revenue authorities were misled into believing that provincial tax was being paid in another province. An estimated \$500 million in tax revenues was lost as a result of the Quebec truffle. See Sylvain Fleury, *Abusive Tax Planning: The Problem and the Canadian Context*, Library of Parliament Background Paper no. 2010-22-E (Ottawa: Library of Parliament, 2010), at 5-8.

99 The point has been aptly summarized by Joel Nitikman, "Many Questions (and a Few Possible Answers) About the Application of Rectification in Tax Law" (2005) 53:4 *Canadian Tax Journal* 941-73.

100 *Neal v. US*, 98-2 USTC paragraph 60,318 (WD PA). The decision was affirmed by the US Court of Appeals, Third Circuit: 99-1 USTC paragraph 60,343.

The plaintiff's key argument was based on a mistake of law—specifically that the release was executed in reliance on a statute that, in legal effect, did not exist after Congress retroactively repealed the legislation. The government argued that the plaintiff's release was executed in accordance with the federal law as it existed at the time of the transfers and therefore could not be the result of a mistake of law.<sup>101</sup> The court disagreed, and permitted the taxpayer to rescind her gift and collect her tax refund. Although *Neal* is a mistake-of-law case, the court is clearly of the view that a mistake as to the future of a law that is later implemented retroactively is not a bar to the granting of equitable relief.

In summary, as one commentator has noted:

[A]ny time the parties intend to achieve a particular tax result and actually consider that tax result, rectification of the transaction as a whole will be permitted even if the executed documents contain the words they were intended to contain and even if the mechanism chosen to obtain the tax result turns out to be the wrong mechanism. There is no true distinction between a mistake as to legal consequences and a mistake as to legal effect [in tax cases]: the court that hears the application must simply be vigilant and ensure that the parties are not merely changing their minds to escape what has turned out to be a plan that they would rather not carry out for commercial reasons.<sup>102</sup>

### **Should Rectification Be Permitted To Undo Retroactive Laws?**

On the basis of Canadian constitutional-law principles, the right of provincial courts to make rectification orders is unambiguous. If one applies basic rule-of-law principles as espoused by Raz, Hart, Fuller, and Hayek, the law should be clear, non-retroactive, stable, fair, and open to adjudication before an independent tribunal. In addition, a tax system should promote institutional integrity and respect the distinct roles of the legislature and the judiciary. A tax system should be structured to uphold core rule-of-law principles. Although the precise content of these principles is the subject of continuing debate, there is consensus that the law should provide certainty for private transactions and respect individual autonomy.

Tax laws apply once private-law rights have been determined. Private-law rights may be affected by equity. Equity is inherently rooted in facts—the particular aspects of a case that render rigid application of legal rules inadequate. The previous analysis shows that the equitable remedy of rectification may be deployed in areas where the parties' reasonable intent was thwarted by a mistake, including potentially in areas where tax legislation has retroactively changed the reasonable assumptions held by the parties.

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101 The following is excerpted from the decision of the District Court, *supra* note 100, at 86,523: “The government states that in ‘order for a gift to be incomplete because of mistake, a mistake of law must be a present mistake about the state of the law when the gift is made. A mistake about the future of the law or the future of the facts will not cause a gift to be incomplete.’”

102 Nitikman, *supra* note 99, at 963.

What are the guiding principles<sup>103</sup> for determining whether rectification (or rescission) should be permitted in these circumstances? We have drawn on a number of perspectives to attempt to answer this question.

- *Non-retroactive tax planning.* Rule-of-law principles make it clear that the law should generally be non-retroactive. Judicial reasoning is also clear that the remedy of rectification should not be used for retroactive tax planning.<sup>104</sup> This “would run contrary to the well-established rule in tax cases that the courts do not look with favour upon attempts to rewrite history in order to obtain more favorable tax treatment.”<sup>105</sup> As discussed, there should be no question of retroactive tax planning where a document is amended merely to reflect the intention of the parties to affect a transaction in a tax-favoured manner. This is arguably true even if the unintended tax liability is the result of retroactive legislation.
- *Fairness.* Fairness is a central guiding principle and a substantive goal of our legal order. But what does “fairness” mean in the context of a tax system? If retroactive legislation is considered unfair, is there a fairness argument for rectifying a transaction that has been negatively affected by retroactive tax legislation when the intention of the parties is to effect the transaction in a tax-free manner? If retroactive legislation results in the collection of more taxes instead of a refund to the taxpayer, the CRA would be quick to assert its claim and the court to enforce it.

