CITATION: Fairmont Hotels Inc. et al v. A.G. Canada, 2014 ONSC 7302
COURT FILE NO.: CV-13-10004-00CL
DATE: 20141218

ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST

BETWEEN:	)	
FAIRMONT HOTELS INC., FHIW HOTEL INVESTMENTS (CANADA) INC. and FHIS HOTEL INVESTMENTS (CANADA) INC.	)	Chia-yi Chua and Brandon Siegal, for the Applicants
Applicants	)	
– and –	)	
ATTORNEY GENERAL OF CANADA	)	Diana Aird and Donna A. Dorosh, for the Respondent
Respondent	)	
	)	**HEARD:** December 15, 2014

NEWBOULD J.

[1] The applicants ("Fairmont") apply on the equitable grounds of rectification to change documentation relating to an internal unilateral share redemption. They say that what occurred was intended to be on a tax free basis but that because of a mistake, the share redemption triggered a foreign exchange gain that resulted in a tax assessment by CRA after an audit of the

applicants' tax returns. The respondent ("AGC") says that rectification should not be granted because there was no specific intent on the part of the applicants to do what they now wish to do and that what is sought is impermissible retroactive tax planning.

History

[2] The events have their genesis in 2002 and 2003 when Fairmont Hotels Inc. ("FHI") became involved in the financing for the Legacy Hotels REIT ("Legacy") purchase of two hotels in Washington and Seattle.

[3] Fairmont carries on an extensive hotel management business throughout the world in respect of properties owned by the Fairmont group of corporations and third parties.

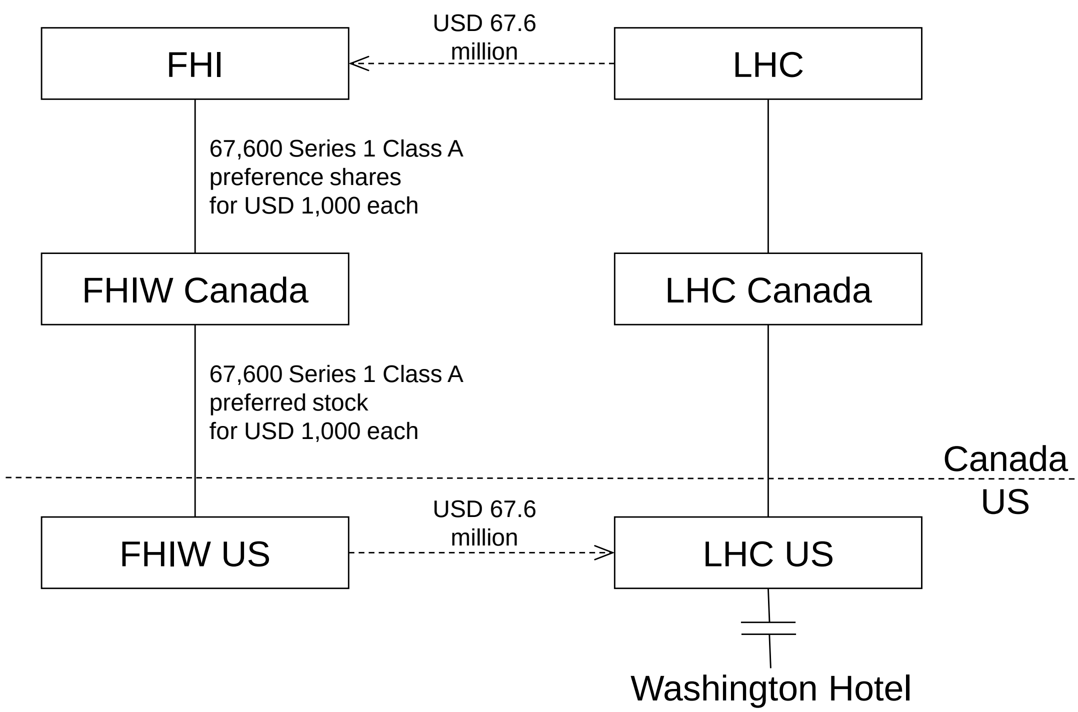
[4] Legacy was a Canadian real estate investment trust, in which FHI had an interest, whose units were traded on the TSX. Legacy was created in 1997 to purchase 11 Canadian city-centre hotels owned by the Fairmont group of companies. FHI continued to manage the 11 city-centre hotels and, when Legacy acquired other hotels over time, Fairmont sought to obtain the management contracts for those hotels.

