Tax Notes

February 2012
Number 589

PRICE ADJUSTMENT CLAUSES

— *Davis Louis*

*Price adjustment clauses have become topical in respect of estate freezes, especially because two recent cases (*Garron *and* Krauss*) have had a critical impact on this issue. The following is an abridged article based on the third edition of* Implementing Estate Freezes, *recently published by the author (2011, CCH Canadian Limited).*

Where an estate freeze is effected, a price adjustment clause will typically be inserted in the Articles in order to "back stop" the retraction rights in terms of possible "conferral of benefit" problems.

In a typical case, which envisions common shares being exchanged for freeze (Class A) shares, the following should be noted:

- The clause will typically be operative only in the event of a dispute with the CRA which proves to be unsuccessful.
- The operation of the clause is conditional on the application of any of a number of factors, most notably, a disparity between the value of the exchanged shares (often termed the "Class A consideration") and the fair market value of the Class A shares such that a benefit has been conferred.
- The clause typically seeks to restore the equilibrium between the value of the exchanged shares (or transferred assets, as the case may be) and the value of the consideration received.
- The primary mechanism for achieving this result is usually an adjustment of the retraction/redemption value of the freeze shares. This purports to be effective retroactive to the time of the freeze (often referred to as "*nunc pro tunc*").
- In addition, in this particular precedent (not reproduced in this article), subsequent clauses purport to create additional obligations (in this case, based on interest at prescribed rates), to compensate for dividends or redemptions based on values which prove to be "incorrect."[1]

The price adjustment clause contained in the articles will typically be "mirrored" by a similar price adjustment clause contained in the actual asset transfer documentation. It has been observed that this is desirable since it is possible that, in isolation, the articles could not be relied upon if the clause was operative after all of the shares had been redeemed. If a similar clause is contained in the share transfer or exchange agreement, the shareholder in the corporation would still be contractually bound by the price adjustment clause under the agreement.

CCH
a Wolters Kluwer business

Triggering of Price Adjustment Clause

Price adjustment clauses have attracted the attention of practitioners by virtue of two recent cases: *Garron* and *Krauss*. Both of these cases involved situations in which the price adjustment clause was not triggered. Both cases had price adjustment clauses that were to come into effect in the event that a tax authority made a determination that the fair market value of the transferred property (pre-freeze common shares in *Garron* and real estate transferred into a frozen partnership in *Krauss*) was other than the amount determined by the corporation (in *Garron*) or the total redemption amount of the units (in *Krauss*).

In *Garron*, the Federal Court of Appeal stated that the clause was "never in play because no such determination [by a court or taxation authority] was made."[2] In *Krauss*, the freeze units could not be unilaterally redeemed; the Tax Court held that the price adjustment clause could not cause such units to have a fair market value equal to the value of the transferred property.

These cases and the resultant consequences are discussed in "Price Adjustment Clauses Under Attack" (Joan Jung, *Tax for the Owner-Manager*, Volume 11, No. 2, April 2011, Canadian Tax Foundation). The author states:

> This suggests that a triggering event for the PAC should be based not solely on a "determination" but should include a proposed assessment or reassessment on the basis that the FMV of the transferred property was greater or lesser than the FMV of the preferred shares issued in consideration therefor. Each of paragraph 85.1(*e*.2), subsection 86(2), subsection 51(2), and paragraph 69(1)(*b*) involve such a comparison.

The author suggests that these could also be triggering events:

(1) A proposed assessment or reassessment on the basis that a benefit was conferred as part of or as a consequence of the transaction or event or series of transactions or events which include the issuance of the preferred shares.

(2) A disposition of property or rights to or for the benefit of another shareholder or perspective shareholder, although this concept is likely inherent in the previous approach.

As noted previously, the triggering of the adjustment mechanism is primarily based on a discrepancy between the fair market value of the assets transferred into the corporation (in this case, common shares) and the fair market value of the consideration received from the corporation (in this case, Class A shares). The primary adjustment mechanism, in this case, is an adjustment to the redemption and retraction amount of the Class A shares (the "Class A redemption amount").

Effect of Clause

In an estate freeze situation, the CRA has indicated that it would be prepared to rule favourably where a clause varies the redemption amount or provides for a cash payment — see question 14 of the 1980 Revenue Canada Round Table.

Another possibility is to effect an adjustment by issuing additional shares. However, in that question, the CRA stated that adjusting the retraction amount was the preferred method: it was indicated that, in its opinion, the cancellation or issue of additional frozen shares carries with it a "host of technical difficulties that are best avoided from the point of view of both taxpayers and the Department." (Note: It is usually possible to adhere to the redemption/retraction adjustment mechanism; however, in some situations, the issuance or cancellation of shares cannot be avoided.)

