CROSS-BORDER TOPICS OF INTEREST

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FOREIGN AFFILIATE DUMPING RULES IN M&A

NIK DIKSIC

Foreign Affiliate Dumping Rules in M&A

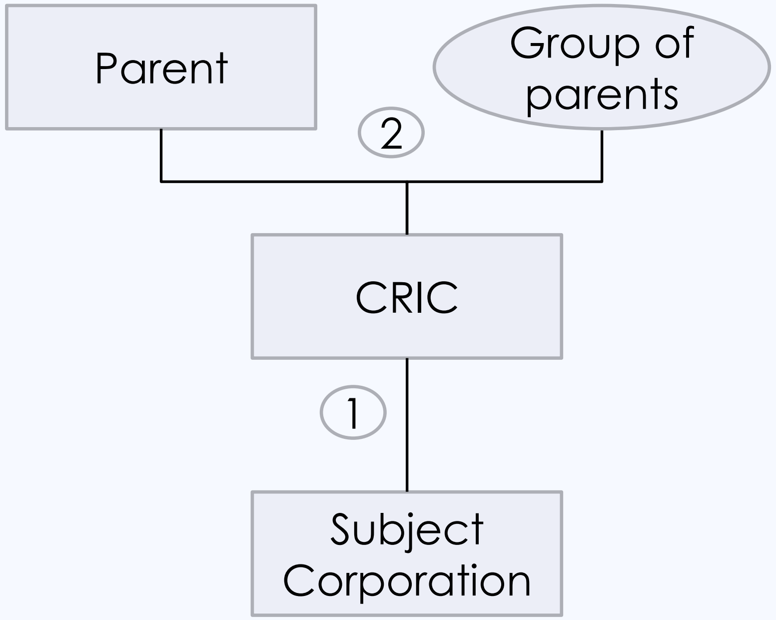
Relevance of the concept of "series of transactions or events " in the FAD rules

- Common law series
- 248(10)
- *Copthorne v. The Queen (2012 DTC 5007)*
- *Agence du revenu du Québec v. Custeau* (2020 QCCA 1496)

212.3(1) – triggering events

212.3(1)(a) 1

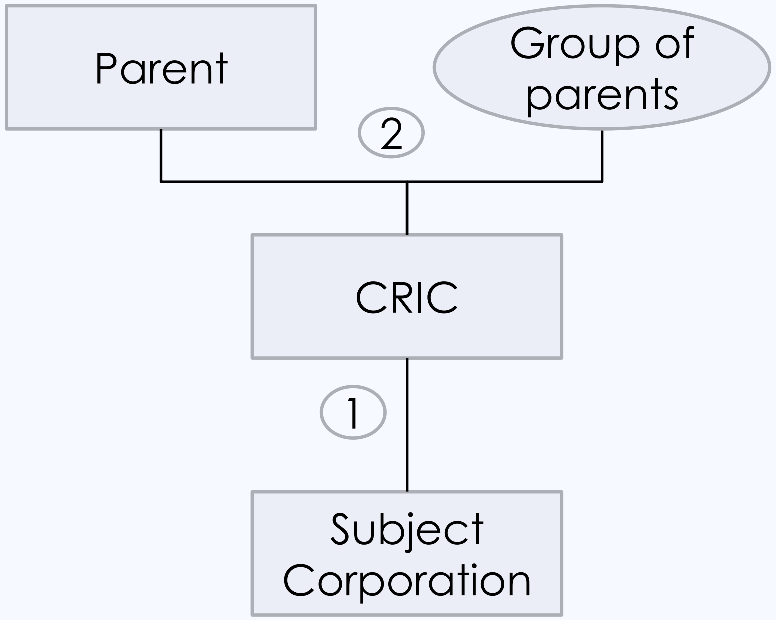
- Investment by a CRIC in a subject corporation that is, or becomes as part of a transaction or event or series of transactions or events that includes the making of the investment, a foreign affiliate of the CRIC or a corporation that does not deal at arm's length with the CRIC (an "other Canadian corporation")



212.3(1) – triggering events

212.3(1)(b) 2

- The CRIC or an other Canadian corporation is immediately after the investment time, <u>or becomes after the investment time and as part of a transaction or event or series of transactions or events that includes the making of the investment</u>, controlled by a single non-resident person ("parent") or a group of non-resident persons not dealing with each other at arm's length ("group of parents")



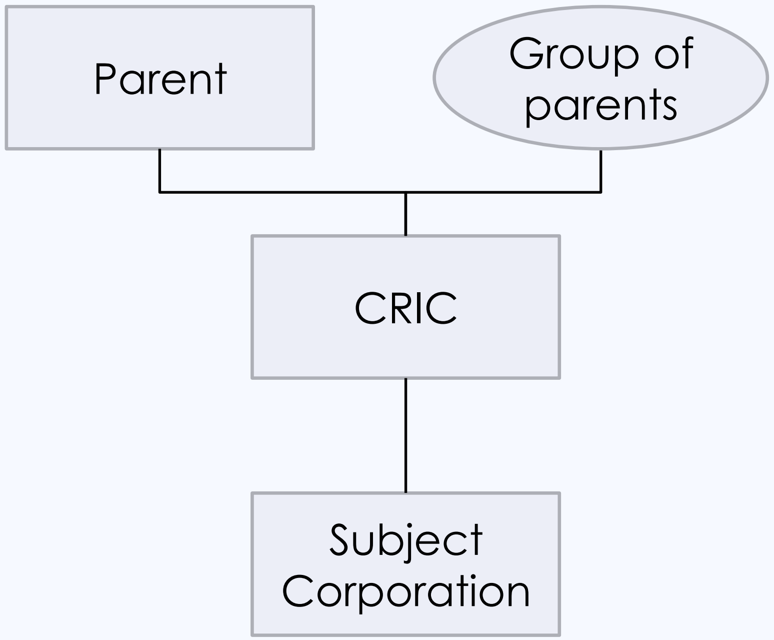
212.3(1) – triggering events

212.3(1)(b)(i)

- Ownership requirement at the investment time (based on assumed exercise of 251(5)(b) rights)
  - When does Parent have a 251(5)(b) right?
  - Is that the beginning of the series?
  - Can the series begin earlier?

212.3(1)(b)(ii)

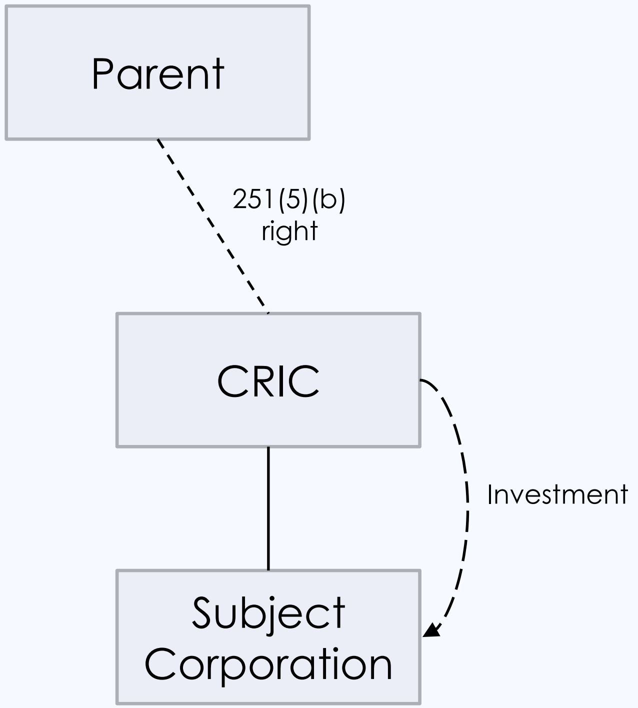
- No investment time ownership requirement for investment that is subject to 212.3(19)



212.3(16) – applicability to pre-closing transactions

212.3(16)

