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A Questionable Equity: Rectification and Tax Avoidance

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Case Commented On: *Harvest Operations Corp. v Attorney General of Canada*, 2017 ABCA 393 (CanLII)

Harvest Operations Corp. v Attorney General of Canada (*Harvest Operations Corp. CA*) is a case about an elaborate but unsuccessful tax avoidance maneuver and an attempt to get contract rectification. The details of the attempted tax avoidance are unreasonably complicated, and so I will focus on the facts necessary for the rectification issue (if you want to learn how to correctly perform the "bump transaction" method of avoiding capital gains tax, this post will not help you).

Viking Holdings Inc. (a predecessor in interest to Harvest Operations Corp.) decided to acquire Krang Energy Inc. for approximately $136.1 million, and it decided to do so on a tax neutral basis. The tax-liability-free reorganization plan involved incorporating a new company, having a Viking Holdings affiliate lend the newly created corporation around $136 million, and having it buy all the shares of Krang Energy Inc. Then the new corporation would amalgamate with Krang Energy; then the newly amalgamated company would transfer its interest in two of the corporations it would own to affiliates of the Viking Holdings group; then Viking Holdings would pass the interest in those corporations to a different partial Viking Holdings affiliate corporation (at paras 15-32).

Could you keep track of all that?

Neither could the Viking Holdings group. They failed to accurately carry out the tax-neutral reorganization plan—several of the payments were made from the wrong subsidiaries and some assets were excluded from a necessary transfer. The errors left the parties holding the assets and corporations they intended to, but also tax bills totaling a little over $12 million (at paras 33-36).

Harvest Operations Corp. filed an originating application for rectification of several documents in order to retroactively carry out the reorganization plan without tax liability, as they intended. Rectification is an equitable remedy allowing a court to retroactively alter a legal instrument that fails to reflect the true agreement of the parties, in order to make the legal instrument align with the true agreement (*Canada (Attorney General) v Fairmont Hotels Inc.*, 2016 SCC 56 (CanLII) at para 12 (*Fairmont Hotels*)). The two parties to the original agreement both wanted the documents adjusted to remove the tax liability, with the Attorney General of Canada representing the interests of the Canada Revenue Agency.

The application was heard by Justice C. Dario at the Court of Queen's Bench (*Harvest Operations Corp v Canada (Attorney General)*, 2015 ABQB 327 (CanLII) (*Harvest Operations QB*)). Harvest Operations argued that it was always their "intent to minimize the taxes owing…

[and] that since it was the parties' intent to complete the transaction with the general goal of minimizing the tax burden, the Court should intervene to correct glitches in the mechanics of implementing such intent" (*Harvest Operations QB* at para 13). Justice Dario denied the application, finding that "the general objective of completing a transaction in a tax efficient manner, or with a goal of tax minimization or avoidance of some other tax disadvantage, is not sufficient; the parties must have intended to achieve that objective in a *particular way*" (*Harvest Operations QB* at para 45, emphasis in original) and that the contracts accurately reflected the agreement of the parties, although the agreement had impacts they did not anticipate (*Harvest Operations QB* at para 77).

Harvest Operations appealed to the Court of Appeal. In between the Queen's Bench trial and the Court of Appeal hearing, the Supreme Court of Canada released *Fairmont Hotels*, a decision on rectification of contracts for tax avoidance purposes. *Fairmont Hotels* did not assist Harvest Operations. Justice Dario had relied on *Graymar Equipment (2008) Inc v Canada (Attorney General)*, 2014 ABQB 154 (CanLII), a decision of Justice Brown while he was on the Alberta Court of Queen's Bench, and the majority decision in *Fairmont Hotels* happened to be authored by Justice Brown, now sitting on the Supreme Court, and taking the same approach he had in *Graymar* (at para 42). Now a leading authority, *Fairmont Hotels* narrowed the scope of rectification and rejected a line of cases that had been moving towards a broader application of the remedy that allowed rectification where the legal instrument failed to align with the parties' general tax avoidance purpose (*Fairmont Hotel*, at 16-19); in the course of doing so, it specifically cited *Harvest Operations Corp QB* with approval (*Fairmont Hotels* at para 24).

So, the Supreme Court had spoken on the legal issue, and cited the Queen's Bench decision that was being appealed up to Court of Appeal. The Court of Appeal unanimously agreed with Justice Dario's findings of fact, and confirmed that "rectification is designed to ameliorate a very specific type of problem – there is a discrepancy between the terms of the agreement and the preagreement consensus" (*Harvest Operations Corp. CA* at para 71). The focus is on whether the documents accurately described the means by which the parties intended to avoid taxes, not whether the documents accurately reflected the intention of the parties to avoid taxes (*Harvest Operations Corp. CA* at para 67). Harvest Operations intended to minimize their taxes, but the legal instruments accurately describe what the parties meant the legal instruments to do, they just did not have the effect that Harvest Operations had hoped (*Harvest Operations Corp. CA* at paras 61-62, 70).

As a result, the expanding scope of contract rectification, especially in the context of tax avoidance, has been reversed, and the equitable doctrine of rectification confined to its correct role.