Although a price adjustment mechanism will typically be used in a closely held situation, e.g., for an estate freeze among family members, it should be noted that the price adjustment mechanism (basically, resultant from a dispute with a taxation authority) effects real economic rights, namely, an adjustment of the redemption amount of the shares. In many instances, particularly in arm's length situations, the parties may not wish these economic rights to be altered, so a price adjustment clause should not be used in a mechanistic manner without considering this possibility.

In this respect, it should also be noted that the main purpose of a price adjustment clause is to prevent the CRA from attempting to apply one of the shareholder benefit-type provisions. Where parties do not wish their economic rights to be altered, it is unlikely that any of the parties desire to confer a benefit on any of the other parties. Most of the benefit provisions are worded in a manner such that motivation is a factor in applying the particular benefit provision. Obviously, however, the parties may not want to risk a dispute with the CRA, based on such amorphous issues.

Note: Consider the interaction of a price adjustment clause with the taxable preferred share rules. A price adjustment clause may jeopardize the subsection 191(4) exemption.

Disclosure

In paragraph 1 of Interpretation Bulletin IT-169, the CRA indicates that the parties to a non-arm's length transaction must notify the CRA (by a letter attached by each party to the tax return) of the price adjustment clause and advise, further, that the parties are prepared to have the price in the agreement reviewed by the CRA, that they will take the necessary steps to settle any discrepancy, and that a copy of the agreement will be filed with the CRA if and when demanded.

Although the CRA has not withdrawn this bulletin, it appears that these administrative policies are archaic. In question 58 of the 1990 Revenue Canada Round Table, the CRA indicated that if the parties failed to notify it in the returns, this failure would not, in and of itself, preclude the application of the adjustment clause, if other conditions set out in the interpretation bulletin were met. The CRA has amended a number of relevant election forms to provide for a question pertaining to price adjustment clauses and has indicated that answering yes is sufficient notification. Also, in circumstances where no form is required (e.g., section 51 or 86 of the Act), the CRA has stated that simply not notifying the CRA does not prevent the application of IT-169 if all other conditions are met.

In any event, most practitioners do not follow the practice of notifying the CRA.

Bona Fide Transaction at Fair Market Value

The validity of a price adjustment clause was considered by the Court in *Guilder News Co. (1963) Ltd. et al. v. M.N.R.,* 73 DTC 5048 (FCA). The issue involved was whether a benefit had been received by a shareholder who acquired property from a corporation at less than fair market value. The agreement of purchase and sale contained the following price adjustment clause:

> It being the intention of the Vendor and the Purchaser that the prices herein stipulated should represent the fair market value of the shares being purchased and sold herein, the parties hereto agree that in the event that the Minister of National Revenue should at any time hereafter make a final determination that the fair market value of the said shares as of the date of the Agreement is less than or greater than the prices herein stipulated, the prices herein stipulated shall be automatically adjusted *nunc pro tunc* to conform with such fair market value as finally determined and all necessary adjustments shall be made, including adjustment of the above mentioned promissory note.

The Court rejected the price adjustment clause as a basis for adjusting the price and eliminating the benefit on the grounds that the parties had not reasonably attempted in good faith to transact at fair market value. In its decision, the Court states (at page 5052):

> This agreement is radically different from a sale that is expressly made for a consideration equal to value. This is an agreement for a sale at a price obviously less than value, which price is to be the only amount payable until such time, if any, as the Minister of National Revenue determines the value of the shares that happen to be the subject matter of this sale. While it can be said, as a matter of law, that a simple sale for value, with no other provisions, cannot result in a benefit, it cannot be said, as a matter of law, that the 1964 sale is such a sale merely because it is an agreement containing clause. That sale is at a substantial undervaluation and, except in a certain event, it will continue indefinitely to be so. Even if that event should arise at some subsequent time, the individual will have had the benefit of not having had to pay the amount in excess of the "price" until that subsequent time and this, in days of high interest, can be a substantial benefit.

It appears that the important elements which led to the majority judgment are as follows:

(1) The sale was made at a substantial undervaluation;

(2) In the absence of a reassessment by the CRA, this situation would have continued indefinitely — i.e., there was no mechanism independent of the CRA's assessment, such as a determination by the parties themselves, to adjust the purchase price;

(3) A benefit must have arisen, because funds could be used interest-free until a subsequent event made it necessary to pay the difference between the original purchase price and fair market value; and

(4) The purchaser's position immediately after the transaction represented an improvement over its position immediately prior to the sale transaction.