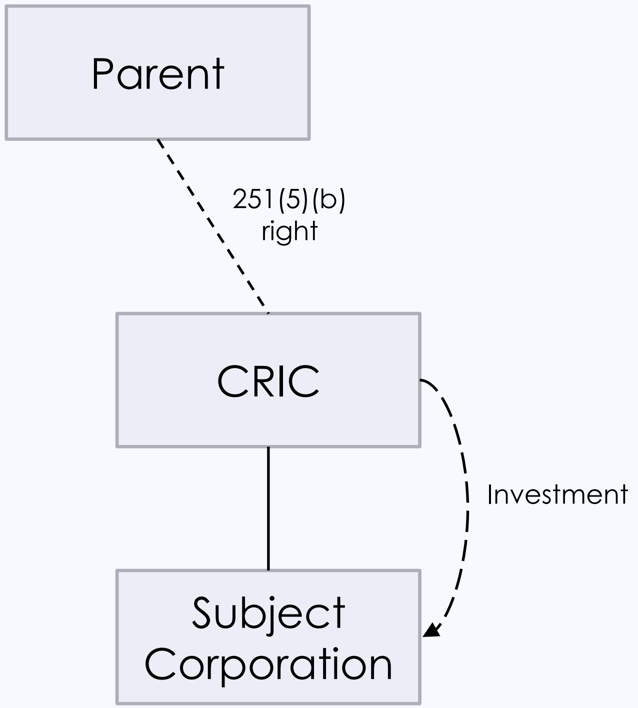
- (a) – more closely connected test
- (b) – principle decision making authority test
- (c) – ongoing principal decision making authority and performance evaluation/compensation test



212.3(16) – applicability to pre-closing transactions

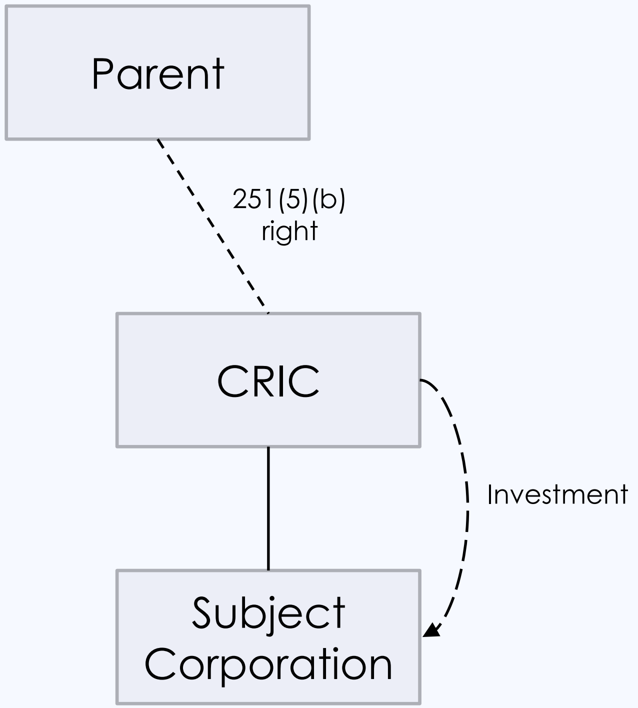
Pre-closing transactions entered into by CRIC at the request of the Parent

- "More closely connected test" – 251(5)(b) right expands the related non-resident group at the investment time
- Who has "principal decision making authority"?



212.3(16) – applicability to pre-closing transactions

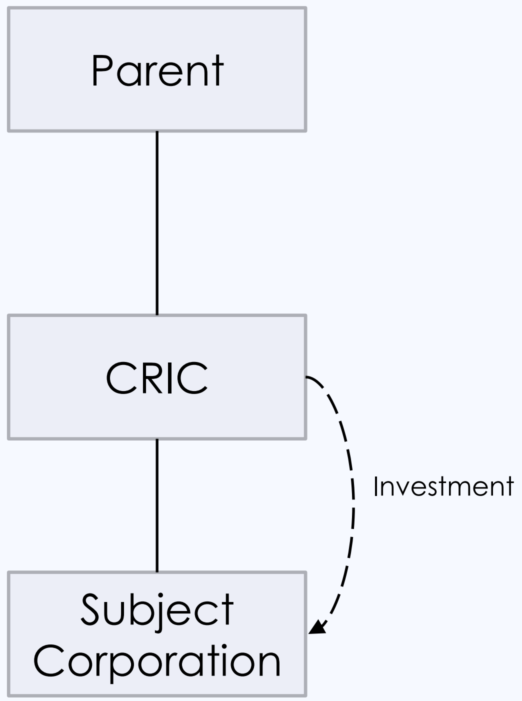
- Is it “reasonable to expect” that officers of the CRIC will have ongoing principal decision making authority in respect of the investment?
- Is it “reasonable to expect” that the performance evaluation and compensation of the officers of the CRIC will be based on the results of the subject corporation “to a greater extent” than will be the performance evaluation and compensation of “any” officer of a non-resident corporation that does not deal at arm’s length with the CRIC?



212.3(16) – applicability to post-closing transactions

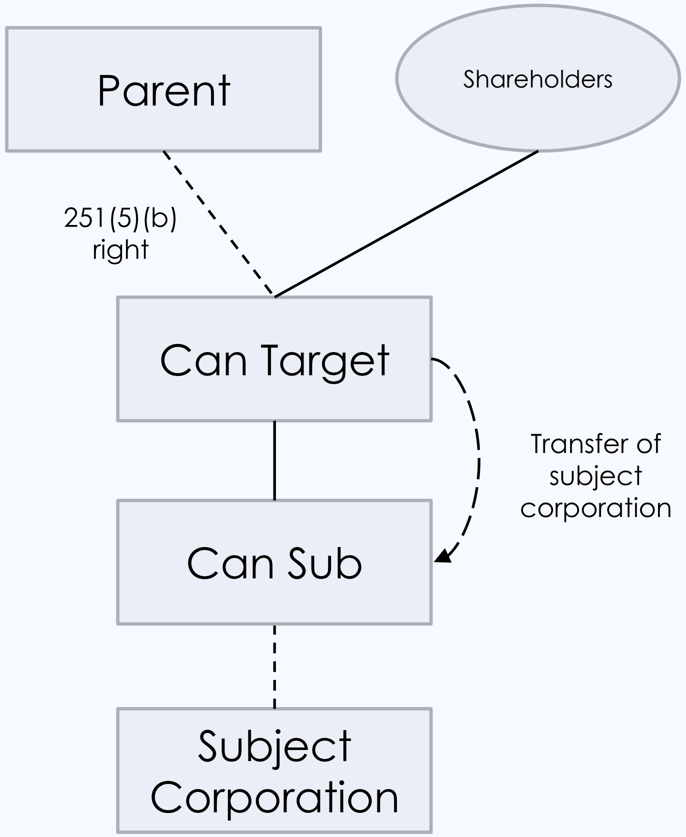
212.3(16)

- Same general issues as pre-closing transactions, but perhaps harder to satisfy given possible Parent involvement
- In addition, be mindful of the dual officer rule in 212.3(17)



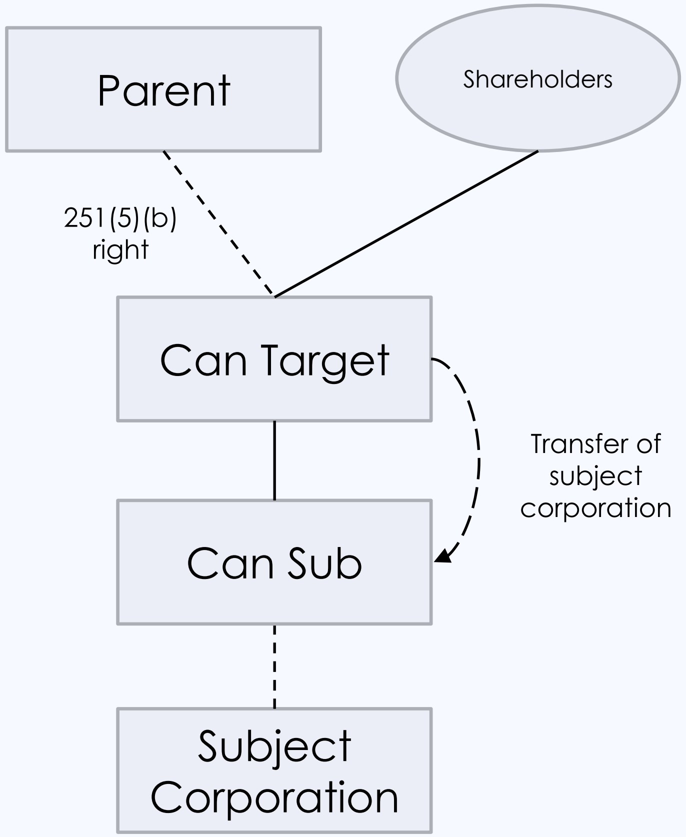
212.3(18)(a)(i) – applicability to pre-closing transactions

