CANADIAN TAX JOURNAL / REVUE FISCALE CANADIENNE (2010) VOL. 58 (SUPP.) 141-48

Breaking Bad: "Remediation" and Tax Plans Gone Wrong—Judicial Attitudes

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KEYWORDS: RECTIFICATION ■ RETROACTIVE ■ LEGISLATION ■ JURISDICTION ■ TAX COURT OF CANADA

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INTRODUCTION

With this contribution, we would like to spark a debate with respect to two distinct yet interrelated questions affecting the parameters of the remedy of rectification (which the planners of this tribute to former Chief Justice Bowman termed "remediation").

The first part of the debate revolves around whether the proper parameters of rectification should be shaped by reference to ostensibly unrelated issues raised by retroactive tax legislation.

The second part of the debate addresses the proper forum for remediation. The current state of the law assigns the jurisdiction for rectification to provincial superior courts. Is there a role for the Tax Court of Canada to play, given its limited statutory jurisdiction?

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It appears to us that the brief overview that follows demonstrates that the topic title aptly circumscribes the boundaries for rectification—namely, rectification was meant to assist with remediating "tax plans gone wrong," as opposed to assisting with the formulation of "tax plans that never were."[1]

OVERVIEW OF THE CURRENT STATUS OF RECTIFICATION

The title of an excellent article on the subject of rectification, "Mistake or Hindsight—The Remedy of Rectification,"[2] neatly encapsulates the principal, and conflicting, issues and notions involved when a taxpayer seeks rectification. Here, 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.[3]

What is a common situation where rectification might be considered? To take a simple example, a corporation declares a capital dividend in the mistaken belief that there is an amount in the capital dividend account.[4] The taxpayer asserts that a "mistake" or "error" or other misstep (by, for example, the taxpayer or its lawyer or

1 An example of the latter may be found in *Re: Aboriginal Diamonds Group et al.*, 2007 NWTSC 37.

2 David Gaskell, "Mistake or Hindsight—The Remedy of Rectification" (2008) vol. XII, no. 2 *Business Vehicles* 626-31. For further articles on this topic, see for example, Sandra E. Jack, Theresa Murphy, Mark R. Robinson, Marc Vanasse, and Arlene E. White, "Canada Revenue Agency Round Table," in *Report of Proceedings of the Fifty-Seventh Tax Conference*, 2005 Conference Report (Toronto: Canadian Tax Foundation, 2006), 6A1-43; Jules L. Lewy, David J. Manoochehri, and Frank E.P. Bowman, "Making Amends: The Juliar Court Victory Concerning the Doctrine of Rectification Is Good News for Taxpayers and Their Advisers" (January/February 2002) *CA Magazine* 41-43; Jim Yager, "CRA Accepts Rectification" (2006) vol. 14, no. 10 *Canadian Tax Highlights* 5; Jack Bernstein, "Fixing Tax Mistakes" (2009) vol. 17, no. 11 *Canadian Tax Highlights* 4-5; John Jakolev, "Snow White Out" (2004) vol. 12, no. 6 *Canadian Tax Highlights* 2-3; Peri Smith, "Rectification Petition Notice" (2006) vol. 14, no. 1 *Canadian Tax Highlights* 2-3; Paul Matthews, "To Err Is Human" (2000) vol. 8, no. 11 *Canadian Tax Highlights* 82-83; Robert Jason, "Between Cup and Lip" (2000) vol. 8, no. 1 *Canadian Tax Highlights* 2; Willard Strug, "Retroactive Resolution" (1998) vol. 6, no. 9 *Canadian Tax Highlights* 69; Garnet Matsuba, "Amendment vs. Rectification," in "Current Cases" (1990) vol. 3, no. 2 *Canadian Petroleum Tax Journal*; Dan Misutka, "Rectification—An Update" *Tax Topics* no. 1888 (Toronto: CCH Canadian, May 15, 2008); and Terry S. Gill, "Documenting Transactions: Backdating and Rectification," in *2009 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2009), tab 15.

3 The judgment of the Federal Court of Appeal in *Dale et al. v. The Queen*, 97 DTC 5252 (FCA), the first reported Canadian rectification case originating in a tax context, established that validly obtained judicial orders from provincial superior courts are binding on tax authorities. *AG of Canada v. Juliar et al.*, 2000 DTC 6589 (Ont. CA) (leave to appeal to the Supreme Court of Canada refused May 24, 2001), confirmed that rectification is available to give effect to the clear intention of the parties to maximize tax efficiency.

