Tax Topics®

July 19, 2012
Number 2106

MORE ON RECTIFICATION IN QUEBEC

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Rectification continues to be a topic of heated debate in Quebec. After a series of decisions by the Court of Appeal last year on the subject, the Quebec Superior Court rendered on June 19, 2012 an important judgment (*Mac's Convenience Stores inc. v. Couche-Tard inc.*, 2012 QCCS 2745) on a motion for declaratory judgment involving a well-known Canadian company. This case is a reminder that rectification is not always available to correct errors made in the planning of a transaction, even if the unintended tax consequences result in a loss of several million dollars for a taxpayer.

The Facts

On April 14, 2005, Mac's Convenience Store inc. ("Mac's") borrowed $185 million from a U.S. corporation, Sildel Corporation ("Sildel"), which was a "specified non-resident" for purposes of the thin capitalization rules in subsection 18(4) of the *Income Tax Act* (the "Act"). Under this loan, Mac's paid interest to Sildel ($911,854 in 2006, $11,069,590 in 2007, and $10,674,247 in 2008). These interest payments were deducted in computing the income of Mac's for income tax purposes in the relevant years. This loan was fully repaid by Mac's in 2008.

On April 25, 2006, Mac's declared and paid a dividend of $136 million to Couche-Tard inc. ("CTI") out of its retained earnings. The decision to declare this dividend was taken after consultation with professional advisers.

More than 18 months later, it was discovered that the dividend of $136 million paid to CTI had the effect of raising the "debt" portion of Mac's debt-to-equity ratio *vis-à-vis* Sildel for thin capitalization purposes beyond the then statutory limit of 2:1 under subsection 18(4) of the Act. In early 2008, Mac's notified the CRA of the situation. After conducting an audit, the CRA issued notices of reassessment to Mac's denying the deduction of all the interest it paid to Sildel during taxation years 2006, 2007, and 2008.

Mac's filed a motion for declaratory judgment with the Quebec Superior Court requesting that the dividend of $136 million declared on April 25, 2006 and paid to the respondent CTI be cancelled retroactively and replaced by a reduction of Mac's paid-up capital in the same amount. This rectification would have required no transfer of funds between the parties, but it would have allowed Mac's to deduct the interest paid to Sildel in computing Mac's income under the thin capitalization rules.

The Position of the Petitioner and the Respondent

Mac's, the petitioner, and CTI, the respondent, argued that they gave their consent to the

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series of transactions that took place on April 25, 2006, including the declaration and payment of the dividend to CTI, upon the following conditions:

(1) The transfer of funds was not to generate any tax payable by any of the entities involved, and

(2) The transfer of funds was intended to maintain the maximum interest deduction by Mac's.

The decision of the petitioner to declare and pay a dividend to the respondent was taken solely on the advice of external advisers. Mac's and CTI were indifferent as to the legal characterization of the transaction (i.e., dividend versus reduction of capital).

According to the petitioner and the respondent, the unexpected tax consequences caused by the series of transactions were contrary to their stated intention.

The Position of the Tax Authorities

The Attorney General of Canada and Deputy Minister of Revenue of Quebec opposed the motion for declaratory judgment. Essentially, the tax authorities argued that rectification would not be appropriate since there is no difference between the "*negotium*" (i.e., Mac's intention to declare a dividend on April 25, 2006) and the "*instrumentum*" (i.e., the resolution of the directors of Mac's dated April 25, 2006, declaring the dividend).

The tax authorities argued that Mac's and CTI were seeking to rewrite tax history.

According to the tax authorities, this error is not a basis for the requested cancellation of the declaration of the dividend because it was not caused directly by the dividend. The cause of the unexpected tax consequences was the non-deductibility of interest paid to Sildel by Mac's. Indeed, without the payment of such interest to Sildel, the notices of reassessment would not have been issued.

The tax authorities also argued that the unexpected tax consequences for Mac's of the dividend cannot be an essential element vitiating the consent of the directors of Mac's in respect of the declaration of the dividend because the tax consequences were never discussed by Mac's and its tax advisers.

Finally, even if the Court concluded that Mac's consent to the dividend was indeed vitiated by this error, the tax authorities argued that, under the relevant sections of the *Civil Code of Quebec* ("C.C.Q."), the remedy sought would not have been available.

