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Supreme Court releases Collins Family Trust decision: Equitable remedies largely unavailable to correct tax mistakes

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In this Update:

- On June 17, 2022, the Supreme Court of Canada (SCC) released its decision in *Collins Family Trust* concerning the availability of equitable rescission and equitable remedies more generally to correct mistakes with tax consequences.
- The SCC accepted the government's argument that principles in its previous decisions concerning rectification apply to all equitable relief, and there is a broad-based prohibition against retroactive tax planning.
- Taxpayers will be bound by the tax results of transactions entered into with very limited relief in respect of any kind of tax planning mistake.

Background to the appeal

In 2016, the Supreme Court rendered its decision in *Fairmont*,[1] in which it restricted the availability of the equitable remedy of rectification in tax contexts to circumstances where the parties' actual agreement was not properly recorded in the written instrument governing their legal relations. In other words, the mere fact that a given agreement did not achieve its desired tax consequences would not be sufficient to be granted rectification.

Collins Family Trust[2] addresses the availability of the distinct equitable remedy of rescission in the context of mistakes that result in unanticipated and undesirable tax consequences. Unlike rectification, which allows parties to rectify mistakes in their written instruments that improperly recorded their actual agreement, rescission allows for the annulment of a transaction, where there was a sufficiently important mistake and it would be unconscionable not to allow the mistaken transaction to be annulled. This test for the application of the rescission remedy was articulated by the United Kingdom Supreme Court in *Pitt v. Holt*,[3] and adopted by the British Columbia Court of Appeal in *Pallen Trust*.[4] Notably, the U.K. Supreme Court held that a mistake as to tax consequences can be a relevant mistake for the purposes of this test.

In *Pallen Trust*, decided prior to the Supreme Court's decision in *Fairmont*, the court granted rescission in respect of dividends paid as part of a tax plan that involved deliberately triggering the anti-avoidance rule in subsection 75(2) of the *Income Tax Act*, which can be triggered by a contribution of property to a trust. After the tax plan was implemented, the Federal Court of Appeal determined that subsection 75(2) is not triggered when the relevant property is contributed to the trust in return for fair market value consideration, contrary to what had been the common understanding of the Canada Revenue Agency and of tax practitioners. As a result, subsection 75(2) did not apply in respect of the tax plan at issue in *Pallen Trust* and the tax plan no longer functioned. The British Columbia Court of Appeal held that the taxpayer's mistake as to the correct interpretation and application of subsection 75(2) met the threshold to justify the remedy of rescission.

Collins Family Trust dealt with an application for rescission on substantially the same facts that were at issue in *Pallen Trust*; the question was whether the Supreme Court's decision in *Fairmont,* and in particular its statements to the effect that taxpayers are not entitled to use rectification to accomplish retroactive tax planning, required a different result. The British Columbia Court of Appeal held that the remedies of rectification and rescission are legally distinct, each with its own test, and that *Fairmont* should not be read as foreclosing all equitable remedies where a tax benefit may be obtained. Rather, rectification and rescission are each available if the relevant test is met, regardless of the tax consequences.

On appeal to the Supreme Court, the Crown argued that in *Fairmont* the Court had articulated as fundamental principles that taxpayers should be taxed on what they actually did and not what they could have done or what they intended to do, and that transactions freely and voluntarily entered into may not be altered retroactively in order to avoid an unintended tax consequence. The Crown urged the Court not to adopt *Pitt v. Holt*, but to adopt a test for equitable rescission in accordance with these principles, maintaining in particular that Canadian law prohibits any kind of retroactive tax planning and the tax consequences of a tax planning mistake should not be considered unfair. The focus of the appropriate test, according to the Crown, is whether the taxpayer agreed to the transaction being undertaken – if the taxpayer agreed to the transaction, the taxpayer should bear the tax consequences of that transaction.

The Respondent argued that the British Columbia Court of Appeal did not err in its analysis and that it was appropriate to adopt the test in *Pitt v. Holt*, as several other commonwealth jurisdictions have done.

Majority decision

An eight-judge majority ruled in favour of the Crown. It rejected the application of *Pitt v. Holt* in Canadian law, holding that the principles articulated in *Fairmont* were not limited to rectification but were broadly applicable to all equitable remedies in the context of tax mistakes. The effect of this broad application is to broadly prohibit relief in equity in order to accomplish "retroactive tax planning," even where the taxpayer could not reasonably have anticipated the negative tax result , unless the test for rectification established in *Fairmont* and *Jean Coutu* can be met.

In particular, the majority described the relevant principles of general application arising out of *Fairmont* as follows:

- "Tax consequences do not flow from contracting parties' motivations or objectives", but rather "from the freely chosen legal relationships, as established by their transactions";
- While taxpayers may structure their affairs so as to reduce their tax liability, this cuts both ways: they may also be taken as having structured their affairs in such a way that increased their tax liability, and are not to be accorded a benefit based on what they could have done if they knew better;
- The proper inquiry is into what the taxpayer agreed to do, any apparent "windfall" for the public treasury from the taxpayer losing a benefit, or for the taxpayer from securing a

benefit, is irrelevant; and

- A court may not modify an instrument merely because a party discovered that its operation generates an adverse and unplanned tax liability.

The majority concluded that the Court of Appeal's reliance on *Pitt v. Holt* flies in the face of the foregoing principles. The divergence in *Pitt v. Holt* from Canadian law is explicable because English law lacks the prohibition against retroactive tax planning that is set out in *Fairmont* and *Jean Coutu.* Furthermore, the Court noted that the conclusion in *Pitt v. Holt* does not account for the fact that, pursuant to Canadian law, the Minister of National Revenue is obligated to apply the provisions of the *Income Tax Act* to the transactions taxpayers performed. This is a fundamental feature of the Canadian tax system that ensures that the public has confidence that the Minister is administering the same tax laws in the same way for everyone, without inconsistent exercises of discretion that could undermine the integrity of the system as a whole.

The dissent

Justice Côté, the lone dissenter, largely adopted the reasoning of the British Columbia Court of Appeal. She noted that *Fairmont* does not stand for the proposition that equitable remedies can never be granted in a tax context, but rather that the test for rectification should be applied indiscriminately to both tax cases and non-tax cases. What follows is that equitable remedies, and rectification specifically, remains available in a tax context so long as the requisite test is satisfied. However, *Fairmont* only dealt with the requisite test for rectification and contained no discussion of the circumstances in which rescission would be available. She maintained that the test for rescission outlined in *Pitt v. Holt* is compatible with Canadian law. It does not provide the Minister with the type of broad discretion alleged by the majority, as rescission will not be available unless the requisite test is met.

Implication and takeaways

The effect of the Supreme Court's decision is to considerably limit the availability of equitable remedies in tax contexts to cases where the test for rectification established in *Fairmont* and *Jean Coutu* can be met. This could include, for example, establishing clerical mistakes in a written agreement or producing compelling evidence that an agreement or transaction was improperly recorded.

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[1] *Canada (Attorney General) v. Fairmont Hotels Inc*., 2016 SCC 56. The Court also considered the equivalent remedy in Québec civil law in a companion case released on the same date, *Jean Coutu Group (PJC) Inc. v. Canada (Attorney General),* 2016 SCC 55. There was no civil law companion case to *Collins Family Trust*.

[2] *Canada (Attorney General) v. Collins Family Trust*, 2022 SCC 26.

[3] *Pitt v. Holt*, 2013 UKSC 26.

[4] *Re Pallen Trust*, 2015 BCCA 222.