

**SHARE CAPITAL DESIGN  
PRICE ADJUSTMENT CLAUSES**

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**May 29, 2011 – June 3, 2011**

# PRICE ADJUSTMENT CLAUSES\*

## CONSIDERATION RECEIVED FOR TRANSFERRED PROPERTY

### I. RELEVANT STATUTORY PROVISIONS

The *Income Tax Act* (Canada)<sup>1</sup> contains a number of rules that are designed to ensure that transactions between non-arm's-length parties occur at fair market value.<sup>2</sup> Paragraph 69(1)(a), for example, provides that where a taxpayer has acquired anything from a person with whom the taxpayer does not deal at arm's length for an amount in excess of its fair market value, the taxpayer will be deemed to have acquired the item in question at its fair market value. As a result, to the extent that the purchase price paid by the taxpayer exceeds fair market value, the taxpayer will receive no cost base recognition for such excess. The non-arm's-length transferor, however, will not be entitled to claim a corresponding deduction in calculating its income for tax purposes and, accordingly, will be taxed on the actual proceeds received.

Similarly, paragraph 69(1)(b) provides that where a taxpayer has disposed of anything to a non-arm's-length person for no proceeds or for proceeds that are less than fair market value, the taxpayer will be deemed to have received fair market value proceeds. As in the case of paragraph 69(1)(a), the rule in paragraph 69(1)(b) is a one-sided adjustment in favour of the Canada Revenue Agency (the "CRA") because it results in increased income to the transferor without any corresponding increase in cost base for the non-arm's-length transferee.<sup>3, 4</sup>

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<sup>1</sup> RSC 1985, c.1, (5th Supp.), as amended. Unless otherwise stated, all statutory references in this paper are to the Act.

<sup>2</sup> Parties will be considered to be dealing at non-arm's length if they are related or do not, in fact, deal with one another at arm's length (section 251).

<sup>3</sup> The rule in paragraph 69(1)(b) also applies where a taxpayer disposes of anything to any person (whether or not arm's length) by way of gift *inter vivos*. In such circumstances, however, the donee does get fair market value cost base recognition for the gifted item.

<sup>4</sup> See, however, *Interpretation Bulletin* IT-405, "Inadequate Consideration - Acquisitions and Dispositions," January 23, 1978, paragraph 5, in which the CRA takes the position that it may permit an adjustment to proceeds of disposition or purchase price where paragraph 69(1)(a) or 69(1)(b), respectively, applies if it can be shown

Even in those circumstances in which subsection 69(1) does not apply, one must be concerned where non-arm's-length parties are involved. For example, the rollover provisions in the Act allow for transfers between non-arm's-length parties at amounts that are less than fair market value.<sup>5</sup> However, many of these rollover provisions will deny all or part of the rollover where the fair market value of the property transferred exceeds the consideration received by the transferor and it is reasonable to regard any part of such excess as a benefit that the transferor desires to confer on a related person.<sup>6</sup>

The issue of fair market value consideration also arises in the context of other conferral of benefit provisions found in the Act (such as subsection 15(1) which deals with shareholder benefits)<sup>7</sup> as well as in those transactions involving capital gain crystallizations for qualified farm property or shares of a qualified small business corporation.<sup>8</sup>

## **II. PRICE ADJUSTMENT CLAUSES**

To avoid the punitive impact of the foregoing provisions, it is typical, in non-arm's-length transactions involving the transfer of property to a corporation in exchange for shares of that corporation, to include a price adjustment clause that will adjust the value of such share consideration if it is ultimately determined that the property had a value, at the time of transfer, that was greater or less than the value originally ascribed thereto. This adjustment is made retroactive to the date when the shares were issued so that it can be said that, at the time the transfer occurred (which is the relevant time for purposes of the foregoing provisions), the

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that the transfer occurred at an amount other than fair market value by reason of an honest error and not as a result of a deliberate attempt to evade or avoid tax.

<sup>5</sup> Subsection 69(1) applies except as otherwise expressly provided for in the Act and these rollover provisions do so otherwise provide.

<sup>6</sup> See, for example, paragraph 85(1)(e.2) and subsections 86(2), 51(2) and 87(4).

<sup>7</sup> See, as well, subsections 56(2) and 246(1).

<sup>8</sup> The concern in these crystallization situations arises because if, in the course of such a crystallization, the farm property or shares are acquired by a corporation or a partnership for consideration that is less than the fair market value of the property so acquired, paragraph 110.6(7)(b) will deny the capital gains exemption with respect to any capital gain realized on the crystallization.

requisite fair market value consideration was received by the transferor. A typical price adjustment clause will also include an adjustment to any other amounts that may be affected by the adjustment to share value such as dividends that have been paid by reference to the value of the shares, as determined prior to the adjustment.

