# Price Adjustment Clauses Under Attack

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Many observers have commented on *St. Michael Trust Corp. v. Canada* (2010 FCA 309, affirming Garron, 2009 TCC 450) and the new central management and control test of residence now applicable to trusts, but few have commented on the ineffective price adjustment clause (PAC) in the structure. As is standard practice, the estate freeze in the case incorporated a PAC in the terms and conditions of the freeze redeemable retractable preferred shares. In theory, such a clause retroactively (nunc pro tunc) adjusts upward or downward the aggregate redemption value of the preferred shares in the event of challenge by the tax authority. The purpose of such an adjustment is to negate the conferral of a benefit on the new common shareholder whose common shares would have been issued from treasury for nominal consideration. But the PAC in *St. Michael* did not assist the taxpayer. Also (and similarly the subject of limited commentary), the freeze partnership units in *Krauss v. Canada* (2010 FCA 284, affirming 2009 TCC 597) included a PAC that was of no assistance to the taxpayer at the Tax Court level. This point does not appear to have been argued at the Federal Court of Appeal in *Krauss*.

If the PAC in the preferred shares (*St. Michael*) or the partnership units (*Krauss*) had been operative, it would not have addressed the grounds on which the Crown ultimately succeeded. In *St. Michael*, an operative PAC might have increased the value to be taxed in the freezor's hands (perhaps from $50 million to $102 million), but the balance of the gain (based on the third-party sale price of $532 million) would nonetheless have been taxed in the hands of trusts that were found to be Canadian-resident. In *Krauss*, an operative PAC would not have addressed the subsection 103(1.1) issue, which was one of the successful grounds in the Tax Court and the basis of the FCA's decision.

*St. Michael* and *Krauss* are two of the few cases in which courts have applied *The Queen v. Kieboom* (92 DTC 6382 (FCA)) and *Romkey et al. v. The Queen* (2000 DTC 6047 (FCA)). The CRA stated long ago (in document no. 922529) that it would not apply *Kieboom* in the context of an estate freeze where a trust paid FMV for the common shares issued in the course of the freeze. Because the purpose of a PAC is to assist in ring-fencing the FMV of the transferred asset (that is, the asset to be frozen), an effective PAC should cause the FMV of the post-freeze common shares to be nominal, thereby permitting the payment of a nominal subscription price for them. In other words, an effective PAC should preclude the application of *Kieboom*.

The freeze partnership units in *Krauss* were found to lack an essential component to support value--namely, a retraction right. The CRA has stated that "the redemption right at the option of the holder could be omitted only if the FMV of the estate freeze preferred shares would still be equal to the FMV of the common shares exchanged, notwithstanding the absence of this redemption right" (2008-0285241C6, October 10, 2008). The units in *Krauss* did not satisfy these requirements. The freeze partnership units could not be unilaterally redeemed, and the Tax Court held that the PAC could not cause such units to have an FMV equal to the value of the transferred property. Faced with an ineffective PAC, the Tax Court in *Krauss* applied *Romkey* to find that there was a transfer of "property" (the right to receive future income) to the "common" partnership unit holder (a family trust), and thus the attribution rules were triggered. Notwithstanding the finding of the Tax Court, query whether a PAC can compensate for a limited retraction right, perhaps with enhanced redemption value.

An effective PAC would not in and of itself have resulted in taxpayer victory in either *St. Michael* or *Krauss*; nonetheless, the cases present some useful lessons. In both cases, the PAC used "determination" language. In the event that the tax authority made a determination that the FMV of the transferred property (pre-freeze common shares of PMPL in *St. Michael*; real estate transferred to the partnership in *Krauss*) was other than the amount determined by the corporation in *St. Michael* or the total redemption amount of the units in *Krauss*, the redemption value of the preferred shares or partnership units was adjusted accordingly. In *St. Michael*, the Federal Court of Appeal stated that the clause "was never in play because no such determination was made." In *Krauss*, the Tax Court said that the Crown "has made no assumption about the valuation of the properties nor has he assessed on the basis of the price adjustment mechanism in the Partnership Agreement." These statements suggest that broader drafting of the triggering events for a PAC may be prudent.

