
# Canada – TaxMatters@EY

April 2019

## In this issue



*TaxMatters@EY* is a monthly Canadian bulletin that summarizes recent tax news, case developments, publications and more. For more information, please contact your EY advisor.

# CRA audits: related party initiative and risk-based audits

*Ameer Abdulla, Waterloo*

A letter from the Canada Revenue Agency (CRA) may well be enough to send most taxpayers into cold sweats. Correspondence from the CRA often contains useful information, but occasionally taxpayers will be notified that they have been selected for an audit.

Although audits of taxpayers are not uncommon, the CRA tends to focus its audit efforts on certain populations of taxpayers that have more complicated tax situations and groups or industries that have historically had higher incidences of non-compliance.

As technology continues to evolve, the CRA has started to employ data analytics and algorithms throughout its departments and in various audit programs to assess risk, and to select files for audit.

The CRA has recently given an update on the status of two of such programs[1]: the related party initiative (RPI), which focuses on high-net-worth individuals, and risk-based audits, which focuses on large businesses.

[1] Presented at the Annual Canadian Tax Foundation Conference, 25-27 November 2018; refer to CRA income tax ruling document 2018-0779961C6 (E).

## RPI: really big fish

High-net-worth individuals and their related entities are often potential candidates for audit. The RPI is the primary CRA audit program that focuses on these individuals. However, individuals selected through the RPI program could also be selected through other programs such as the High Income Earners and Postal Code programs, or even through something else such as the CRA's review of Form T1135.

The RPI program has been in place since 2005. Historically, audit activity was enforced by a single auditor and more likely focused on one specific entity. In recent years, a key change to the RPI program is using a "holistic approach," classifying the high-net-worth individual and related entities as one economic group. The economic group would receive an overall risk assessment and, if selected for audit, would generally be audited by a team of auditors.

The scope of the program generally includes those with a net worth of over $50m. As of 31 March 2018, more than 800 groups that qualify have been identified.[2] During the risk assessment stage, the RPI population is examined extensively, in part due to the complexity of the business, investment and estate planning structures inherent in these groups.

The CRA combines the results of a taxpayer-completed RPI questionnaire, its own internal data analytics and publicly available information to determine the overall risk level and which entities to include in an audit.

In addition, the CRA examines the role of personal trusts, private foundations, partnerships, offshore activities and corporations in the organizational structure to assist in determining the risk level for the entire economic group. There are more than 30 audit teams across the country.

Once selected for audit, the audit approaches that are applied to files in the RPI program are comparable to those used in the Large File program. An RPI audit is generally a complex and often lengthy process that may span a number of years; however, consistent with other CRA audit programs, taxpayer cooperation affects the length of the audit and may impact the tax years and entities under review.

## Risk-based audits: finding the needle in the haystack

The large business population — that is, entities having annual revenues of more than $250m — comprises approximately 20,000 entities. The CRA uses an integrated, risk-based approach to identify the highest-risk cases nationally and focus its audit resources on large businesses with the highest risk of non-compliance. Generally, taxpayers that do not engage in transactions that the CRA may consider abusive, maintain an effective tax control framework and are open and transparent with the CRA are considered low risk.[3]

The CRA employs an automated system that runs risk algorithms to identify risk issues and generate a risk ranking of the taxpayers in the large business population. The specific risk issues are then pre-populated in an audit case file. The cases are then reviewed by regional and national committees, and the highest risk taxpayers/cases will be selected for a full audit.

The audit team is led by an international and large business case manager, who is responsible for the overall audit and acts as the single point of contact between the CRA and the taxpayer. In the preliminary stages of the audit, if the audit team determines that the taxpayer is, in fact, low risk, the case will be closed. For taxpayers that remain high risk, the CRA will proceed with the full compliance audit.[4]

## Implications

The CRA continues to develop its programs and tools to identify and quantify the level of risk of non-compliance for both individual and business taxpayers. There is now a wealth of data available on taxpayers in addition to domestic tax filings which is all used in forming the assessment of risk. If selected for an audit, having clear records, being transparent and cooperating with the CRA should help the audit proceed faster.

For assistance, consult your EY tax advisor.

[2] Ibid. The 2019 federal budget documents (p. 197) state that as a result of the CRA's focus on high-net-worth individuals and their associated corporate structures, there are now 1,100 offshore audits underway.

[3] Ibid.

[4] Ibid.



Back to contents

# Improving board performance through effective evaluation

*Originally published in **EY BoardMatters January 2019***

Investors, regulators and other stakeholders are seeking greater board effectiveness and accountability and are increasingly interested in board evaluation processes and results. Boards are also seeking to enhance their own effectiveness and to more clearly address stakeholder interest by enhancing their board evaluation processes and disclosures.

The focus on board effectiveness and evaluation reflects factors that have shaped public company governance in recent years, including:

- Recent high-profile examples of board oversight failures
- Increased complexity, uncertainty, opportunity and risk in business environments globally
- Pressure from stakeholders for companies to better explain and achieve current and long-term corporate performance
- Board evaluation requirements outside the US; the UK, in particular
- Increased focus on board composition by institutional investors
- Activist investors

In view of these developments, EY reviewed the most recent proxy statements filed by companies in the 2018 Fortune 100 to identify notable board evaluation practices, trends and disclosures. Our first observation is that 93% of proxy filers in the Fortune 100 provided at least some disclosures about their board evaluation process. This article outlines elements that can be considered in designing an effective evaluation process and notes related observations from our proxy statement review.