4 For example, *Felix & Norton International inc. et Canada (Procureur général)*, 2009 QCCS 919; and *Winclare Management Services Ltd. v. Canada (Attorney General)*, [2009] 5 CTC 278 (Ont. SCJ).

accountant) has frustrated the taxpayer's intention, objectives, and results (that is, the tax effects). The further assertion is that this mistake or error has changed in an unintended way the legal effects of the intended transaction, and therefore it is only equitable and appropriate that such mistake or error be redressed (to return to the taxpayer's intentions) by a court-ordered "rectification" of the matter—and, as a tax matter, that such rectification be respected and taken into account (under and by the Income Tax Act).[5] Proponents of the need for and the propriety of rectification may express the matter in a variety of terms—for example, "a genuine mistake"; "the documents do not reflect the drafter's tax-related intentions"; "an equitable remedy to more accurately reflect intentions"; "a mistake in reducing an agreement to writing"; or "an attempt to rectify a mistake made by the taxpayer in entering into or completing a transaction."[6]

The Canada Revenue Agency (CRA) may, however, express opposition to the notion for any of a number of reasons.[7] For example, the request for a remedy may simply be a case of hindsight, where the parties, after the fact, see that documents could have been drafted better. Rectification may also be viewed as being used to alter the agreement the parties intended or as a convenient way of fixing aggressive tax plans once the CRA starts auditing. What interests us is the claim that rectification is a tool for retroactive tax planning. Here we have the hook linking this article to the tribute to Bowman J, whose decisions often applied equitable solutions to remediate problems facing taxpayers.

FRAME OF REFERENCE FOR COMMENTARY

It might be useful, in considering the issues raised, to use the following hypothetical examples as a frame of reference for developing policy on the availability of rectification. Assume, as the starting position, that an individual, A, carries on a business as a sole proprietor; the business has a fair market value of $1 million and aggregate cost bases of $500,000. Consider two scenarios:

1. A's commercial lawyer, who knows nothing about tax, recommends the "incorporation" of the business to limit liability. A proceeds to act on this advice without consulting any other professional, such as a qualified tax accountant. The incorporation is effected in such a way that it does not qualify for a rollover under section 85 of the Act. Should rectification be available to remedy

5 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

6 See, for example, Gaskell, supra note 2, at 626.

7 There is always concern when notice should be given to the Crown of any attempts to rectify. For recent judicial commentary, see *Aim Funds Management Inc. v. Aim Trimark Corporate Class Inc.*, [2010] GTC 1001 (Ont. SCJ); and *Stone's Jewellery Ltd. v. Arora*, 2009 ABQB 656. For the CRA's views, see Jack et al., supra note 2; and Timothy G. Duholke, Edwin G. Kroft, Roy Shultis, and Marc Vanasse, "The Impact of Recent Cases," in *Report of Proceedings of the Fifty-Third Tax Conference*, 2001 Conference Report (Toronto: Canadian Tax Foundation, 2002), 39:1-23.

the unintended tax consequences of A's actions? Under the current state of the law, the answer seems to be "no."

2. The second scenario contemplates that A's advisers are aware of the adverse tax consequences flowing from section 69 and the failure to properly apply section 85. Yet they foul up by, for example, having A first subscribe for all the shares to be issued, for $1,000, and subsequently sell the business for a note of $1 million. Should the negligence of the advisers affect the availability of rectification?[8] Negligence should not prove to be a bar to equitable relief afforded by rectification.

THE FIRST PART OF THE DEBATE: RECTIFICATION, RETROACTIVE LEGISLATION, AND THE RULE OF LAW

Overview

Should the debate on the role and propriety of rectification be elevated to another level? Should the ambit and limits of rectification ultimately be established by reference to, and as a matter of, the rule of law? Can rectification be used as a taxpayer tool to violate the rule of law (or the sanctity of contracts) so that agreements made in error can be rewritten retroactively with effect as against third parties, such as the CRA?

The concept is that hindsight-based rectification would simply be the taxpayer's counterpart to (and "revenge" for) retroactive legislation that favours the government. In other words, can the remedy of rectification serve the same function as retroactive legislation? Both may, at least superficially, be seen as restorative by aiming to mend drafting mistakes that only became apparent through hindsight. Would an expansion of the doctrine of rectification be a possible riposte to the positivist and restrictive interpretation of the rule of law by the Supreme Court of Canada in *British Columbia v. Imperial Tobacco Canada Ltd.*[9] and previous cases? Does it not make sense that the Supreme Court, which gave its nearly unqualified blessing to retroactive (tax) legislation, should also give taxpayers a remedy before a superior court to "rectify" a written instrument on the basis of hindsight with retroactive effect as against third parties?[10]

Before taking this argument further, we must first comment briefly on both retroactive legislation and the rule of law.