However, another fairness argument goes to equal access to the rectification remedy. Rectification orders are made by provincial courts and affect federal taxes. Thus, the remedy may be provided to some but not all taxpayers, depending on the prevailing views of a particular provincial court.

- *Substance over form.* As discussed within the cases, tax legislation is designed to attach fiscal consequences to identifiable and “real” transactions and events. In Canada, tax consequences are generally based on legal substance. For example, the definition of “income” in the federal Income Tax Act<sup>106</sup> is a legal definition that is informed by accounting practice.<sup>107</sup> The legal substance

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103 According to Dworkin, principles are not laws, so it is not necessary to find legislative or judicial authority for them in order to prove their existence. Principles exist independently of laws, although many laws and judicial decisions may be reflections of principles. In a conflict between two competing rules, a principle or principles may assist in tipping the scales one way or another. See Ronald Dworkin, *Taking Rights Seriously* (Cambridge, MA: Harvard University Press, 1978).

104 *McPeake*, supra note 31.

105 *Bramco*, supra note 14 (CA), at paragraph 9.

106 Section 3 of the Act.

107 See *Canderel Limited v. The Queen*, 98 DTC 6100 (SCC), holding that the determination of profit is a question of law that may be informed by “well-accepted business principles” that include generally accepted accounting principles (GAAP).

of a particular transaction or relationship is determined by reference to the substantive legal rights and obligations that are created:

The true principle, then, is that the taxing Acts are to be applied in accordance with the legal rights of the parties to a transaction. It is those rights which determine what is the “substance” of the transaction in the correct usage of that term.<sup>108</sup>

The Canadian tax system includes a general anti-avoidance rule (GAAR) to give effect to substance over form in certain circumstances. Rectification, arguably, also gives effect to the substance of the transaction regardless of its form. For the same reason that there is ongoing debate about establishing clearer guideposts for imposing a GAAR, there may be arguments for establishing similar guideposts to determine when the remedy of rectification may or should be granted in the context of retroactive tax laws.

- *The role of the judiciary.* The tax system should respect the constitutionally distinct roles of Parliament and the judiciary. Parliament may pass retroactive tax laws, but judges have the right to provide equitable relief at their discretion. However, the current law forces judges into a policy-based inquiry in a tax system designed to achieve multiple, broad, and often conflicting objectives. Owing to these complexities, a rectification order may also result in a breach of the rule of law in favour of a taxpayer (for example, by ignoring legislative intent to give effect to retroactive laws), and therefore may by implication be contrary to the rule-of-law expectations of other taxpayers.<sup>109</sup> Moreover, on occasion Canadian governments have passed retroactive tax laws to overturn judicial decisions that they were unhappy with, thereby precluding the ability of the taxpayer to arrive at a “fair” outcome through a hearing before an independent tribunal.
- *Economic efficiency.* Lurking in the background of the previous analysis are questions as to whether retroactive tax legislation is economically harmful or beneficial. Proponents of retroactive tax laws often concede that the approach is unfair to taxpayers, but maintain that the overall effect does not unduly harm efficiency interests.<sup>110</sup> The obvious goals of most retroactive tax laws are to inhibit abusive tax-planning efforts and to raise revenues from transactions that would otherwise remain tax-free. But do such tax reforms backfire by unduly inhibiting economic activities? Revenue collection will be inhibited to the extent that overall economic activity is reduced, frustrating one of the main goals of retroactive tax laws.

108 *Front & Simcoe Ltd. v. MNR*, 60 DTC 1081 (Ex. Ct.), quoting from J.A.S. Simon, *Simon's Income Tax*, 2d ed., vol. 1 (London: Butterworths, 1965), at 50.

109 Comment by John Prebble of the Faculty of Law, Victoria University of Wellington, New Zealand, in private correspondence to the authors dated July 11, 2012.

110 See Michael J. Graetz, “Retroactivity Revisited” (1985) 98:2 *Harvard Law Review* 1820-41.

On the one hand, proponents of retroactive tax legislation have argued that the approach encourages an overall efficient outcome, and thus taxpayers who are adversely affected by the change should not be compensated. They argue that compensation or grandfathering is normally not required because taxpayers incorporate into their transactions the risk of a future tax-law change.<sup>111</sup> Thus, the price of a given transaction already takes into account the risk of a future legal change; the greater the aggressiveness of the tax planning, the argument goes, the greater the price (or risk premium) that should be incorporated into the transaction.