**A. The CRA's Position**

The CRA's position with respect to price adjustment clauses is set out in *Interpretation Bulletin IT-169*<sup>9</sup> which clarifies some of the uncertainties that arose as a result of the decision of the Federal Court of Appeal in *Guilder News Company (1963) Limited et al. v. MNR*.<sup>10</sup> In *Guilder*, the court held that a price adjustment clause in respect of assets transferred by certain corporations to their shareholders was ineffective and the shareholders were therefore deemed to have received a shareholder's benefit. The basis for the court's decision was that the parties did not really attempt to determine the fair market value of the assets transferred such that their expressed intention to sell at fair market value was not genuine.

The *Guilder* case raised concerns that the use of price adjustment clauses would no longer be permitted. Accordingly, *Interpretation Bulletin IT-169* was introduced and, in it, the CRA stated that it would recognize a price adjustment clause if all of the following conditions were met:

1. the agreement reflects a *bona fide* intention of the parties to transfer the property at fair market value and arrives at that value for the purposes of the agreement by a fair and reasonable method;<sup>11</sup>
2. each of the parties to the agreement notifies the CRA by a letter attached to such party's return for the year in which the property was transferred that:
  - (a) such party is prepared to have the price in the agreement reviewed by the CCA

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<sup>9</sup> Dated August 16, 1974.

<sup>10</sup> 73 DTC 5048.

<sup>11</sup> See CRA Views 2008-0285251C6; Transfers and Loans to Corporations, for CRA's views as to how to determine a "fair and reasonable method".

- pursuant to the price adjustment clause;
- (b) such party will take the necessary steps to settle any resulting excess or shortfall in the price; and
  - (c) a copy of the agreement will be filed with the CRA if and when demanded; and
3. the excess or shortfall in price is actually refunded or paid, or a legal liability therefor is adjusted.

The foregoing requirement that the CRA be notified of any price adjustment clause has been viewed by most practitioners as having no basis at law. Thus, general practice has been to ignore this requirement even though the CRA has in the past insisted that it be complied with before the CRA would consider a price adjustment clause to be effective.<sup>12</sup> In recent years, however, the CRA has reversed its position in this regard and has stated that a failure to notify the CRA of a price adjustment clause will not in and of itself preclude the application of *Interpretation Bulletin* IT-169 if the other conditions set out in the bulletin are met.<sup>13</sup>

Where a price adjustment clause applies to a transfer in respect of which a subsection 85(1) election has been filed, the CRA used to take the position that an amended election form must be filed under subsection 85(7.1).<sup>14</sup> This position, however, has now been reversed.<sup>15</sup>

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<sup>12</sup> See, for example, "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Second Tax Conference*, 1980 Conference Report (Toronto: Canadian Tax Foundation, 1981), 591-628, question 14.

<sup>13</sup> "Revenue Canada Round Table," in *Report of Proceedings of the Forty-Second Tax Conference*, 1990 Conference Report (Toronto: Canadian Tax Foundation, 1991), 50:1-68, question 58.

<sup>14</sup> *Information Circular* IC 76-19R3, "Transfer of Property to a Corporation under Section 85," June 17, 1996, paragraph 26.

<sup>15</sup> See CRA Views, Conference 2007-0243251C6 – Price Adjustment Clause.

## **B. Effecting the Adjustment**

A price adjustment may be effected:

1. by issuing more shares, in the case of an adjustment increase, or, in the case of an adjustment decrease, by redeeming or cancelling for no payment some of the shares originally issued on the transfer (the “**Consideration Shares**”);
2. by increasing or decreasing the redemption amount of the Consideration Shares; or
3. by the corporation making a payment to the transferor equal to the amount of any adjustment increase or by having the transferor make a payment to the corporation equal to the amount of any adjustment decrease.<sup>16</sup>

The CRA has stated that, in its view, method (1) above is best avoided as it can give rise to a number of technical problems.<sup>17</sup> For example, if there has been an intervening transaction between the date of issuance of the Consideration Shares and the date of the adjustment, such as a winding-up, amalgamation or reorganization of the issuer, it might not be possible for additional shares of the same class as the Consideration Shares to be issued or for some of the Consideration Shares that were issued on the transfer to be redeemed or cancelled without payment.<sup>18</sup> The choice as to which of methods (2) or (3) to use will depend on whether any of the Consideration Shares have been redeemed or cancelled prior to the adjustment.