Back to contents

## Planning and designing an effective evaluation process

Prior to designing and implementing an evaluation process, boards should determine the substantive and specific goals and objectives they want to achieve through evaluation. The evaluation process should not be used simply as a way to assess whether the board, its committees and its members have satisfactorily performed their required duties and responsibilities. Instead, the evaluation process should be designed to rigorously test whether the board's composition, dynamics, operations and structure are effective for the company and its business environment, both in the short and long term, by:

- Focusing director introspection on actual board, committee and director performance compared to agreed-upon board, committee and director performance goals, objectives and requirements
- Eliciting valuable and candid feedback from each board member about board dynamics, operations, structure, performance and composition
- Reaching board agreement on action items and corresponding timelines to address issues observed in the evaluation process
- Holding the board accountable for regularly reviewing the implementation of evaluation-related action items, measuring results against agreed-upon goals and expectations, and adjusting actions in real time to meet evaluation goals and objectives

In determining the most effective approach to evaluation, boards should determine who should lead the evaluation process, who and what should be evaluated, and how and when the evaluation process should be conducted and communicated.

## Leading the evaluation process

Leadership is key in designing and implementing an effective evaluation process that will objectively elicit valuable and candid director feedback about board dynamics, operations, structure, performance and composition.

A majority (69%) of Fortune 100 proxy filers disclosed that their corporate governance and nominating committee performed the evaluation process either alone or together with the lead independent director or chair. These companies also disclosed that evaluation leaders did or could involve others in the evaluation process, including third parties, internal advisors and external legal counsel. Twenty-two percent of Fortune 100 proxy filers disclosed using or considering the use of an independent third party to facilitate the evaluation at least periodically.

## Determining who to evaluate

Board and committee evaluations have long been required of all public companies listed on the New York Stock Exchange. Today, board and committee evaluations are leading practice for all public companies.

Approximately one quarter (24%) of Fortune 100 proxy filers disclosed that they included individual director self-evaluation along with board and committee evaluation. Ten percent of Fortune 100 proxy filers disclosed that they conducted peer evaluations. Individual director self- and peer evaluations are discussed below.

## Prioritizing evaluation topics

Board, committee and individual director evaluation topics should be customized and prioritized to elicit valuable, candid and useful feedback on board dynamics, operations, structure, performance and composition. Relevant evaluation topics and areas of focus should be drawn from:

- Analysis of board and committee minutes and meeting materials
- Board governance documents, such as corporate governance guidelines, committee charters and director qualification standards, as well as company codes of conduct and ethics
- Observations relevant to board dynamics, operations, structure, performance and composition
- Company culture, performance, business environment conditions and strategy
- Investor and stakeholder engagement on board composition, performance and oversight

Forty percent of Fortune 100 proxy filers disclosed the general topics covered by the evaluation. These disclosures typically focus on core board duties and responsibilities and oversight functions, such as:

- Strategy, risk and financial performance
- Board composition and structure
- Company integrity, reputation and culture
- Management performance and succession planning

The evaluation process should be designed to rigorously test whether the board's composition, dynamics, operations and structure are effective for the company.

## Asking focused evaluation questions to elicit valuable feedback

About 40% of Fortune 100 proxy filers disclosed use of questionnaires in their evaluation process, with 15% disclosing use of only questionnaires and 25% disclosing use of both questionnaires and interviews. Questionnaires are a key tool in the evaluation process but must be thoughtfully and carefully drafted to be effective.

Questionnaires are helpful because each director receives the same question set – even if there are separate questionnaires for the board, its committees and individual directors. This approach facilitates comparison of director responses and can help indicate the magnitude of any actual or potential issues as well as variances in director perspective and perception.

Evaluation questionnaires often put questions in the form of a statement, such as "The board is the right size," which calls for a response along a numerical scale. The larger the numerical scale, the more variance, which allows for a relatively more nuanced response. More specific and candid feedback can be obtained by prompting directors to provide detailed freestyle commentary to explain a response on a numerical scale or to a "yes" or "no" question.

Well-drafted, targeted questions – or questions in the form of a statement – should be written specifically for the board, its committees and individual directors, as applicable, with the goal of eliciting valuable and practical feedback about board dynamics, operations, structure, performance and composition. High-quality feedback is what enables boards and directors to see how they can better perform and communicate, with the result that the company itself better performs and communicates.

Template evaluation questionnaires often do not demonstrate the strong potential of a well-drafted questionnaire. Many template questionnaires seem overlong and include unnecessarily hard-to-answer or unclear questions, such as, "Does the board ensure superb operational execution by management?" These types of questions don't seem to lend themselves to eliciting practical feedback. Complicated or unclear questions should be revised to be more practical or omitted from the questionnaire. Overlong questionnaires should be streamlined to be more relevant and effective in eliciting valuable and useful information.

Template evaluation questionnaires also often include numerous questions about clearly observable or known board and director attributes, practices and requirements. A short set of common examples includes:

- I attend board meetings regularly.
- Advance meeting materials provide sufficient information to prepare for meetings, are clear and well organized, and highlight the most critical issues for consideration.
- I come to board meetings well prepared, having thoroughly studied all pre-meeting materials.
- The board can clearly articulate and communicate the company's strategic plan.
- The board discusses director succession and has implemented a plan based on individual skill sets and overall board composition.