On the other hand, Feldstein<sup>112</sup> and other writers have argued that retroactive tax legislation encourages “inefficient precautionary behavior.” Taxpayers incur costs and take steps to hedge against the risk of future changes that potentially raise their tax liabilities. Under this view, these costs outweigh the perceived benefits derived from retroactive tax legislation. That is, in addition to incurring costs to protect against the risk of “overtaxation” under current tax laws (that is, the risk that the taxpayer’s tax liability will be reassessed), taxpayers incur costs associated with guarding against the risk of “overtaxation” by future tax laws that reach back and alter prior tax laws. This latter risk can significantly increase transaction costs in part because it is so vague and uncertain; it is difficult to hedge against undefined risks. This raises an important question concerning how governments should allocate the risk of unforeseen tax liabilities (and other transaction costs) among differently situated taxpayers.

As explored below, a focus on the difference between targeting perceived planning abuse and targeting general individual income, as well as the risk surrounding the potential magnitude of the loss, suggests that retroactive tax hikes on individual income, such as the now-withdrawn Quebec proposal, can carry significant economic costs. This will be illustrated by comparing the plight between two taxpayers—a corporate taxpayer facing a retroactive tax law that reaches back in time and targets a tax plan that is ripe for a challenge under GAAR, and an individual taxpayer faced with a general retroactive tax increase to her high marginal income.

Transaction cost analysis can help us to understand the economic implications of retroactive tax hikes on these differently situated taxpayers.<sup>113</sup> As

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111 See, for example, Michael J. Graetz, “Legal Transitions: The Case of Retroactivity in Income Tax Revision” (1977) 126:1 *University of Pennsylvania Law Review* 47-87; and Louis Kaplow, “An Economic Analysis of Legal Transitions” (1986) 99:3 *Harvard Law Review* 509-617.

112 See Martin Feldstein, “On the Theory of Tax Reform” (1976) 6:1-2 *Journal of Public Economics* 77-104, at 98-99.

113 For a similar approach, see Avishai Shachar, “From Income to Consumption Tax: Criteria for Rules of Transition” (1984) 97:7 *Harvard Law Review* 1581-1609, at 1590-99 (discussing which taxpayer should bear the risk of a retroactive tax law); and Graetz, *supra* note 110 (suggesting that the magnitude of the risk of large losses that cannot be readily insured is an important factor for consideration).

explained by Coase, transaction costs are the costs associated with discerning a price on a given exchange; these costs include costs of negotiating the exchange, preparing the necessary contracts, and creating arrangements to resolve disputes.<sup>114</sup> Coase asserted that these costs are heavily influenced by (formal) legal rules. This results from the fact that an exchange really involves an exchange of *rights* to perform certain actions (and not merely the trade in particular goods and services), and these rights are largely delineated by law.<sup>115</sup> According to Coase, legal rules should be justified to the extent of their ability to allocate rights to the most efficient right-bearer.<sup>116</sup>

Building on Coase, Calabresi concluded that the optimal tort liability regime is one that minimizes the sum of the cost of accidents and the cost of avoiding accidents.<sup>117</sup> He noted that this regime should generally assign tort liability to the “cheapest cost-avoider,” namely, the party that can minimize negative externalities (harms to third parties) most efficiently. Hence, Calabresi focused to a large extent on who should bear the risk of liability.<sup>118</sup>

From this, we return to our two hypothetical taxpayers, the corporation and the individual taxpayer, to see how they bear risks associated with retroactive tax laws. Those who claim that retroactive tax laws do not harm efficiency interests essentially rely on the view that prices incorporate the risk of legal change, including new retroactive tax laws. With respect to the corporate taxpayer, it has engaged in tax planning of a type that raises the risk of audit and/or retroactive tax legislation to

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114 R.H. Coase, “The Problem of Social Cost” (October 1960) 3 *Journal of Law & Economics* 1-44, at 15. Coase describes these costs as the costs “to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on.”

115 *Ibid.*, at 15-16 and 43-44.