The minority judgment considered the price adjustment clause itself (rather than the transaction or the overall agreement) to be a sham and went on to state (at page 5054):

> Clause 4 was a mere sham, and in any event has no application on the facts of the case, for the following reasons:
>
> (1) Fair value was not considered at the time the agreement was negotiated by the parties. Hence, there was never any intention to sell at the market value but only at par.
>
> (2) There was no finding by the Minister of the fair market value within the meaning of clause 4. There was at the most an assessment by the Minister under the power of the *Income Tax Act*, and not a valuation pursuant to clause 4.
>
> (3) Further, the agreement acknowledging the further indebtedness was a mere sham as it acknowledges that the balance of indebtedness is payable on demand of the selling company but without interest . . . and as the company is wholly owned and controlled by the member acknowledging as a party there is no possibility that the company could collect.

Subsequent to *Guilder News,* the CRA issued Interpretation Bulletin IT-169. Paragraph 1(a) of the bulletin indicates that the agreement must reflect a bona fide intention of the parties to transfer the property at fair market value and that they must arrive at that value for the purposes of the agreement "by a fair and reasonable method." Per paragraph 2 of the bulletin, whether the method used by the parties to determine the fair market value is fair and reasonable in the Department's view will depend on the circumstances in each case.

Given the comments of the Court in *Guilder News*, a formal objectively prepared and independent valuation of the property being transferred to a corporation would support the intention of the parties to transact at fair market value. Thus, the parties would be in a position to show that they reasonably believe that the price stated in the agreement is the fair market value of the transferred property, in accordance with the *Guilder News* case. In *Miko Leung and Sit Wa Leung v. M.N.R.,* the Court rejected the CRA's position that a price adjustment clause should not apply. The Court was of the view that there had been a reasonable attempt to value the property shares, which in fact had been overvalued.

— David Louis is a tax partner at Minden Gross LLP, a member of MERITAS law firms

Notes:

[1] In question 23 of the 2008 APFF Round Table (Doc. No. 2008-0285241C6), the CRA indicated that a price adjustment clause should contain "other appropriate adjustments when the shares have already been redeemed at the time of an adjustment to the redemption price."

In question 23 of the 1998 APFF Round Table (Doc. No. 9M18520), the CRA indicated that an upward adjustment following a share redemption would be treated as a deemed dividend. [This position was more recently taken in Doc. No. 2011-0422191E5, November 21, 2011.]

[2] Paragraph 38. [In Doc. No. 2010-0366301I7 (November 2, 2010), the CRA took the position that subsection 75(2) applied to an offshore freeze in which the value of freeze shares was set at a lower amount than a formal valuation report. See *Implementing Estate Freezes*, page 162.]

INFORMATION CIRCULAR IC99-1, REGISTERED DISABILITY SAVINGS PLANS

On January 10, 2012, the Canada Revenue Agency released Information Circular IC99-1, Registered Disability Savings Plan, dated November 30, 2011. This circular describes the provisions relating to a registered disability savings plan ("RDSP") that are set out in section 146.4 of the *Income Tax Act*. The CRA notes that this circular does not explain the rollover provisions in section 60.02, the joint liability of taxes from deregistration of a non-compliant plan described in section 160.21, or the penalty taxes on the plans under Part XI. The CRA publishes information on these issues in its guide RC4460. The circular describes what an RDSP is, including who can participate, contributions to a plan, payments out of a plan, and qualified investments; the approval process for a specimen plan being offered by an issuer; and the administration of an RDSP. The circular also provides some basic information about the Canada Disability Savings Program.

EMPLOYEE BENEFITS — REIMBURSEMENT OF GAS EXPENSES IN CARPOOLING SITUATION

The CRA was asked whether the reimbursement by an employer of gas expenses incurred by an employee using his or her car to drive colleagues to or from work under a carpooling arrangement would be considered a taxable or non-taxable benefit under s. 6(1)(*a*) of the Act. If the benefit would be taxable, the CRA was also asked how to allocate it between the employee driving his or her car (and receiving the reimbursement from the employer) and the employees who benefited from the transportation. Under the carpooling arrangement, an employee driving a colleague to work is reimbursed for 50% of his or her gas expenses upon presentation of vouchers and an attestation by the colleague who was transported. If the employee drives two or more other employees to work, the employee is reimbursed for 100% of his or her gas expenses, subject to the same documentation requirements. The program applies for both business travel and personal travel between the place of work and home.