[5] In 2002 and 2003, FHI and its affiliates entered into reciprocal loan transactions to provide financing to Legacy, which was acquiring two hotels in Washington and Seattle. FHI did this because it provided certain Canadian and US tax benefits to Legacy. Instead of financing the purchase of the hotels directly, Legacy routed the financing money through Fairmont corporations. Fairmont participated in the financing in order to obtain the management contracts for the hotels. The financing was in US dollars, which meant a potential foreign exchange tax exposure to Fairmont.

[6] For the purposes of the loan transactions, two Fairmont subsidiaries, FHIW Investments Canada Inc. ("FHIW Canada") and FHIS Hotel Investments Canada Inc. ("FHIS Canada"), were

established. The result of the arrangement was that the reciprocal loans were neutral for accounting purposes, and Fairmont's foreign exchange exposure on the financing was fully hedged as each of FHI, FHIW Canada and FHIS Canada had a US dollar denominated asset and a US dollar denominated liability of equal value.

[7] The diagram below summarizes the transactions for the US$67.6 million Washington hotel loan:



[8] The same structure was used for a US$19 million loan for the Seattle hotel, FHIS Canada and FHIS US being used rather than FHIW Canada and FHIW US. The AGC does not dispute that the financing was set up to fully hedge Fairmont's foreign exchange exposure and that Fairmont and Legacy's tax and financial advisors spent at least a year planning the structures to ensure they were set up in a way that would achieve the parties' business and tax objectives.

[9] In 2006, Fairmont was purchased by Kingdom Hotels International and Colony Capital LLC and its shares ceased to be publicly traded. FHI and its advisors recognized that if nothing was done, the acquisition of control would frustrate the intention that no entity would realize a net foreign exchange gain or loss in connection with the reciprocal loan arrangements. In particular, the acquisition of control would cause FHI to realize a deemed foreign exchange loss on the preferred shares it held in FHIW Canada and FHIS Canada, FHIW Canada to realize a deemed foreign exchange loss on the preferred shares it held in FHIW US and FHIS Canada to realize a deemed foreign exchange loss on the preferred shares held by it in FHIS US, but such acquisition of control would not cause these entities to realize the matching foreign exchange gains.

[10] Initially, Fairmont's tax advisors proposed a plan which would have allowed for each of FHI, FHIW Canada, and FHIS Canada's foreign exchange exposures to continue to be fully hedged for economic and tax purposes, and would also have allowed for FHIW Canada and FHIS Canada to later redeem their shares without realizing taxable foreign exchange gains. It is not necessary to describe the structure. It was contained in a memorandum dated March 3, 2006.

[11] However, the purchaser's tax advisors were concerned that subsection 40(3.6) of the *Income Tax Act* (Canada) might apply to any redemption of shares so as to deem the foreign exchange losses arising on a redemption of shares to be nil for tax purposes. That would create a tax issue as the corresponding foreign exchange gain would not be deemed to be realized and thus there would be a tax problem of what counsel for the respondent described as a "pregnant gain" that would have to be dealt with.

[12] Fairmont and the purchasers agreed on a modified plan that is described in a March 23, 2006 memorandum. This modified plan caused FHI to realize its accrued foreign exchange gains and losses and, going forward, enabled FHI's foreign exchange exposure to be hedged. However, the modified plan did not address the foreign exchange exposure of FHIW Canada and FHIS Canada. The foreign exchange losses deemed to be realized by FHIW Canada and FHIS

Canada on the acquisition of control could not be carried forward. Thus the foreign exchange exposure of FHIW Canada and FHIS Canada was no longer hedged and Fairmont knew that.

[13] Mr. Badour of Fairmont acknowledged on his cross-examination that they knew at the time of the change of control that the issue had to be addressed at some point so as not to incur a taxable foreign exchange gain. In his words, they were kicking the can down the road to be dealt with on another day when some other event intervened. He said that they knew that they were going to have to find a means of ensuring that the structure remained tax and accounting neutral going forward. He said there was no specific plan as to how they would do that.

[14] The next time they considered the issue was in 2007 when Legacy approached Fairmont on September 10, 2007 to terminate the reciprocal loan arrangements on an urgent basis so as to allow for the sale of the Washington Hotel and the Seattle Hotel. Legacy's chief financial officer requested that Fairmont approve Legacy's proposed unwind steps that same day. At that time, the Fairmont management team was particularly busy, completing multiple transactions with an aggregate value of almost a billion dollars.

