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COMMENT

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WHEN CONTRACTS RESULT IN UNINTENDED TAX CONSEQUENCES

On December 9, 2016, the Supreme Court of Canada (SCC) released two important decisions, Fairmont Hotels and Jean Coutu Group, clarifying the circumstances under which the lower courts should grant a taxpayer's application for rectification.

In very simple terms, the Canadian justice system has a process that allows contracting parties to apply for an order of rectification of a written contract if it does not reflect what the parties originally intended. The theory of rectification is that the parties to a written business agreement should, under limited circumstances, be permitted to recast the agreement if it did not reflect the original intention of the parties. By granting an order of rectification, the court affirms their support to recast the written agreement to reflect the original anticipated outcome.

Rectification has become an important remedy when businesses undertake a corporate reorganization, which results in unintended income tax consequences. For example, a taxpayer's instructions to his or her team of professional advisors could miss a step, or not take into account an important fact, that inadvertently changes the intended income tax consequences.

Typically, a taxpayer will undertake a transaction with the assumption of a tax neutral or tax minimization outcome but, if an aspect of the transaction is misinterpreted causing a mistake from each party's perspective, the results of the actual transaction could trigger an unintended income tax liability. Rectification is a process that allows the taxpayer to apply to the courts for their review of the transaction, with the objective of restructuring the transaction to meet the client's original intended tax outcome. The intention is to correct errors, not to permit retroactive tax planning.

Until these recent decisions, applications for rectification were being granted in situations where the written agreements correctly reflected the intentions of the parties, but the subsequent income tax results were less than desirable. The parties in these situations were able to obtain a rectification order, by demonstrating to the courts that one of their intentions was to minimize income taxes, or at least avoid the unexpected tax consequence that arose as a result of the transaction.

In the Fairmont Hotel case, the Ontario Superior Court and the Ontario Court of Appeal agreed with the taxpayer and allowed the contract to be recast on the basis that the parties to the contract had a common understanding and intention to hedge currency risk on a tax-neutral basis. The SCC viewed the situation differently, ruling that the lower courts "erred in holding that the parties' intention of tax neutrality could support a grant of rectification."

In overturning the Court of Appeal's decision, the SCC took the opportunity to set out clear responsibilities of the parties involved if rectification is to be affirmed. As outlined in the SCC decision, "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. In the case of a unilateral mistake, the party seeking rectification must also show that the other party knew or ought to have known about the mistake and that permitting the defendant to take advantage of the erroneously drafted agreement would amount to fraud or the equivalent of fraud."

The court's ruling underlines the importance of carefully drafting the legal documents in respect of the transaction to fully reflect all of the parties' intentions; perhaps adding additional recitals to the beginning of the agreement. In addition, the parties to the agreement should keep full and clear records of all communications leading up to the final agreement.

Rectification will continue to be a possible solution to transactions that have unintended income tax consequences; however, it will only be possible if the parties to the contract can meet the terms set out by the SCC.

A NEW YEAR: *REVISITING MARGINAL AND AVERAGE RATES*

When income tax is withheld at source by an employer, the final balance owing or refund due at the time of tax filing is typically quite small because of the high degree of accuracy in the published withholding tables used for payroll purposes. While tax withholding is predictable, understanding the actual tax rates can be advantageous for financial planning purposes.

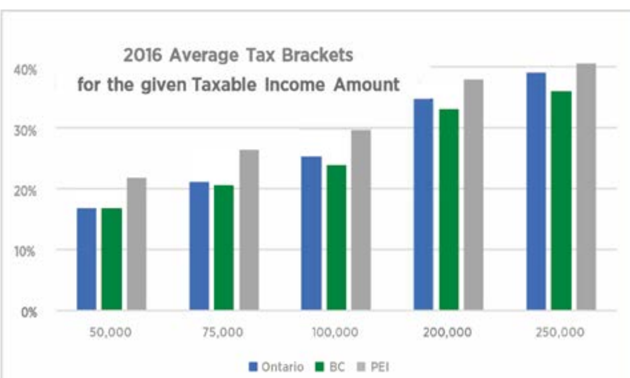
One aspect of tax planning is the appropriate use of the average and marginal tax bracket information for maximum leverage. These rates are important when undertaking financial planning and making financial decisions. Using the wrong rate at the wrong time could lead to flawed decisions.

Average Tax Rate

An individual's average tax rate is derived by dividing total income taxes due by total income. This is an important percentage because it considers the taxpayer's situation at a macro level, identifying the percentage of a taxpayer's total income being spent on income taxes.

Figure 1 presents the 2016 average tax brackets, using three provinces and five different taxable income amounts.

Figure 1



The average tax bracket is a good measure for financial forecasting as it considers the total amount of income taxes due relative to a certain salary amount earned. Assuming the federal and provincial governments continue to index tax brackets, a taxpayer's average tax rate would be a safe assumption when calculating inflationary adjustments.