- Can Target to Can Sub – related party transfer
- Additional conditions:
  - (i)(A) – each shareholder of the disposing corporation immediately before the investment time is the CRIC or a corporation resident in Canada that is related to Parent, and at no time in the series and before the investment time dealing at arm's length with Parent (ignoring 251(5)(b) rights), OR



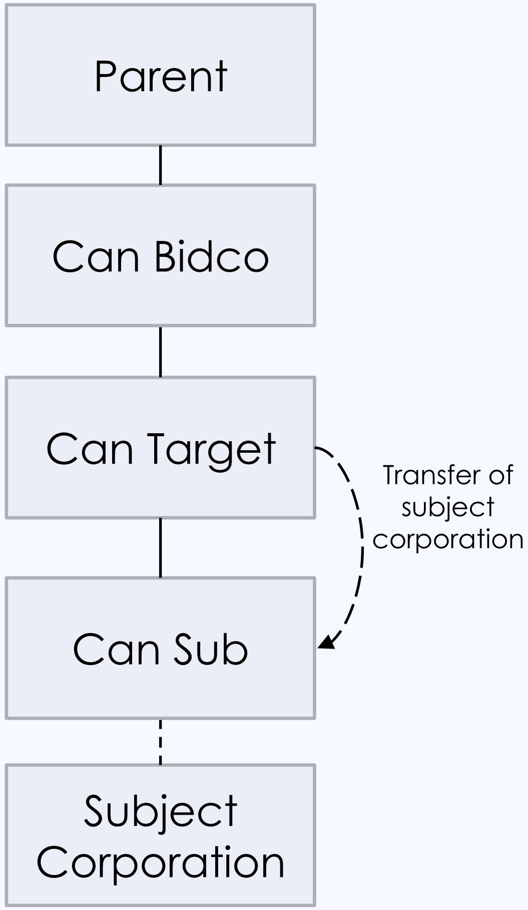
212.3(18)(a)(i) – applicability to pre-closing transactions

- (i)(B) – the disposing corporation is at no time in the series and before the investment time dealing at arm's length with the Parent (ignoring 251(5)(b) rights)
- When does the series begin?
- When will it be possible to say that the relevant shareholders or the disposing corporation never dealt with the Parent at arm's length during the series?



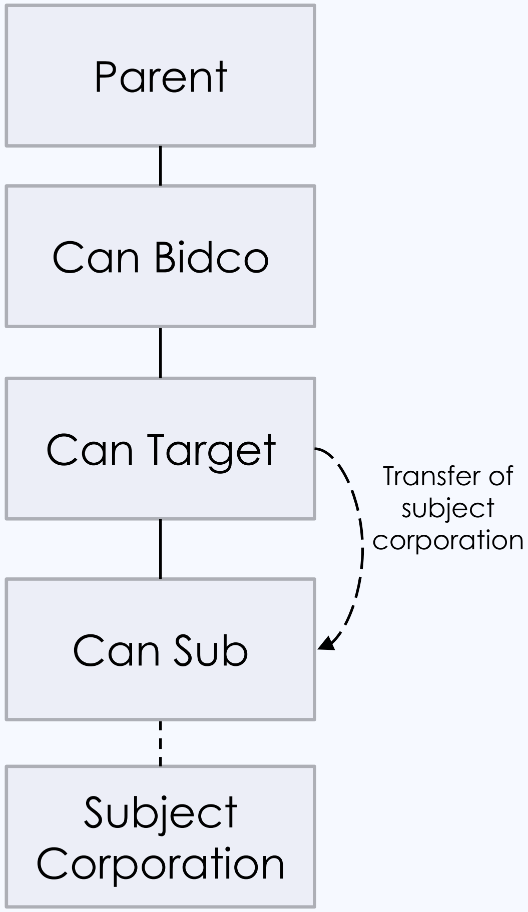
212.3(18)(a)(i) – applicability to post-closing transactions

- Can Target to Can Sub – related party transfer
- Additional conditions:
  - (i)(A)(I) – each shareholder of the disposing corporation immediately before the investment time is the CRIC or a corporation resident in Canada that is related to Parent, and at no time in the series and before the investment time dealing at arm's length with Parent (ignoring 251(5)(b) rights) or a non-resident person that participates in the series and is, at any time in the series and before the investment time, related to the Parent



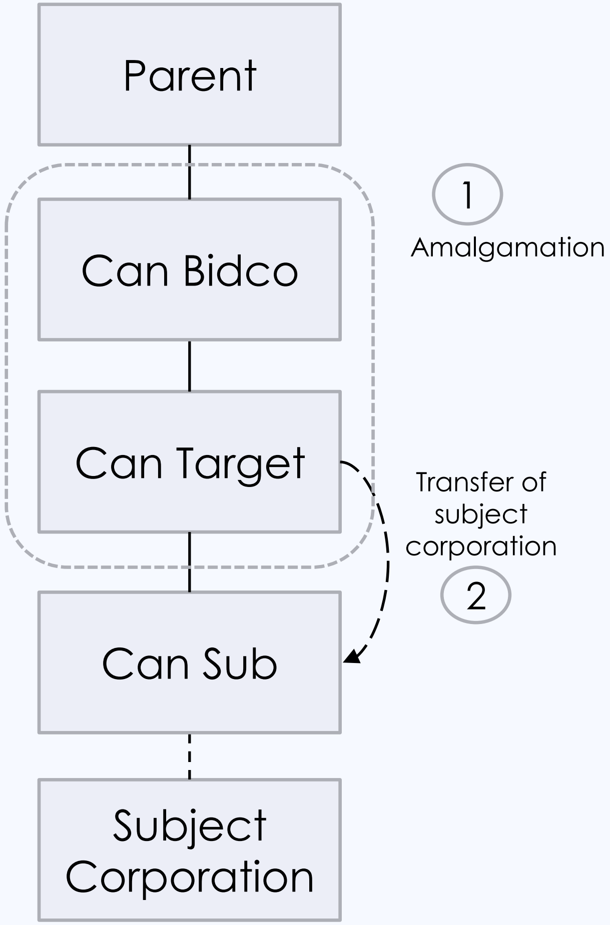
212.3(18)(a)(i) – applicability to post-closing transactions

- Can Bidco would satisfy the first part
- However, under 212.3(18)(a)(i)(A)2, Can Bidco also must never deal at arm's length with a non-resident person that participates in the series and is, at any time in the period and before the investment time, related to the Parent
    - Does the subject corporation "participate in the series"?