[15] In his haste to unwind the reciprocal loan arrangements, Fairmont's vice-president and treasurer advised by e-mail of September 11, 2007 of his preference for the Fairmont companies to redeem their preference shares. Fairmont's vice-president of tax Joseph Zahary was not alert to the fact that the proposed redemptions would trigger taxable foreign exchange gains, as he mistakenly believed that the original plan had been implemented in 2006. Under the original plan, the redemption of shares of FHIW Canada and FHIS Canada would have not resulted in any taxable foreign exchange gains. Mr. Zahary states in his affidavit, on which he was not cross-examined, that because of the extreme time constraints with only a few days until the closing of the acquisition of Legacy on September 18, 2007 and several other significant transactions ongoing at the same time, he did not have the opportunity to review the last-minute unwind proposal in great detail or engage external tax advisors to review it. As a result of his mistaken belief that the original 2006 plan had been implemented, he agreed with the suggestion

that FHIW Canada and FHIS Canada redeem the preference shares held by FHI. On September 14, 2007, the directors of FHIW Canada and FHIS Canada passed resolutions to implement the share redemptions.

[16] Mr. Zahary was responsible for reporting the 2007 transactions in filing the tax returns for each of FHIW Canada and FHIS Canada for their taxation years ended on December 31, 2007. In each case, the unwind transactions were reported as if the original 2006 plan had been implemented such that at the time of the acquisition of control in 2006, the accrued foreign exchange losses were offset by accrued foreign exchange gains and were fully hedged going forward for tax purposes. This filing is confirmatory of the mistaken belief of Mr. Zahary that the original plan in 2006 was carried out. There is no suggestion otherwise.

[17] The mistake was learned after CRA undertook to audit the 2007 tax returns of FHIW Canada and FHIS Canada and asked questions of Fairmont about the returns. In the course of preparing responses to the CRA query sheets, FHI, FHIW Canada and FHIS Canada discovered that when planning the 2007 transactions, they failed to take into account the fact that the 2006 acquisition of control had caused FHIW Canada and FHIS Canada to realize accrued foreign exchange losses for tax purposes but not the matching accrued foreign exchange gains. FHI, FHIW Canada and FHIS Canada mistakenly believed that FHIW Canada and FHIS Canada's foreign exchange exposure was fully hedged for tax purposes.

[18] Mr. Zahary stated in his affidavit that had he realized in September 2007 that the original 2006 plan had not in fact been implemented, he would not have agreed with the redemption of preferred shares to effect the unwind because it did not fulfil Fairmont's intention that existed since 2002 not to have any net foreign exchange gains or losses as a result of the reciprocal loan arrangements with Legacy.

Position of the parties

[19] The applicants now apply to rectify the 2007 resolutions of FHIW Canada and FHIS Canada under which the preference shares in those corporations owned by FHI were redeemed. They wish to remove the redemption of those shares from the resolution and instead resolve to make loans by FHIW Canada and FHIS Canada to FHI in the same amount that had been paid to FHI for redemption of the preference shares. In short, to change the share redemption to a loan because a loan will not trigger a taxable foreign exchange gain.

[20] The applicants say that that their intent from 2002 was consistently to have the loan transactions and their unwinding done on a tax neutral basis. They say that the mere fact that in 2006 after control of FHI changed due to it being purchased they had not considered the exact way in which they would solve the tax neutrality problem does not preclude rectification.

[21] The AGC takes the position that a loan to FHI as now planned was not part of the plan in 2006 or even 2007 and that it only came into play after the CRA audit disclosed the problem. The AGC says that replacing the share redemptions with loans is retroactive tax planning. Rectification is a remedy that corrects a written instrument when it does not accurately reflect what the parties intended to record. The mistake is not that the Fairmont's directors' resolutions inaccurately recorded what Fairmont intended. Fairmont's mistake was that it failed to develop a plan to avoid capital gains until after the shares had already been redeemed. Rectification should not be used to sanction a new plan that Fairmont wishes it had implemented in 2007.

Analysis

[22] The equitable remedy of rectification is available to relieve against mistake in a document. The basis for this remedy is the protection of an applicant, so that he or she is not prejudiced by the existence of a document, reliance upon which would, without rectification, be unconscionable. See Spry, *The Principles of Equitable Remedie*s, 6th edition, at p. 607.