116 Under the Coase theorem, *supra* note 114, when rights are well defined and transaction costs are zero, resource allocation is efficient and independent of the pattern of ownership (that is, it does not matter which party assumes liability for the effects on the other party). Coase readily recognized that transaction costs will always exist and thus will play a role in determining how resources are allocated. For discussion, see, for example, Yoram Barzel, *Economic Analysis of Property Rights* (Cambridge, UK: Cambridge University Press, 1997), at 77.

117 See Guido Calabresi, *The Cost of Accidents: A Legal and Economic Analysis* (New Haven, CT: Yale University Press, 1970). See also Kyle D. Logue and Joel Slemrod, “Of Coase, Calabresi, and Optimal Tax Liability” (2010) 63:4 *Tax Law Review* 797-866, at 798 and 804-9 (discussing the Coase theorem along with critiques).

118 Normally, a party that “produces” a harm is in a better position to know what measures to take to reduce harm, and can be the cheapest avoider. Following Calabresi’s views, Logue and Slemrod, *supra* note 117, at 781, maintain that, with respect to developing an optimal tax remittance regime, tax liabilities should be assigned so as to minimize the overall social costs of compliance and administration, for a given level of achievement of the tax law’s desired distributional and revenue goals.

address the planning (since the corporate taxpayer understands that such legislation has been enacted in the past). In these circumstances, the price of the company to its owners (that is, the share price based on the net present value of the company's after-tax profits) should reflect information available to investors about this tax future. In other words, the retroactive tax hike is already priced by the market, and investors expect that the potential tax liability of a retroactive tax increase will not unduly affect the firm's return.

In contrast, consider the hypothetical individual, mentioned in the introduction to this article, who gifts her cottage in Quebec and is faced with retroactive tax laws that apply generally to income, and thus increase the tax liability associated with the gift. Does the valuation of the gift already reflect potential retroactive tax increases to individual income? There does not appear to be any evidence that either the federal government or a provincial government has enacted such a tax in the past, unlike retroactive taxes directed at abusive, potentially GAARable tax planning. Hence, neither the individual nor other participants in the real estate market can hold a reasonable belief that such a tax increase will take place.<sup>119</sup> Moreover, consider the potential magnitude of the loss facing the taxpayer. A taxpayer could dispose of a large asset, such as the gifted cottage, resulting in a gain that subjects the individual to the higher marginal tax rates associated with the retroactive tax law (because capital gains are included in the income tax base), leading to a significantly higher tax bill. Depending on the proposed rates and marginal amounts of income affected by the retroactive tax laws, an individual's expected retirement savings could be materially

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119 Now that the cat is out of the bag, so to speak, and Quebec has attempted to introduce such retroactive tax laws (before subsequently withdrawing them), it is interesting to note how this could vary traditional expectations. The traditional contract between individual taxpayers and the government has been one where the worker is not faced with past-era tax liabilities for his or her income-generating activities (with the exception of those investors who faced reduced returns from retroactive tax increases on corporations that reduced the value of the investments held by these individuals). Both sides trusted in this traditional contract. However, the announcement by the Quebec government of the general retroactive tax hike has placed individual taxpayers in an environment of greater risk, since they will now hold reasonable beliefs that such a retroactive tax hike could occur in the future. That is, these individuals no longer trust in the original contract and, as a result, risk uncertainty is enhanced and the efficiency-reducing activities discussed above are encouraged (for example, a high-income individual could deal with the risk by leaving the province and hoping that another province will not follow suit). In this sense, it no longer matters whether at some point in the future either the current Quebec government or a successor government proposes or enacts a general retroactive hike. Under this view, governments should consider the costs associated with breaking and undermining trust in traditional political promises as part of their analysis of potentially deploying different types of retroactive tax laws. For views on how reductions in trust in contracting lead to higher transaction costs and reduced efficiencies, see Oliver E. Williamson, "Credible Commitments: Using Hostages To Support Exchange" (1983) 73:4 *American Economic Review* 519-40; Douglass C. North and Barry R. Weingast, "Constitutions and Commitment: The Evolution of Institutional Governing Public Choice in Seventeenth-Century England" (1989) 49:4 *Journal of Economic History* 803-32; and Avinash K. Dixit, *The Making of Economic Policy: A Transaction-Cost Politics Perspective* (Cambridge, MA: MIT Press, 1996), at 62-80.

reduced by this new tax liability. Returning to Feldstein's concern surrounding inefficient precautionary behaviour, high-income taxpayers in Quebec must now incur Coasean transaction costs to identify and potentially defend their tax liabilities against the risk of retroactive taxation on their income. Faced with such a possibility, high-income and other taxpayers may hold assets longer than their productive use, ensure that their sales are spread out over different fiscal periods (to reduce high marginal incomes subject to retroactive taxation), work less to lower their incomes below levels of perceived threat, exit the taxing jurisdiction, or engage in other precautionary behaviour.