But something about the case bothers me: why is rectification available at all to tax avoiders? (I am not the first to be puzzled by this sort of question – see Neil Brooks and Kim Brooks, "The Supreme Court's 2013 Tax Cases: Side−Stepping the Interesting, Important and Difficult Issues" (2015), 68 SCLR (2d) 335 at 386-387). Rectification is an equitable remedy, and parties who come into a court of equity must come with clean hands: "He who seeks equity must do equity" (*Harvest Operations Corp. QB* at para 93, *Performance Industries Ltd. v Sylvan Lake Golf &*

Tennis Club Ltd., 2002 SCC 19 (CanLII) at para 34, *McAllister v Forsyth*, 12 SCR 1, 1885 CanLII 67 (SCC) at 5.)

The following chart (an appendix to the Court of Appeal decision) shows part of the tax avoidance plan Krang intended to carry out; does it appear to be an honest and straightforward sale?

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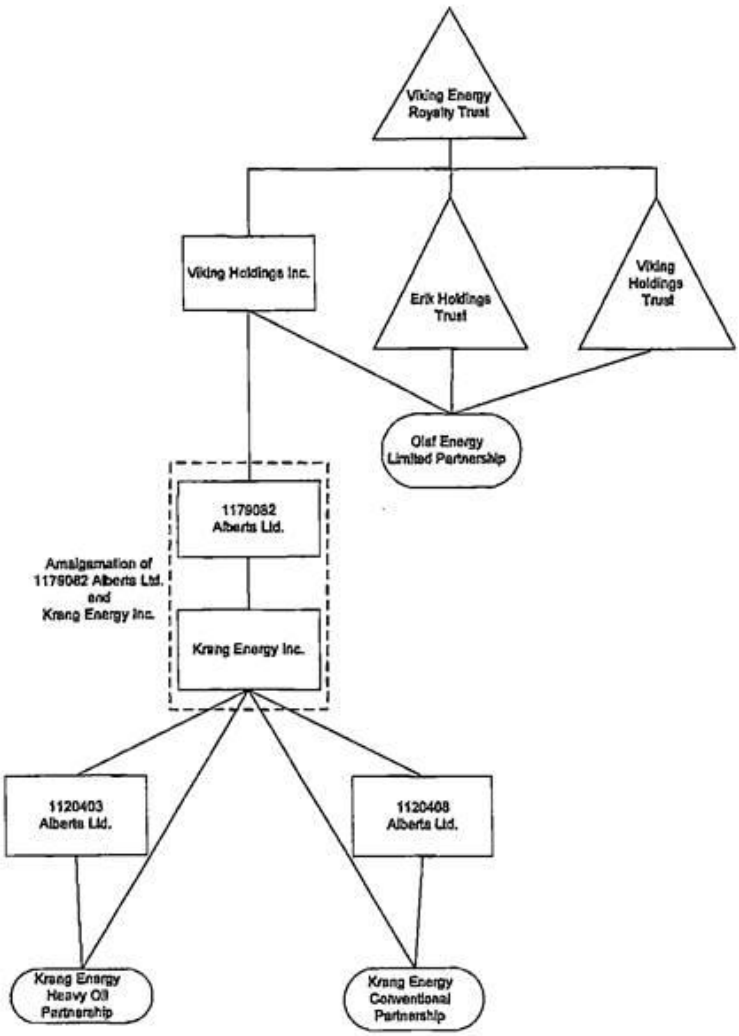
Krang Re-Organization

Step 1: Amalgamation of 1179082 and Krang to Form Krang #2



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I am unable to say exactly what Krang is doing on that chart, but it does not appear to "do equity".

Equitable remedies are discretionary, and the parties have no legal right to have their errors corrected. However, *Harvest Operations Corp QB* (at para 27) cites *McPeake v Canada (Attorney General)*, 2012 BCSC 132 (CanLII) at para 25 as authority for the principle that rectification is available for legal instruments with tax avoidance purposes, and *McPeake* cites *Re Slocock's Will Trusts,* [1979] 1 All ER 358 at 363, which includes the point that: "Parties are entitled to enter into any transaction which is legal…It 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." This reasoning is hardly compelling. Tax avoidance pushes the tax burden onto others who do not or cannot engage in such schemes and is primarily an option open only for the benefit of those at the upper end of the income scale. When a tax avoidance scheme fails, it is not an "accidental windfall" for the Crown, it is the Crown obtaining exactly the taxes it is entitled to, for the benefit of the public through government expenditures.

Tax avoidance is legal, but equitable remedies should not be helping with tax avoidance. The severe shortage of court resources in Alberta is a common topic on ABlawg, and we often hear Alberta judges tell the parties before them to consider court resources in deciding how to proceed. The problem has been exacerbated by the recent strengthening of the *Charter* right to trial within a reasonable time (see earlier posts on *R v Jordan*, 2016 SCC 27 (CanLII) here. Rather than spend precious Alberta court time checking for the evidence of an inconsistency between legal instruments and the intentions of the parties, when applicants are asking for court assistance in avoiding their taxes, courts should be turning them away at the outset.

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