[23] In Council of the Wasauksing First Nation v. Wasausink Lands Inc. (2004), 43 B.L.R. (3d) 244 (Ont. C.A.), Laskin J.A. summarized the principles as follows:

> 81. As relevant to the appellants' rectification claim, the following principles concerning equitable rectification emerge from the foregoing authorities. Rectification is available in the exercise of the court's discretion. Such discretion is not to be exercised lightly but, rather, only where it is demonstrated that, by mistake, a written document or instrument does not accord with or accurately reflect the agreement or arrangements intended by the parties. Rectification is not used to vary the intentions of the parties, or to speculate on the substance of those intentions; rather, it is designed to correct a mistake in carrying out the settled intentions of the parties as established by the evidence. As well, and importantly, rectification is not available to correct erroneous assumptions or beliefs as to what was intended; the remedy seeks to effect the actual intentions of the parties which, by mistake, were not accurately recorded.

[24] *Performance Industries Ltd. v. Sylvan Lake Golf and Tennis Club Ltd*, [2002] 1 S.C.R. 678 involved rectification of an agreement made between parties at arms' length in which there was a unilateral mistake by one party to the knowledge of the other in that the written signed agreement did not record what had earlier been orally agreed. It does not strictly deal with a non-arms' length situation in which there was no oral agreement. However, Binnie J. made a statement regarding the law of rectification relied on by the AGC:

> The court's task in a rectification case is corrective, not speculative. It is to restore the parties to their original bargain, not to rectify a belatedly recognized error of judgment by one party or the other.

[25] A number of cases have considered how to apply rectification principles to situations where the document was not the result of arms' length bargaining but involved the reorganization of the affairs of a person or business. See for e.g. *Juliar v. Canada (Attorney-General)* (2000), 50 OR (3d) 728; *Amcor Packaging Canada Inc. (Re)*, [2012] O.J. No. 5148; *Kanji v. Canada (Attorney General)*, 2013 ONSC 781; *Kraft Canada Inc. v. Pitsadiotis*, [2009] O.J. No. 885.

[26] In *Kanji*, Justice D. Brown (as he then was) articulated a test as follows:

> **20** First, in such situations, as a practical matter the requirements of prior agreement and error tend to be articulated in the following way: the applicant must show that (i) a common, specific intention existed amongst the creators of the instrument effecting the transaction to accomplish a particular result and (ii) a mistake caused the instrument not to comport with the common intention of the parties.

[27] As for the standard of proof, in *Performance Industries* the Supreme Court of Canada said that the hurdles must be established by proof which is "convincing". However the Supreme Court of Canada in *F.H. v. McDougall*, 2008 SCC 53 made clear that in civil cases only one standard of proof exists at common law, that standard being on a balance of probabilities. That standard applies to rectification cases. See *McLean v. McLean*, 2013 ONCA 788 at para. 41-42. I do agree with Brown J. in *Kanji* that in considering a rectification claim, judges must remain mindful of inherent probabilities or improbabilities of what is being asserted as the basis for rectification.

[28] The AGC says that there is no contemporaneous documentation at the relevant times establishing a plan to use a loan to solve any tax issue relating to foreign exchange losses or gains and that such lack of documentation should weigh heavily against Fairmont. I understand this concern but would note that even in *Performance Industries* in which Binnie J. said the evidence had to be convincing, he did say that documentation was not always necessary, particularly when the parole evidence was corroborated by the conduct of the parties:

> **43** It was formerly held that it was not sufficient if the evidence merely comes from the party seeking rectification. In *Ship M. F. Whalen, supra*, Duff J. (as he then was) said, at p. 127, "[s]uch parol evidence must be adequately supported by documentary evidence and by considerations arising from the conduct of the parties". Modern practice has moved away from insistence on documentary corroboration (Waddams, supra, at para. 337; Fridman, supra, at p. 879). In some situations, documentary corroboration is simply not available, but if the parol

> evidence is corroborated by the conduct of the parties or other proof, rectification may, in the discretion of the court, be available.

[29] There is evidence that because of concerns regarding potential tax on redemption of the preferred shares of FHIW Canada and FHIS Canada, it was recognized in 2006 that the shares should not be redeemed. In his affidavit, Mr. Barbour, the general counsel for Fairmont stated:

> 25. However, Kingdom and Colony's tax advisors were concerned that subsection 40(3.6) of the Income Tax Act (Canada) might apply to any redemption of shares so as to deem the foreign exchange losses arising on a redemption of shares to be nil for tax purposes. Accordingly, the tax advisors recommended, and FHI accepted such recommendation, that no redemption of the preferred shares should occur at any time.