When evaluation questionnaires include numerous questions on observable practices or required duties and responsibilities, the evaluation becomes more of a checklist exercise than a serious effort to elicit valuable and useful information about how to improve board dynamics, operations, performance and composition. Overlong, vaguely worded, generic, checklist-type questionnaires can lead to director inattention and inferior feedback results, further impairing the evaluation process.

More effective questionnaires are purposefully and carefully drafted to focus director attention on matters that cut to the core of board and director performance. This may be facilitated when the questions focus succinctly on agreed-upon board goals and objectives or requirements and director qualifications considered together with the company's performance and short- and long-term strategy.

For example, a written evaluation questionnaire need not ask whether the board and its directors have discussed and made a plan for director succession because the directors already know the answer. A better approach might be to recognize that such action did not take place and to ask each director, during a confidential interview process, "What factors or events distracted or prevented the board from discussing and implementing a plan for director succession?" Candid responses to that interview question should provide feedback that can uncover practices or leadership that should change in order to improve board performance.

## Conducting confidential one-on-one interviews to elicit more candid feedback

Conducting well-planned, skillful interviews as part of the evaluation process can elicit more valuable, detailed, sensitive and candid director feedback as compared to questionnaires. The combined use of questionnaires and interviews may be most effective and, as noted above, was the approach disclosed by about one quarter of Fortune 100 proxy filers. Fifteen percent of Fortune 100 proxy filers disclosed use of interviews only.

Interviews are particularly effective when there is an actual or potential issue of some sensitivity to address, as directors may prefer to discuss rather than write about sensitive topics. If boards believe interviews will be helpful, they should carefully consider who should conduct them – with the key criteria being that the interviewer is:

- Well informed about the company and its business environment as well as board practices
- Highly trusted – even if not well known – by the interviewees
- Skilled at managing probing and candid conversations

Special considerations may arise when the interviewer is also part of the evaluation process. Where sensitivities like this are perceived, using an experienced and independent third-party interviewer can be effective.

While interviews do not enable anonymity, a trusted and skilled interviewer may still confidentially elicit valuable and sensitive feedback. Interviewer observations and interviewee feedback can be presented to the board without attribution.

## Individual director self- and peer evaluations

Individual self- and peer evaluations – whether through questionnaires or interviews – can improve an evaluation process, especially one that is already generally successful as applied to the board as a whole and its committees. When directors understand and see value in evaluations at the collective level, they often perceive enhanced value in individual evaluations – both of themselves and of their peers.

Self-evaluations call for directors to be introspective about themselves and their performance and qualifications. Interestingly, simply being asked relevant questions about performance can lead directors to strive harder. The goal of self-evaluation is to enable directors to consider and determine for themselves during the evaluation process – and every other day – what they can proactively do to improve personal performance and better contribute to optimal board performance. Approximately one quarter of Fortune 100 proxy filer boards included individual director self-evaluations in their evaluation process.

Peer evaluations are increasingly seen as critical tools to develop director skills and performance and promote more authentic board collaboration. A successful peer evaluation can also help improve director perspective. While some suggest that peer evaluations, even if provided anonymously, can be uncomfortable to provide and receive, a key characteristic of an effective board is that the board's culture inspires and requires active, candid, relevant and useful participation from all members, as well as healthy debate and rigorous and independent yet collaborative decision-making. Where the board culture and dynamic is healthy, directors should see peer evaluation as important and beneficial guidance and coaching from esteemed colleagues. Ten percent of Fortune 100 proxy filer boards included peer evaluations in their evaluation process.

## Using a third party

Use of third-party experts, such as governance advisory firms or external counsel, to facilitate the evaluation process is increasing. Twenty-two percent of Fortune 100 proxy filers disclosed that they had a third party facilitate their evaluation at least periodically, typically stated as every two or three years.

A third party can perform a range of evaluation services, from leading the evaluation process to conducting interviews to providing evaluation questions and reviewing questionnaire responses. Third parties can also help oversee implementation of evaluation action items.

Where the third party is independent of the company and the board, its participation in the evaluation process can meaningfully enhance the objectivity and rigor of the process and results. Third-party experts can provide new and different perspectives, both gained from work with other companies as well as simply being from outside the company, which can lead to improved action-item development and evaluation results.

The use of a third party may be especially helpful when:

- The board wants to test or improve its existing evaluation process.
- Directors may not be forthcoming and candid with an internal evaluator.
- The board believes an independent third party can objectively bring new perspectives and issues to the board's attention.
- The board is new or has undergone a significant change in composition and its directors are not yet poised to conduct an effective evaluation.
- The board has not seen significant change in composition over a period of time and new perspective is desired on board composition and performance.
- The company and its board are facing and addressing a crisis.



Back to contents

Where the board culture and dynamic is healthy, directors should see peer evaluation as important and as beneficial guidance and coaching from esteemed colleagues.

## Intra-year evaluations and feedback

Board evaluations generally are performed annually. Common evaluation topics, however, relate to board practices and director attributes that are observable either in real time, over a three- or six-month period, or with reference to board agendas and minutes. In such cases, boards should formally encourage real-time or prompt feedback to constructively address actual or potential issues. Indeed, doing so allows directors themselves to embody the "see something, say something" culture needed to promote long-term corporate value.

The concept of real-time or intra-year evaluation of board and director composition and performance is not new, even if not now widely practiced. A few (just fewer than 10%) of proxy filers in the Fortune 100 disclosed that they carry out phases of the evaluation process on an ongoing basis, at every in-person meeting, quarterly, biannually or otherwise during the year.

