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SCC rules out rescission as remedy for unintended tax consequences

AUTHORS

Andrew Gray

Martha MacDonald

For the past 20 years, courts have grappled with whether taxpayers can use equitable remedies to “fix” unintended and adverse tax consequences by rewriting or rescinding underlying transactions. The Supreme Court has now ruled out using rescission when tax is the only item alleged to be a mistake, unconscionable or unfair—complementing its previous similar ruling on rewriting, or rectification. The Court has held that taxpayers must generally bear any tax consequences of transactions and arrangements voluntarily made, and that equity does not allow so-called retroactive tax planning.

What you need to know

- The Supreme Court has ruled out rescinding underlying transactions solely to engage in retroactive tax planning.
- The decision, in *Collins Family Trust,* follows in the footsteps of *Fairmont Hotels* and *Jean Coutu*, which barred the use of another equitable remedy in similar circumstances: rectification.
- Taxpayers are taxed based on what they actually do—not on the tax outcome they may have desired but failed to achieve.
- The Court identified four key principles to navigate the interplay of equity and tax.
- While the Court doesn’t articulate the exact availability of rescission for tax purposes, the general law of rescission requires the taxpayer to show a mistake of the kind that leads to an unfair or unconscionable result in some legal aspect other than tax.

Background

In 2000, the Ontario Court of Appeal allowed a taxpayer to rectify certain transactions as a result of unintended, adverse tax consequences[1]. The Court held that, if a mistake is made in a transaction legitimately designed to avoid the payment of tax, there is no reason why it should not be corrected.

Since that decision, many taxpayers sought to rectify their written instruments when unintended and adverse tax consequences arose. The government often opposed such claims, on the basis that they constituted retroactive tax planning. The caselaw culminated in the Supreme Court’s companion cases released in 2016: *Fairmont Hotels*[2] and *Jean Coutu*[3]. The Supreme Court barred the use of rectification to rewrite agreements or other documents merely to achieve intended tax outcomes.

After *Fairmont Hotels* and *Jean Coutu*, taxpayers sought equitable remedies other than rectification, such as rescission, to avoid unintended and adverse tax consequences. These efforts came to a head in the newly released decision in *Collins Family Trust*[4].

Facts in Collins Family Trust

The two taxpayers in *Collins Family Trust* each organized their affairs through transactions intended to protect their assets in a tax-efficient manner, based on professional advice and a well-understood interpretation of the attribution rules in subsection 75(2) of the *Income Tax Act* (Canada). Subsequently, the Tax Court, affirmed by the Federal Court of Appeal, adopted a narrower interpretation of the relevant rules, resulting in the taxpayers being reassessed for unintended and adverse tax liabilities. The taxpayers turned to the British Columbia courts to rescind the transactions to avoid the tax liabilities. The BC Supreme Court granted the orders, and the BC Court of Appeal upheld them on appeal.

Decision: Retroactive tax planning is not a maxim of equity

The Supreme Court reversed the rescission orders, with Justice Côté dissenting. In doing this, the Supreme Court barred the use of rescission to unwind transactions to avoid unintended and adverse tax consequences unless other material facts support that remedy.

The majority in *Collins Family Trust* held that it is neither unconscionable nor unfair for a taxpayer to live with the tax consequences of their voluntary transactions or arrangements. A taxpayer is barred “from resorting to equity in order to undo or alter or in any way modify a concluded transaction or its documentation to avoid a tax liability arising from the ordinary operation of a tax statute”. Equitable remedies are unavailable even in a case like *Collins Family Trust*—when the commonly held interpretation of a tax statute changes as a result of a judicial decision released after the transactions were concluded, vitiating the intended tax consequences.

The Supreme Court’s decision in *Collins Family Trust* provides the strongest statement yet that retroactive tax planning is not a maxim of equity: “the prohibition against retroactive tax planning, as stated in *Fairmont Hotels* and *Jean Coutu*, should be understood broadly, precluding *any* equitable remedy by which it might be achieved, including rescission”. Taxpayers are taxed on what they actually do—on the tax consequences of the transactions or other arrangements they voluntary make—and not on their motivations or desired tax outcomes.

Equitable remedies and tax: Current status

The Supreme Court identified four interrelated principles for the interplay of equity and tax:

1. Tax consequences flow from what a taxpayer actually does in its transactions and arrangements, not from their motivations or desired tax outcomes.
2. Where a tax statute requires a particular tax outcome, a taxpayer should not be given an equitably benefit by the court based merely on what the taxpayer may have done differently with the benefit of hindsight.
3. The possibility of a windfall to the public treasury, or a benefit to the taxpayer, is not relevant to equity.
4. “A court may not modify an instrument merely because a party discovered that its operation generates an adverse and unplanned tax liability”.

The combined effect of *Fairmont Hotels, Jean Coutu* and *Collins Family Trust* is to restrict the availability of equitable remedies in the tax context to cases involving non-tax mistakes, unfairness or unconscionability. For example, according to *Fairmont Hotels* and *Jean Coutu*, rectification is available in the tax context if a written instrument fails to correctly record the intended agreement between the parties (it would be inequitable to hold them to a written instrument that fails to record their agreement correctly). With respect to rescission, *Collins Family Trust* requires something more than an unintended tax consequence for a court to rescind completed transactions.

FOOTNOTES

To discuss these issues, please contact the author(s).