### 1. NO PRIOR REDEMPTION OR CANCELLATION

#### (a) Adjustments to Redemption Price

If the none of the Consideration Shares has been redeemed or cancelled prior to the adjustment, the adjustment to redemption price is relatively straightforward. All that need be

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<sup>16</sup> In paragraph 26 of *Information Circular* IC 76-19R3, *supra* footnote 14. The CRA takes the position that an acceptable price adjustment clause must adjust the price of the property transferred and the consideration received, not the quantity of the property transferred.

<sup>17</sup> *Supra* footnote 12.

<sup>18</sup> Claude Désy, ed., TAP Tax Authority Papers, 1991, B.C. Tax Study Group - Round Table 1991, *Access to Canadian Income Tax Act* (1992, Dacfo Publications Inc.), paragraph 365.

done in these circumstances is to adjust the redemption price of each Consideration Share so that the aggregate adjusted redemption price of all such shares is equal to the fair market value of the property as finally determined. Provided that the price adjustment clause forms part of the terms and conditions of the Consideration Shares (see discussion below under “Where to Include Price Adjustment Clause”), there should be no immediate tax impact to the transferor of this adjustment. Rather, any such tax impact should only be recognized at the time the Consideration Shares are redeemed and then only to the extent that the adjusted redemption price exceeds the paid-up capital of such shares<sup>19</sup> (which would more likely be the case in the event of an upward adjustment).

With regard to paid-up capital, consideration should be given to including a stated capital adjustment clause in the directors’ resolution authorizing the issuance of the Consideration Shares.<sup>20</sup> Such a clause would provide that, in those circumstances in which the price adjustment clause results in an upward adjustment to the redemption price of the Consideration Shares, the stated capital of such shares will automatically be increased by a corresponding amount. Accordingly, any additional redemption proceeds received as a result of such upward adjustment will be offset by the increase in paid-up capital, such that there will be no deemed dividend realized by the shareholder in the circumstances. Such a clause, however, is not recommended where the paid-up capital of the Consideration Shares is otherwise fixed by the Act.<sup>21</sup>

(b) Adjustment to Dividends

Although the adjustment to redemption price poses no problem in these circumstances, concerns can arise if dividends have been paid on the Consideration Shares prior to the adjustment. This is so because, as stated above, the price adjustment clause will usually require that all dividends that have been paid and calculated by reference to the unadjusted

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<sup>19</sup> Any such excess will be considered to be a deemed dividend under subsection 84(3).

<sup>20</sup> Stated capital is a corporate concept while paid-up capital is a tax concept. Paid-up capital is essentially equal to stated capital, as adjusted under the Act. Accordingly, unless the Act otherwise provides, any increase to stated capital will result in a corresponding increase to paid-up capital.

<sup>21</sup> See, for example, paragraph 84.1(1)(a) and subsections 85(2.1) and 51(3).

redemption price of the Consideration Shares, be recalculated by reference to the adjusted redemption price of such shares and that the shareholder or the corporation, as the case may be, make an adjusting payment to the other to reflect the increased or decreased dividends that should have been paid. These dividend adjustments give rise to certain tax and corporate issues.<sup>22</sup>

(i) TAX ISSUES/SHAREHOLDER: If the adjustment results in the corporation having to pay increased dividends to the shareholder, the question arises as to the year in which the shareholder must include such dividend payments in income. Are such payments to be included in income in the earlier year(s) in which such increased dividends should have been paid or in the year in which such increased dividends are, in fact, paid? On the one hand, it is arguable that, since the general rule under the Act regarding dividends is that dividends must be included in income in the year received, the shareholder should have to include such dividends in income in the year in which they are actually paid. On the other hand, based on the decisions of the Federal Court of Appeal in *Her Majesty the Queen v. Johnson & Johnson*<sup>23</sup> and *Her Majesty the Queen v. Canada Safeway Limited*,<sup>24</sup> an argument might possibly be made that such dividends should be included in income in the year(s) in which such dividend payments should have been made. The *Johnson* and *Safeway* cases, however, dealt with an adjustment to an *expense*, whereas a dividend adjustment represents an adjustment to an income *receipt*. Accordingly, the *Johnson* and *Safeway* decisions may not be of much assistance in resolving this issue.<sup>25</sup>

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<sup>22</sup> The concurrent, retroactive adjustment to dividends, although usually incorporated into the price adjustment clause, arguably need not be a part of any such adjustment. The CRA has stated that a dividend right is not necessary to establish share value (although it would prefer that the share bear a reasonable dividend rate). (See "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Third Tax Conference*, 1981 (Toronto: Canadian Tax Foundation, 1982), 726-66, question 45. Accordingly, one might consider fixing the dividend rate by reference to the redemption price of the share, as originally determined, and specifically providing that dividends will not be adjusted in the event of a redemption price adjustment. Such an approach would avoid the issues that arise with respect to retroactively adjusted dividends.

