Takeovers and Tax Issues

20th Taxation of Corporate Reorganization Conference

January 27, 2016

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CUMMINGS COOPER SCHUSHEIM BERLINER LLP

Takeovers and Tax Issues

1. Acquisition of Control Issues
2. Planning for the Vendor
   - Tax-deferred rollovers
   - Earnouts
   - Safe income planning
   - Proposed amendments and s.s. 55(2)
3. Planning for the Purchaser
   - Structuring
   - Financing
4. Takeover/Reorganization Expenses/Receipts
5. Other Considerations

1. Acquisition of Control Issues

Acquisition of Control Issues

- Takeover bid will often = acquisition of control
  A person or group of persons who acquire more than 50% of the voting stock acquire control of a corporation
- Provision deems control to have been acquired or not to have been acquired for specific provisions (e.g., s.s. 256(7))
- Provision deems corporation to be controlled for associated corporation rules (e.g., s.s. 256(1.2), s.s. 256(1.4))
- Provision deems corporation to be controlled for "related person" rules and for purposes of definition of "Canadian-controlled private corporation" (e.g., 251(5))

Acquisition of Control and Timing

Timing

- Deemed to occur at commencement of the day unless elect in return not to have s.s. 256(9) apply
- If election made, time control legally acquired, under commercial law principles = time of Acquisition of Control (AOC) for tax purposes

Implications of Acquisition of Control

- Deemed year end immediately before time of AOC and new year deemed to have commenced at time of AOC
    - Requirement to file tax return and pay taxes
    - Shorter carry-forward/carry-back periods
    - Pro-ration for capital cost allowance
    - Income inclusion of unpaid amounts (s.s. 78(1))
    - Deduction denial for unpaid salary and bonuses (s.s. 78(4))
    - Income inclusion of shareholder loans (s.s. 15(2))
    - Imputed interest on loans to non-residents (s.s.17(1))

Implications of Acquisition of Control, cont'd.

- Recognition of reserves on inventory and capital gains
- Inventory write-down (s.s. 10(10))
- Contributions to plans (RPP, EPSP, DPSP)
- Time to acquire replacement properties (s.s. 13(4), 14(6) and 44(1))
- Loss of capital dividend account (s.s. 89(1.1))
- Restrictions on use of investment tax credits (s.s. 127(9.1) and (9.2))
- Reduction in SR&ED expenses (s.s. 37(6.1)
- Restriction on use of Charitable Donation Carryforward (s.s. 110.1(1.2)

Acquisition of Control and Losses

Use of Losses – Capital Losses

- Capital loss carryforward balances are lost and new capital losses can only be applied against post-AOC gains

Use of Losses – Non-Capital Losses

- Pre-AOC non-capital losses may be carried forward and deducted if <u>same business</u> carried on by corporation for profit or with reasonable expectation of profit and only to extent of corporation’s income from <u>that business</u>

Acquisition of Control and Losses

Use of Losses - Non-Capital Losses – cont'd

- Post-AOC non-capital losses can be carried back against income from pre-AOC business if criteria for carrying forward non-capital losses satisfied
- Vertical amalgamation (parent and wholly-owned subsidiary)—post-amalgamation losses may be carried back against predecessor parent corporation
- Subsidiary's prior year losses can't be carried back against parent's prior year income

Acquisition of Control and Non-Depreciable Capital Property

- Inherent loss = ACB of non-depreciable property exceeds FMV immediately before AOC, excess deducted from ACB and deemed to be capital loss in year ending on AOC
- If no inherent loss—possible designation deeming non-depreciable property to be disposed of for proceeds equal to lesser of:
  - FMV of property
  - ACB of property (or greater amount as designated)

Acquisition of Control and Depreciable Property

- If depreciable property in prescribed class has inherent loss, in computing pre-AOC income:
    - required to deduct excess of UCC of class over aggregate FMV of all property of class and amount of CCA or terminal loss otherwise deductible in computing income in respect of class in year ending on AOC
- Unrealized terminal losses converted into non-capital losses
- Deemed to be CCA allowed under 20(1)(a)

Depreciable Property – No Inherent Loss

- If depreciable property of class and no inherent terminal loss, election can be made deeming property to have been disposed of for amount not exceeding FMV

Acquisition of Control and Eligible Capital Property

- Amount by which CEC exceeds 75% of FMV of ECP and amount otherwise deductible under paragraph 20(1)(b) must be claimed as a deduction in computing income
- Note: Federal Budget 2014 announced public consultation on proposal to repeal eligible capital property regime and replace it with a new capital cost allowance class available to businesses and transfer taxpayers' existing cumulative eligible capital pools to the new capital cost allowance class.
- Under the proposal, expenditures which are currently added to cumulative eligible capital (at a 75% inclusion rate) would be included in the new capital cost allowance class at a 100% inclusion rate. The new class would have a 5% annual depreciation rate (vs. 7% of 75% of eligible capital expenditures)

Acquisition of Control and Doubtful/Bad Debts

- No amount deducted as doubtful debt in computing income for year ending on AOC
- Maximum amount that would be deductible as doubtful debt deemed to be separate debt owing that became a bad debt and must be deducted

Deemed Taxation Year End

- "Loss Restriction Events" trigger deemed year-end immediately before time of events and new taxation year deemed to begin at that time:
  - Trusts—Where a person becomes a majority interest beneficiary of a trust the Act now deems there to be an acquisition of control of the Trust.
  - Corporation
    - Control of corporation is acquired by person or group of persons
    - If control of corporation acquired within 7 days of corporation's preceding taxation year having ended, corporation can (unless intervening acquisition of control) elect to extend preceding taxation year to include additional days
- Corporation ceases to be a Canadian-controlled private corporation, deemed taxation year end immediately before that time and new taxation year deemed to begin at that time