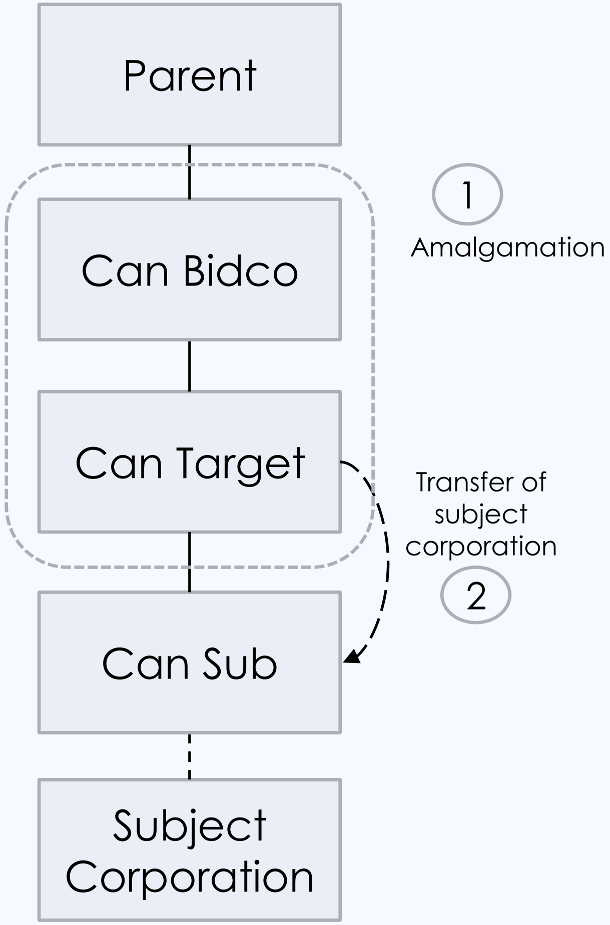
212.3(18)(a)(i) – applicability to post-closing transactions

- Amalgamation not an investment because of 212.3(22)
- However, pursuant to 212.3(22)(a) continuity rule, Amalco is deemed to be the same corporation as, and a continuation of, both predecessor corporations



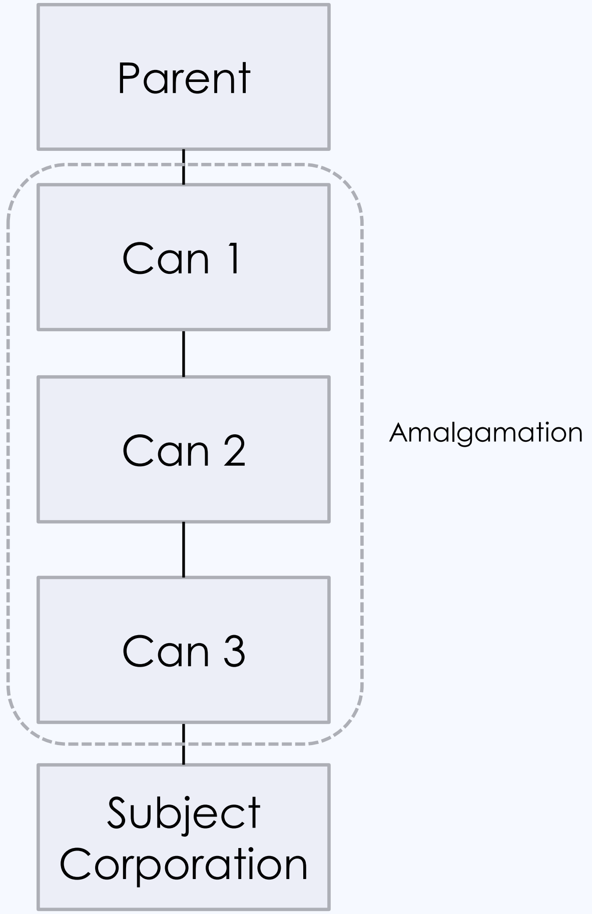
212.3(18)(a)(i) – applicability to post-closing transactions

- As a result, conditions in 212.3(18)(a)(i) cannot be satisfied in respect of the transfer of the subject corporation to Can Sub
  - Shareholders of disposing corporation (Amalco) are not the CRIC or a related corporation resident in Canada
  - Disposing corporation (deemed to be continuation of Can Target) presumably dealt at arm's length with Parent during the series and before the investment time



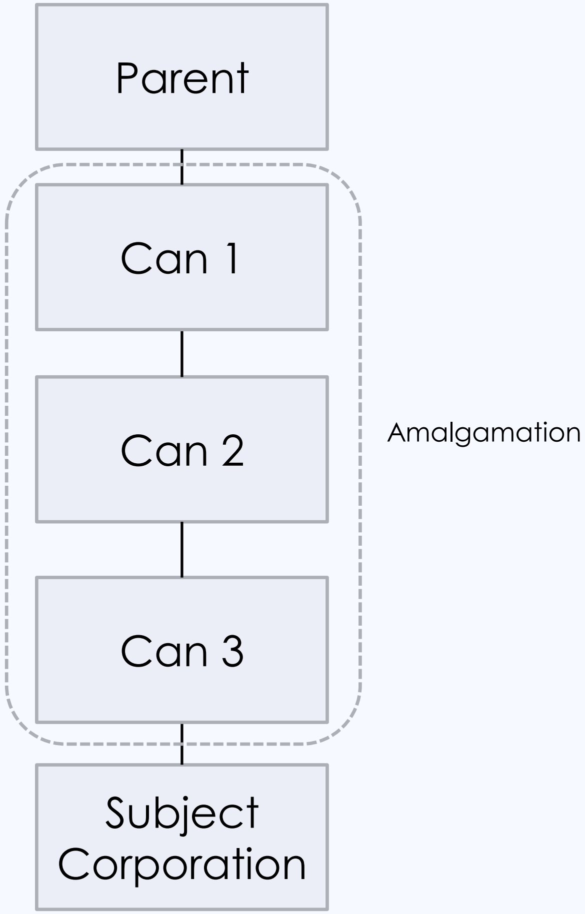
212.3(18)(a)(ii) / 212.3(22) – amalgamations

- Amalgamation of Can 1, Can 2 and Can 3 is not an 87(11) amalgamation covered by 212.3(22)
- 212.3(18)(a)(ii) applies to other 87(1) amalgamations, but with conditions:
  - (A) – none of the predecessor corporations <u>dealt at arm's length with the Parent during the series</u> and before the investment time, OR
  - (B) each shareholder of the predecessor is either the CRIC or a related corporation resident in Canada that is related to the Parent, and <u>at no time during the series and before the investment time dealt at arm's length with the Parent</u>



212.3(18)(a)(ii) / 212.3(22) – amalgamations

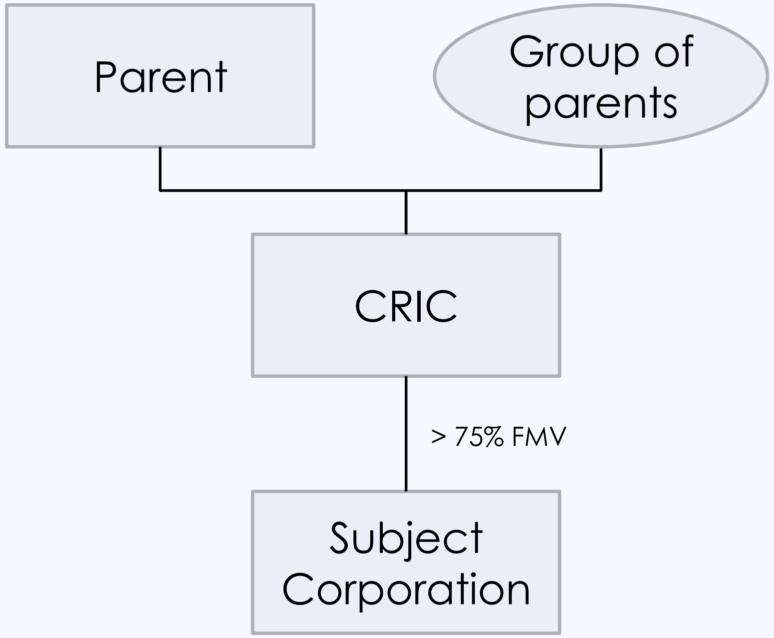
- Conditions are not met
- Sequential amalgamations of Can 1 and Can 2, and then Amalco and Can 3 would both be covered by 212.3(22)



