

GST/HST Policy Statement

P-249

October 18, 2006

Agreements and Novation

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| Legislative references | Part IX of the <i>Excise Tax Act</i> (the Act) and the Regulations made there under |
| National coding system file numbers | 11605-1, 11705-1 |
| Effective date | January 1, 1991 for GST, and April 1, 1997 for HST |

Note: Please note that the following policy statement, although correct at the time of issue, may not have been updated to reflect any subsequent legislative changes.

Issue

At issue is how to determine if an agreement has been modified, varied or otherwise materially altered to the extent that novation has occurred and the existing agreement is terminated and a new agreement is entered into.

The scope of this policy is only to address the principles of novation and is not intended to determine whether or not, in any particular circumstance, a supply is grandfathered under transitional rules. It is not intended to address the issue of whether section 182 of the Act applies when a payment is made to modify or terminate a particular contract.

Whether an existing agreement has been terminated and a new agreement entered into may be relevant when applying the provisions of Part IX of the Act. However, even if novation does not occur, amendments to an agreement may still have GST/HST consequences when applying specific provisions in the Act. Additionally, it may be the case that a new agreement is created even if an existing agreement has not been terminated.

Novation has the effect of replacing an existing agreement with a new one that either extinguishes an existing debt or obligation and creates a new one or introduces a new party as debtor or creditor, as the case may be.

Therefore, a novation serves to substantially alter an existing agreement and generally provides for a new liability in respect of a debt or the performance of some obligation, or both. In essence, a novation creates new rights, entitlements and liabilities.



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La version française du présent document est intitulée
Accords et novation.

Canada

Decision

Whether a novation has occurred is a question of mixed fact and law. However, the Canada Revenue Agency (CRA), on a case-by-case basis and at the request of all parties, will provide its views as to whether or not there has been a novation.

Discussion

The following text sets out our understanding of the application of law that would apply to determine whether a novation has occurred, taking into account the nature of novation and the indicators of novation. It will also identify certain situations where a novation may not have occurred.

Deeming provisions

Before applying the established legal principles of novation to agreements, as examined below, ensure that a novation is not deemed by statute to have occurred or not occurred.

Nature of novation

Novation is a process by which:

- an existing obligation by one party to another is extinguished because a new obligation between the same parties has been created and substituted for that previous obligation;
- an existing obligation is transferred from a party to another person who undertakes liability in respect of the obligation. The former party is discharged from the liability; or
- a party transfers its claim against another party to a new person. The other party is then discharged from its liability to the first party but now has a liability towards the new person.

Conditional novation

If the agreement constituting a novation depends upon a condition being fulfilled, novation takes effect only when the condition is fulfilled. Until that time, the existing obligation remains unchanged. Should the condition never be fulfilled, the novation never occurs. Also if the obligation is extinguished before the condition is fulfilled, the novation agreement has no effect because there is no longer any obligation to be novated.

An event that is certain to take place is not a condition. Therefore, for example, fixing a date for payment in the future is not a condition attached to a liability; the liability exists independently of the due date for payment.

Consent requirement

The pivotal element of novation is that, at a minimum, there must be consent of the parties that have continuing rights and obligations that arose under the former agreement and that remain in effect under the new agreement. Novation may require the consent of a party whose rights under the original agreement are to be relinquished. This consent must be arrived at even if the parties have only entered into a new agreement to settle a dispute.

In no case will a novation occur unless the parties who have continuing rights (obligee) and obligations (obligor) agree to replace an existing obligation, or, in the case of an introduction of another party, the person to whom an obligation is owed (i.e., the obligee) accepts the delegated party in place of the original party being replaced. A novation agreement does not have to be in writing (unless the original

agreement was required by law to be in writing). It can either be implied by the circumstances of the case or inferred from the conduct of the relevant parties.

Novation may be voluntary through consensus or compromise. Novation may also arise out of judicial proceedings or at law (i.e., bankruptcy, receivership, etc.). With respect to an estate of a deceased debtor, the appointment of an administrator, executor or a personal representative by virtue of the deceased person's last will and testament, or otherwise by law (e.g. by a court grant of administration where the deceased died intestate), may not result in novation depending on the terms of the original agreement.

Indicators of novation

There are several indicators that must be considered when determining whether a novation has occurred. The most essential ones are as follows.

Existing obligation extinguished / new obligation created

1. There must be a prior obligation.

An agreement must have existed between at least two parties that provides for the performance of some obligation by at least one of the parties.

2. A new obligation must be created.

The essence of novation is that a new obligation replaces a previous obligation where the previous obligation is extinguished.