<sup>23</sup> 94 DTC 6125. This case involved the payment of a federal sales tax refund in 1982 in respect of the taxpayer's 1975-1981 taxation years. The court held that although the refund became receivable by the taxpayer in 1982, it had to be included in the income in the year to which such federal sales tax refund applied.

<sup>24</sup> 98 DTC 6060. This case also involved a federal sales tax refund and the same timing issues as in the *Johnson* case.

<sup>25</sup> See, however, *Kotylak, D. v. The Queen*, [2004] 5 CTC 2226 (TCC) (Informal Procedure).



It is interesting to note that the CRA takes an approach similar to the court in *Johnson* when dealing with certain expense adjustments arising as a result of the operation of a price adjustment clause. Specifically, in paragraph 3 of *Interpretation Bulletin* IT-169, the CRA states that:

In recognizing the price adjustment clause, appropriate adjustments in computing the income of all parties to the agreement will be made in their taxation years in which the property was transferred. If the purchasers filed returns and claimed capital cost allowances, deductions from income based on cumulative eligible capital, or exploration and development expenses in respect of the property for taxation years subsequent to that in which it was transferred, any necessary adjustments will be made in *those subsequent years*. Likewise, any reserve claimed by the vendor to defer the reporting of income will be adjusted. *(emphasis added)*

Unfortunately, however, the bulletin does not go on to deal with income receipt adjustments.

Similar issues arise if the shareholder is required to repay dividends previously received. In such circumstances, the concern is whether the shareholder will be permitted to refile his/her return for the year(s) in which such dividends were received so as to reduce his/her income for those years by the amount of the repayments. If the shareholder is not permitted to do so, there appears to be no other basis upon which the taxpayer can receive “credit” for such repayment, in which case the repayment will simply represent a non-deductible outlay to the shareholder.

(ii) TAX ISSUES/CORPORATION: A question also arises as to the tax treatment of a dividend repayment in the corporation’s hands. One would assume, however, that such payment would not be taxable to the corporation either because it represents a refund of an amount previously paid in error or because it can be characterized as a capital contribution made by the shareholder to the corporation.

(iii) CORPORATE ISSUES: Under corporate law, a corporation must meet certain solvency tests before it can declare or pay a dividend.<sup>26</sup> Accordingly, where the adjustment involves increased dividends having to be paid by the corporation, the question arises as to

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<sup>26</sup> See, for example, section 38(3) of the *Business Corporations Act* (Ontario).

whether the corporation must meet these solvency tests in the year in which such increased dividends should have been paid or in the year in which they are actually paid. Arguably, since the solvency tests are designed to protect creditors of the corporation, it would make sense for these tests to be applied in the year in which the dividends are actually paid and cash flow of the corporation is actually affected.

## 2. PRIOR REDEMPTIONS OR CANCELLATIONS

### (a) Adjustments to Redemption Price

(i) ADJUSTING REDEMPTION PRICE OF OUTSTANDING CONSIDERATION SHARES: If some of the Consideration Shares have been redeemed or cancelled prior to the adjustment, it may be possible for the adjustment to be effected by increasing or decreasing the redemption price of each Consideration Share outstanding as at the time the adjustment is made. The adjustment to each such outstanding Consideration Share would be equal to the amount of the adjustment divided by the aggregate number of outstanding Consideration Shares. The benefit of this type of adjustment is that, as is described above, there should be no immediate tax consequences to the shareholder, provided that this form of price adjustment clause is contained in the terms and conditions of the Consideration Shares (see discussion below under “Where to Include Price Adjustment Clause”). There are, however, problems with an adjustment of this kind.