Deemed Acquisition of Control

- To address Finance's perceived circumvention by taxpayer's of loss-streaming provisions
- Deemed AOC of corporation that has loss pools where person or group of persons acquire shares of the corporation having more than 75% of the fair market value of all the shares of the corporation, without otherwise acquiring control of the corporation, if it is reasonable to conclude that one of the main reasons that control was not acquired was to avoid restrictions that would have been imposed on the use of loss pools

Letters of Intent & Closing

- Letters of intent or "term sheets" often first document produced in acquisition transaction
- Letters of intent can be binding or non-binding
- Most non-binding, with certain exceptions (e.g., confidentiality, costs, exclusivity)
- Question—having intention to creating legally binding obligations, parties reach consensus on essential terms of bargain
- Letter of Intent should set out intention of parties

Letters of Intent & Closing

- If letter of intent binding (unusual)
  - May create right or option within meaning of para. 251(5)(b)
  - Association issues may also arise under s.s. 256(1.4)—deeming rule where right or option to acquire shares of target
  - If target corporation is CCPC but not purchaser, signing binding letter of intent results in change in CCPC status
  - Deemed year end immediately on signing letter of intent and year end on closing
- Same circumstance if target CCPC but not purchaser and not "sign and close"
- Association issue
- Capital gains exemption still available (to extent otherwise was)—subpara. 110.6(14)(b)

2. Planning for the Vendor

Planning for the Vendor

- Cash takeover bid, vendor can’t defer gain

Capital Gains Reserve

- Reserve may be available in respect of debt consideration (para. 40(1)(a)(iii))

Tax-Deferred Rollovers

- Deferral of vendor’s gain may be available in case of share consideration consisting of shares of purchaser
  - s. 85
  - s. 85.1
- Deferral for vendor may also be available on takeover by way of amalgamation (s. 87)

Capital Gains Reserve

- Not a "rollover" but method of tax deferral
- Not exceeding 5 years
- Reasonable reserve
- Minimum 20% reported each year
- Reserve in one year is capital gain for next year
- Planning--Take back debt on sale with proceeds payable over 5 years
- In order to claim the reserve, an amount must not "be due" until after the end of the year
    - If there is an entitlement to enforce payment in the year, the reserve may not be claimed

Tax-Deferred Rollovers-s. 85

- Disposition of "eligible property" to a taxable Canadian corporation
- Consideration includes shares of purchaser
- Joint election filed (Form T2057)
- Elected amount (as adjusted)=proceeds of disposition to vendor and cost of property to purchaser
- <u>Cost</u> to vendor of <u>purchaser shares</u> = elected amount <u>less</u> FMV of non-share consideration

Tax-Deferred Rollovers-s. 85

- General Limits on elected amount
  - can't exceed FMV of property sold
  - can't be less than FMV of non-share consideration
  - can't be less than lesser of FMV of property sold and ACB of the property
- Specific limits on elected amount for depreciable assets and eligible capital property
  - Paragraph 85(1)(d.11) re recaptured eligible property deductions
- Conflict in deeming rules (paragraph 85(1)(e.3))

Tax-Deferred Rollovers-s. 85.1

- Vendor's shares must:
    - be capital property
    - of taxable Canadian corporation
- Vendor's shares can be of any class – (i.e., common or preference)
- Vendor must take back shares of a "Canadian" corporation
- Vendor must take back previously unissued shares of one class of the purchaser corporation

When will s.85.1 Not Apply?

- If immediately before share exchange:
  - Vendor and purchaser are non-arm's length
- If immediately after share exchange Vendor (and non-arm's length persons) either:
  - controlled purchaser; OR
  - own shares representing more than 50% of the FMV of all shares of the purchaser
- If vendor includes any portion of gain/loss in income
- If vendor and purchaser file a section 85 election
- If non-share consideration received by vendor for exchanged shares (subject to discussion on next slides)

Tax Deferred Rollovers-s.s. 85.1(2)(d)

Non-Share Consideration

- IT-450R vendor must be able to clearly identify which shares exchanged for cash and which exchanged for shares
- IT-450R tracking
  - X shares for cash
  - Y shares for shares
  - Rollover for Y shares
- Similar CRA position for different classes of shares of purchaser corporation

Tax-Deferred Rollovers-s. 85.1

Fractionalization

Offer must specify the fractions

Formula based on relative FMV of consideration taken back for determining how many shares exchanged for cash and how many for shares.

$$\text{No Rollover} \quad \frac{\text{Cash}}{\text{Cash \& FMV Shares}} \times \text{Exchanged Shares}$$

$$\text{Rollover} \quad \frac{\text{FMV}}{\text{Cash \& FMV Shares}} \times \text{Shares}$$

Tax-Deferred Rollovers-s. 85.1

Consequences to Vendor

- Vendor may choose to report the gain or loss
- Otherwise rollover at ACB
- If exchanged shares TCP, so are acquired shares
- No joint election required

Consequences to Purchaser

- ACB to purchaser is lesser of FMV and PUC of shares of vendor (concern to purchaser if low PUC shares of vendor)
- Not impacted by vendor electing to recognize gain/loss on exchange

Tax-Deferred Rollovers-s.s. 85.1(2.1)

PUC Reduction

- PUC reduction equal to increase of PUC as a result of share exchange over PUC of exchanged shares received from vendor
    - i.e., the PUC Grind found in subsection 85.1(2.1) grinds the PUC of the new shares down to the PUC of the old shares

Tax-Deferred Rollovers-s. 85 vs. s. 85.1 (assuming no non-share consideration)

s. 85

- Applies to inventory and capital property
- ACB of old shares equal to vendor's ACB (provided joint election)
- PUC of new shares ground to ACB of old shares not PUC of old shares (provided joint election)
- Joint election required

s. 85.1

- Applies only to shares of a Canadian company which are capital property
- ACB of old shares equals lesser of PUC and FMV
- PUC of new shares ground to PUC of old shares
- Applies automatically (no joint election required)