212.3(10)(f) – indirect investment

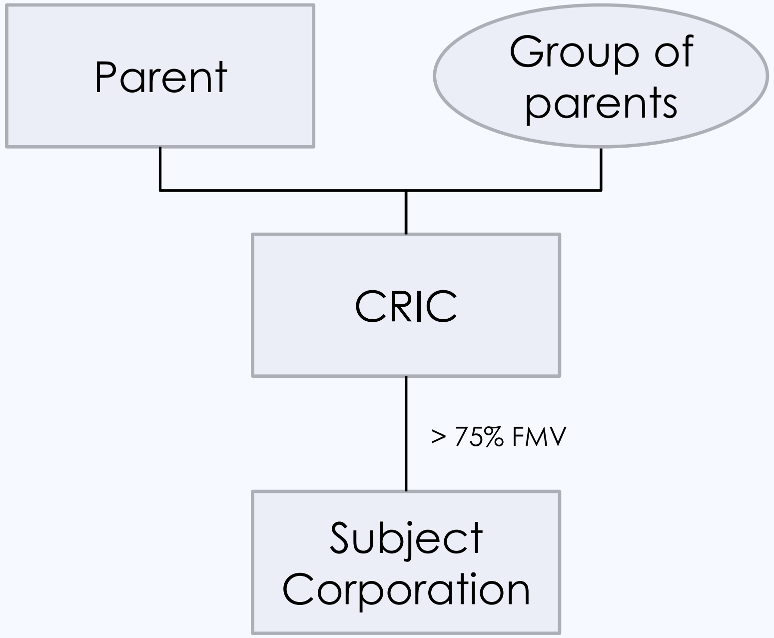
212.3(14)

- Condition deemed to be satisfied at the time of the acquisition if
  - Any property (other than shares of FA that is referred to in (10)(f))) held directly or indirectly by the other corporation is disposed of, after the time of acquisition, directly or indirectly by that corporation <u>as part of a series of transactions or events that includes the acquisition</u>, and
  - At any time that is subsequent to the acquisition time and that is <u>during the period during which the series occurs</u>, the condition in (10)(f) would have been satisfied



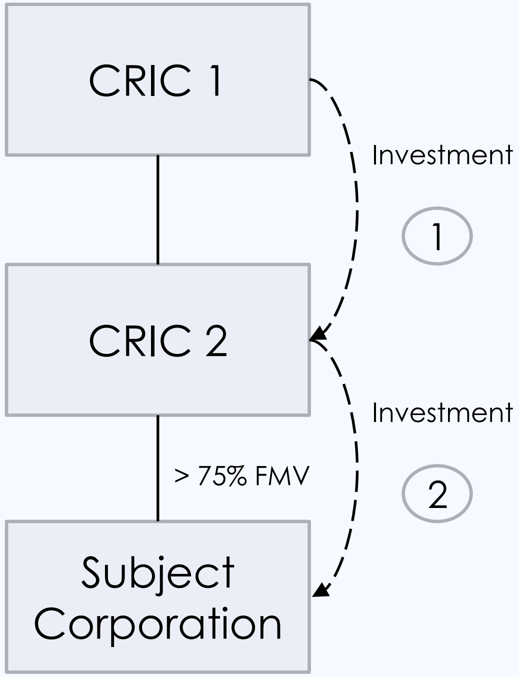
212.3(10)(f) – indirect investment

- Need a disposition and satisfaction of the condition as part of the series
- Condition is deemed satisfied – but consequences based on what values?
  - Presumably based on values at the first time after the acquisition time that the condition is satisfied?



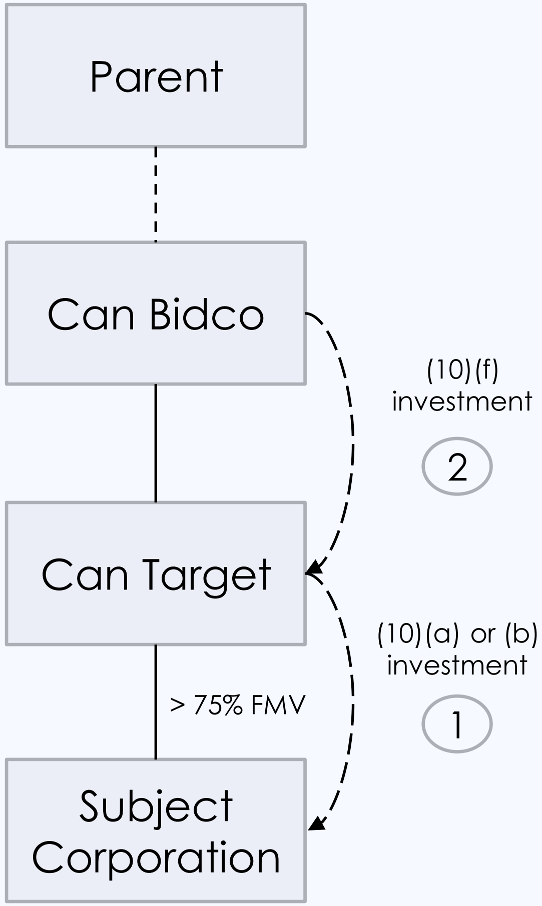
212.3(18)(c)(v)

- 212.3(2) does not apply to the (10)(f) investment by CRIC 1 in CRIC 2, provided CRIC 2 uses property transferred by CRIC 1 to make the direct investment in the subject corporation, and
  - The two investments occur within 90 days of each other, <u>and</u>
  - Are part of the same series of transactions or events



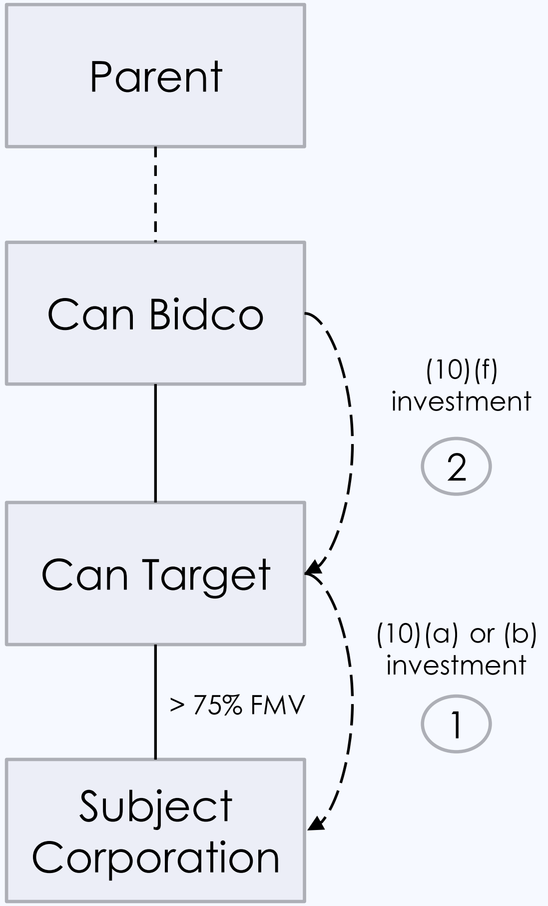
212.3(5.1)

- Intended to prevent double application of FAD rules in circumstances where
  - Can Target makes a (10)(a) or (10)(b) investment in the subject corporation and that investment is subject to 212.3(2), and
  - Can Bidco subsequently makes a (10)(f) investment in CRIC, that is an indirect investment in the subject corporation



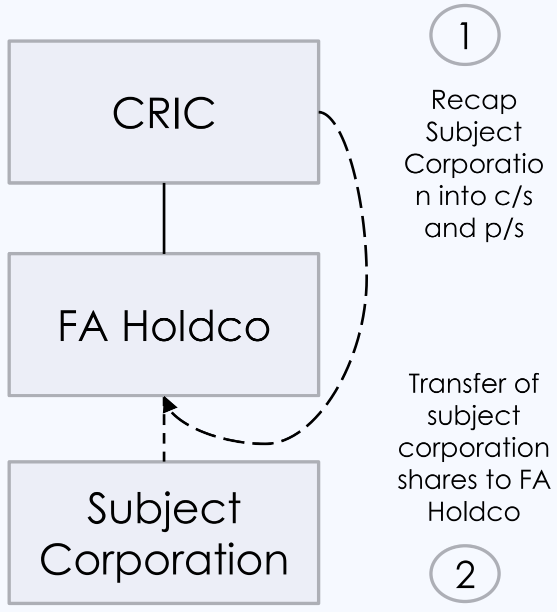
212.3(5.1)