Firstly, the adjustment will not operate properly if there is more than one shareholder and not all the shareholders’ Consideration Shares have been previously redeemed or cancelled. For example, assume that Mr. and Mrs. X each transfers his/her interest in a jointly-owned property to Company A in exchange for redeemable, retractable shares of Company A, having an aggregate redemption price equal to the fair market value of that property, as initially determined. The terms of the shares include the type of price adjustment clause referred to above. The fair market value of the property is ultimately determined to be higher than that originally determined. However, prior to such determination, Mrs. X retracts all her shares. In these circumstances, the price adjustment clause would operate to allocate the *full* adjustment to Mr. X’s shares - a result that is clearly inappropriate and one that will not assist either Mr. X or Mrs. X with the problem of having received inadequate consideration on the transfer (that is,

Mr. X will have received too much consideration while the consideration received by Mrs. X will still be inadequate).

Secondly, where the adjustment is a downward adjustment requiring a decrease in the redemption price of the Consideration Shares, it is possible that the aggregate redemption price of the Consideration Shares outstanding on the date of adjustment will be insufficient to absorb the full adjustment amount.

Thirdly, this type of adjustment may not, in fact, address the concern that the shareholder must be considered to have received fair market value consideration as *at the date of transfer* - that is, although this type of price adjustment clause increases the aggregate consideration received by the shareholder to the correct amount, it is not clear that it does so retroactively to the date of transfer since the adjustment is not made with reference to all the Consideration Shares issued on the transfer.

(ii) ADJUSTING REDEMPTION PRICE OF ALL CONSIDERATION SHARES: The better approach to price adjustment in these circumstances is to adjust the redemption price of *all* the Consideration Shares originally issued, by retroactively increasing or decreasing the redemption price of each such share. This type of adjustment will result in an increase or decrease to the redemption price of those Consideration Shares still outstanding on the date of adjustment and a payment by the corporation to the shareholder (in the case of an increase) or by the shareholder to the corporation (in the case of a decrease) in respect of the Consideration Shares that have already been redeemed or cancelled.

(A) Tax Issues/Shareholder: From the shareholder's perspective, the downside to this approach, as opposed to the first approach, is that a payment made by the corporation to the shareholder may result in immediate tax consequences to the shareholder. Whether or not such tax consequences arise will depend on the characterization of the payment in the shareholder's hands. Two possible characterizations are as follows:

The payment can be characterized as additional redemption proceeds. The theory underlying such a characterization is that when the corporation redeemed or cancelled the shares, it did not (as was subsequently determined) pay the full redemption price owing. Accordingly,

the adjusting payment simply represents a late payment of a portion of the price payable on redemption or cancellation. If this characterization is correct, it would appear that the shareholder will be required to include these additional redemption proceeds in income in the year in which the Consideration Shares in question were redeemed or cancelled. Specifically, in *Cabezuelo v. MNR*,<sup>27</sup> the Tax Court of Canada stated:

I disagree that the deemed dividend in the subsection is to be determined by reference to what was actually paid and when ... as I construe subsection 84(3), a corporation is deemed to have paid the dividend at the time of the acquisition of its shares and, *even if the consideration for the shares acquired is payable over a considerable period of time, it must, for the purposes of income tax law, be regarded as being payable at the time of the acquisition. (emphasis added)*

In such circumstances, the shareholder may or may not suffer any adverse tax consequences, depending on whether the paid-up capital of the Consideration Shares that were redeemed or cancelled is correspondingly increased by the amount of the redemption price adjustment (see discussion above regarding paid-up capital adjustment). If there is such an adjustment to paid-up capital, there will be no additional deemed dividend arising on the redemption and thus no additional tax for the shareholder to pay.

If the shareholder is required to repay a portion of the redemption proceeds received, such adjustment should arguably also be accounted for in the year of redemption or cancellation to be consistent with the timing approach adopted in *Cabezuelo*. Accordingly, unless such year is statute-barred, the shareholder should be able to refile his/her return to reflect the reduced redemption proceeds received. Presumably, however, the shareholder would only do so, if he/she was deemed to have received a dividend (and/or a capital gain) on the initial redemption. If no such dividend was deemed to have been received (or no such capital gain realized), the downward adjustment of redemption proceeds will have no impact on the shareholder and thus there would be no reason to refile his/her return.