Tax Deferred Rollovers on Amalgamation – s. 87

- On amalgamation, section 87 generally allows for a tax-free rollover of the predecessors' property into the amalgamated corporation
- The new corporation is a continuation of predecessor corporations
- Subsection 87(2) generally allows for a carryover of various tax attributes and pools of predecessor corporations to the amalgamated corporation

Tax Deferred Rollovers on Amalgamation – s. 87

- In order to be a qualifying amalgamation, the following conditions must be met:
  - There must be a merger of two or more taxable Canadian corporations to form one corporate entity
  - All of the property and liabilities of the predecessor corporations immediately before the merger must become property of the amalgamated corporation ("Amalco") by virtue of the merger (87(1)(a-b)); and
  - All of the shareholders who owned shares of the capital stock of any predecessor corporation immediately before the merger must receive shares of the capital stock of Amalco because of the merger (87(1)(c))

Triangular Mergers-s.s.87(9)

- CBCA and OBCA permit shares of a non-amalgamating corporation to be issued on an amalgamation
- Subsection 87(9) introduced to make such an amalgamation qualify under subsection 87(1)(c) and to give rollover to shareholders who takes shares of such third party corporation

Pre-Conditions to Application of s.s. 87(9)

- Merger of taxable Canadian corporations
- New corporation must be controlled by a taxable Canadian corporation (the parent)
- Shares of parent issued by parent to shareholders of predecessor

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Effect of s.s. 87(9)

- Shares of parent deemed to be shares of Amalco so that amalgamation qualified under para. 87(1)(c) and eligible for rollover in s.s.87(4) and benefit of ITAR 26(21)
- Reduction of PUC of shares of parent to extent the increase in PUC of shares of parent exceeds PUC of shares of predecessor exchanged for parent's share and owned by third parties

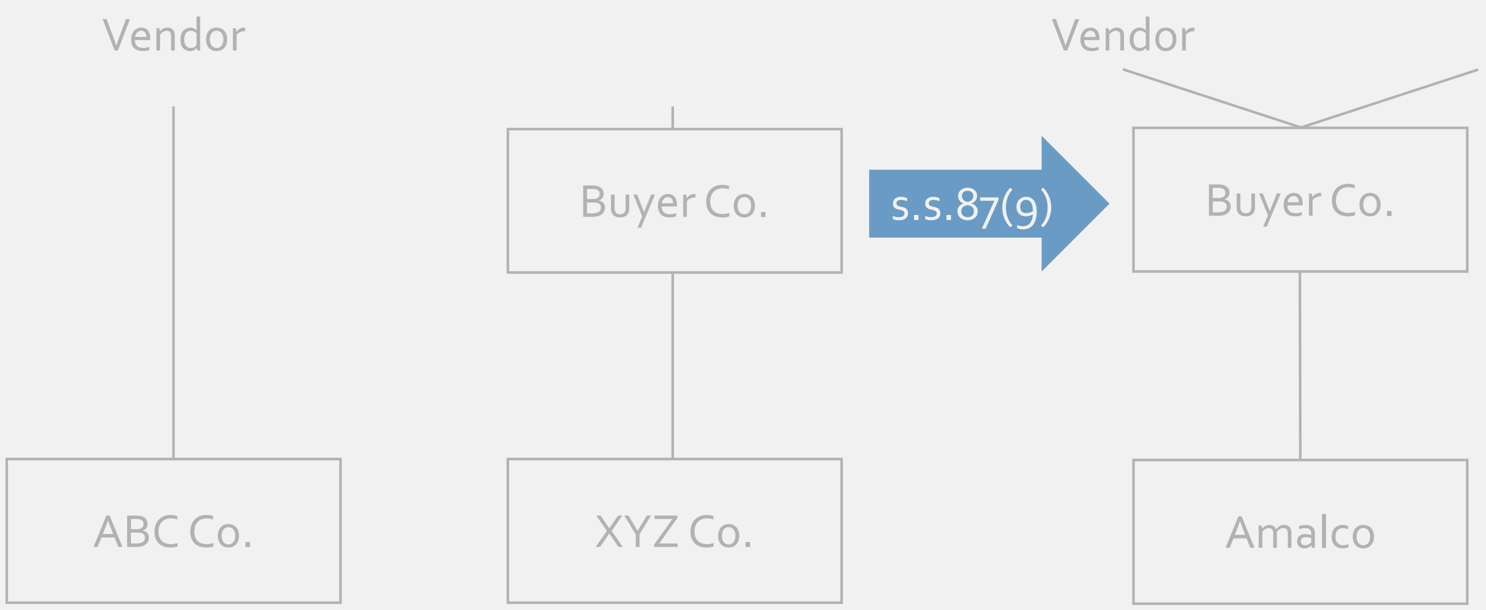
Tax-Deferred Rollovers-s.s. 87(9)

- If more than one class of shares of parent issued on the merger, then the reduction of PUC is allocated based on the relative PUC's of such classes
- Cost to parent of shares of Amalco is ACB of shares of predecessor owned by parent plus bump in certain circumstances
- Bump available where parent owns all of Amalco immediately after merger

Tax-Deferred Rollover-s.s. 87(9)

- Amount of bump is net asset value at tax values over ACB to parent of shares of predecessor immediately before the merger
- Amount may be allocated by parent among different classes of shares of Amalco except that amount allocated in respect of a particular class cannot result in cost exceeding FMV of shares of the particular class
- Allocation made in parent's return of income for year in which the merger occurred

Tax-Deferred Rollovers-s.s. 87(9)



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Earnouts

- If Earnout – (parties unable to settle on price for target and therefore the purchase price is determined partly by reference to future earnings of target)
    - Para. 12(1)(g) income inclusion (instead of capital gain)
    - Subject to CRA administrative position, withholding tax under subpara. 212(1)(d)(v)
    - If shares sold under agreement and proceeds at least partially determined pursuant to earnout, CRA accepts use of “cost recovery method”