The Jurisdiction of the Superior Court of Quebec

A preliminary issue was raised regarding the jurisdiction of the Superior Court of Quebec as Mac's is incorporated under the *Business Corporations Act* (Ontario) and its head office is located in Ontario.

However, the Court determined that it had jurisdiction because the evidence showed that the relevant facts pertaining to Mac's internal affairs, particularly the decision to declare and pay the dividend on April 25, 2006, originated in Quebec.

This is an interesting finding of the Court and highlights the jurisdictional issues that can arise on a rectification application. It is also interesting to consider why the parties chose to bring the action in Quebec as opposed to Ontario.

The Law

The Court first noted that the Court of Appeal of Quebec had recently ruled in two cases[1] where a difference between the intention of a taxpayer and the written instrument led to adverse tax consequences.

In *AES*, the Court of Appeal indicated that the Superior Court has the authority to rectify a written instrument where there is a discrepancy between the common intention of the parties and the stated intention in the instrument. This follows from section 1425 of the C.C.Q. which provides that, in interpreting contracts, the true intention of the parties must prevail over what is stated in the written contract.

A four-step test was set out by the Court of Appeal to determine whether a motion for rectification may be granted:

- Is there a discrepancy between the parties' common intention (*negotium*) and the intention recorded in writing (*instrumentum*)?
- Is the motion for rectification legitimate?
- Is the motion for rectification necessary?
- Would the rectification affect the rights of third parties?

The Court of Appeal noted in *AES* that the circumstances giving rise to a rectification must not be confused with an error vitiating the consent of a party to a contract. Under section 1400 of the C.C.Q., an error vitiates consent of the parties or of one of them where it pertains to the nature of the contract, the object of the prestation, or anything that was essential in determining that consent. However, an inexcusable error does not constitute a defect of consent. An error vitiating the consent of one or more parties to a contract can only result in its cancellation and not a rectification of the content.

Application to the Facts of the Case

The Court accepted the evidence that no discussion occurred between the parties relating to the tax consequences of the dividend and the deduction of interest paid by Mac's on a loan from a "specified non-resident". The Court determined that the series of transactions reflected the intent of the parties. *AES* and *Riopel* can be distinguished because in those cases, there was a discrepancy between the *negotium* and the *instrumentum*. However, in the present case, the resolutions of the directors declaring the dividend of $136 million reflected the actual intent of Mac's at that time.

The Court could have ended its analysis at this stage because it had determined that the Mac's motion for rectification did not meet the first criterion established by the Court of Appeal in *AES*. However, the judge made the following comments in *obiter*.

Regarding the second criterion developed in *AES*, the Court concluded that the motion was not justified because Mac's was seeking more than the rectification of a written instrument. Indeed, Mac's wanted to replace a legal act (i.e., the declaration of the dividend) by another legal act (the reduction of its paid-up capital) in order to obtain a more favourable tax treatment. The Court held that these two acts are very different and that granting the rectification would amount to rewriting the history of the transaction. The Court concluded that Mac's motion for rectification was not valid for this reason, citing *Carpanzano* v. *3660524 Canada Inc.* (2005 CanLII 7316), a 2005 decision of the Court of Quebec, as precedent.

The Court added a second reason to support its conclusion about the legitimacy of the motion: granting Mac's motion would amount to creating several new written instruments. Moreover, another entity not party to the proceedings, ACT Financial Trust, would have had to give retroactive consent. In addition, under the *Business Corporations Act* (Ontario), it is the board of directors that can declare a dividend, whereas an increase and decrease of paid-up capital must be voted on by the shareholders.

Finally, regarding the issue of the error, the Court sided with the tax authorities. The judge stated that, generally speaking, an "economic" error (that is, an error on the value of the object of the contract) is not a valid ground to request the cancellation of a contract under the C.C.Q. However, the Court of Appeal decided that an error on the value of the object of the contract, when a primary consideration and a condition to the consent, can give rise to cancellation in certain circumstances. However, the threshold of this test is very high.