Car expenses (including gas expenses) incurred by employees for travel between their homes and places of work would be considered personal expenses, not business expenses, even if the car was used in the course of the employer's carpooling arrangement. The portion of the reimbursement related to travel between the residence of the employees and their place of work represents a taxable benefit received by the employees under s. 6(1)(*a*) of the Act. Although the benefit would normally be included in the income of the employee using his or her car and receiving the reimbursement, the CRA would accept a distribution of the benefit between employees using their cars and those employees being transported. The employer and employees would have to agree on a reasonable allocation of the benefit.

— Association de planification fiscale et financière (APFF), 2011 Conference, Federal Taxation Round Table — Question 2, October 7, 2011, Document No. 2011-0411941C6 (French document)

FINANCING EXPENSES — SALE OF INVESTMENTS

Considering that s. 20(1)(*e*) of the Act may allow an issuer of shares, units of a unit trust, or partnership interests to deduct its financing expenses over five years, the CRA was asked these four questions:

(1) If the issuer does not intend to earn property income but intends instead to realize gains or losses from the sale of its investments, would its financing expenses still be deductible under s. 20(1)(*e*)(i) of the Act?

(2) If a unit trust files an election under s. 39(4) of the Act to have all the gains resulting from the disposition of its investments treated as capital gains, would its financing expenses still be deductible under s. 20(1)(*e*)(i) of the Act?

(3) If the answer in (2) is negative, would those financing expenses be deductible if a minimum portion of the issuance proceeds was invested in an investment generating property income?

(4) Would the answer be different if the investment income did not cover the financing expenses?

The CRA did not have enough information to answer the four questions specifically but provided general comments. No deduction could be claimed under s. 20(1)(*e*)(i) of the Act if there was no source of business or property income. The facts provided by the taxpayer did not allow the CRA to determine whether there was a source of income. Because s. 9(3) of the Act provides that income from a property would exclude the capital gain realized on the disposition of the property, the increase in value of a capital property (as this term is defined in s. 54) would not in itself constitute a source of property income. However, capital property could in particular circumstances be considered a source of property income or be held in the course of a business to generate business income. An election under s. 39(4) of the Act may only be used for a "Canadian security" (see the definition in s. 39(6) of the Act) and may not be used by a trader or dealer in securities, a financial institution, a non-resident, or a corporation whose main business is lending money or purchasing debt obligations (see s. 39(5)).

— Association de planification fiscale et financière (APFF), 2011 Conference, Federal Taxation Round Table — Question 3, October 7, 2011, Document No. 2011-0412061C6 (French document)

CRA'S 2011 MEAL AND VEHICLE RATES

The CRA has released the 2011 meal and vehicle rates that can be used by individuals to calculate meal and travel expenses for purposes of the northern residents' deductions, moving expenses, and transportation to obtain medical services. The flat rate meal amount remains at $17 per meal to a maximum of $51 per day. For the simplified method of calculating vehicle expenses, the 2011 per kilometre rates are shown in the chart below.

Province/Territory	*Kilometre*
Alberta	53.0
British Columbia	52.0
Manitoba	49.0
New Brunswick	52.0
Newfoundland and Labrador	55.0
Northwest Territories	61.5
Nova Scotia	53.0
Nunavut	61.5
Ontario	57.0
Prince Edward Island	52.0
Quebec	59.0
Saskatchewan	47.5
Yukon	63.5

RECENT CASES

Minister did not provide adequate reasons for decision, but decision to deny relief reasonable and procedural fairness not breached

Federal Court, October 21, 2011

The taxpayer requested a judicial review of a taxpayer relief request that was denied by the Minister for interest and penalties, based on financial hardship under s. 220(3.1) of the *Income Tax Act* for the years 1989 to 2000. The Canada Revenue Agency (the "CRA") had determined that the taxpayer was able to meet her tax obligations, as she had sufficient cash flow and equity in her home during the relevant period. The taxpayer argued that: (a) the CRA's reasons for denying relief were not adequate; (b) she should have an opportunity to comment on the CRA's conclusion for denying relief before a decision was made on the matter; (c) the CRA was not entitled to rely on a third-party affidavit to supplement its reasons; and (d) the Minister erred in exercising its discretion.

The taxpayer's appeal was allowed in part, with costs. The Minister did not provide adequate reasons for its decision. However, the rules of procedural fairness do not entitle a taxpayer to further comment before the CRA makes its decision. As to the affidavit, it was not filed to supplement the CRA's reasons and was appropriate. Lastly, without evidence to the contrary, the Minister's decision to deny relief was reasonable.