3. The obligations must be different from each other.

In circumstances where no new party is introduced, the obligation to be performed by either party to the novation contract must be significantly different to require altering the original agreement. For instance, varying the form, terms and conditions of an agreement to such an extent that a fresh undertaking is being concluded and agreed upon between the same parties would usually result in a novation.

4. The parties must have expressed their intention to novate (except where novation is involuntary, for example, where novation arises out of judicial proceedings).

Clear and unequivocal evidence of the circumstances of the case and the conduct of the parties is required before novation will be considered to have occurred.

The evidence must clearly establish a new contract. As indicated earlier, the intention of the parties need not be formally expressed or declared, but it should not be too readily presumed. If there is doubt, the new obligation will not extinguish the old.

Substitution of a party to a contract

The courts have established a three-part test, as follows, for determining if, by the introduction of a third party to an agreement, a novation has occurred:

1. The new party must assume complete liability.

As a party to the new agreement, the new party has to voluntarily accept its obligation towards the continuing party and the resulting liability and effects. Confirmation of this is the new party signing the novation contract and/or the conduct of the new party towards the continuing party.

2. The continuing party must accept the new party in place of the departing party.

The departing party will be discharged and novation will occur only if the new party undertakes the obligation of the departing party and the continuing party agrees to accept him/her in place of the departing party.

Generally, a party to an agreement cannot divest itself of its obligations without the consent of the continuing party.

3. The continuing party must accept the new contract in full satisfaction and substitution for the old contract.

Where the continuing party accepts the new contract in full satisfaction of the old one, the old contract must be extinguished, along with any obligation included in the old contract. If this does not happen, a novation has not occurred.

Effects of novation

As previously mentioned, the effect of novation is to extinguish a debt or obligation and to create a new one. Therefore, if one of several parties who have a joint and several obligation under an agreement contracts a novation, the other parties who had an obligation may also be released from the old obligation. Likewise, if one of several parties who possess joint and several rights under an agreement contracts a novation, the party who has an obligation may be released from liability under the original agreement to the other continuing parties as well. Whether a party is released from its joint obligation by the continuing parties is a question of fact, and, in certain provinces, a question of law¹, and depends on all of the circumstances surrounding the original agreement.

Form of novation

No particular form or formality is necessary to effect a novation, unless a particular statute or enactment requires a particular form or formality to make novation effective. Thus, even if the original contract was in writing and a new verbal contract has been entered into in substitution for it, there is nothing to prevent novation by means of the new verbal contract, unless the original contract was required to be in writing.

¹ For example, in the Quebec Civil Code, Articles 1665 and 1666 of Section 3 of Chapter VII in TITLE SIX of BOOK FIVE

Situations when novation might not occur

- Extending the time for payment of an existing debt;
- Changing the place of payment;
- Accepting something other than money for the sum due;
- Paying a smaller or larger sum than is due; and
- Paying a higher or a lower rate of interest.

Transactions sometimes confused with novation

1. *Abandonment* means the intention or act of surrendering, relinquishing, disclaiming, or ceding property or rights. It includes the voluntary relinquishing of all rights, titles, claims and possessions, with the intention of not reclaiming those rights. Usually, abandonment occurs where an obligee surrenders its rights towards a particular obligor, due to the latter's financial hardship or such other like considerations. In determining whether a person has abandoned property or rights, the person's intention is the determining factor.
2. *Assignment* is the transfer of an obligee's rights against the obligor to another person. For instance, consider the case where a transfer is effected without the participation of the obligor. The obligor's obligation remains the same. The obligor also remains liable to the obligee and has no direct obligation to the other person to whom the obligee has transferred rights. The other person might be the obligee of the original obligee, such that the latter is not released from its liability to the other person by the assignment. Even though the original obligee may have discharged its obligation to the other person, the obligor remains liable for its original obligation, regardless if the payments are now to be paid to the other person.

Assignments may also occur between an obligor and another person, who, under the instrument creating the assignment, takes on the rights and obligations of the obligor towards the obligee. In such situations, novation may have occurred if the obligee releases the original obligor from its obligation and accepts the other person (i.e., the assignee) in substitution for the latter. For example, a mineral exploration company A, which is financed by C, assigns its mineral exploration rights to a mining conglomerate B. As long as C consents to the assignment, releases company A from its obligation and accepts in substitution conglomerate B as obligor, novation of the financing agreement has occurred.

These comments relate to the relationship between parties to a contract and not to interests in property.

3. *Commitment* is an order by an obligor in favour of the obligee made upon a third person to pay the obligor's debt to its obligee. This is merely a mandate to the third person to make payment, not to promise payment. There is no transfer of the obligation of the obligor to the third person, nor, if the third person is under an obligation to the obligor, is there any transfer of the third party's obligation to the obligee.
4. *Nominee* may be a person designated to act for another as his or her representative, in a rather limited sense. A nominee can act for an obligee or an obligor. The term is sometimes used in this context to signify an agent or trustee.