In this case, the thin capitalization rules had not been specifically considered in the process of deciding to declare and pay the dividend. In fact, when the dividend was declared, Mac's was not aware it would result in adverse tax consequences with respect to the deductibility of interest paid to Sildel. Accordingly, the thin capitalization rules were not a primary consideration when Mac's declared the dividend. In fact, the adverse application of the thin capitalization rules were an unintended consequence of the series of transactions.

In addition, there had been no error by Mac's on the value of the object of the declaration of the dividend. Rather, the error was the result of the dividend, which is a separate transaction from the payment of interest to Sildel.

In all cases, according to the rules of the C.C.Q., rectification of the error could have only resulted in the cancellation of the declaration of the dividend and not the rectification of the written instrument. That is not what was sought by

the petitioner.

For these reasons, the Court denied Mac's motion for declaratory judgment.

Conclusion

This judgment serves as a caution that rectification is not a panacea that can be used to correct any error made in the course of a transaction. Following the *AES* and *Riopel* decisions, it seems that the Superior Court will rectify written instruments only in specified circumstances. The threshold now appears to be high.

It is too early to tell if this decision will be appealed. However, given the quantum of denied interest deduction, it is likely that the Court of Appeal of Quebec will once again hear a rectification case involving a taxpayer that has to suffer the consequences of transactions that gave rise to an unintended tax result.

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A number of tax lawyers from Fraser Milner Casgrain LLP write commentary for CCH's Canadian Tax Reporter *and sit on its Editorial Board as well as on the Editorial Board for CCH's Canadian* Income Tax Act with Regulations, Annotated. *Fraser Milner Casgrain lawyers also write the commentary for CCH's* Federal Tax Practice *reporter and the summaries for CCH's* Window on Canadian Tax. *Fraser Milner Casgrain lawyers wrote the commentary for* Canada–U.S. Tax Treaty: A Practical Interpretation *and have authored other books published by CCH:* Canadian Transfer Pricing *(2nd Edition, 2011);* Federal Tax Practice; Charities, Non-Profits, and Philanthropy Under the Income Tax Act; *and* Corporation Capital Tax in Canada. *Tony Schweitzer, a Tax Partner with the Toronto office of Fraser Milner Casgrain LLP, and a member of the Editorial Board of CCH's* Canadian Tax Reporter, *is the editor of the firm's regular monthly feature articles appearing in* Tax Topics.

Notes:

[1] *Québec (Deputy Minister of Revenue) et al. v. Services Environnementaux AES Inc. et al.*, 2011 QCCA 394 ("*AES*") and *Ripoel v. Agence du Revenu du Canada*, 2010 QCCA 1045 ("*Riopel*"). An appeal from each of these cases is presently before the Supreme Court of Canada.

TAX TREATIES

Canada–Colombia Convention Enters into Force

The Department of Finance announced that the Tax Convention between Canada and Colombia entered into force on June 12, 2012. In Canada, for taxes withheld at source, the Convention will have effect on amounts paid or credited on or after January 1, 2013 and for other taxes, for taxation years beginning on or after January 1, 2013. The text of the Convention is reproduced on CCH Online and on DVD and in Volume 6 of the print reporter.

Canada–Australia Tax Convention to be Updated

On July 10, 2012, the Department of Finance announced that Canada and Australia have begun treaty negotiations to update the Canada–Australia Tax Convention that was signed in 1980 and amended by a Protocol signed in 2002. The Department of Finance is interested in hearing about difficulties that Canadians may have had under the tax system of Australia or other issues that could be raised during the negotiations. Interested parties should send comments to the Department of Finance, 17th Floor, East Tower, 140 O'Connor Street, Ottawa, Canada, K1A 0G5. Fax: 613-992-4450. For further information contact: Sophie Chatel, Tax Legislation Division, (613) 995-3586.

INFORMATION CIRCULAR IC-100 NOW IC12-1

The Canada Revenue Agency has renumbered Information Circular IC-100, GST/HST Compliance Refund Holds as IC12-1. The content of the circular, which was described in *Tax Topics*, No. 2099 has not changed nor has the date, May 18, 2012. IC12-1 is reproduced on CCH Online and on DVD in the Bulletins, Circulars, Rulings collection and in Volume 8 in the print version of the *Canadian Tax Reporter*.