Given the attention to board effectiveness, we expect companies will expand their disclosures relating to board evaluation and effectiveness.

## Disclosing the evaluation process and evaluation results

A vast majority, 93%, of Fortune 100 proxy filers provide at least some disclosure about their evaluation process, but we observed wide variances in the scope and details of the disclosures. Given the attention to board effectiveness, we expect companies will expand their disclosures relating to board evaluation and effectiveness.

About 20% of Fortune 100 proxy filers disclosed, at a high level, actions taken as a result of their board evaluation.

Some examples include:

- Enhanced director orientation programs
- Changes to board structure and composition
- Changes to director tenure or retirement age limits
- Expanded director search and recruitment practices
- Improvements to the format and timing of board materials
- More time to review key issues, such as strategy and cybersecurity
- Changes to company and board governance documents
- Improved evaluation process

Companies with more detailed disclosures often use graphics to explain their evaluation process, such as in this example:

### Our board's evaluation process

**Determine format**
The formal self-evaluation may be in the form of written or oral questionnaires, administered by the board members, management or third parties. Each year, our governance and nominating committee discusses and considers the appropriate approach and approves the form of the evaluation.

**Conduct evaluation**
Members of our board and each board committee participate in the formal evaluation process, responding to questions designed to elicit information to be used in improving board, committee and director effectiveness.

**Review feedback**
Director feedback provided during the formal evaluation process is discussed during board and committee meetings, in executive session or with management present when appropriate.

**Respond to evaluation feedback**
Following discussion of director feedback, the board and its committees work with one another and management to take specific steps to improve policies, processes and procedures to improve board, committee and director effectiveness.

## Conclusion

Investors, regulators, other company stakeholders and governance experts are challenging boards to examine and explain board performance and composition. Boards should address this challenge – first and foremost through a tailored and effective evaluation process. In doing this, boards can work to identify areas for growth and change to improve performance and optimize composition in ways that can enhance long-term value. Boards can also describe evaluation processes and high-level results to investors and other stakeholders in ways that can enhance understanding and trust.

### Observations about Fortune 100 company board evaluation practices

| Observation | % of total* |
|---|---|
| Performed individual director self-evaluation, in addition to board and committee evaluation | 24% |
| Used or considered using a third party at least periodically to facilitate the evaluation | 22% |
| Used both questionnaires and individual director interviews to conduct the evaluation | 26% |
| Provided board evaluation disclosures in their proxy statement | 93% |
| Identified in the proxy statement general topics covered in the evaluation | 40% |
| Disclosed in the proxy statement general actions taken as a result of the evaluation | 21% |

* Data based on the most recent proxy statements available for the 86 public companies on the 2018 Fortune 100 list.