- Additional conditions:
  - Can Target is not controlled by Parent immediately after the investment time in respect of the first investment, and
  - Can Target becomes, after the time that is immediately after the investment time in respect of the first investment and as part of the same series, controlled the Parent because of the second investment
- Note: Only applies if the first investment is made under (10)(a) or (10)(b)



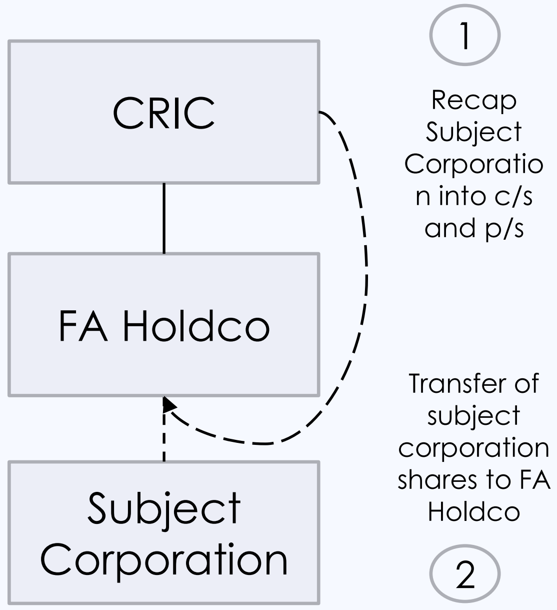
212.3(19) – preferred share investments

- Investment in preferred shares subject to 212.3(19)
- "throughout the series", subject corporation would be a "subsidiary wholly-owned corporation" of the CRIC taking into account only shares owned by
  - the CRIC
  - a Canadian resident corp that is a subsidiary wholly-owned corporation of the CRIC,
  - a corp resident in Canada of which the CRIC is a subsidiary wholly-owned corporation



212.3(19) – preferred share investments

- Conditions would not be met
- Note again that 212.3(19) is not subject to any ownership (or deemed ownership) requirement by the Parent – just needs to be part of the series that includes the CRIC becoming controlled by the Parent



111(4)(e) PLANNING – IMPACT OF PROPOSED "SUBSTANTIVE CCPC" RULES

FRANCESCO GUCCIARDO

111(4)(e) Planning – Impact of Proposed "Substantive CCPC" Rules

- Pre-closing "111(4)(e)" planning in the context of the cross-border acquisition of a Canadian private company had become an increasingly common technique in recent years:
  - Target company makes a designation under paragraph 111(4)(e) in its acquisition of control return so as to achieve a taxable step-up in basis of certain properties (e.g. depreciable capital properties, such as goodwill)
  - Target pays safe and/or capital dividends immediately before closing so as to achieve a step-up in outside basis in the shares held by sellers

111(4)(e) Planning – Impact of Proposed "Substantive CCPC" Rules

- Purchase price generally reduced by the amount of tax payable by target company as a consequence of the designation
- Such tax would be based on general corporate rates (e.g. exclusive of any refundable tax component) due to the fact that the non-resident's purchase right in respect of the shares of target under the SPA disqualified target from being a CCPC
- The monetized outside basis in the shares as part of the transaction generally neutralized the impact of any purchase price reduction
- In general, purchaser has the same total outlay (e.g. Adjusted Purchase Price plus inside tax), seller is in approximately the same after-tax position following the sale and Target has some stepped up basis in underlying depreciables.

111(4)(e) Planning – Impact of Proposed "Substantive CCPC" Rules

- A cornerstone of the traditional "111(4)(e)" planning is that any gains realized by Target as a consequence of a designation that is made under paragraph 111(4)(e) is subject to tax at ordinary corporate rates and not subject to the refundable tax otherwise levied on CCPCs
- Budget 2022 (April 7, 2022) proposes an extension of the refundable tax regime to "substantive CCPCs"
  - A "substantive CCPC" is a Canadian resident private corporation that is not a CCPC but that is ultimately controlled (in law or in fact) by Canadian-resident individuals
  - An extended definition of control will aggregate shares owned, directly or indirectly, by Canadian resident individuals and deem a corporation to be controlled by a Canadian resident individual where Canadian individuals own, in aggregate, sufficient shares to control the corporation

111(4)(e) Planning – Impact of Proposed "Substantive CCPC" Rules

- Budget 2022 *specifically* notes that these rules would cause a corporation to be a substantive CCPC in circumstances where the corporation would have been a CCPC but for the fact that a non-resident or public corporation has a right to acquire its shares
- An anti-avoidance rule will be introduced to address arrangements or transactions where it is reasonable to consider that a particular arrangement, transaction or series was undertaken to avoid the refundable tax regime

111(4)(e) Planning – Impact of Proposed "Substantive CCPC" Rules

Simplified Illustration – Individual Vendor

Base Sale

Proceeds: $10,000,000

Share Cost: $1,000,000

Taxable Capital Gain: $4,500,000

Personal Tax: $2,408,850 (@53.53%)

After-Tax Proceeds: **$7,591,150**

111(4)(e) Sale (Pre-Budget 2022)

Goodwill Value: $5,000,000

111(4)(e) Gain/Step-Up: $5,000,000

Inside Tax: $662,500* (Non-CCPC Rate) (@26.5%)

PUC Bump: $2,500,000 (CDA)

Proceeds: $9,337,500

Share Cost: $3,500,000 ($1M + $2.5M tax-free CDA bump)

Taxable Capital Gain: $2,918,750

Personal Tax: $1,562,407 (@53.53%)

After-Tax Proceeds: **$7,775,093**

111(4)(e) Sale (Post Budget – No Grandfathering)

Goodwill Value: $5,000,000

111(4)(e) Gain/Step-Up: $5,000,000

Inside Tax: $1,254,166.67* (CCPC Rate) (@50.167%)

Refundable: $766,666.67

PUC Bump: $2,500,000 (CDA)

Proceeds: $8,745,833.33

Share Cost: $3,500,000 ($1M + $2.5M tax-free CDA bump)

Taxable Capital Gain: $2,622,916.66

Personal Tax: $1,404,047.29 (@53.53%)

After-Tax Proceeds: **$7,341,786.04**

111(4)(e) Planning – Impact of Proposed "Substantive CCPC" Rules

Substantive CCPCs

36 (1) **Subsection 248(1) of the Act is amended by adding the following in alphabetical order:**

Substantive CCPC means a private corporation (other than a Canadian-controlled private corporation) that at any time in a taxation year

(a) is controlled, directly or indirectly in any manner whatever, by one or more Canadian resident individuals, or

(b) would, if each share of the capital stock of a corporation that is owned by a Canadian resident individual were owned by a particular individual, be controlled by the particular individual. (SPCC en substance)

111(4)(e) Planning – Impact of Proposed "Substantive CCPC" Rules

(2) **Section 248 of the Act is amended by adding the following after subsection (42):**

Substantive CCPC — anti-avoidance

(43) For the purposes of this Act, a corporation (other than a Canadian-controlled private corporation) that is resident in Canada and would not, in the absence of this subsection, be a substantive CCPC, is deemed to be a substantive CCPC if it is reasonable to consider that one of the purposes of any transaction (as defined in subsection 245(1)), or series of transactions, was to cause the corporation not to qualify as a substantive CCPC.

111(4)(e) Planning – Impact of Proposed "Substantive CCPC" Rules

(3) Subsections (1) and (2) apply to

(a) taxation years of a corporation that begin on or after Budget Day, if

(i) the corporation's first taxation year that ends on or after Budget Day ends due to a loss restriction event caused by a sale of all or substantially all of the shares of a corporation to a purchaser before 2023,

(ii) the purchaser deals at arm's length (determined without reference to a right referred to in paragraph 251(5)(b)) with the corporation immediately prior to the loss restriction event, and

(iii) the sale occurs pursuant to a written purchase and sale agreement entered into before Budget Day; and

(b) in any other case, taxation years that end on or after Budget Day.

