**STEP Inside**

## Tax Court Examines Partnership Freeze in Estate Case
## (Published February 2010)

Toronto real estate was frozen using an Ontario partnership. These were the basic fact in *Kato Krauss v. The Queen*, 2009 TCC 597 which may be the first reported case involving a partnership freeze. While the use of a corporation is the more standard estate freeze structure, the partnership as a freeze vehicle has been the subject of some discussion. The Canada Revenue Agency has not generally commented favourably on this structure. It has indicated that it had never issued a favourable advance income tax ruling a proposed partnership freeze (See CRA document no. 2004-0070001C6 dated June 28, 2004) and has suggested that there might be reallocation of income among the partners by virtue of subsections 103(1) or (1.1). The choice of a partnership structure rather than a corporation may derive from the character of the property, e.g., land inventory can be "rolled" to a partnership but not a corporation. In Ontario, the choice of a partnership structure may also derive from land transfer tax planning.

In *Krauss*, the taxpayer and her son Larry each transferred their respective undivided interest in certain Yonge Street property to a partnership pursuant to subsection 97(2) of the *Income Tax Act*. In consideration, each received Class A units of the partnership and their respective capital accounts in the partnership were credited with an amount equal to the fair market value of the contributed property less assumed liabilities. The Class A units were apparently redeemable and had a priority income return. A corporation controlled by the taxpayer, Kraussco, transferred an interest in other Yonge Street property to the partnership, as did Larry. Kraussco and Larry received redeemable Class B units in consideration. Immediately thereafter, Class C units were issued to a family trust for nominal consideration. The beneficiaries of the family trust included the taxpayer's minor grandchildren. In the taxation year in question, approximately $108,000 was allocated to the Class A units (representing an approximate 8% return) while the remaining income, or approximately $126,000 was allocated to the trust.

The CRA reassessed on the basis of subsections 103(1) and (1.1) and subsection 74.1(2). The reassessment pursuant to subsections 103(1) and (1.1) was not surprising given previous CRA statements. The reassessment pursuant to subsection 74.1(2) is most interesting. Subsection 74.1(2) is the attribution rule applicable where there is a transfer of property directly or indirectly, by means of a trust or by any other means whatever, to or for the benefit of a non-arm's length minor.

The Tax Court of Canada found that it did not have to answer the question of "whether an estate freeze can be effected through a partnership in the abstract." Justice C.H. McArthur held that "to the extent that an estate freeze can be effected through a corporate vehicle, if the same economics can be replicated through a partnership…an estate freeze could be effected through a partnership." In the case at hand however, the Tax Court of Canada found that the Krauss partnership departed from a typical estate freeze in the following respects.

First, the redemption of the taxpayer's Class A units could not be achieved unilaterally by her. Apparently, this would require the cooperation of her son, Larry. It is not clear why the taxpayer could not unilaterally redeem her units. Perhaps the Class A units did not have the equivalent of a retraction right. Perhaps there was an express requirement in the partnership agreement that the other Class A unit holder (Larry) consent. It was also not clear if the partnership in question was a limited partnership or a general partnership. If it was a limited partnership, perhaps the consent of the general partner was required. In a corporate estate freeze, the preferred shares issued to the freezor invariably are both redeemable (i.e., at the option of the corporation) and retractable (i.e., at the option of the holder).

The second difference noted by the Court was that the partnership agreement provided that all losses in respect of the transferred Yonge Street property were to be allocated to the Class A units, notwithstanding that income may have previously been allocated to the Class C units (i.e., the units held by the family trust). Although the Court noted this as a "departure" from a typical estate freeze, there does not seem to be any valid comparison to the corporate estate freeze, as the above difference seems to derive from the flow-through nature of a partnership.

The Court also noted that the Class A unit holders were subject to a potential capital call in relation to the ongoing operation of the contributed properties.

Faced with the above issues, the taxpayer argued that the Class A units and the partnership agreement contained a price adjustment clause to adjust the redemption amount of the Class A units. The Court noted that even assuming that the redemption amount could be so adjusted (presumably meaning that the price adjustment clause "worked" without making any finding that the clause could indeed be operative), the fair market value of the Class A units would nonetheless not equal the fair market value of the contributed property as the lack of unilateral redemption and future capital requirements detracted from the value of the units.

Having found such a deficiency, the Court applied the Federal Court of Appeal decision in *Romkey v. The Queen*, 2000 DTC 6047 (FCA) affirming 97 DTC 7199 (TCC). The Court held that Mrs. Krauss had foregone "the right to receive an increased measure of any future rental or other income beyond the preferred return" on the Class A units. The Court held that the right to participate in income and no obligation to suffer losses were "transferred". Curiously, the Court stated that such rights were "transferred before the admission of the Class C unit holders" although the Court made no finding as to the person to whom such rights were transferred. Given that subsection 74.1(2) requires a transfer of property directly or indirectly to or for the benefit of a non-arm's length minor, the Court presumably considered that the rights were so transferred, albeit before the trust became a Class C unit holder.

As a result, the Court upheld the reassessment of the taxpayer pursuant to subsection 74.1(2) to attribute certain income of the trust to the taxpayer.

*Krauss* is noteworthy because it may be the first reported partnership freeze tax case. If the Class A units had been structured so that they were unilaterally redeemable by the taxpayer, query whether the result would have been the same. In *Krauss*, the Court noted that in theory, in a corporate estate freeze, common shares have no value at the time of issue because the freeze preferred shares carry a fixed value equal to 100% of the frozen value. The Court held that in the case of the Krauss partnership, the Class C units did not have nominal value at the time of issue because they carried the right to participate in income. This seems troubling because this is true for all post-freeze common shares of a corporation. *Krauss* may perhaps be rationalized by noting that there is no benefit rule applicable in the partnership context. A corporate estate freeze typically relies on one of the "rollover" rules in the *Income Tax Act* (Canada), such as section 51; 85; or 86. In a corporate freeze, if the value of the freeze preferred shares do not equal the fair market value of the frozen transferred assets and new common shares are issued to a family trust, the "rollover" rules mentioned above include benefit provisions which may be triggered with immediate adverse consequences. There is no equivalent benefit provision in section 97. Thus, invoking *Romkey* provided a means for the CRA to reassess.