Earnouts

- Conditions for “cost recovery method”:
  - Arm’s length
  - Gain/loss on sale capital in nature
  - Reasonable to assume earnout relates to underlying goodwill value of which can’t be expected to be agreed upon at date of sale
  - Earnout ends no later than 5 years after end of taxation year in which shares sold
  - Vendor submits sales agreement, letter requesting cost recovery method and undertaking to follow procedure
  - Vendor is Canadian resident person

Earnouts

- If “cost recovery method” applies:
    - CRA will not apply para. 12(1)(g) (administrative concession)
    - Vendor reduces ACB of shares as amounts on account of sale price become determinable
    - Once amount on account of sales price exceeds ACB, capital gain realized
    - Subsequent amounts treated as capital gains when determinable
- CRA View—taxpayer cannot amend previous tax return to use cost recovery method to report capital gain realized from share sale that subject to an earnout

Earnouts

- Capital loss recognized only when maximum that may be received irrevocably established to be less than vendor's ACB
- Where in taxation year aggregate of amounts established to have become determinable is in excess of ACB, reserve under subpara. 40(1)(a)(iii) may be claimed for that year in respect of part of aggregate payable after end of the year
- Reserve can't defer gain beyond 5 years

Safe Income Planning

Individual Shareholder

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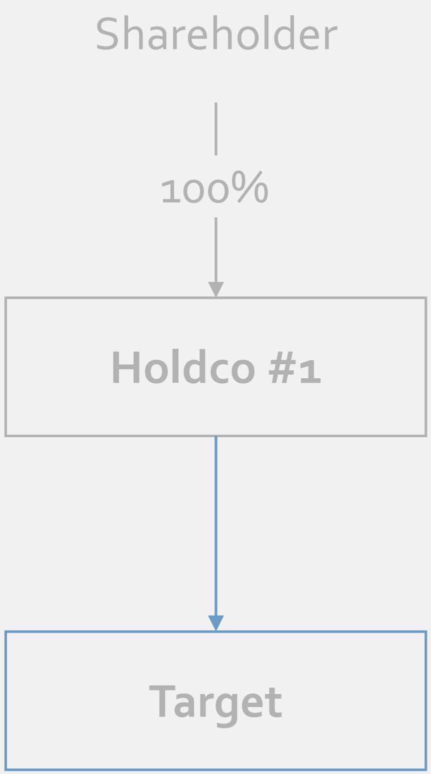
Target

- Adjusted Cost Base $100,000
- Retained Earnings $600,000 assume = Safe Income
- Fair Market Value $1,000,000

Safe Income Strips



- Adjusted Cost Base $100,000
- Fair Market Value $1,000,000

Safe Income Strips

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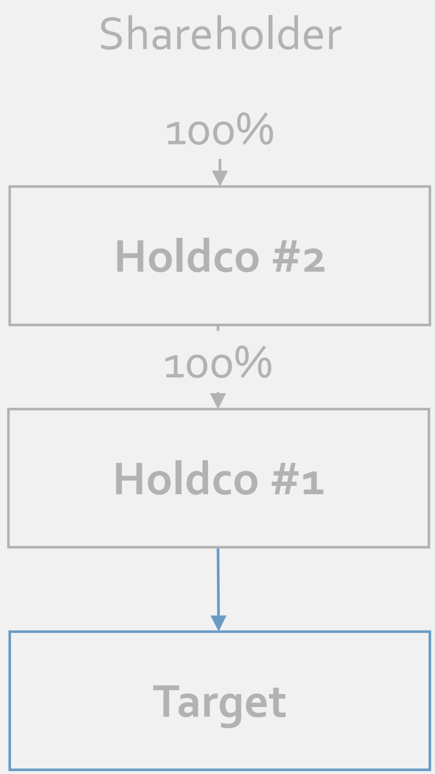
Safe Income Strips



Increased capital by $600,000

84(1) / 53(1)(b)

- Adjusted Cost Base $100,000
- Fair Market Value $1,000,000

- **Adjusted Cost Base** **$100,000**
- Fair Market Value $1,000,000

D&D Livestock Ltd. v. The Queen

- ISSUE: Whether safe income on hand of shares in a subsidiary are reduced by the amount of a stock dividend paid on the shares of the subsidiary's parent?
- Subsection 55(2)—safe income includes safe income of subsidiary attributable to shares Parent holds in subsidiary and safe income attributable to shares subsidiary holds in another subsidiary
    - Safe income of subsidiary taken into account twice (two stock dividends) in paying safe income dividends, <u>without any reduction to safe income attributable to shares of subsidiary as a result of first safe income dividend</u>
    - s.s. 55(2) n/a when effect of dividend in kind (shares of another subsidiary) was to create an unrealized loss on shares—unrealized loss then used avoid capital gains tax otherwise payable on sale of another property
- Tax Court of Canada ruled that, while taxpayer engaged in capital gains stripping, no ambiguity or equivocation in wording of s.s. 55(2)
- Minister was asking Tax Court of Canada to give effect to the purpose of s.s. 55(2) *in spite* of its wording rather than interpreting wording in manner which gives effect to its purpose

Proposed Amendments and s.s. 55(2)

- Finance bothered by ruling
- Proposed amendments target D&D Livestock but go further
- In addition to existing purpose test (i.e, one of the purposes of which was to effect significant reduction in portion of capital gain that would have been realized on disposition at fair market value…), new purpose test added
- New purpose test in proposed s.s. 55(2.1)(b) looks at whether one of purposes of a dividend is to effect:
    - significant reduction of the FMV of any share; or
    - significant increase in cost of property in hands of dividend recipient
- New proposed rules re: s.s. 55(2), stock dividends and safe income
- If proposed s.s.55(2) applies, amount of dividend deemed to be either proceeds of disposition of share redeemed, acquired or cancelled, or a gain of dividend recipient (not a dividend received by corporation)

Proposed Amendments and s.s.55(2)