The payment could alternatively be characterized as proceeds of disposition of the shareholder's right to receive such additional amounts. Such a characterization is premised on

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<sup>27</sup> 83 DTC 679. See also "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Sixth Tax Conference*, 1984 Conference Report (Toronto: Canadian Tax Foundation, 1985), 783-845, question 45.

the analysis that when the Consideration Shares were redeemed or cancelled, the redemption proceeds consisted of the original redemption price of the shares plus a promise to pay such further amount, if any, as would be necessary to give effect to the price adjustment clause.<sup>28</sup> At the time of redemption, the value of this promise to pay was arguably nil if there was no reasonable expectation that the price adjustment clause would be called into operation. The shareholder, therefore, did not include, as part of the redemption proceeds, any amount in respect of this promise to pay and, accordingly, this right to receive future payments, if any, under the price adjustment clause had a cost to the shareholder of nil. When the price adjustment clause is, in fact, called into operation and an amount paid pursuant thereto, the amount so paid represents the proceeds of disposition to the shareholder of the foregoing right. Assuming that such right is capital property in the shareholder's hands, ½ of the payment will be required to be included in the shareholder's income. If the right does not represent capital property to the shareholder, then the full amount of such payment will be required to be included in income. Thus, unlike the first characterization referred to above, the tax consequences to the shareholder under this characterization must be accounted for in the year of adjustment.

The CRA's approach to this issue was expressed in a Round Table discussion.<sup>29</sup> In response to a question as to how increased redemption proceeds are to be treated if received after the redemption of the shares in question, the CRA stated that such proceeds are to be treated, from the perspective of both the payor and the payee, as a dividend (presumably, to the extent that such proceeds, together with the proceeds received on the actual redemption, exceeded the paid-up capital of the shares redeemed). The reasons for such treatment are as follows:

- the payment results from a right relating to a share;
- the payment is made by reason of a redemption of shares referred to in subsection 84(3) of the Act and the payment is accessory to such redemption;
- treating the payment as a capital payment would change the nature of the payment

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<sup>28</sup> *Ibid.*

<sup>29</sup> See "Federal Taxation Round Table", 1998 APFF Congress, in CCH Tax Window Files [this is an online database], question 23.

otherwise made or the income otherwise realized; and

- this position promotes uniform treatment of shareholders and corporations in respect of the application of subsection 84(3).

Unfortunately, the response does not deal with the issue of timing although it appears implicit in the response that the additional dividend would be included in the shareholder's income in the year of receipt, and not in the year of redemption.

(B) Tax Issues/Corporation: Adjustment payments made to the corporation in respect of redemption proceeds should not be taxable in the corporation's hands for the same reasons that dividend adjustment payments should not be so taxable.

(C) Corporate Issues: As in the case of dividend payments, a corporation is generally required to meet certain solvency tests before it can redeem or cancel its shares.<sup>30</sup> The question, therefore, also arises in this context as to whether these solvency tests must be met in the year of the adjustment or in the year of redemption or cancellation. Again, there is no clear answer to this question but, arguably, these tests should be applied in the year in which any additional redemption proceeds are actually paid and cash flow of the corporation is actually affected.

(b) Adjustments to Dividends

The considerations described above with respect to adjustments to dividends also apply in these circumstances.

**C. Where to Include Price Adjustment Clause<sup>31</sup>**

It is probably best that the price adjustment clause be included in both the share terms and the transfer agreement. By including a price adjustment clause in the share terms, one precludes the argument that a later adjustment to the redemption amount of the shares or the dividends payable in respect of the shares results in a change to the shares that is so significant

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<sup>30</sup> See, for example, subsections 32(2) and 30(2) of the *Business Corporations Act* (Ontario).

<sup>31</sup> *Supra* footnote 18.

that the share is deemed to be disposed of and a new share acquired in its stead.<sup>32</sup> As well, by including the price adjustment clause in the transfer agreement itself, one is assured that there will be a price adjustment clause in effect even if the shares are all redeemed prior to the time that the price adjustment clause is invoked. Accordingly, if it is determined, after the shares are all redeemed, that the value of the share should have been different than the value originally attributed to such shares, the former shareholder will generally not be able, under corporate law, to use the share provision rights to claim the adjustment. In these circumstances, the price adjustment clause in the transfer agreement may be relied upon to effect such adjustment.

Sample price adjustment clauses for both share terms and transfer agreements are attached as an addendum to this paper. It should be noted that, in these clauses, the triggering event for the adjustment is either an agreement with the relevant taxation authority as to the correct value or, failing such agreement, a determination by the corporation's auditors or independent accountants retained by the corporation as to such value. Many price adjustment clauses, however, fix the triggering event as either an agreement with the relevant taxation authority as to value or, failing such agreement, a court adjudication as to such value from which all further rights of appeal have expired. The sample clauses attached hereto do not refer to a court adjudication because such adjudication appears to be of no assistance to the taxpayer.

