Date: 20101026

Docket: A-507-09

Citation: 2010 FCA 284

CORAM: **EVANS J.A.**
SHARLOW J.A.
STRATAS J.A.

BETWEEN:

KATO KRAUSS

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard at Toronto, Ontario, on October 26, 2010.

Judgment delivered from the Bench at Toronto, Ontario, on October 26, 2010.

REASONS FOR JUDGMENT OF THE COURT BY: SHARLOW JA

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REASONS FOR JUDGMENT OF THE COURT
(Delivered from the Bench at Toronto, Ontario, on October 26, 2010)

SHARLOW J.A.

[1] Ms. Kato Krauss is appealing the judgment of Justice McArthur of the Tax Court of Canada (2009 TCC 597) dismissing her appeals of tax assessments for 1992, 1993 and 1994 under the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.). The appeal to this Court involves one issue in relation to 1994, and two issues in relation to 1992. We have concluded, for the following reasons, that this appeal must be dismissed.

1994 – Partnership income allocation

[2] For 1994, the principal issue in this Court is whether the Minister was justified in relying on section 103(1.1) of the *Income Tax Act* to reallocate the 1994 income of the Krauss Partnership. Subsection 103(1.1) reads as follows:

103 (1.1) Where two or more members of a partnership who are not dealing with each other at arm's length agree to share any income or loss of the partnership or any other amount in respect of any activity of the partnership that is relevant to the computation of the income or taxable income of those members and the share of any such member of that income, loss or other amount is not reasonable in the circumstances having regard to the capital invested in or work performed for the partnership by the members thereof or such other factors as may be relevant, that share shall, notwithstanding any agreement, be deemed to be the amount that is reasonable in the circumstances.	103(1.1) Lorsque plusieurs associés d'une société de personnes qui ont, entre eux, un lien de dépendance conviennent de partager tout revenu ou toute perte de la société de personnes, ou tout autre montant qui se rapporte à une activité quelconque de la société de personnes, et qui doit entrer en ligne de compte dans le calcul du revenu ou du revenue imposable de ces associés et que la part du revenu, de la perte ou de cet autre montant revenant à l'un de ces associés n'est pas raisonnable dans les circonstances, compte tenu du capital qu'il a investi dans la société de personnes ou du travail qu'il a accompli pour elle ou de tout autre facteur pertinent, cette part est réputée, indépendamment de toute convention, être le montant qui est raisonnable dans les circonstances.

[3] The Minister relied in the alternative on subsection 103(1) or subsection 74.1(2) of the *Income Tax Act*, but we do not consider it necessary to consider those provisions.

[4] The Krauss Partnership was formed in 1992. Ms. Krauss and her son Larry became equal partners. They each acquired an equal number of redeemable Class A units in the Partnership in

exchange for a 50% undivided interest in certain real property. They were each credited with a capital contribution in an amount equal to the value of a 50% undivided interest in the contributed property at the time of the contribution. Other property was later contributed to the Partnership on a similar basis for Class B units. In 1993, the Krauss Family Trust contributed $100 to the Partnership and received in return 100 Class C Units.

[5] In 1994, the Partnership made a profit of $343,431. According to the partnership agreement, $108,355 of that profit was allocated to the Class A units and the balance, $126,721, was allocated to the Class C units. The Minister assessed Ms. Krauss to increase her income allocation for 1994 by $63,360 (50% of the partnership profit that had been allocated to the Class C units). Justice McArthur concluded that subsection 103(1.1) was properly applied because the allocation of $126,721 of income to the holders of the Class C units for 1994 was unreasonable, given that the holders of the Class C units contributed only $100 of capital and provided no services to the Partnership.

[6] It was argued for Ms. Krauss in the Tax Court and in this Court that, despite the nominal contributions of the holders of the Class C units, their income allocation was reasonable because it gives effect to the partnership structure chosen for the Partnership, which was functionally analogous to the kind of corporate estate freeze that is generally considered acceptable income tax planning. Justice McArthur rejected that argument on the basis that the partnership structure deviated substantially from a typical estate freeze. That conclusion is not wrong in law and, in so far as it was a factual determination, it was reasonably open to Justice McArthur on the record before

him. We recognize that he did not appreciate that holders of Class A units who were required to pay cash calls would receive 1 Class D unit per dollar. However, we do not consider that misunderstanding to be a material error. We see no basis for appellate intervention on this issue.

[7] We note that Justice McArthur accepted the notion that it is possible to achieve an acceptable estate freeze through a partnership. We do not consider it necessary to express an opinion on that issue and we decline to do so.

1992 – income or capital

[8] In 1992, Ms. Krauss sold her 20% interest in certain real property to Kraussco Investments Ltd. at a loss, which she claimed as a deduction on income account. She was reassessed on the basis that the loss was a capital loss. Justice McArthur concluded that the loss was a capital loss, for reasons that he stated. That was a finding of mixed law and fact that must stand absent an error of law or a palpable and overriding error of fact. The record discloses no such error.

1992 – deduction for reduction in account receivable

[9] In 1990, Elkay Consultants Inc. (a corporation owned and controlled by Larry Krauss) was retained to provide marketing services to the Blythwood Limited Partnership. At the time, it was apparently agreed that the compensation payable for those services was approximately $200,000. In 1990, Elkay Consultants Inc. assigned to the Brewers Joint Venture the account receivable representing that compensation. Ms. Krauss had an interest in the Brewers Joint Venture and reported her share of the assigned amount as income. By 1992, circumstances caused the parties to

conclude that the amount of the compensation payable by Blythwood Limited Partnership should be reduced. Ms. Krauss claimed her share of the reduction of the account receivable, approximately $24,000, as a deduction in computing her 1992 income. The deduction was denied on the basis that it was not an outlay or expense incurred to earn income.

[10] Justice McArthur concluded that the assignment of the account receivable by Elkay Consultants Inc. to Brewers Joint Venture did not represent compensation for any services provided by Brewers Joint Venture, and so it followed that the assigned amount did not represent an amount receivable by them for services and that there was no basis for the deduction when the receivable was reduced. That was a factual conclusion that was reasonably open to Justice McArthur on the record before him. There is no basis for appellate intervention.

Conclusion

[11] The appeal will be dismissed with costs.

"K. Sharlow"

J.A.

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKET:	A-507-09

(AN APPEAL FROM THE JUDGMENT OF THE HONOURABLE MR. JUSTICE C.H. MCARTHUR FROM THE TAX COURT OF CANADA, DATED NOVEMBER 19, 2009, IN TAX COURT FILE NO. 2006-2858(IT)(G)).

STYLE OF CAUSE:	KATO KRAUSS v. HER MAJESTY THE QUEEN
PLACE OF HEARING:	TORONTO, ONTARIO
DATE OF HEARING:	OCTOBER 26, 2010
REASONS FOR JUDGMENT OF THE COURT BY:	(EVANS, SHARLOW, STRATUS JJ.A.)
DELIVERED FROM THE BENCH BY:	SHARLOW J.A.

APPEARANCES:

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