- New purpose test is question of fact—look at purpose and motivation of taxpayer paying dividend
- Questions:
  - What does taxpayer intend to accomplish with such a reduction in value?
  - How will such a reduction in value be beneficial to the taxpayer?
  - What actions did taxpayer take in connection with reduction in value?
- CRA—purpose of reducing FMV could exist when dividend creates capital loss on any share that has potential to shelter gain on some other property
- CRA—new purpose tests can be applied even if older purpose test in s.s. 55(2) (…*significant reduction in capital gain*…) found not to apply
- CRA—proposed s.s. 55(2) permits safe income on hand to exist only with respect to a share that has an accrued gain
- CRA—whether reduction is significant—will look at absolute dollar amount involved, or at percentage reduction in value of the shares

Proposed Amendments and s.s.55(2)

Stock Dividends

- "Amount" of stock dividend paid by corporation deemed to be greater of:
  - Amount by which PUC of corporation that paid dividend is increased by reason of payment of dividend; and
  - FMV of share(s) issued as stock dividend at time of payment
- If Canadian corporation holds share(s) upon which receives stock dividend, FMV of share(s) issued as stock dividend exceeds amount by which PUC of corporation that paid stock dividend is increased because of dividend and "bad" purpose, amount of dividend can be either:
  - Taxable dividend paid out of safe income (to extent s.s. 55(2.3) applies); or
  - Taxable dividend to which s.s. 55(2) applies (except to extent that Part IV exception applies to the dividend, or if the exemptions in s.s. 55(3) apply)

Proposed Amendments and s.s.55(2)

Stock Dividends

- s.s. 55(2.3) applies to stock dividend if FMV of share(s) issued as stock dividend exceed related increase in PUC of corporation that paid dividend to the extent that dividend would have been subject to s.s. 55(2) if the exception regarding safe income on-hand did not exist
- s.s. 55(2.3)—amount of stock dividend deemed to be separate taxable dividend for purposes of applying s.s. 55(2) to extent of portion of dividend that doesn't exceed safe income on-hand that could reasonably be considered to contribute to the capital gain that could be realized on a disposition at FMV, immediately before the dividend, of the share(s) on which dividend is received
- Separate dividend out of safe income on-hand to which s.s. 55(2.3) applies deemed to reduce safe income on-hand of any corporation that could reasonably be considered to contribute to the capital gain that could realized on a disposition at FMV, immediately before dividend, of share on which dividend is received

Proposed Amendments and s.s.55(2)

Paragraph 55(3)(a) Exception

- Taxpayers used to rely on para. 55(3)(a) exception re: intercorporate dividends received as part of a "related party" reorganization
- Para. 55(3)(a) exception proposed to be limited to only dividends deemed to arise on redemption, acquisition, cancellation of shares under s.s. 84(2) or (3)
- CRA asked whether share redemptions could be utilized as alternative to regular dividends to avoid application of proposed s.s. 55(2)
- CRA response that will seek to apply GAAR to transactions that undermine intended purpose of proposed s. 55 in cases where transactions don't technically run afoul of proposed provisions
- Para. 55(3)(a) exception excludes cash dividends, stock dividends, dividends in kind, dividends under s.s. 84(1) arising in increase in PUC of share
- To avoid application of proposed s.s. 55(2), these dividends must now not run afoul of Proposed Purpose Test, or shares must have sufficient safe income on-hand

Proposed Amendments and s.s.55(2)

Safe Income On-Hand Exception

- Currently, s.s. 55(2) n/a to dividend that reduces a capital gain that is attributable to "safe income" (determined in accordance with s.s 55(5))
- Safe income on-hand exception continue to be available
- Practically, should provide corporate taxpayers with relief from proposed s.s. 55(2)
- But computation of safe income on-hand becomes critical—extremely difficult computation
- Corporate taxpayers may wish to compute safe income on-hand on annual basis
- Proposed para. 55(2.1)(c)—safe income available when it "contributes" to capital gain that could be realized—change from "reasonably attributable to" safe income

Proposed Amendments and s.s.55(2)

Part IV Tax Exception

- Currently, s.s. 55(2) n/a to any portion of a taxable dividend that is received by a corporate shareholder which is subject to Part IV tax, provided that the Part IV tax is not refunded as consequence of payment of a dividend "to" a corporation as part of same series—if dividend refund arises as a result of the payment by the corporate shareholder of a dividend to a shareholder that is an individual, even if dividend is part of the series that includes the receipt of the dividend by the corporate shareholder, view is that exception still available
- Part IV exception maintained in pre-amble to s.s. 55(2)
- But, exception only available if the Part IV tax is not refunded as a consequence of a payment of a dividend "by" a corporation as part of same series
- Explanatory Notes—Exception no longer available where a dividend refund arises as a result of the payment by the corporate shareholder of any dividend as part of the series, including those paid to a shareholder that is an individual
- Part IV tax exception maintained but narrowed

Proposed Amendments and s.s. 55(2)

- Uncertainty for taxpayers and tax advisors
- CRA indicated more likely to scrutinize purpose of dividend where dividend appears to be part of transactions that s.55 intended to thwart
- But, CRA indicated that "normal course" dividends paid in accordance with "well established dividend paying policy" should not run afoul of proposed s.55
- CRA acknowledges difficult to define what constitutes a "normal" dividend
- CRA will issue future rulings re: when proposed s.s 55(2) applies
- Favourable rulings only issued if CRA satisfied that complete set facts provided and taxpayer makes representation that purpose of dividend is not described in proposed s.s. 55(2.1)
- Over time, CRA indicated rulings will provide guidance re: parameters of what constitutes a "normal course" dividend

Proposed Amendments and s.s. 55(2)

- Takeaways:
  - s.s. 55(2) is anti-avoidance rule—remember that it is aimed at mischief
  - Dividend before any capital gain likely subject taxpayer to higher burden of proof re: purpose of dividend
  - RESULT of dividend not relevant to payer/recipient's purpose of dividend but PURPOSE may be inferred from result if purpose not otherwise explained
  - Don't assume purpose is obvious or that analysis/documentation not required
  - Document purpose of intercorporate dividend payment based on facts of transaction
  - Carefully calculate safe income annually like other tax attributes
  - If paying a safe income dividend, pay in increments of smaller amounts