For example, assume that the CRA asserts that the fair market value of the property transferred by a taxpayer to its non-arm's-length corporation (in exchange for Consideration Shares of that corporation) was \$150 as opposed to \$100, the latter figure being the fair market value of the property at the time of transfer, as determined by the taxpayer and the corporation. The taxpayer and the corporation dispute the CRA's \$150 valuation and the parties cannot ultimately come to an agreement on this valuation issue. The CRA will then likely reassess the taxpayer pursuant to paragraph 69(1)(a) on the basis that the taxpayer is deemed to have received proceeds of \$150 on the transfer (as opposed to the \$100 of proceeds originally reported) and should, accordingly, pay tax on \$50 of additional proceeds.

The problem is that if the court agrees with the CRA's valuation and the resulting

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<sup>32</sup> Interpretation Bulletin IT-448, "Disposition - Changes in Terms of Securities", June 6, 1980. See also *Rundell Seaman v. MNR* [1990] 2 CTC 2469 (TCC).

applicability of paragraph 69(1)(a), the taxpayer will immediately become liable to pay tax on the extra \$50 of proceeds *upon* the court's decision to that effect being rendered (that is, *before* the price adjustment clause is triggered). Thus, when the price adjustment clause does "kick in" (which would occur after the appeal period from the court's decision has expired), it is too late for the adjustment to be of any assistance since the taxpayer will already have suffered the very tax consequences that the clause was designed to avoid.<sup>33, 34</sup> In addition, as a result of the price adjustment becoming operative, the value of the Consideration Shares will now be increased to \$150. Consequently, the taxpayer will have the worst of both worlds - he/she will have to pay the tax assessed pursuant to paragraph 69(1)(a) and he/she will now own Consideration Shares having a value of \$150, which is \$50 more consideration than the taxpayer originally wanted to receive.

## **AGREED AMOUNT FOR PURPOSES OF SUBSECTION 85(1) ROLLOVER**

Where property is transferred to a corporation pursuant to subsection 85(1), the transferor and the corporation will generally agree to have that transfer take place at an amount equal to the cost amount of that property to the transferor. This cost amount is usually easily

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<sup>33</sup> The subsequent adjustment to value would not appear to nullify or vitiate the court's decision notwithstanding the retroactive nature of the adjustment. Note, however, that in a recent Round Table discussion, the CRA stated that, in the context of an estate freeze where the terms of the preferred shares include a price adjustment clause based on fair market value as ultimately determined by a court, the CRA will give effect to the price adjustment clause and not apply paragraph 85(1)(e.2) or subsection 51(2) or 86(2), as the case may be, provided that the parties have made:

- (a) a *bona fide* attempt to deal at fair market value;
- (b) reasonable efforts to determine fair market value; and
- (c) the adjustments stipulated by the price adjustment clause on the basis of the fair market value as established by the court.

However, in order for the court to rule on the fair market value issue in the first place, it would be necessary for the Department to assess the transferor on the basis of paragraph 85(1)(e.2) or subsection 51(2) or 86(2), as the case may be. What the CRA appears to be saying, therefore, is that it will assess on the basis of these provisions in order to put the fair market value issue before the court, but if the parties thereafter comply with the price adjustment clause and make the necessary adjustments to reflect the court's fair market value determination, the CRA will not, in fact, enforce the court's judgment. (See "Federal Taxation Round Table", *supra* footnote 28, question 22.)

<sup>34</sup> See *Nussey Estate v. The Queen*, 2001 DTC 5240 (FCA) which illustrates this type of timing problem.



ascertainable unless the property was acquired prior to December 31, 1972 (“**V-day**”). Where the agreed amount is based on the V-day value, the transferor and the corporation may wish to include an adjustment clause in the transfer agreement which will have the effect of adjusting the V-day value (and thus the agreed amount) if it should subsequently be determined that the V-day value is greater or less than the V-day value originally determined. Such an adjustment clause, however, is not necessary since the CRA takes the position that an amended subsection 85(1) election can be filed in these circumstances pursuant to subsection 85(7.1).<sup>35</sup>

## **CONCLUSION**

The foregoing discussion describes many of the technical problems to which price adjustment clauses give rise. Despite these various problems, however, one does not hear or read much about them. Accordingly, one can only assume that price adjustment clauses are either not invoked very often or that, when invoked, they are dealt with by the CRA in a manner that is generally acceptable to the taxpayers in question.

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<sup>35</sup> Paragraph 17(a) of *Information Circular* IC 76-19R3, *supra* footnote 14. See also *Technical Interpretation* 2007-0243251C6 “Price Adjustment Clause – Section 15(1), 85(1)(e.2), 69(1)”, regarding price adjustment clauses and the subsection 85(7.1) election.