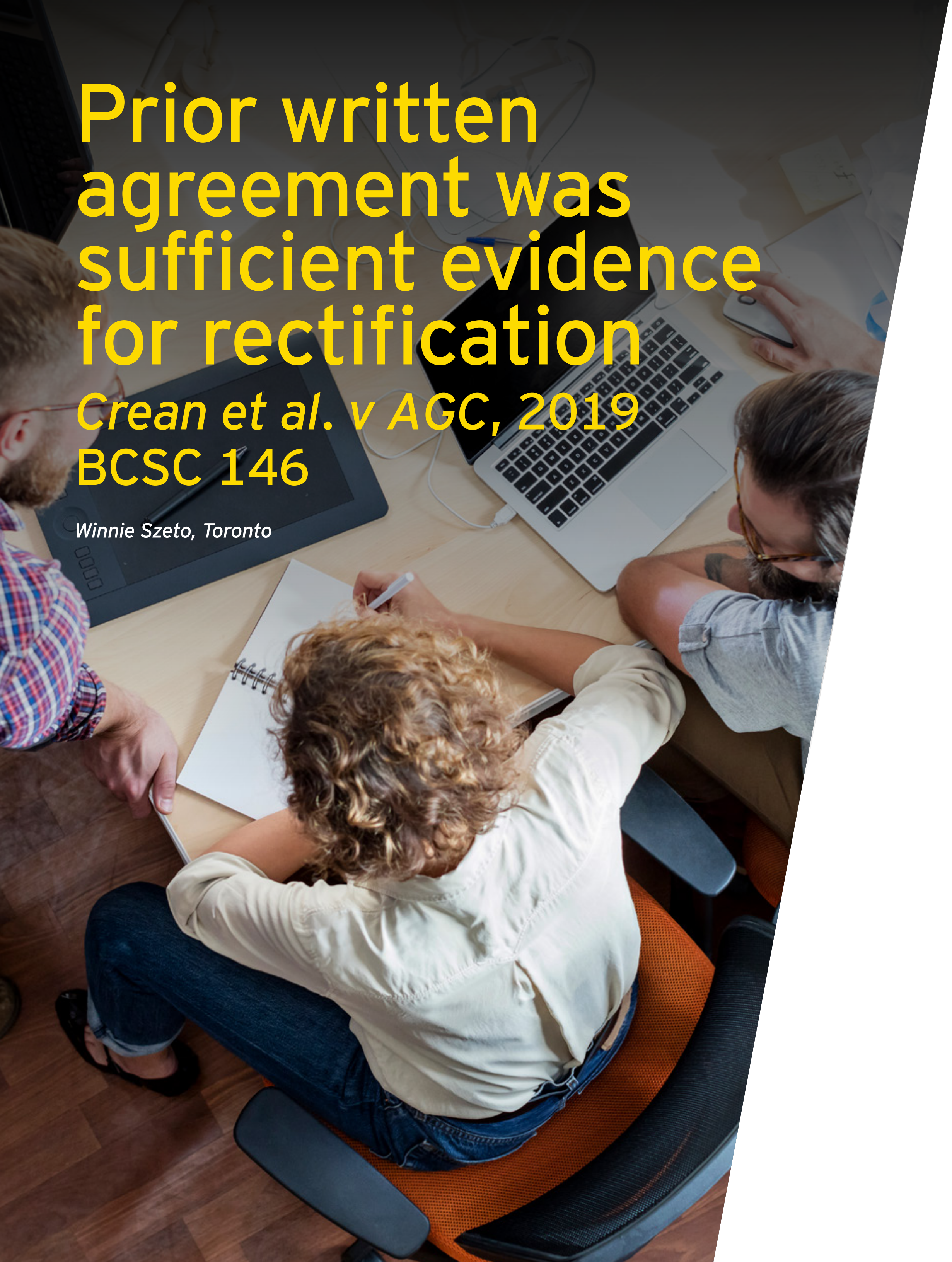
### Questions for the board to consider

- Has the most recent evaluation process enabled the board and individual directors to identify actions to optimize board and director performance and board composition?
- Has the company considered disclosing the evaluation process and summarizing the nature of actions taken to enhance stakeholder understanding of the board's work and value?
- Does the board as a whole and each director have a common and clear understanding of the term "effectiveness" as applied to the board as a whole, its committees and each director individually?
- Has the board formulated clear goals, objectives and standards for itself, its committees and each director that can be referenced during and outside of the evaluation process? If the board has director qualification standards, should they be expanded in more specific ways to include standards and requirements that each director must consistently meet to earn renomination?
- Does the evaluation process include components that occur on a biannual, quarterly and/or real-time basis? If not, why not?
- Is the evaluation process appropriately synergized with the board's annual governance review, orientation and education programs, director nomination process, succession planning and stakeholder engagement programs?
- Does the evaluation process provide validation to each director that he or she is the right director at the right time for the right company?

# Prior written agreement was sufficient evidence for rectification

## *Crean et al. v AGC*, 2019 BCSC 146

*Winnie Szeto, Toronto*

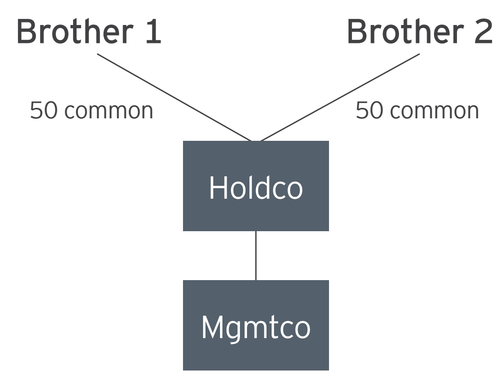


This is a case of the British Columbia Supreme Court that involved an application for rectification in the context of a sale of shares.

### Facts

Brother 1 and Brother 2 each owned 50 of the issued and outstanding common shares of Holdco. Holdco is part of a group of companies (the Group) that includes Mgmtco and other related corporations. Holdco owns 100% of Mgmtco, which provides funeral and related services.

**Simplified corporate structure before sale of shares**




Back to contents

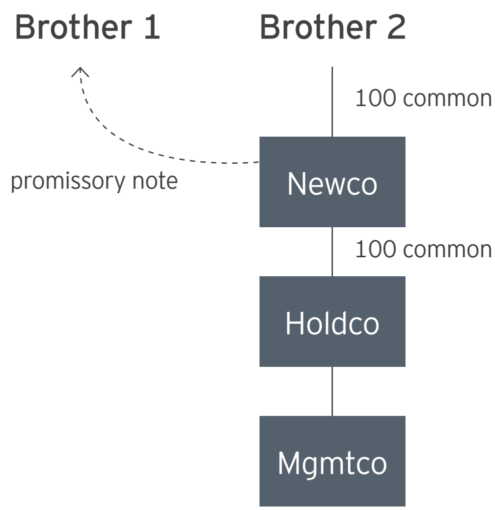
Brother 1 wanted to retire from the family business, so he decided to sell his Holdco shares to Brother 2. On 27 May 2016, the brothers entered into an agreement in principle regarding the sale of the shares.

After entering into the above agreement, the brothers sought advice from their tax advisor about how to proceed with the share sale. They were advised to create a new company and to have the new company purchase the shares. Specifically, their tax advisor devised the following plan, which they implemented:

1. On 22 August 2016, Brother 2 incorporated a numbered company (Newco) and subscribed for 50 common shares for $50.
2. On 31 August 2016, Holdco paid capital dividends to Brother 1 in the amount of $452,697.50 and Brother 2 in an unknown amount.
3. On 31 August 2016, Brother 2 rolled his 50 common shares of Holdco into Newco at cost under subsection 85(1) of the Income Tax Act (the Act) in exchange for 50 additional common shares of Newco.
4. On 31 August 2016, Brother 1, Newco and Holdco entered into a share purchase agreement (the purchase agreement) whereby Brother 1 sold his 50 common shares of Holdco to Newco in exchange for a promissory note issued by Newco to Brother 1 in the amount of $2,747,303.50.

At the conclusion of the transactions, Brother 2 became the sole shareholder of Newco and Newco became the sole shareholder of Holdco, which in turn was the sole shareholder of Mgmtco.