When we compare the two hypothetical taxpayers, it is clear that the corporate taxpayer is in a better position to bear the risk of a retroactive tax increase targeting potentially GAARable tax planning. The individual taxpayer is not so well prepared because it is more difficult for her to protect against the risk of a large tax liability at some unforeseen date.<sup>120</sup> Assuming that she has knowledge of past hikes and takes this risk seriously, as suggested above she may engage in behaviour that reduces economic productivity. Moreover, consider the plight of other market participants in a world where retroactive taxes potentially apply to general income; the price of many investment assets will be affected by such a hike. For instance, the price of building a new cottage as well as other assets that generally appreciate in value (such as paintings) could reflect the expected legal change. All of this suggests that governments should take into account the potential adverse economic effects of a retroactive tax increase to general income, which will encourage more efficiency losses than those associated with targeting GAARable planning. A government will need to weigh the value of expected new revenues resulting from the general retroactive income taxes against these economic costs.

Finally, note that the traditional retroactive tax-law regime performs the additional function of trying to deter abusive tax planning, which in itself leads to deadweight losses as economic resources are directed at tax planning instead of, say, investing in technological research.<sup>121</sup> To the extent that these laws achieve this deterrence goal, then retroactive tax laws may promote further efficiencies. In comparison, retroactive taxes that target general income do not deter any economically harmful activities, although they may encourage unproductive activities.

For these reasons, to promote optimal outcomes, assignment of liability for retroactive tax laws should account for the twin goals of revenue collection and deterrence

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120 For instance, Graetz, who argues that retroactive tax laws generally do not lead to efficiency concerns, concedes that the magnitude of the risk of large losses that cannot be readily insured is an important factor in considering whether retroactive tax laws unduly harm economic efficiency. See Graetz, *supra* note 110, at 1836-37.

121 In fact, it is not clear whether the Canadian government collects any revenues from reassessments arising from retroactive tax legislation—at least, the government does not maintain records of such revenue collection. Even if no significant revenues are collected, retroactive tax laws can be justified on the basis of their prophylactic nature as long as they serve to deter aggressive tax planning.

of abusive tax planning. If a government's retroactive tax legislation is not limited to targeting abusive, potentially GAARable tax planning, rectification remedies or the law of mistakes could refine the assignment of tax liability to its optimal level.

## CONCLUSION

As seen in the development of case law in the area, the judiciary has used its equitable role to provide unprecedented relief giving rise to favourable tax consequences to the taxpayer. This relief is based on the view of the judiciary that it should fix tax mistakes whether they result from the agreement itself or from the form in which the agreement is implemented. Would a provincial court judge permit rectification (or rescission) of a transaction affected by retroactive tax legislation? The answer is, "Maybe." Should the remedy apply to counter the effects of retroactive legislation? We conclude that the answer is, "Yes—in some circumstances."

Assuming that there are convincing arguments for making rectification orders, does tax policy dictate additional limits? If so, a host of additional issues must be addressed. For example, if limits are to be imposed on rectification in tax matters, what principles should guide them? Would efforts to formalize principles of equity as they affect tax matters run aground against the tradition's most central tenet that equity "eschews mechanical rules" and "depends on flexibility"?<sup>122</sup> This article does not attempt to answer these broader questions in any comprehensive sense, but rather restricts the analysis to answering the following question: In what situations should it be acceptable for the taxpayer to bear the risk of being adversely affected by retroactive legislation?<sup>123</sup>

122 *Holmberg v. Armbrrecht*, 327 US 392, at 396 (1946).

123 The Canadian government developed criteria, in its response to the seventh report of the Standing Committee on Public Accounts, for circumstances in which it may be appropriate to adopt retroactive "clarifying" tax laws. While the criteria focused on potential retroactive changes that seek to clarify the interpretation of tax laws, similar considerations could be taken into account by a provincial court in determining whether to grant rectification in respect of retroactive tax laws. According to the government, clarifying retroactive tax laws should be deployed when

- "the amendments reflect a long-standing well-known interpretation of the law by the Department of National Revenue" (that is, the CRA);
- "the amendments reflect a policy that is clear from the relevant provisions that is well-known and understood by taxpayers";
- "the amendments are intended to prevent a windfall benefit to certain taxpayers";
- "the amendments are necessary to preserve the stability of the government's revenue base"; or
- "the amendments are corrections of ambiguous or deficient provisions that were not in accordance with the object of the Act."