Such a nominee does not affect the obligor's obligation to the obligee. For instance, the indication by an obligee of a person to whom its obligor may make payment of a debt is merely the addition of a person to whom payment may be made.

5. *Payment by a Third Party* in place of the party who has an obligation (obligor), is a transaction that releases the obligor. This is done independently of the existing obligor, not on the obligor's instruction or direction, and possibly, without the obligor's knowledge. Although the same obligation remains, there is no novation. An example would be when a third party gives a bank a promissory note for the payment of the obligor's debt, which the bank, as obligee, accepts.
6. *Rescission* amounts to the unmaking of a contract, or an undoing of it from the beginning. A rescission can be executed by mutual agreement of the parties, or by one of the parties declaring rescission of the contract without the consent of the other if a legally sufficient ground exists. The effect is as if the contract never existed and as a result, each party is bound to restore to the other anything already received.
7. *Suretyship* introduces a new party in addition to the existing obligor. Two obligations now exist, that of the principal obligor and that of the surety. The surety undertakes that the principal obligor will perform the existing obligation, failing which, the surety will perform the obligation or indemnify the obligee.

Examples

EXAMPLE NO. 1

Facts

1. A corporation issued a promissory note to BankCo, with respect to an existing loan of \$100 million dollars.
2. The promissory note extended the date of the expiry of the loan by 1 year, and included another party as guarantor of the promissory note.
3. BankCo accepted the promissory note and agreed to change the terms of the loan, but at a higher rate of interest.
4. The new document was signed by all parties and endorsed by the guarantor.

Decision

A novation has not occurred.

Rationale

According to the facts, the obligation and the parties remain the same. The extension of the loan does not affect the main obligation to pay the loan of \$100 million. In addition, the extension of time and the increase in interest rate does not alter the obligation. The guarantor that was added to the note is not a substituted obligor, within the meaning of novation, as the guarantor is only providing additional security in respect of the original loan. Therefore, for GST/HST purposes, there is only one supply, that of an exempt financial service supplied by BankCo.

EXAMPLE NO. 2**Facts**

1. BankCo agreed to finance a \$10 million dollar mortgage for RealCo for the purpose of acquiring a commercial building.
2. RealCo, because of financial difficulty, defaulted in the performance of its obligation to BankCo.
3. In settlement of the mortgage arrears, RealCo offered to give BankCo a piece of land, which BankCo accepted on the condition that RealCo pay the mortgage interest arrears of \$7,000.
4. BankCo registered the real estate transaction with respect to the piece of land.
5. BankCo sold the land and applied the sale proceeds to the mortgage arrears.

Decision

A novation has not occurred.

Rationale

An agreement involving the acceptance of something other than money for the sum due is not, in and by itself, a novation. The essence of the transaction of accepting another form of consideration does not affect the original obligation between BankCo and RealCo. It is merely a partial/full settlement of the original obligation. Accordingly, the financing agreement has not been altered, and the exempt financial service supplied by BankCo to RealCo remains.

EXAMPLE NO. 3**Facts**

1. LeaseCo concluded a ten-year lease agreement with CanCo, in respect of a piece of heavy equipment.
2. LeaseCo assigns the lease payments to FinanceCo, effective January 1 the following year.
3. FinanceCo then informed CanCo that, beginning January 1, the lease payments are to be sent to FinanceCo.
4. CanCo, with the approval of LeaseCo, subleases the equipment to MineCo. A clause in the lease agreement provides that CanCo may enter into a sublease agreement with a third party provided that CanCo first receives approval from LeaseCo.
5. The sublease begins January 1 and is for the remainder of the lease.

Decision

A novation has not occurred.

Rationale

For a novation to occur, MineCo would have had to be the substituted obligor of CanCo. In this case, MineCo has simply become an obligor of CanCo. Its obligation is to CanCo and it has no obligation towards LeaseCo. Furthermore, the assignment of the lease payments by LeaseCo to FinanceCo does not result in a novation. FinanceCo does not assume any of the liability that LeaseCo has under the terms of the lease and the contractual obligations of LeaseCo have not been extinguished. Therefore, LeaseCo remains liable for charging and accounting for tax on the lease payments pursuant to the original

agreement. Also, Canco must now charge and account for tax with respect to the sub-lease to MineCo, effective January 1, as the sub-lease is a separate agreement between CanCo and MineCo.

EXAMPLE NO. 4

Facts

1. A municipality contracts with an artist to produce a statue of the town's founder.
2. Before completing the work, the artist dies.
3. The municipality holds the artist's estate liable for the work to be completed.
4. His daughter administers the estate of the deceased artist. Her brother, a talented artist in his own right, agrees to complete his father's work.
5. The municipality releases the estate, and accepts the son in substitution of his deceased father.