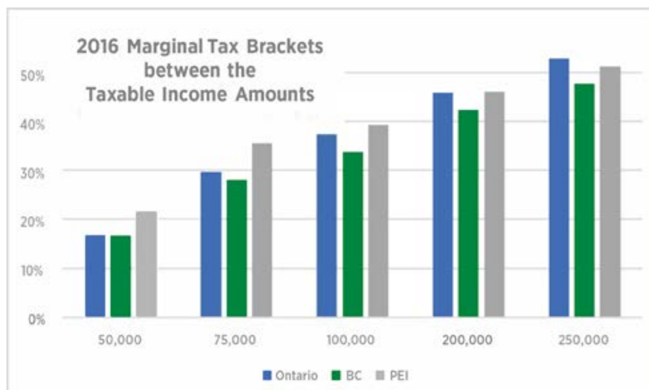
A taxpayer's average tax rate is also a good figure to use when creating a cashflow budget. By multiplying the average tax rate by salary earned, the result provides good guidance when developing after-tax cash flow projections.

Marginal Tax Rate

A taxpayer's marginal tax rate is derived by dividing the amount of income tax due on the next dollar of taxable income earned by a factor of one. Sometimes $1,000 of income is used (instead of a factor of one) so that decimal places can be more accurately determined. For example, if John's tax bill increases by $330 because he earns an extra $1,000 of income working overtime, his marginal tax rate is 33 percent.

Figure 2 below presents the 2016 marginal tax brackets, using three provinces and five different taxable income amounts.

Figure 2



The marginal tax rate was calculated as the extra income earned on the income above the amount shown in the prior data point. This is an important figure because it allows the individual to determine the effect of a tax deduction. For example, an individual's marginal tax rate would be used to determine how much income tax would be saved by making an RRSP contribution. A second use for an individual's marginal tax rate is to evaluate the financial benefit of redeploying non-registered savings to pay down a mortgage or make a TFSA contributions.

Other Considerations:

There are several tax reductions that impact a taxpayer's income tax lability that are not determined using an individual's average or marginal tax rate. For example, tax credits available to individuals (e.g. the medical expense tax credit or pension income tax credit) typically utilize the lowest tax bracket for both the federal and provincial calculation. For charitable gifts, the tax credit utilizes a split calculation with the first $200 applied at a low tax rate and amounts in excess of $200 applied at a higher tax rate.

Both the average and marginal tax rates are important considerations when individuals prepare their financial plans and projections.

GOVERNMENT PENSION PLANS: BENEFITS AND CONTRIBUTIONS FOR 2017

Contributions and benefits under government pension plans are adjusted periodically to reflect increases in the Consumer Price Index or the average Canadian wage. The new amounts, commencing January 1, 2017, are shown in the table below. Each benefit is subject to income tax when received, with the exception of the Guaranteed Income Supplement and the Allowance. All benefits shown are paid monthly unless otherwise indicated, and are the maximum amounts.

CPP / QPP Benefits (for new beneficiaries)			
Retirement pension (at age 65) Post-Retirement benefit (at age 65) Retirement Pension Supplement	$1,114.17 $27.85 n/a	$1,114.17 n/a $21.42	
Disability pension	$1,313.66	$1,313.63	
Disabled contributor's child benefit (each child)	*$241.02	*$76.52	
Survivor's*** pension			
• under age 65	**$604.32	**$895.81	
• age 65 or over	$668.50	$668.50	
Surviving child's benefit (each child)	*$241.02	*$241.02	
Death benefit (lump sum)	$2,500.00	$2,500.00	
Combined benefits			
• survivor's*** pension and disability (under age 65)	$1,313.66	n/a	
• survivor's*** pension and retirement (age 65 and over)	$1,114.17	$1,114.17	
Annual CPP contribution			
Self-employed (9.9%)	$5,128.20		
Employee (matched by employer) (4.95%)	$2,564.10		
Annual QPP contribution			
Self-employed (10.8%)		$5,594.40	
Employee (matched by employer) (5.4%)		$2,797.20	
Old Age Security (OAS)			
January to March 2017			$578.53
Guaranteed Income Supplement (GIS)			
January to March 2016			
Spouse/common-law partner receives OAS or Allowance			$520.17
Single person (or spouse/common-law partner receives neither OAS or Allowance)			$864.09
Allowance			
January to March 2017			
Age 60 to 64, and spouse/common-law partner receives OAS and GIS			$1,098.70
Age 60 to 64, survivor's*** Allowance			$1,309.67

Notes:
* flat benefit amounts
** these amounts may vary depending on whether the survivor is under age 45, disabled, or with or without children
***a survivor is the spouse or common-law partner of a deceased individual

2017 AMOUNTS	
Federal Employment Insurance	
$51,300	Maximum annual insurable earnings
1.63	Rate
$836.19	Maximum annual employee premium
$1,170.67	Maximum annual employee premium
Quebec Employment Insurance	
$51,300	Maximum annual insurable earnings
1.27	Rate
$651.51	Maximum annual employee premium
$912.11	Maximum annual employee premium
CRA Reasonable Mileage Allowance	
$0.54 per kilometre (first 5,000 kilometres); and,	
$0.48 per Kilometre thereafter	
Additional $0.04 per kilometre in NWT, Yukon, and Nunuvut	
Lifetime Capital Gains Exemption	
$835,716	Exemption Limit
$164,284	Additional exemption amount for qualified farm or fishing property
Tax-Free savings Account (TFSA)	
$5,500	Annual dollar limit
Registered Retirement Savings Plan (RRSP)	
$26,010	Annual dollar limit
Money Purchase Pension Plan	
$26,230	Annual limit
Defined Benefit Pension Plan	
$2,914.44	Annual Limit

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