### Simplified corporate structure after sale of shares




The brothers subsequently became aware that the sale as implemented would run afoul of subsection 84.1(1) of the Act. Subsection 84.1(1) is an anti-avoidance rule intended to prevent surplus stripping, where accumulated surplus of a corporation is extracted via the sale of shares, thereby giving rise to a capital gain, rather than by the payment of a dividend.[5]

As a result, Brother 1, Brother 2, Holdco and Newco (collectively, the petitioners) applied to the British Columbia Supreme Court to rectify the purchase agreement to provide for the sale of 50 common shares of Holdco from Brother 1 directly to Brother 2, and the subsequent sale of the 50 common shares of Holdco by Brother 2 to Newco.

## The parties' positions

The petitioners argued that the agreement in principle represented the true agreement between the parties. They further argued that the purchase agreement did not reflect their true agreement, which was for a direct sale of the Holdco shares and for capital gains treatment for Brother 1. They asserted that the reason for this discrepancy was due to a sequential error in the transaction steps.

The petitioners pointed to the first term of the agreement in principle in support of their argument:

> [1] [Brother 2] to purchase all of [Brother 1's] interest in the [Group], direct or indirect, for the sum of $3,200,000 CDN. The full amount shall be payable to [Brother 1] in cash or by way of certified cheque, bank draft or solicitor's trust check on closing. <u>The transaction will be structured, to the extent possible, so that [Brother 1] receives capital gains treatment for tax purposes</u>; *[emphasis added]*

The petitioners relied on the last sentence of that term to support their argument that they clearly intended that Brother 1 would receive capital gains treatment for tax purposes.

The Attorney General of Canada (the AG) disagreed with the petitioners and argued that they were seeking rectification of the purchase agreement because it produced adverse tax consequences. The AG was of the view that the petitioners were dishonest when they claimed that their tax advisor made a mistake in effecting their true agreement. The AG maintains that no mistake was made other than the failure to consider the application of subsection 84.1(1) of the Act, and based on the jurisprudence in *Canada (Attorney General) v Fairmont Hotels*,[6] rectification should not be granted.

[5] Subsection 84.1(1) applies when a taxpayer resident in Canada (other than a corporation) disposes of shares (the subject shares) of a corporation resident in Canada (the subject corporation), which are capital property, to another corporation (the purchaser corporation) with which the taxpayer does not deal at arm's length and immediately after the disposition, the subject corporation is connected with the purchaser corporation. Brother 1 triggered subsection 84.1(1) when he sold his 50 common shares of Holdco to Newco: Brother 1 was an individual who sold shares to a corporation (Newco); Brother 1 and Newco did not deal at arm's length because Newco was wholly owned by Brother 2; and after the sale, the subject corporation (Holdco) is connected with the purchaser corporation (Newco) because Holdco is wholly owned by Newco. If subsection 84.1(1) applies, paragraph 84.1(1)(b) deems the taxpayer to have received a dividend to the extent that the non-share consideration received exceeds the greater of the paid-up capital and "hard" adjusted cost base (generally the amount paid for the shares when they were purchased) of the subject shares.

[6] 2016 SCC 56. See EY Tax Alert 2016 Issue no. 48.

## The decision

At the outset, the Court noted that the Supreme Court of Canada had recently issued two landmark decisions regarding the law of rectification: *Fairmont Hotels* and *Jean Coutu Group (PJC) Inc. v Canada (Attorney General)*.[7] In *Fairmont Hotels*, the Court summarized the law of rectification as follows:

> [38] To summarize, rectification is an equitable remedy designed to correct errors in the recording of terms in written legal instruments. Where the error is said to result from a mistake common to both or all parties to the agreement, rectification is available upon the court being satisfied that, on a balance of probabilities, there was a prior agreement whose terms are definite and ascertainable; that the agreement was still in effect at the time the instrument was executed; that the instrument fails to accurately record the agreement; and that the instrument, if rectified, would carry out the parties' prior agreement.... *[emphasis added]*

The Court then set out the key legal principles of rectification:

> [22] Rectification is an equitable remedy designed to correct errors in written legal instruments.... The remedy functions to amend the legal instrument but not the agreement itself. The Court cannot modify an instrument merely because it generated adverse tax liability. When reasonably sophisticated business people reduce their oral agreements to written form, and those materials are prepared and reviewed by lawyers, there is usually little scope for rectification.... Rectification only "aligns the instrument with what the parties agreed to do, and not what, with the benefit of hindsight, they should have agreed to do...."
>
> [23] ... Rectification is concerned with contracts and documents, not intentions. If the terms of the written document set out a distinct plan for a tax strategy, those terms may be capable of rectification. A general statement of intent, however, does not meet this threshold.

After examining recent case law, the Court then went on to apply the four conditions as enunciated in *Fairmont Hotels* to the facts of this case.

### Was there a prior agreement whose terms were definite and ascertainable?

The Court found that the agreement in principle set out a sequence of proposed transactions that were definite and ascertainable. The Court also noted that the document continually described the share sale and associated transactions as being between Brother 1 and Brother 2, which led the Court to conclude that a direct purchase was intended.

### Was the agreement in effect when the instrument was executed?

The Court found that the evidence weighed in favour of the petitioners that the agreement in principle was still in effect when the purchase agreement was executed. The Court agreed with the petitioners' claim that their agreement for a direct purchase was a "common, continuing" intention that never changed, despite several changes to the agreement in principle, including the form of consideration.