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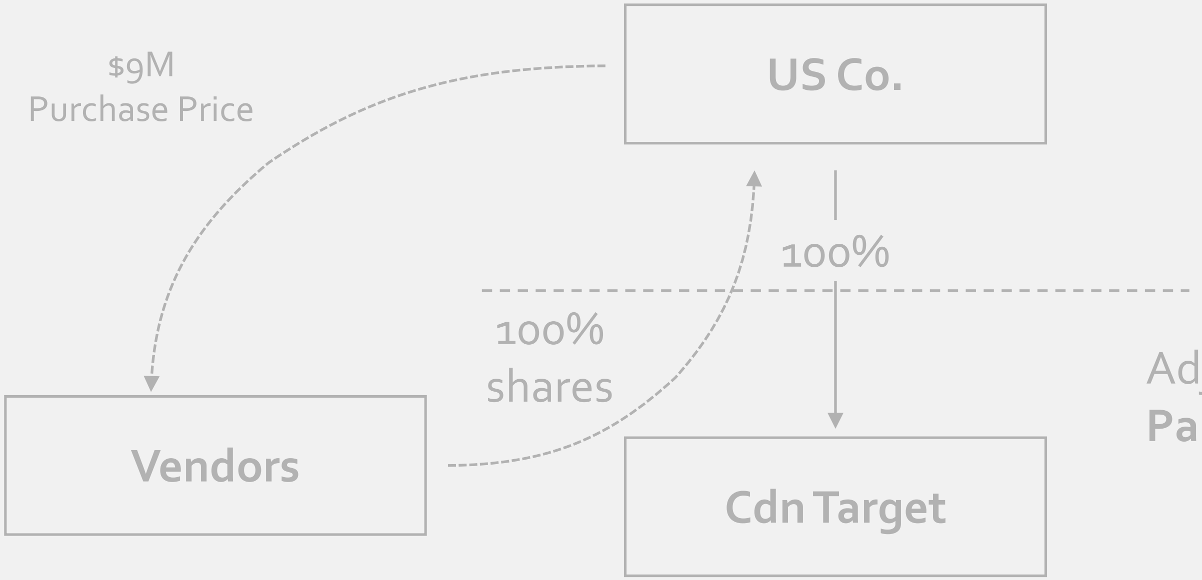
3. Planning for the Purchaser

Non-Resident Purchaser

- Use of Canadian corporation
    - Maximize cross-border capital
    - Maximize debt financing
    - Potential for “bump” transaction

Non-Resident Purchaser

Cross Border Capital



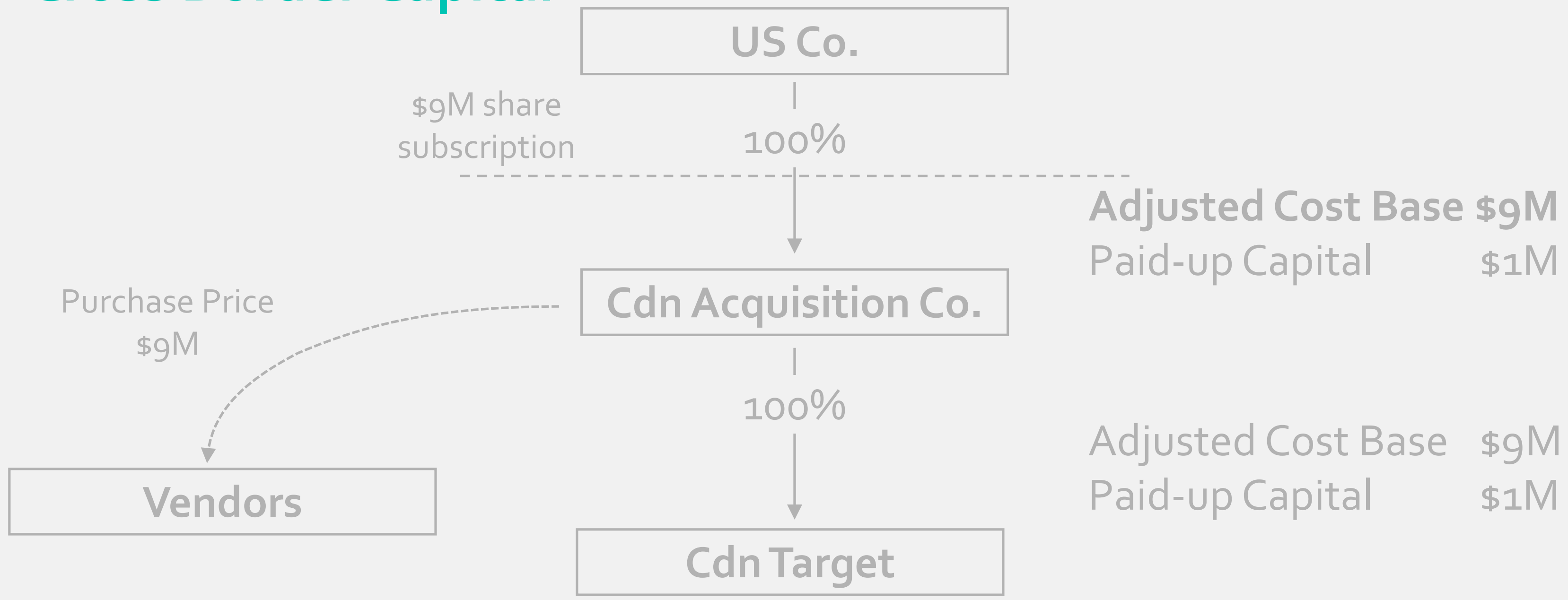
Adjusted Cost Base $9M
Paid-up Capital $1M