[30] Ms. Carrie Smit, the head of the tax group at Goodmans LLP, was a tax lawyer working for Colony when it acquired Fairmont in 2006. She wrote in an e-mail of November 30, 2012 of her involvement in the 2006 transaction, which she swore in her affidavit was true, and stated among other things:

> However, there was a concern that a redemption of the preferred shares of FHIW and FHIS would result in a loss denial to FHI. This loss was needed by FHI to offset the inherent foreign exchange gain in the Legacy Loans. The loss denial issue was unclear and was the subject of discussion among the advisors representing Fairmont and the investors [Colony and Kingdom]. As a result, it was determined that the preference shares of FHIW and FHIS would not be redeemed, but rather the loss inherent in such shares to FHI would be realized in a transfer of such shares to a new corporation. …
>
> It is my clear recollection that this tax planning was based on the intention of the advisors that the preferred shares of FHIW and FHIS would never be redeemed. Rather, the advisors contemplated that the Legacy Financing could be unwound in the future through other transactions (including possibly the wind-up of FHIW and FHIS into FHI, or the amalgamation of such companies with FHI). I believe that this intention was communicated to Fairmont's tax advisors, although I cannot recall at which meeting or conference call this may have occurred.

[31] Ms. Smit was not cross-examined on her affidavit. She did produce a contemporaneous note of hers in 2006 that contained a reference to a concern that section 40(3.6) of the ITA might

apply, in which case a loss would be denied. It also contained a reference to the Canadian company and whether it would have a gain on its preference shares and the statement “But we don’t ever have to redeem the shares”. The fact that she could not remember precisely the meeting or call that the purchaser’s tax advisors discussed the issue with Fairmont’s tax advisors is not surprising given the passage of time. But she was clear to say that the issue was was the subject of discussion among the advisors representing Fairmont and the investors, which is hardly surprising given that the investors were going to acquire the business with all of its tax attributes. There obviously had to be discussions amongst them.

[32] I think a fair conclusion from the evidence, and I so find, is that there was a continuing intention on the part of Fairmont from the time of the 2002 loan arrangements with Legacy that the loan arrangements would be carried out with a view to being tax and accounting neutral and a continuing intention from the time of the 2006 transaction in which control of Fairmont passed to the purchaser of its shares that the preference shares of FHIW Canada and FHIS Canada would not be redeemed in light of the modified plan that was carried out at that time.

[33] I also think a fair conclusion from the evidence, particularly that of Mr. Barbour from his cross-examination, and I so find, is that when the 2006 transaction was undertaken, Fairmont had an intent that at some point in the future they would have to deal with the unhedged position of FHIW Canada and FHIS Canada in a way that would be tax and accounting neutral although they had no specific plan as to how they would do that.

[34] In these circumstances Fairmont relies on *Juliar v. Canada (Attorney-General)* (1999), 46 O.R. (3d) 104; aff’d (2000), 50 OR (3d) 728(C.A.).

[35] In *Juliar*, a holding company owned all the shares of a family convenience store business. Mr. and Mrs. Juliar owned half of the shares of the holding company and the sister and brother in law of Mrs. Juliar owned the other half. Both sides decided to transfer their shares to new

holding companies each side set up, the purpose being to enable the two holding companies to be operated independently. The case involved the transaction on the Juliar side of the family.

[36] Due to a mistaken assumption as to the tax cost base of the shares of the holding company, the accountant had advised the Juliars to transfer their shares in exchange for promissory notes. It had been assumed that the tax cost base of the shares was sufficient so not as to trigger taxable deemed dividends under the ITA. However, the tax cost base of the holding company shares was in fact less than assumed and the Juliars were deemed under the ITA to have received dividends on the excess, resulting in significant tax liabilities. The trial judge held that the Juliars had a common and continuing intention that the transaction was to occur on a basis which would not attract immediate income tax liability and that the intention was not just formed as the result of the assessment of CRA. He held that the structure of the transaction would have been in accordance with a roll-over under s. 85 of the Income Tax Act, with no immediate tax, had the mistake in determining the cost of the holding company shares not been made.