**ADDENDUM****SAMPLE PRICE ADJUSTMENT CLAUSE****ARTICLES**

“Class A redemption price” means, with respect to all the Class A shares, an amount determined by the directors of the Corporation to be equal to the fair market value of the consideration for which all the Class A shares were issued (the “Consideration”) **[together with any declared and unpaid dividends]**; but if any taxing authority having jurisdiction issues or proposes to issue an assessment or reassessment of tax on the basis that the fair market value of the Consideration was more or less than the amount so determined by the directors of the Corporation, the Class A redemption price shall be adjusted, effective as of the date of issuance of the Class A shares, to be, as applicable:

- (i) the amount determined by the relevant taxing authority to be the fair market value of the Consideration if such amount is agreed to by the Corporation (as evidenced by a resolution of directors) and all the holders of Class A shares (as evidenced by a written acknowledgement thereof) including, for such purpose, all holders of Class A shares whose shares have been redeemed **[or purchased for cancellation]** as at the date of such assessment or reassessment (together, “Holders”); or
- (ii) in the absence of such agreement by the Corporation and the Holders, the amount determined by the Corporation’s auditors **[or independent accountants retained by the Corporation]** to be the fair market value of the Consideration.

If any such assessment or reassessment occurs after any Class A share has been redeemed **[or purchased for cancellation]**, then the amount of such adjustment due to Holders whose Class A shares have been redeemed **[or purchased for cancellation]** shall be treated as follows:

- (iii) if such adjustment results in an increase to such redemption price, such increase shall constitute indebtedness due by the Corporation to such Holders as at the date of redemption **[or purchase for cancellation]** of such Class A shares; and
- (iv) if such adjustment results in a decrease in such redemption price, such decrease shall constitute indebtedness due by such Holder to the Corporation as at the date of redemption **[or purchase for cancellation]** of such Class A shares;

In the event of an adjustment that results or, but for the redemption of all Class A shares would result, in an increase or decrease in the Class A redemption price, then the Corporation and each Holder shall make such additional adjustments to or in respect of the Class A shares held or formerly held by each Holder as may be necessary to give effect to such adjustment to the redemption price.

**SAMPLE PRICE ADJUSTMENT CLAUSE**  
**TRANSFER AGREEMENT**

**I. Purchase Price Adjustments**

A. Redemption Price Adjustments - The Vendor and the Purchaser intend that the Purchase Price be equal to the fair market value of the Shares. Therefore, if any taxing authority having jurisdiction issues or proposes to issue an assessment or reassessment of tax on the basis that the fair market value of the Shares was more or less than the Purchase Price, then the Vendor and Purchaser agree to adjust the Purchase Price, effective as of the Closing Date to be, as applicable:

1. the amount determined by the relevant taxing authority to be the fair market value of the Shares if such amount is agreed to by the Purchaser (as evidenced by a resolution of its directors) and all the holders of Shares (as evidenced by a written acknowledgement thereof) including, for such purpose, all holders of Shares whose shares have been redeemed [**or purchased for cancellation**] as at the date of such assessment or reassessment (together, “Holders”); or

2. in the absence of such agreement by the Corporation and the Holders, the amount determined by the Corporation’s auditors [**or independent accountants retained by the Corporation**] to be the fair market value of the Shares as of the Closing Date.

Any such increase or decrease in the Purchase Price provided for in this section shall be effected by increasing or decreasing, as the case may be, the redemption price of the Shares outstanding at the time of such agreement (in the case of clause (1)) or determination (in the case of clause (2) above), all as provided in the terms and conditions attaching to the Shares. If any such assessment or reassessment occurs after any Share has been redeemed [**or purchased for cancellation**], then the amount of such adjustment in respect of such Share shall be treated as follows:

3. if such adjustment results, or would have resulted, in an increase to such redemption price, such increase shall constitute indebtedness due by the Purchaser to the Vendor as at the date of redemption [**or purchase for cancellation**] of such Share; and

4. if such adjustment results, or would have resulted, in a decrease in such redemption price, such decrease shall constitute indebtedness due by such Holder to the Purchaser as at the date of redemption [**or purchase for cancellation**] of such Share.

B. Other Adjustments: In the event of an adjustment that results or, but for the redemption [**or purchase for cancellation**] of all the Shares, would result in an increase or decrease in the redemption price of the Shares as contemplated in Section A, then the Vendor and the Purchaser shall make such additional adjustments to or in respect of the Shares as may be necessary to give effect to such adjustment to the redemption price.

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