### Was the instrument inconsistent with the prior agreement?

The Court found that the purchase agreement was inconsistent with their true intentions as reflected in the agreement in principle. The Court accepted the petitioners' affidavit evidence that their intention was for a direct transfer. This was further supported by the evidence of their tax advisor, who admitted that he made a mistake in misrepresenting the petitioners' true intentions. The Court noted that the respondents failed to cross-examine this evidence. In addition, after they had realized the mistake, the petitioners almost immediately notified the Canada Revenue Agency of the error, which is consistent with the existence of a true prior agreement.

### Can the instrument be modified to carry out the prior agreement?

The petitioners provided the Court with a draft agreement that contained their proposed amendments. The Court was of the view that the document was helpful and clear in pointing out the changes that were necessary to bring the purchase agreement in line with the petitioners' true intentions. While the AG argued that the petitioners were proposing an entirely different agreement involving several new transactions, the Court disagreed and found that the purchase agreement could be modified to give effect to the true agreement.

## The Court's conclusion

Based on the above, the Court concluded that the agreement in principle was sufficient evidence to grant a petition for rectification.

## Lessons learned

In this case, the Court recognized the applicability of the test in Fairmont Hotels, and acknowledged the narrow circumstances in which rectification will be granted. Nevertheless, it allowed rectification in this instance because the applicants were able to show successfully, based on the evidence they provided, that there had been a clear agreement that was not properly implemented. In our view, this case highlights the importance of maintaining a prior written agreement that documents specific tax (and other) intentions of the parties when contemplating significant business transactions.

It's clear that where a tax plan produces unintended tax consequences, a general intention for tax neutrality is insufficient to support an application for rectification. On the other hand, a specific tax intention documented in a prior agreement, such as capital gains treatment, may very well be "going the extra mile" that is required for rectification to be granted.

# Publications and articles

## Tax Alerts – Canada

Tax Alert 2019 No. 6 – Manitoba budget 2019-20

Tax Alert 2019 No. 7 – Yukon budget 2019-20

Tax Alert 2019 No. 8 – Customs increases AMPs

On 5 March 2019, the Canada Border Services Agency (CBSA) released Customs Notice 19-05, announcing that 22 contraventions related to commercial trade under the Administrative Monetary Penalties (AMPs) system will be amended with increases to the penalty levels.

Tax Alert 2019 No. 9 – Federal budget 2019-20

Tax Alert 2019 No. 10 – New Brunswick budget 2019-20

Tax Alert 2019 No. 11 – Saskatchewan budget 2019-20

Tax Alert 2019 No. 12 – Quebec budget 2019-20

Tax Alert 2019 No. 13 – Nova Scotia budget 2019-20

## Publications and articles

### EY's Global Capital Confidence Barometer

The 19th edition of EY's *Global Capital Confidence Barometer* describes how Canada's executives are optimistic about the strength of the Canadian and global economies but are dialing back their merger and acquisition intentions.

### EY's Worldwide Personal Tax and Immigration Guide 2018-19

This guide summarizes personal tax systems and immigration rules in more than 160 jurisdictions, including Australia, Brazil, Canada, France, Germany, Mexico, the Netherlands, the Russian Federation, the UK and the US.

### EY's Worldwide Capital and Fixed Assets Guide 2018

The *Worldwide Capital and Fixed Assets Guide* helps our clients navigate the rules relating to fixed assets and depreciation. It summarizes the complex rules relating to tax relief on capital expenditures in 29 jurisdictions and territories.

### EY's Worldwide Estate and Inheritance Tax Guide 2018

EY's Worldwide Estate and Inheritance Tax Guide summarizes the estate tax planning systems and describes wealth transfer planning considerations in 39 jurisdictions around the world, including Australia, Canada, China, France, Germany, Italy, the Netherlands, the UK and the US.

### Worldwide Corporate Tax Guide 2018

Governments worldwide continue to reform their tax codes at a historically rapid rate. Chapter by chapter, from Afghanistan to Zimbabwe, this EY guide summarizes corporate tax systems in 166 jurisdictions.

### Worldwide VAT, GST and Sales Tax Guide 2018

This guide summarizes the value-added tax (VAT), goods and services tax (GST) and sales tax systems in 122 jurisdictions, including the European Union.

### Worldwide R&D Incentives Reference Guide 2018

The pace at which countries are reforming their R&D incentives regimes is unprecedented. This EY guide summarizes key R&D incentives in 44 countries, and provides an overview of the European Union's Horizon 2020 program.

### 2017-18 Worldwide Transfer Pricing Reference Guide

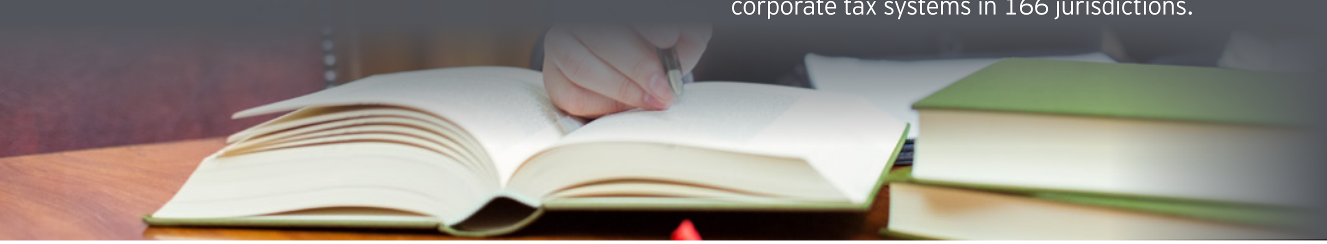
The proliferation of transfer pricing rules and regulations around the world, and the huge increase in focus on the subject by the world's tax authorities, require practitioners to have knowledge of a complex web of country tax laws, regulations, rulings, methods and requirements. This guide summarizes the transfer pricing rules and regulations adopted by 119 countries and territories.