[37] Fairmont relies on this case as authority for the proposition that the exact method to achieve a common intention to avoid tax is not required to be decided at the time of the transaction, just as the exact method to avoid tax from the unhedged position of FHIW Canada and FHIS Canada was not yet decided in 2006. This comes from the statement of the trial judge:

> The Juliars had no expectation as to how the tax neutral effect would occur except as Fast [their accountant] might advise them. The Roffs [the sister and brother in law] achieved it by use of s. 85 of the Income Tax Act. Fast thought he had achieved it through the existence of a cost base which was higher than the fair market value at the time of sale.

[38] The decision of the trial judge was upheld in the Court of Appeal. Austin J.A. for the Court made the comment that it was probable that no one even mentioned tax at the relevant time:

> 26 The appellant quarrels with the finding of fact that "it was the intention of the Juliars that the transactions would not trigger an immediate obligation to pay income tax." The appellant argues that this finding "was based more on an inference than on clear, direct, and admissible evidence."
>
> 27 This latter is a fair comment. It is possible, even probable, that no one mentioned income tax throughout the nine or ten months in issue. The plain and obvious fact, however, is that the proposed division had to be carried out on a no immediate tax basis or not at all.

[39] Thus while the Juliars had no expectation as to exactly how to accomplish their tax objective, and it was not discussed with their accountant at the time, it was held that the intention to achieve the transfer of shares on a tax free basis was sufficient to rectify the corporate resolutions to permit a section 85 rollover rather than the use of promissory notes.

[40] The AGC is critical of the result in *Juliar* and points to the decision of Mr. Justice Brown in Alberta in the case of *Graymar Equipment (2008) Inc. v. Canada (Attorney General)*, 2014 ABQB 154. In that case, Brown J. questioned *Juliar* by stating:

> 66 Viewed in the light of this evidence, *Juliar* sits uneasily with Supreme Court's direction in *Performance Industries* and *Shafron* that rectification is granted to restore a transaction to its original purpose, and not to avoid an unintended effect. A transaction which does not succeed in achieving its goal of avoiding tax is not the same thing as a transaction whose goal is other than tax avoidance but which unexpectedly results in a tax disadvantage. While, therefore, rectification is available in order to avoid a tax disadvantage which the parties had originally transacted to avoid, it is not available to avoid an unintended tax disadvantage which the parties had not anticipated at the time of transacting.
>
> 67 In my respectful view, the Superior Court decision in *Juliar* skates over this distinction. The Ontario Court of Appeal's response in *Juliar* (at paras 26-27) to the CRA's criticism of the evidentiary basis for the chambers judge's finding as to the parties' intention is in a similar vein…

[41] Whatever his views of the trial and appellate decision in *Juliar*, I unlike Brown J. in Alberta do not have the luxury of ignoring appellate authority in *Juliar*. I would also note (i) I do not think he has accurately described what happened in *Juliar* and (ii) that Brown J.'s colleague

Mr. Justice Graesser in another case in Alberta, with whom Brown J. did not agree, relied on *Juliar*.

[42] In this case, the intention of Fairmont from 2002 was to carry out the reciprocal loan arrangements with Legacy on a tax and accounting neutral basis so that any foreign exchange gain would be offset by a corresponding foreign exchange loss. When control of Fairmont changed in 2006 that intention did not change and when the loan unwind occurred in 2007 that intention did not change. By reason of a mistake on the part of Mr. Zahary, the preferred shares of FHIW Canada and FHIS Canada held by FHI were redeemed in 2007, which unbeknown to Mr. Zahary by reason of his mistake caused an unintended tax assessment.

[43] I do not see this as a case in which tax planning has been done on a retroactive basis after a CRA audit. The purpose of the 2007 unwind of the loans was not to redeem the preference shares of FHIW Canada or FHIS Canada, but to unwind the loans on a tax free basis. The redemption of the preference shares was mistakenly chosen as the means to do so.

[44] In the circumstances denial of the application to rectify would result in a tax burden which Fairmont sought to avoid from the inception of the 2002 reciprocal loan arrangement and but for an unfortunate mistake would have been avoided in 2007. It would give CRA an unintended gain because of the mistake.

[45] I allow the rectification claim of the applicants to rectify the corporate resolutions in the form set out in Schedule A and B to the Notice of Application.

[46] In accordance with the agreement of the parties as to quantum, the applicants are entitled to costs of $30,000 all inclusive, to be paid within 30 days.

Newbould J.

Released: December 18, 2014

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Applicants

– and –

ATTORNEY GENERAL OF CANADA

Respondent

REASONS FOR JUDGMENT

Newbould J.

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