Sherry v. M.N.R., 2011 DTC 5168

Jeopardy collection order issued against corporate taxpayer

Federal Court, November 7, 2011

N was the sole director of a corporation (the "Company") of which the Canada Revenue Agency (the "CRA") believed he and his wife were the shareholders. The Company was the registered owner of N's family home (the "McCulloch Property"). The Minister applied *ex parte* to the Federal Court for a jeopardy collection order against the Company.

The Minister's application was granted. In a previous case, the Federal Court cited the following factors that justify the issuance of a jeopardy collection order: (a) there are reasonable grounds to believe that the taxpayer has acted fraudulently and has proceeded to liquidate or transfer assets; (b) the taxpayer is evading tax liabilities and has assets that could diminish in value over time; and (c) the tax debt is significant in relation to the taxpayer's income and expenses. In this case, the Company, N, and his wife, had engaged in unorthodox conduct in the past to thwart the CRA's tax collection efforts. The McCulloch Property was subject to a questionable mortgage in favour of N's son, and was in the past the subject of a series of non-arm's length transfers for inadequate consideration orchestrated by N and his wife. In addition, they had failed to make proper financial disclosure to the CRA and had been generally uncooperative with the CRA for the past 20 years. Furthermore, N had been declared a vexatious litigant by the British Columbia Supreme Court, the British Columbia Court of Appeal, and the Federal Court with respect to various actions targeted against the Canadian government. As a result, the Minister's tax collection efforts would be jeopardized by any further delay.

M.N.R. v. Friends of Googolplexion for Human Rights Inc., 2011 DTC 5175

Motor vehicle allowances paid to taxpayer by employer required to be included in income

Tax Court of Canada, November 16, 2011

The taxpayer was the sole shareholder and an employee of a corporation (the "Corporation"). He personally owned three vehicles, only one of which (a Jeep) was insured to be driven commercially. The Minister included in the taxpayer's income for 2004 and 2005, as employment benefits, motor vehicle allowances the Corporation paid to him. The Minister allowed the deduction of motor vehicle expenses claimed for 2004, 2005, and 2006 for the Jeep only, and disallowed the deduction of all other motor vehicle expenses claimed for 2004 to 2006. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. Under s. 6(1)(*b*)(v) and s. 6(1)(*b*)(x), all motor vehicle allowances from employers must be included in employees' incomes, except for allowances that are reasonable. The taxpayer kept no kilometre log books for his vehicles, and chose not to produce any evidence at his hearing concerning the purposes for which these vehicles were being used. He was therefore unable to show that the allowances he received were reasonable, or that the vehicles other than the Jeep were being used by him during the course of his employment. The Minister's reassessments were affirmed accordingly.

Paré v. The Queen, 2012 DTC 1008

Taxpayer not entitled to deduct investment as business investment loss

Tax Court of Canada, November 18, 2011

The taxpayer invested $25,000 into a company ("CGFLP") that promoted itself as an investment entity through which individuals could realize substantial returns on their contribution. CGFLP was later determined to be in violation of British Columbia's securities law, and subsequently went bankrupt. The taxpayer claimed a $25,000 business investment loss ("BIL") for 2006, but the Minister reassessed the taxpayer and determined that he was entitled only to a capital loss.

The taxpayer's appeal was dismissed. The taxpayer failed to satisfy the criteria that his investment qualified as a BIL, or to meet his burden of proof in establishing a *prima facie* case to rebut the Minister's assumptions.

Allisen v. The Queen, 2012 DTC 1015

TAX NOTES

Published monthly by CCH Canadian Limited. For subscription information, contact your CCH Account Manager or call 1-800-268-4522 or (416) 224-2248 (Toronto).

For CCH Canadian Limited

Susan Peart, C.A., LL.M.
(416) 224-2224, ext. 6434
email: Susan.Peart@wolterskluwer.com

Natasha Menon, Content Product Manager
Tax, Accounting and Financial Planning
(416) 224-2224, ext. 6360
email: Natasha.Menon@wolterskluwer.com

CCH Canadian Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 · 1 800 268 4522 tel
416 224 2243 · 1 800 461 4131 fax
www.cch.ca

PUBLICATIONS MAIL AGREEMENT NO. 40064546
RETURN UNDELIVERABLE CANADIAN ADDRESSES TO CIRCULATION DEPT.
330–123 MAIN ST
TORONTO ON M5W 1A1
email: circdept@publisher.com

CCH
a Wolters Kluwer business