Subsection 75(2) and the Estate Freeze: Importance of Valuation and Price Adjustment Clause

By Vincent De Angelis

A recent Canada Revenue Agency (“CRA”) ruling emphasizes not only the importance of exercising the price adjustment clause when required, but also the scope of the application of subsection 75(2) of the Income Tax Act (the “Act”) to a typical estate freeze transaction.

The price adjustment clause is an essential provision of any purchase and sale agreement involving a tax deferred transfer of assets between non-arms’ length persons - including a rollover pursuant to subsection 85(1) of the Act. In such a non-arms’ length transaction, the vendor and the purchasing corporation will typically agree on a price adjustment clause. If the CRA later determines that the value of the consideration did not equal the value of the asset transferred, the parties will be bound to increase or decrease the value of the consideration as required to achieve equality and avoid undue tax consequences. Without the opportunity to adjust the price for example, CRA may assess a shareholder benefit, or deny any capital gains exemption claimed by the transferor if the shares have been under-valued. Similarly, if the shares have been over-valued, a one-sided adjustment to the transaction price will take place whereby the purchaser will have the unadjusted cost at the original under-valued price, but the transferor’s proceeds will be increased to the fair market value.

The ruling makes the utilization of such a clause even more critical within the context of an estate freeze where a trust will hold the growth shares: to avoid the application of subsection 75(2) of the Act.

To summarize, within the context of an inter-vivos personal trust, section 75(2) of the Act provides for the attribution of income and capital gains from the trust property to a person where the property was received from that person and:

1 RSC 1985, c. 1 (5TH Supplement), as amended.
2 For more information regarding price adjustment clauses see Interpretation Bulletin IT-169. Note that such clauses will not be effective if the parties did not make a real attempt to determine fair market value – see Guilder News Company (1963) Limited et al. v. MNR 73, DTC 5048.
3 See subsection 15(1) and paragraph 110.6(7)(b).
4 See subsection 69(1) (a) and (b).
5 Subsection 75(3) provides for exceptions relating to certain trusts, including registered plans, employee benefit plans, retirement plans, and prescribed trusts (although there are no prescribed trusts to date).
6 In addition, where subsection 75(2) applies, or has ever applied at any time to the trust, all transfers of any property from the trust to a beneficiary in satisfaction of a capital interest in the trust will take place at fair market value, and not on a rollover basis (subsection 107(4.1).
a) it may revert to him or her;  
b) it may be given to a person or persons determined by him or her; or,  
c) during the lifetime of that person, the property may not be disposed of except with the person’s consent or direction.

It is the CRA’s view that subsection 75(2) of the Act may apply not only to the settlor of the trust but to any person that has transferred property to that same trust.  

In the typical estate freeze, Taxpayer A exchanges the common shares in exchange for special shares in the same corporation with a set redemption price pursuant to subsection 85(1) of the Act and pursuant to a written agreement of purchase and sale. The agreement contains a price adjustment clause. A trust or a child of Taxpayer A then purchases the common shares at a nominal amount. Taxpayer A may inadvertently be caught by subsection 75(2) if s/he transferred the common shares of the corporation for less than fair market value and fails to exercise the price adjustment clause.

The CRA was asked whether subsection 75(2) would apply in an estate freeze transaction.  

A corporation (“#Co”) was incorporated. On incorporation, the Son of the Settlor was issued the original common shares in the capital of #Co for a nominal amount. The Settlor established a trust with a gold coin for the benefit at any time of the Son, another person, and their children. On the creation of the trust, the Son was the sole Trustee and one of several discretionary capital beneficiaries.

The Son transferred his common shares in #Co in exchange for referred shares of # Co with a fixed redemption price. Son and # Co jointly elected to have the provisions of subsection 85(1) of the Act apply to the transfer. The agreement contained a price adjustment clause.

The Trust subscribed for common shares in #Co for a nominal amount.

A subsequent private valuation revealed that the preferred shares were worth more than the fair market value attributed to them on the initial freeze.

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7 Interpretation Bulletin IT 369R, para. 11. However, in Sommerer v. The Queen, 2011 DTC 1162, [2011] 4 CTC 2068, Miller J., held:

“The nature of the trust, and whether it is of a type contemplated by subsection 75(2) of the Act, is to be discerned at the time of creation. On the creation of the trust by a settlor, there can only be one person from whom property is received – the settlor. There is no other person. This does not however preclude the possibility of another person settling property in trust with the same trustee and on the same terms, but in such a case, I would suggest there is another trust created. In effect, by the opening words of subsection 75(2) of the Act only a settlor, or a contributor akin to a settlor is contemplated as being the defined person.”

This contradicts the current position of the CRA. It could be read narrowly based on the facts of the case which involved a transfer of assets to a trust for consideration equal to fair market value. The issue of value did not come into play. For a different perspective, see article by Marie-Claire Dy, The Estate Planner No. 198, July 2011, “Who Is “the person” in Subsection 75(2)?”.

8 Other provisions may be used, including s.86 (reorganization) and s.51 (share for share exchange), depending on the circumstances. I am using ss.85 (1) as an example.

9 CRA Document No. 2010-036630117, November 2, 2010
All of the shares in #Co. were subsequently sold to an arms-length third party.

The CRA determined that subsection 75(2) applied with the result that all of the income of the Trust from the common shares and all capital gains realized on their disposition were deemed to be the income and capital gains of the Son.

The CRA held that the Son transferred property to the Trust when he gave up a portion of his ownership interest in the equity of #Co. as a consequence of:

a) the undervaluation of the preferred shares received as consideration; and,

b) the issuance of growth shares to the Trust

The CRA relied on the Tax Court of Canada decision in the Estate of David Fasken:

“The word “transfer” is not a term of art and has not a technical meaning. It is not necessary to a transfer of property from a husband to his wife that it should be made in any particular form or that it should be made directly. All that is required is that the husband should so deal with the property as to divest himself of it and vest it in his wife, that is to say, pass the property from himself to her. The means, by which he accomplishes this result, whether direct or circuitous, may properly be called a transfer”

The court also relied on the Tax Court of Canada decision in Garron Family Trust v. The Queen 2009 DTC 1287 where it confirmed that the shift in value from an undervaluation of exchanged common shares is a transfer of share rights attributable to existing equity from the former holders of common shares to the new common shareholders.

It also relied on Kieboom v. The Queen, 92 DTC 6382 (FCA) for the principle that the growth shares held by the Trust may be viewed as substituted for the equity transferred by the Son for the purposes of the Act (i.e. including subsection 75(2)) pursuant to Subsection 248 (5) of the Act.

It determined that the existence of the price adjustment clause did not apply because the original proceeds represented by the freeze shares were never adjusted by it.

As the Son was a capital beneficiary of the Trust, the CRA concluded that he held the growth shares on condition that they may revert to him within the meaning of paragraph 75(2) (a) (i). Furthermore, as the sole trustee of the Trust for a period of time, the Trust held the shares on condition that they may revert to persons to be determined by the Son within the meaning of paragraph 75(2) (a) (ii). Finally, during that time frame, the Trust could not dispose of the growth shares except with the Son’s consent and in accordance with the Son’s direction, within the meaning of paragraph 75(2)(b).

The CRA’s decision might have been different had the parties attended to exercising the price adjustment clause as soon as it became apparent to them that there was a deficiency - and certainly before selling the shares to the third party. The decision not only serves to remind us how important it is that all steps in a transaction are followed in accordance with the terms agreed to by the parties, it also illustrates the scope of transactions that may be subject to subsection 75(2) of the Act.

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10 49 DTC 491 at p. 497.