It should be noted, however, that the CRA uses "determination" language in IT-169 to describe a PAC: "agreements which state that if the Department determines that the fair market value of the property is greater or less than the price otherwise determined in the agreement, that price will be adjusted to take into account the excess or the shortfall." "Determination" language was also used in the PAC in *Guilder News Co. (1963) Ltd. et al. v. MNR* (73 DTC 5048 (FCA)). The words of the clause were carefully considered in the minority reasons of Sheppard J, who held that the tax authority had made no finding on the basis of the clause; rather, it had assessed but not made a valuation (as if determination were akin to a formal valuation). The taxpayers in *Guilder News* were each assessed a shareholder benefit; therefore, it is implicit that the tax authority considered the value of the transferred assets to be greater than the value of the consideration given by the taxpayers. While a notice of reassessment presumably included an amount in income as a shareholder benefit, the pleadings set out a dollar amount as an assumption of fact (72 DTC 6146, at 6147 (FCTD). This suggests that a triggering event for the PAC should not be based 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) involves such a comparison. Another triggering event could be 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, including the issuance of such preferred shares. This approach may address possible subsection 15(1) situations. Finally, to answer a *Kieboom*- or *Romkey*-based attack, one might say that the triggering event also refers to a disposition or transfer of property or rights to or for the benefit of another shareholder or prospective shareholder, although this concept is likely inherent in the previous approach. (All of the above assumes taxpayer acquiescence in the proposed assessment or reassessment.)

The PAC in *Guilder News* is the foundation for the typical clauses in use today:

> 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 this 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 opening words of the clause led to the CRA's requirement in IT-169 that the agreement reflect a bona fide intention on the part of the parties to transfer the property at FMV. In *Guilder News*, shares were sold at par value. There was no suggestion in the facts that a professional valuation had been obtained. Two years previously, in 1962, the individuals had sold the shares in question to each of their respective holding companies at par value in consideration of a promissory note. In 1964, each holding company sold the same shares back to the individuals at par value, and the promissory notes were cancelled. It was accepted as a fact (based on the taxpayers' memorandum of fact and law) that the purchase price was "obviously less than the fair market value of the shares sold." Jackett CJ (writing for the majority in the Federal Court of Appeal) held that the opening words of the above clause were untruthful and could have no effect (other than as evidence that the clause was a sham). The minority reasons of Sheppard J bluntly stated that the clause was a sham because the parties intended to transact not at FMV but at par value. (It is interesting to note that in *Guilder News*, the clause--not the transaction or agreement--was said to be a sham.)

Similarly, in *Wagner v. Canada* (2001 FCA 319), the court found that the parties did not intend to transact at FMV and could not rely on a PAC. A sale of real estate by a corporation to its shareholders was implemented on the basis of a 21/2-year-old professional appraisal, which the appraiser orally updated by 10 percent in a meeting with one or more of the shareholders. The transaction value was $200,000 less than the value given by the taxpayers' own valuation expert at trial. The CRA stated that a "significant" difference between the FMV determined by the taxpayers and the "real" FMV may mean that the taxpayers did not make a genuine effort to determine FMV (2008-0285251C6, October 10, 2008). The CRA said that these circumstances could lead to a PAC being ignored, but it declined to say what would constitute a significant difference.

IT-169 refers to the parties arriving at the value by a "fair and reasonable method." This wording also derives from *Guilder News*, where the majority said that there would be no benefit if the agreement (1) expressly provided that the price would be FMV and (2) provided a "fair manner" in which to determine it. In the same document, the CRA was asked for the meaning of "fair and reasonable method." Its answer was that it is not sufficient to choose a generally accepted valuation method; that method must be properly applied. No further guidance was given, other than that there must be a complete examination of the facts.

Taxpayers will be comforted to know that a disputed valuation with the CRA will not necessarily constitute a misrepresentation attributable to neglect, carelessness, or wilful default leading to an extension of the reassessment limitation period pursuant to subparagraph 152(4)(a)(i). On the basis of *Petric v. The Queen* (2006 TCC 306), there is no misrepresentation unless the taxpayer's view of FMV is so unreasonable that it cannot be honestly held. However, it is implicit that if the taxpayer did not intend to transact at FMV, as in *Guilder News*, a PAC in the transaction documents may be ignored. In such a case, a reassessment outside the normal limitation period may be appropriate