8 Compare the harsh comments of the CRA in Duholke et al., supra note 7, at 39:11, with the comments of Strekaf J in *Stone's Jewellery*, supra note 7, at paragraph 52.

9 2005 SCC 49.

10 This could even include, ironically, an election, designation, or elective deduction in a tax return (or in a similar instrument) where it rested on an error resulting from a retroactive change in the applicable tax legislation.

Retroactive Legislation

"Retroactive legislation" refers to legislation that applies to past situations and changes their legal effects for the past.[11] The legislative intent for retroactivity must be clear and the text must be specific because of the existing presumption against the retroactive application of legislation. A statute will be interpreted as having a retroactive effect only if it is clearly retroactive,[12] and, as a corollary to the foregoing, retroactive legislation will be construed as not having greater retroactive effect than is necessary to achieve its purpose.[13]

Also, retroactive legislation may have effects in the past and come into force either in the past or in the present.[14]

The Rule of Law

The relevant point for our commentary is that retroactive legislation has been found not to be incompatible with the Supreme Court's understanding and vision of the scope and normative authority of the rule of law. Should that "lawlessness" not also be available to taxpayers to undo or change transactions that were not properly tax-planned?

The rule of law constitutes a fundamental tenet of our constitutional structure, if not of our legal regime and system of government, at the very least through its implicit inclusion in the preamble of the Constitution Act, 1867[15] ("With a constitution similar in principle to that of the United Kingdom"), and its explicit reference in the preamble of the Constitution Act, 1982[16] ("Whereas Canada is founded upon principles that recognize the supremacy of God and the rule of law").

Whatever its scope, the rule of law has not pre-empted retroactive legislation.[17] In *Imperial Tobacco*, the Supreme Court employed language almost definitively ousting the possibility of successfully challenging retroactive legislation on the basis of the

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11 As opposed to "retrospective legislation." Most contemporary definitions provide that retrospective legislation changes the future legal effects of past or ongoing situations. In that connection, see, for example, *Benner v. Canada (Secretary of State)*, [1997] 1 SCR 358, at 381 et seq.; and *Épiciers Unis Métro-Richelieu Inc., division "Économos" v. Collin*, [2004] 3 SCR 257, at paragraph 45 et seq.

12 See, for example, *Imperial Tobacco*, supra note 9, at paragraph 71; and *Gustavson Drilling (1964) Ltd. v. Minister of National Revenue*, [1977] 1 SCR 271, at 279.

13 *Hornby Island Trust Committee v. Stormwell* (1988), 53 DLR (4th) 435 (BCCA).

14 Contrast the legislative mechanisms used in *Air Canada v. British Columbia*, [1989] 1 SCR 1161, with the one used in *Imperial Tobacco*, supra note 9.

15 30 & 31 Vict., c. 3 (UK).

16 Being schedule B to the Canada Act 1982, c. 11 (UK).

17 See discussion in *Imperial Tobacco*, supra note 9. In that case, the court was dismissive of the scholarly debate on the broader scope of the rule of law, which was said to merely "underlie Strayer J.A.'s apt observation in *Singh* . . . that advocates tend to read into the principle of the rule of law anything which supports their particular view of what the law should be" (paragraph 62), apparently on the basis that such a broader interpretation could "trivialize or supplant the

rule of law. Ultimately, the court spoke of "[t]he absence of a general requirement of legislative prospectivity" and held that "retrospectively and retroactivity do not generally engage constitutional concerns."[18]

Therefore, 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 (i.e., the procedures by which legislation is to be enacted, amended and repealed),"[19] should there 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?

THE SECOND PART OF THE DEBATE: TAX COURTS AND JURISDICTION IN RESPECT OF RECTIFICATION

There are two cascading or sequential questions, the second arising only because of the issue underlying the first. The remedy of rectification evolved in provinces, other than Quebec, where superior courts have jurisdiction to alter, retroactively, the terms and effects of contractual relationships. This has provided the opportunity for courts to apply the remedy in circumstances where taxes are in issue.[20]

Persons based in Quebec, however, are effectively denied the full scope and parameters of the remedy available to those in the common-law provinces. Under the Civil Code of Quebec,[21] a court does not normally have jurisdiction to alter contractual relations retroactively. It can only annul them totally (or correct clerical errors).[22] This distinction creates a totally different playing field as between persons

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Constitution's written terms" (paragraph 67). See also the Supreme Court of Canada in *British Columbia (Attorney General) v. Christie*, 2007 SCC 21.