See Canada, *Comprehensive Response of the Government of Canada to the Seventh Report of the Standing Committee on Public Accounts*, Sessional Paper no. 8512-351-79 (Ottawa: Queen's Printer, September 18, 1995), at 15. See also Canada, House of Commons, Standing Committee on Public Accounts, *Seventh Report* (Ottawa: Queen's Printer, February 10, 1995).

As touched on earlier, courts accept limits on rectification, including situations where the remedy would harm the interests of an innocent third party, or where there has been undue delay in bringing a claim, as well as the conduct of the plaintiff seeking rectification. The analysis suggests that the equitable remedy of rectification, or possibly a broader category of the law of mistaken assumptions, can and should be brought to bear with respect to some categories of retroactive tax laws:

- Minimal retroactivity implies that retroactive tax legislation should be interpreted in a restrictive fashion.
- Minimal retroactivity implies that retroactive tax laws should be effective only against specifically enumerated transactions that the government perceives to amount to abusive tax planning; that is, when the scope of the retroactive legislation is unclear, it should be interpreted restrictively in such a way as to permit rectification of a taxpayer's transaction.<sup>124</sup>
- In accordance with the Supreme Court's pronouncement on rectification in *Performance Industries*, discussed above, the conduct of the adversely affected party needs to be taken into account; thus, rectification may be considered to be justified for those taxpayers who can establish that they honestly and reasonably relied on earlier tax laws when ordering their fiscal affairs.

The last criterion would provide relief in many circumstances to taxpayers who had not engaged in abusive, potentially GAARable tax planning to reduce their tax liabilities. First, a taxpayer who deploys a potentially GAARable strategy should have a reasonable belief that the strategy could be subject to audit and/or retroactive tax laws (whereas one who has not deployed such a strategy should have a reasonable belief that he or she would not likely be subject to audit and/or retroactive tax laws). Second, the Canadian federal and provincial governments have thus far focused virtually all of their retroactive tax laws on combatting areas of perceived abuse, and hence taxpayers should not hold reasonable beliefs that these governments will enact retroactive tax laws in other areas such as general revenue-raising measures. On a related final issue, retroactive tax measures that apply generally to high marginal incomes are very difficult to foresee, and force taxpayers to engage in inefficient precautionary behaviour that could unduly harm important economic interests.

For these reasons, we think that a provincial court could deploy its equitable jurisdiction to rectify contracts that are affected by, for instance, a general retroactive tax hike on high-income individuals, such as that proposed (and now abandoned) by the

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124 See also Loomer, *supra* note 76, at 82 (indicating that constitutional scrutiny of retroactive tax laws could involve “weighing such matters as the legislative objective, the rationality of the means employed, and the degree to which the law affirms or repudiates taxpayers’ expectations”).

Quebec government.<sup>125</sup> The Quebec proposal was not directed at abusive, potentially GAARable tax planning, but rather simply reflected the government's wish to generate new revenues through a retroactive tax increase aimed at a specific category of taxpayers. The Quebec government would presumably try to protect against judicial intervention by passing legislation that denied the ability of taxpayers to use rectification (as occurred with respect to the Quebec truffle matter).<sup>126</sup> It is unclear how this legislation would affect matters outside the province (as in the case of the hypothetical person in the introduction who gifted her cottage located in, say, British Columbia, which triggered the application of the retroactive tax hike in Quebec). A BC court could hold that the Quebec legislation did not apply within its jurisdiction, and hence that the remedy of rescission or rectification was warranted. The Quebec government would then have to determine whether it would tax the proceeds of a transfer that had not occurred.

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125 See the discussion in note 9, *supra*. An earlier publication by the Quebec tax authorities, which was published prior to the proposed tax hike on high income earners, appears to support the view that retroactive tax laws should be deployed only in narrow circumstances for the purpose of combatting abusive tax planning. See Finances Québec, *Aggressive Tax Planning*, Working Paper (Quebec: Finances Québec, January 2009), at 50-56.

126 See *supra* note 98 and the related text.