### Board Matters Quarterly

The January 2019 issue of Board Matters Quarterly includes four articles from the EY Center for Board Matters. Topics include: the board's role in confronting crisis, cybersecurity disclosure benchmarking, improving board performance through effective evaluation, and today's independent board leadership landscape.

### EY Trade Watch

*EY Trade Watch* is a quarterly communication prepared by EY's Customs & International Trade Practice. This edition includes Argentina's temporary duties on exports of services, Brazil's single-window product database and Costa Rica's draft resolution regulating inclusion of royalty payments in an import's customs value.



# Publications and articles

## Websites

### EY Law LLP

Our national team of highly qualified lawyers and professionals offers comprehensive tax law services, business immigration services and business law services. Serving you across borders, our sector-focused, multidisciplinary approach means we offer integrated and comprehensive advice you can trust. Visit **eylaw.ca**.

### Focus on private business

Because we believe in the power of private mid-market companies, we invest in people, knowledge and services to help you address the unique challenges and opportunities you face in the private mid-market space. See our comprehensive private client services **webcast series**.

### Online tax calculators and rates

Frequently referred to by financial planning columnists, our mobile-friendly calculators on ey.com/ca let you compare the combined federal and provincial 2018 and 2019 personal tax bills in each province and territory. The site also includes an RRSP savings calculator and personal tax rates and credits for all income levels. Our corporate tax-planning tools include federal and provincial tax rates for small business rate income, manufacturing and processing rate income, general rate income and investment income.

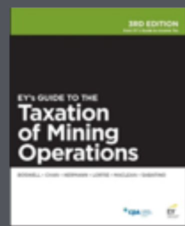
### Tax Insights for business leaders

Tax Insights provides deep insights on the most pressing tax and business issues. You can read it online and find additional content, multimedia features, tax publications and other EY tax news from around the world.

### The Worldwide Indirect Tax Developments Map

Updated monthly, our interactive map highlights where and when changes in VAT, global trade and excise duties are happening around the world. The map can be filtered by tax type, country and topic (e.g., VAT rate changes, compliance obligations and digital tax).

## CPA Canada Store




### EY's Guide to the Taxation of Mining Operations

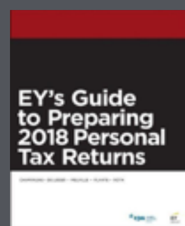
*Editors: Lee Boswell, Irene Chan, Craig Hermann, André Lortie, Jim MacLean, Michael Sabatino*

This guide is designed to help Canadian mining businesses interpret and apply the rules under the federal *Income Tax Act*, as well as under provincial and territorial legislation.


### EY's Guide to Scientific Research and Experimental Development, 3rd Edition

*Editors: Susan Bishop, Kevin Eck, Elizabeth Pringle, Krista Robinson*

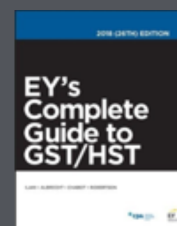
This guide has been prepared to assist Canadian tax professionals in understanding the scientific research and experimental development (SR&ED) rules in Canada.




### EY's Guide to Preparing 2018 Personal Tax Returns

*Editors: Lucie Champagne, Maureen De Lisser, Gael Melville, Yves Plante, Alan Roth*

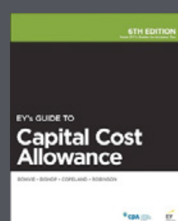
This is the line-by-line guide busy tax professionals rely on throughout the tax season. The guide includes a summary of what's new for the 2018 taxation year as well as tips, suggestions and reminders to consider when preparing 2018 personal tax returns. Available as an easy-to-use and searchable internet collection (includes access to four years of previous internet editions).




### EY's Complete Guide to GST/HST, 2018 (26th) Edition

*Editors: Dalton Albrecht, Jean-Hugues Chabot, Sania Ilahi, David Douglas Robertson*

Canada's leading guide on GST/HST, including GST/HST commentary and legislation, as well as a GST-QST comparison. Written in plain language by a team of EY indirect tax professionals, the guide is consolidated to 15 July 2018 and updated to reflect the latest changes to legislation and CRA policy.




### EY's Guide to Capital Cost Allowance, 6th Edition

*Editors: Allan Bonvie, Susan Bishop, Brett Copeland, Krista Robinson*

Takes you through the capital cost allowance and eligible capital expenditure rules in Canada with commentary and illustrative examples. Unique CCA lookup tables (by class and by item) are included.

To subscribe to *TaxMatters@EY* and other email alerts, visit ey.com/ca/EmailAlerts.

For more information on EY's tax services, visit us at ey.com/ca/Tax.

Learn about EY's Electronic Publishing Services.

For questions or comments about this newsletter, email Tax.Matters@ca.ey.com.

And follow us on Twitter @EYCanada.

EY | Assurance | Tax | Transactions | Advisory



3112039
ED None



ey.com/ca