Decision

A novation has occurred.

Rationale

In this case, the son is prepared to assume the obligation of performing the rest of the work and the municipality accepts the son in place of his deceased father. Therefore, a new contract has been created in satisfaction and substitution for the old contract. The son, if a GST/HST registrant, will charge and account for tax on his supply to the municipality.

EXAMPLE NO. 5

Facts

1. Company A has a cleaning contract with Company B.
2. Company A is unable to fulfill its obligation to Company B.
3. Company C is also a cleaning contractor.
4. Company B has agreed to meet with both Company A and Company C to resolve the contract difficulties it is having with Company A.
5. At the meeting, the parties verbally agreed that Company C will perform the obligation of Company A.

Decision

A novation has occurred.

Rationale

Company A has delegated Company C to replace it in the performance contract. As Company B has verbally agreed that Company C will undertake the cleaning contract, Company B has in effect extinguished Company A's obligation under the original agreement.

Thus, in this case, the actions of the parties are clear evidence that a novation has occurred. Under the new agreement, Company C will be required to charge and account for the tax on its supply of the cleaning services to Company B.

As a result of the novation, Company A is no longer making a supply to Company B, as Company A is no longer obligated to perform the cleaning services as set out in the original contract.

EXAMPLE NO. 6**Facts**

1. A landlord has a 5-year lease with a lessee who is occupying a commercial building.
2. At the end of the second year, the lessee wants to lease space in another commercial property and wants to assign the current leasehold interest to a third party.
3. An assignment agreement is entered into between the lessee and the third party, with the approval of the landlord.
4. Under the terms of the assignment agreement, the fact that the landlord agreed to the assignment does not discharge the lessee from its obligations under the lease in the event of a breach by the assignee.

Decision

A novation has not occurred.

Rationale

Although an assignment of the leasehold interest has been agreed to by all parties, the lessee, under the terms of the original lease agreement is not discharged, a necessary condition for novation to have occurred. With respect to the landlord's liability for tax, if a GST/HST registrant, it will continue to be responsible for charging and accounting for the tax on the lease amounts charged under the original lease.

EXAMPLE NO. 7**Facts**

1. Party A, the lessor, and Party B, the lessee, have entered into a two-year agreement to lease a tractor-trailer.
2. Nine months after the lease agreement was entered into, Party B asks Party A to accept Party C as a lessee in place of Party B.
3. Party A agrees to accept Party C in substitution of Party B, on the condition that Party C agrees to enter into a separate agreement to buy the tractor-trailer when the lease expires.
4. The original agreement between Party A and Party B did not require Party B to eventually purchase the vehicle.

Decision

A novation will have occurred only when Party C enters into the separate agreement with Party A to buy the tractor-trailer.

Rationale

As Party A will only accept Party C in place of Party B on the condition that a separate agreement to buy the tractor-trailer is entered into, novation does not occur until the condition has been fulfilled. Only then is Party B released from its obligation under the original lease agreement and replaced by Party C. Until the condition is fulfilled and novation has occurred, Party A will charge and account for tax on the lease

payments to be made in accordance with the original agreement and Party C is responsible for paying those amounts. In the meantime, Party B remains liable towards Party A should Party C default in making the lease payments.

The agreement to buy the vehicle upon termination of the lease would be in the form of a separate agreement between Party A and Party C.

EXAMPLE NO. 8

Facts

1. A homeowner hired a contractor to renovate a bungalow by adding a second floor.
2. During the course of construction, the contractor discovers that the first floor walls will not support a second floor.
3. The parties agree that the contractor will restore any work already done and build a garage instead. All obligations under the existing contract are cancelled.
4. Both parties agree to the new work to be performed on the house, which would include restoration of the infrastructure, and any obligations under the existing contract are rescinded.

Decision

A novation has occurred.

Rationale

Even though the parties remain the same, as the terms of the original agreement have been substantially altered to the extent that a new obligation has been created, a novation has occurred with respect to the original obligation between the parties.

EXAMPLE NO. 9

Facts

1. XYZ, a registrant supplier of appliances, rents appliances to consumers.
2. QST, also a GST/HST registrant, purchases all of XYZ's rental agreements.
3. QST, as the new lessor of the appliances, notifies the lessees. QST indicates that the lessees' obligations towards QST remain the same as their obligations to XYZ and that they now must remit their payments to QST.

Decision

A novation has occurred.

Rationale

XYZ relinquishes its claim on the lessees and is replaced by QST. QST now possesses title to the appliances and the lease agreements and must charge and account for tax on the lease payments pursuant to the new agreements. Accordingly, the lessees are released from their original obligation towards XYZ.