111(4)(e) Planning – Impact of Proposed "Substantive CCPC" Rules

- Rules should not deny the ability to achieve a step-up in basis via a 111(4)(e) designation by monetizing tax attributes of the target company
- Coming into force provisions (e.g. grandfathering or exception for arm's length acquisition transactions completed on or after April 7, 2022 and before 2023 for which a written agreement was entered into before April 7, 2022) should help alleviate any GAAR concerns participants have/had with respect to previously executed "111(4)(e)" planning
- Subject to the ultimately enacted legislation, there may still be circumstances where traditional "111(4)(e)" planning is a viable and useful planning tool

EARNOUTS AND OTHER FORMS OF NON-SHARE CONSIDERATION IN CROSS-BORDER STRUCTURES

CHRISTOPHER ANDERSON

Earnouts paid to non-residents

- At the 2019 CTF Annual Conference Roundtable, CRA was asked whether a purchaser is required to withhold tax when an earn-out payment is made to a non-resident shareholder?
- Consistent with views adopted at the 2005 APFF Conference, CRA stated it would generally not apply WHT when a non-resident disposes of shares, the consideration for which includes an earnout payment, provided that the first four conditions in paragraph 2 of IT-426R are met, namely:

1. The vendor and purchaser are dealing with each other at arm's length
2. The gain or loss on the sale of shares is clearly of a capital nature

See CRA document no. 2019-0824461C6.

Earnouts paid to non-residents

3. It is reasonable to assume that the earnout feature relates to underlying goodwill, the value of which cannot reasonably be expected to be agreed upon at the date of sale
4. The earnout feature in the sale agreement must end no later than 5 years after the end of the first taxation year of the corporation (whose shares are sold) in which the shares are sold

See CRA document no. 2019-0824461C6.

Earnouts paid to non-residents

- At the 2021 APFF Roundtable, the CRA stated that the cost recovery method could not be used by a limited partnership that is vendor
- Where the conditions for the cost recovery method are NOT met, there are two potential outcomes:
  1. paragraph 12(1)(g) could apply to the vendor; or
  2. the FMV of the earnout right could be included in the POD of the vendor in the year of sale, with subsequent settlements of the rights being treated as separate dispositions
- As an alternative, consider structuring as a reverse earnout

Earnouts: treatment on immigration/emigration

- The FMV of an earnout right will generally be part of the non-resident's POD for the purposes of s. 116 of the ITA. Any subsequent disposition of this right, in whole or in part, by the non-resident will generally not be taxable under Part I of the ITA since such right does not constitute TCP for purposes of the ITA. When the non-resident immigrates to Canada, the right will be deemed to have been disposed of by the non-resident and re-acquired for proceeds equal to its FMV. Any disposition of the right after the non-resident became a Canadian resident should be subject to tax under Part I of the ITA and could result in a taxable capital gain (see CRA document no. 2006-0196211C6)
- To the extent that payments made subsequent to emigration would be dependent on the use of, or production from, property (i.e., subject to paragraph 12(1)(g)), the CRA is of the view that such portion would be subject to Part XIII withholding tax (see CRA document no. 2013-0494251E5)

Contingent Value Rights (CVRs)

Contractual Rights:

- closely resemble earnouts
- in respect of an asset sale, it is expected that the value of the rights will form part of the POD to the vendor (see CRA document no. 9403435)
- in respect of a share sale, query whether amounts have any correlation with the property of the entity sold (i.e., "dependent on the use of or production from property")

Contingent Value Rights (CVRs)

Debt-based CVR:

- tax consequences largely determined by rules in the ITA applicable to debt holders
- non-interest-bearing debt vs. contingent-interest debt
- issuer of a debt-based CVR should consider potential application of debt forgiveness rules
- arguably a contractual CVR should generally not be considered a debt obligation (i.e., *Barejo* should be limited to the particular facts of that case)

Contingent Value Rights (CVRs) – Market Trends (2017-present)

- Contractual rights-based CVRs most common
- Often disclaimer that the Canadian federal income tax consequences in respect of CVRs are not entirely clear, particularly in respect to whether a CVR is income or capital
- CVRs generally considered capital property (i.e., additional proceeds received)
- As such, disposition by a resident holder will generally result in a capital gain (or loss). Disposition by a non-resident holder will generally not be subject to tax under the ITA, unless such CVRs are, or are deemed to be, TCP
- Canadian WHT should generally not apply to the payment of CVRs to NR shareholders

Tax Receivable Agreements (TRAs)

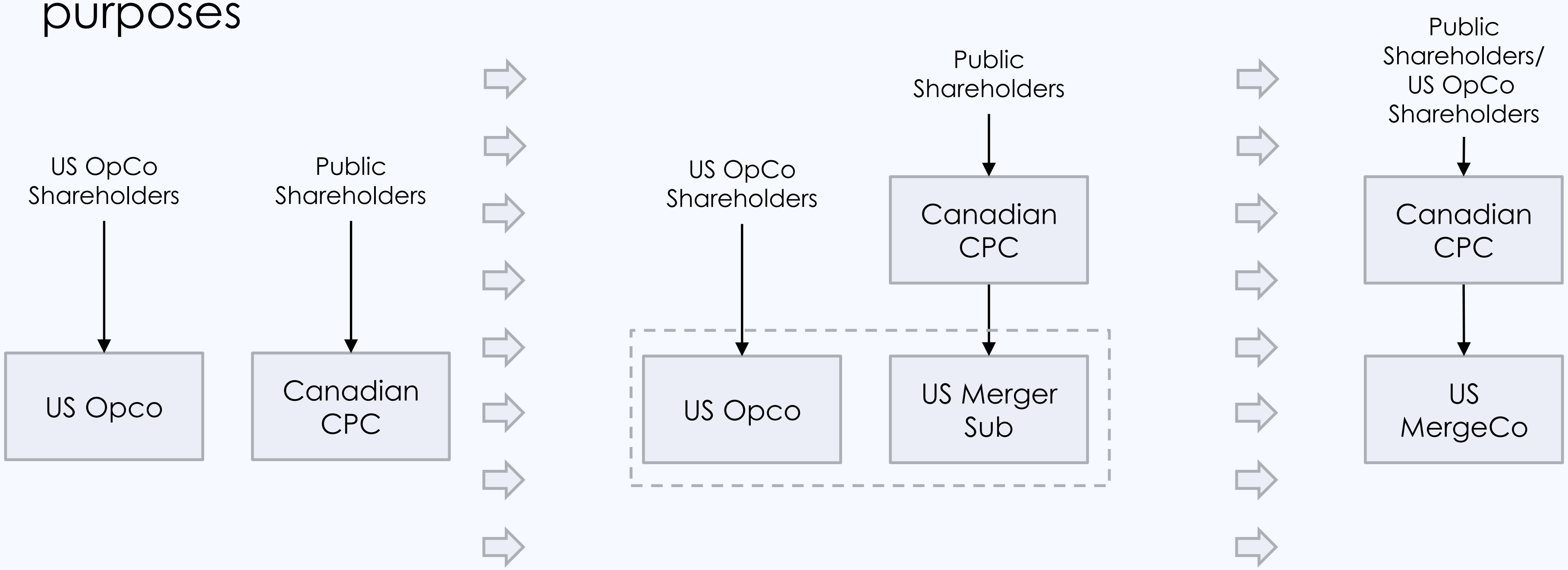
- Primarily used as a planning tool for IPOs of US enterprises, but are becoming more common in Canada
- A TRA is, effectively, no different than a contractual rights-based CVR. It is a contract for payments based on a predefined contingency, namely tax savings. As such, the Canadian-tax considerations should be no different than those already canvassed

CANADIAN TAX ISSUES WHEN DEALING WITH CANADIAN COMPANIES THAT ARE TREATED AS INVERTED FOR US TAX PURPOSES

FRANCESCO GUCCIARDO

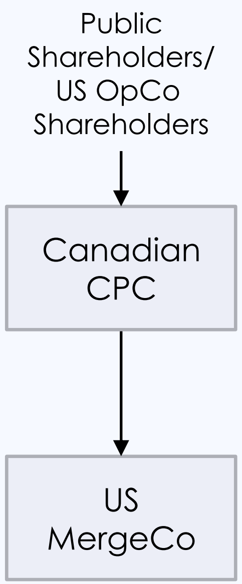
CPCs & Cross-Border (US) RTOs

- Small and mid-sized US companies might seek quick, flexible and efficient access to the Canadian capital markets by completing a reverse takeover with a Canadian-listed capital pool company, often driven by the additional non-tax benefit of achieving foreign private issuer status for US securities law purposes