Non-Resident Purchaser

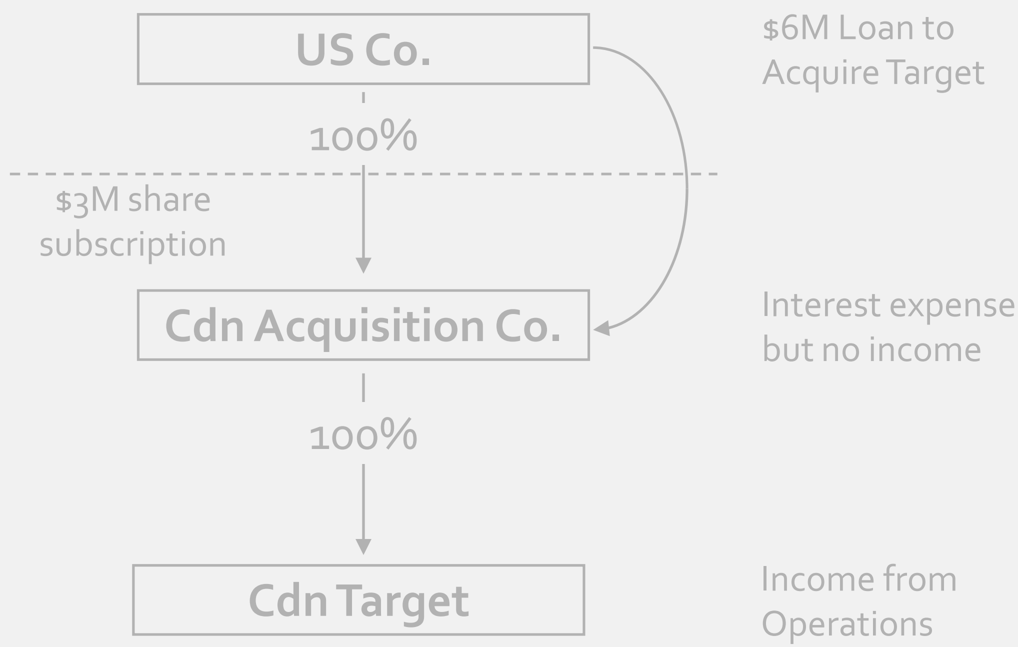
- Paid-up capital
  - Repatriate tax-free at any time vs. withholding tax on dividends
  - Starting point is stated capital, then modified based on certain transactions/provisions (see subpara. 89(1)(b)(iii) of the definition of paid-up capital)