More specifically, the court concluded that, except with respect to criminal and penal matters, which are subject to section 11(g) of the Canadian Charter of Rights and Freedoms (being part I of the Constitution Act, 1982), the rule of law does not embody a general requirement of legislative prospectivity. The court's conclusion is undistinguishable from that in *Air Canada*, supra note 14, where a retroactive gasoline tax was held to be constitutionally valid.

18 *Imperial Tobacco*, supra note 9, at paragraphs 71 and 72.

19 Ibid., at paragraph 60.

20 For example, see *QL Hotel Service Ltd. v. Ontario (Minister of Finance)* (2008), 90 OR (3d) 760 (SCJ). Compare *Binder et al. v. Saffron Rouge Inc. et al.*, 2008 DTC 6112 (Ont. SCJ), where rectification was rejected and preservation of the lifetime capital gains exemption was not permitted.

21 LRQ, c. C-1991 (herein referred to as "the Civil Code").

22 Chikwa Zahinda, "La doctrine de rectification de contrats et son application en droit fiscal : étude comparée des principes de common law, droit civil et droit corporatif" (2006) vol. 27, no. 1 *Revue de planification fiscale et successorale* 17-104. The article mainly deals with the differences between the remedies available in the common-law provinces (doctrine of rectification) and those available in Quebec under the Civil Code (correction of errors). See also *BEA Holdings Inc. v. Trafsys Inc. et al.* (February 12, 2004), docket no. 500-09-013408-034 (Que. CA).

in the common-law provinces and those in Quebec, and one that is manifestly inappropriate from a national tax policy perspective, particularly in light of the recent movement toward bijuralism.

This dichotomy leads to two questions. First, should the Tax Court of Canada be given the jurisdiction to grant rectification (including orders involving parties based in Quebec) and to apply common-law theories (not the Civil Code) in so deciding the matter? This would enable a Quebec-based taxpayer to rise above the limitations imposed by the Civil Code (for federal income and sales tax matters).

There seems to be no current basis available to the Tax Court of Canada under either section 171 of the Income Tax Act or the Tax Court of Canada Act[23] to expressly order rectification. Judicial activism may, however, prompt a legal or factual finding that relieves a taxpayer of tax liabilities created by documents created "in error." Nevertheless, to level the playing field, Parliament might give to the Tax Court the express jurisdiction to order rectification overtly.

The second question that arises is whether the limitations heretofore adopted by the superior courts of the common-law provinces regarding the scope of rectification should be expanded in a fashion that would apply to not only "tax plans gone wrong" but as well "tax plans that never were." The policy question here is simple. Should the Tax Court be given the jurisdiction to order rectification as a remedy even when a transaction has been carried out without adequate, or any, tax analysis or planning and the CRA subsequently determines that the results are far inferior to those that would have arisen had there been proper planning? Practically, this idea would become a matter for debate about the ability of taxpayers to undo tax plans gone bad when the concept of "bad" was not even in the consciousness of the parties to the transaction at the outset.

EXPANSION OF RECTIFICATION TO A "NOVEL SITUATION"—RETROACTIVE LEGISLATION

Should rectification serve as a complete or partial riposte for a taxpayer to counter the effects of retroactive tax legislation? A superior court's discretion to fashion the appropriate remedies must be viewed as considerable and dynamic when granting declaratory relief; that is, the court has all necessary discretion to fashion remedies and to grant other orders necessary to make such relief effective.

In such circumstances, the rectification remedy would enable petitioners to obtain a court order correcting even elections, designations, or elective deductions forming part of the income tax return (or a similar instrument) filed during the taxation year(s) at issue, on the basis that they constitute written instruments expressing intentional juridical acts.

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

23 RSC 1985, c. T-2.

authorities from relying upon written instruments that do not reflect their authors' clear underlying intentions. As indicated in *Amalgamation of Aylwards (1975) Ltd., Re*,[24] rectification remedies may be applied, in appropriate cases, to "novel situations."

CONCLUSION

Our views are intended to spur debate. Former Chief Justice Bowman never shied away from sparking debate when rendering reasons in certain cases where he believed that justice needed to be done. We can only hope to follow his lead by equally igniting some sparks that may lead a court or the legislative branch of government to fashion a remedy that provides justice and fairness to taxpayers in a broader set of circumstances than now exists.

24 (2001), 16 BLR (3d) 34, at paragraphs 38 and 41 (NLSC).