Non-Resident Purchaser

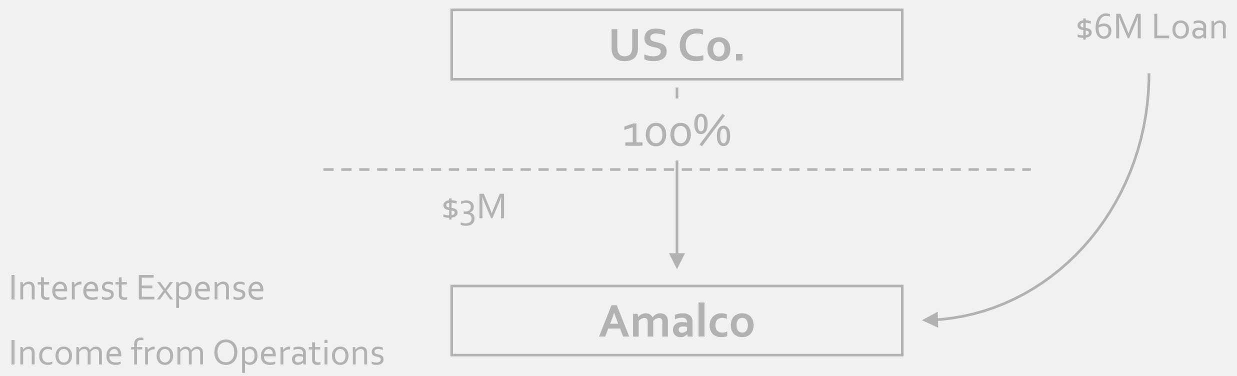
Cross Border Capital



Financing the Purchase



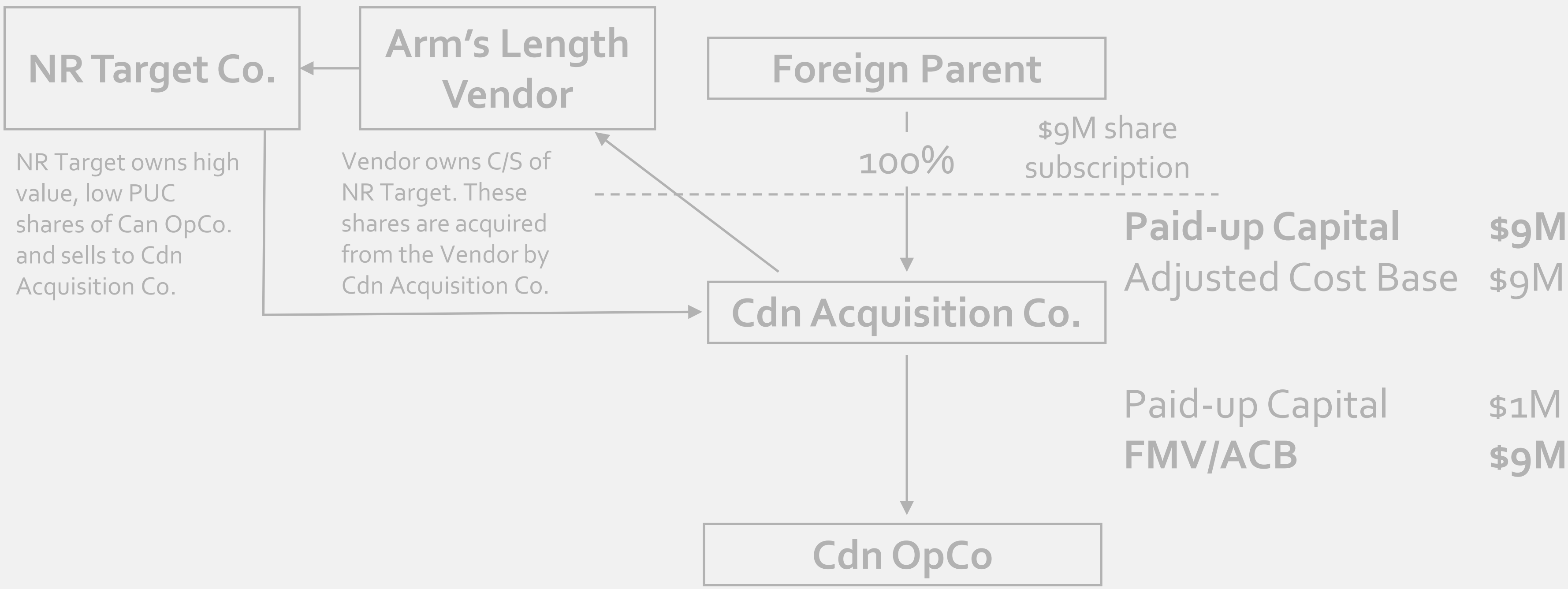
Financing the Purchase



- Interest deduction against income from operations
- Interpretation Bulletin IT-533 (para. 21)

Non-Resident Purchaser

Cross Border Capital – 212.1 and GAAR



Non-Resident Purchaser

Cross Border Capital – 212.1 and GAAR – cont'd

- CRA Response – CRA Views 2014-0547401C6:
- CRA concluded that GAAR would apply - stating:
  - The sale of Cdn OpCo shares to Cdn Acquisition Co together with the subsequent transfer by Cdn Acquisition Co of NR Target to Foreign Parent sidestep the provisions of subsection 212.1(1) resulting in the surplus of Cdn OpCo being transferred offshore without payment of Part XIII tax by NR Target.

Thin Capitalization Rules

- Where a Canadian subsidiary of a specified non-resident has a debt to equity ratio of greater than 1.5:1, the excess interest paid from the Canadian subsidiary to a specified non-resident is treated as a deemed dividend
- Where the rule applies and the excess interest is treated as a dividend, the non-resident will either be subject to a 25% withholding tax, or a withholding tax amount specified in an applicable treaty

Thin Capitalization Rules, cont’d

- In 2012, the thin capitalization rules were extended to apply to partnerships with Canadian resident corporate partners, and the permitted debt-to-equity ratio was reduced from 2:1 to 1.5:1
  - for taxation years ending after March 28, 2012; pro-rating taxation years that include March 29, 2012
- In 2013, rules extended to apply to Canadian resident trusts and to non-resident corporations and trusts that operate in Canada, along with partnerships in which a Canadian-resident trust is a member and introduced “equity amount” calculation for each entity to which the rules apply (18(5))

4. Takeover/Reorganization Expenses/Receipts

Takeover/Reorganization Expenses

Overview

- s.s. 9(1), s.s.14(5) and paras. 18(1)(a) and (b)
- para. 20(1)(e)— Expenses re: financing
- para. 20(1)(g)— Share transfer and other fees
- para. 20(1)(bb)—Fees paid to Investment Counsel
- para. 20(1)(cc)—Expenses of Representation (to government authority)

Deductible on Income Account

- Expenses (e.g. legal and accounting fees, costs of obtaining fairness opinions (valuation reports), printing, mailing costs) incurred to meet target's obligations under securities or corporation legislation– *Boulangerie*
  - ▫Where a public company fights a proposed takeover, the company must make a reasonable allocation of costs between those required to meet its obligations under securities and corporate legislation and those incurred to put a defence mechanism in place (which CRA views as non-deductible)—CRA View
- Success fee paid to a financial adviser to advise on possible amalgamation/merger - *International Colin Energy*
- Fees incurred in defending hostile takeover bid (including payment of a break fee) - *BJ Services*

Eligible Capital Expenditure

- 75% deductible on declining 7% basis
- Fees to generate an intangible plan to achieve a tax efficient result – *Potash Corp.*
- Expenses incurred as part of expansion plans (completed or not completed) not constituting part of the cost of specific assets – *Rona Inc*
- Expenses relating to an unsuccessful takeover incurred by the purchaser will be treated as capital in nature but may be ECE if the purchaser can demonstrate that it intended to make the business of the target corporation part of a similar business that the purchaser already operated – CRA View

Capital Outlay and Non-Deductible

- Fees for implementing a planned expansion of a business – *Rona Inc.*
- Fees incurred to put a defence mechanism in place in response to a proposed take-over – CRA View
- Investment banking fees paid by a target corporation in the course of the issuance of shares – CRA View

Litigation re: Tax Treatment of Transaction Fees

- *Rio Tinto Alcan Inc.*, 2013-3028(IT)G
- Appeal before the court
- Written arguments due at end of January
- Decision?

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Takeover/Reorganization Expenses

- Benefits
    - The question of whether corporate-paid expenses constitute a shareholder’s benefit under subsection 15(1) depends on whether the expenses were incurred primarily for the benefit of the shareholder, which is a question of fact to be determined on a case-by-case basis

Takeover/Reorganization Expenses - Summary

GST/HST on Takeover/Reorganization Expenses

- GST/HST issues relating to GST/HST paid on takeover fees and whether GST/HST is recoverable

Tax Treatment of Receipt of Break Fees

- If aquiror’s business demonstrates a pattern of acquisitions then receipt of break fee is on income account – *Morguard*
- Although a break fee received may represent income to the recipient under either subsection 9(1) or paragraph 12(1)(x), depending on the facts and circumstances, it may alternatively be proceeds of disposition of the taxpayer's rights under a support agreement – CRA View

5. Some Other Considerations

- Stock Option/Employee Incentive Plans
- Non-Resident Considerations
  - Interest deductibility/thin capitalization
  - Withholding tax
  - Section 116
- Existing Shareholder Agreements

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