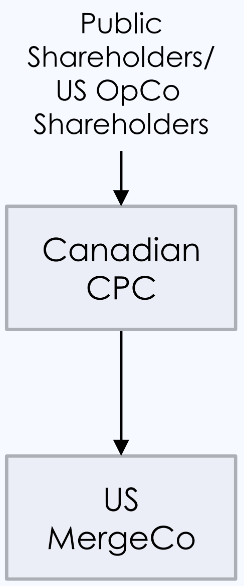
CPCs & Cross-Border (US) RTOs – US Inversions

- Presume 80%+ of the shares of Canadian CPC are owned by the former US OpCo Shareholders
- (Presuming no exception is met), section 7874 of the *US Internal Revenue Code* (anti-inversion rules) applies to deem Canadian CPC to be a US-resident corporation for US federal income tax purposes – US MergeCo is an “inverted” US company
  - Seek qualified US tax advice regarding the application of this provision, the thresholds that must be met in order to trigger an inversion and the type that may be triggered, the availability of any exceptions, and general US tax consequences of an inversion to the company(ies) and shareholders



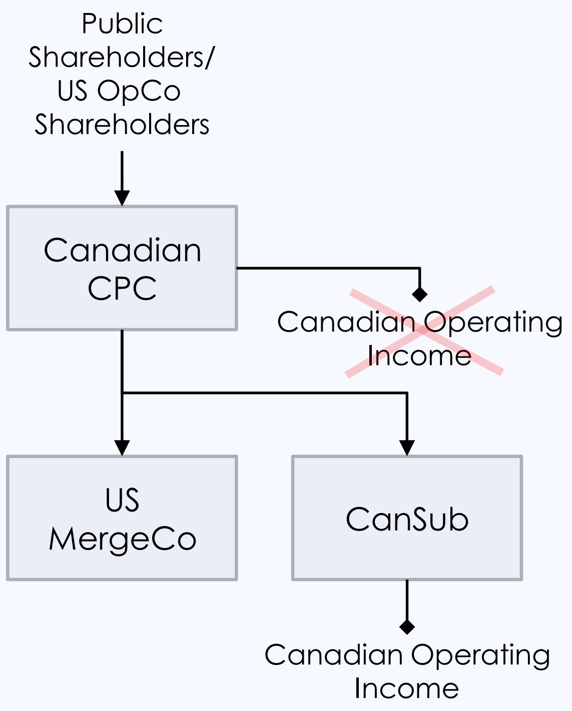
CPCs & Cross-Border (US) RTOs – US Inversions

- *Canada-US Tax Convention* does not relieve the dual residency issue created as a result of an inversion because the US rules specifically and unilaterally override treaties (e.g. Article IV(3)(a) would otherwise tie-break to Canadian CPC's jurisdiction of formation)
- Canadian CPC is subject to <u>both</u> US and Canadian income tax on its worldwide income and dividends paid by Canadian CPC subject to both Canadian and US withholding tax, as applicable



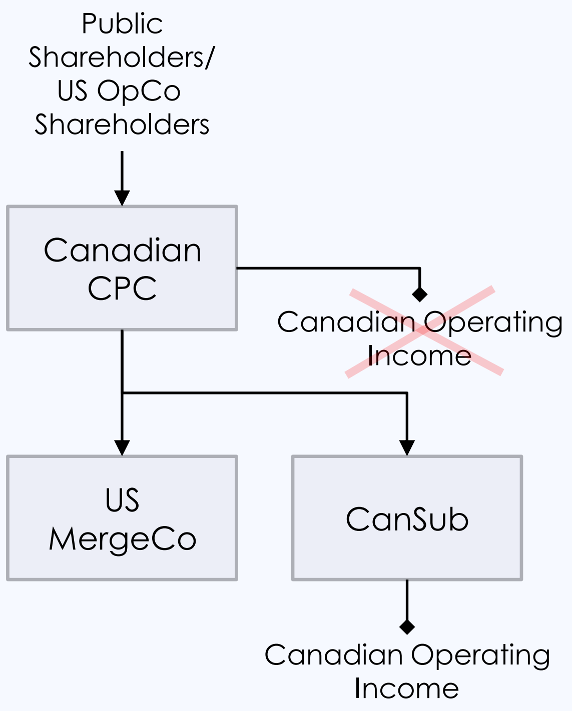
CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- Canadian CPC should not carry on business in Canada directly as US taxes paid on Canadian business income of Canadian CPC will not generally be creditable against Canadian taxes payable on that income (e.g. a credit for business income tax paid to the U.S. is generally limited to such tax paid by the taxpayer for the year "in respect of businesses carried on by the taxpayer <u>in that country</u>…" and the income sourcing rules at Article XXIV(3) of the *Canada-US Tax Convention* does not operate so as to source the income to the US)



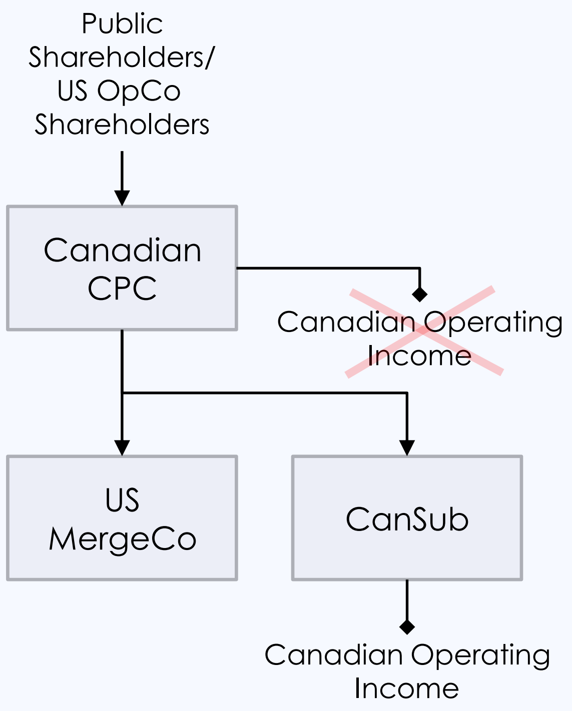
CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- In the context of a CPC RTO, Canadian CPC would not be expected to earn any income directly; future Canadian business should be earned via a subsidiary Canadian operating corporation, and partnership and/or joint venture interests held via a blocking Canadian holding company
  - US tax advice is needed to confirm that the subsidiary Canadian corporations would be regarded and that the income earned by or allocated to such corporations not imputed to Canadian CPC on an accrual basis or otherwise, and not subject to the US Global Intangible Low-Taxed Income (GILTI) regime



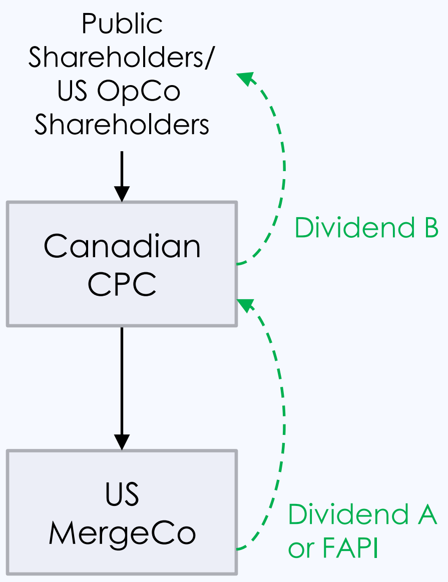
CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- US shares a similar exemption regime as Canada on repatriation of foreign active profit to the US (e.g. dividends paid by CanSub to Canadian CPC) such that the interposition of blocking entities should not be expected to result in current US taxation on the active business income of the Canadian subsidiary



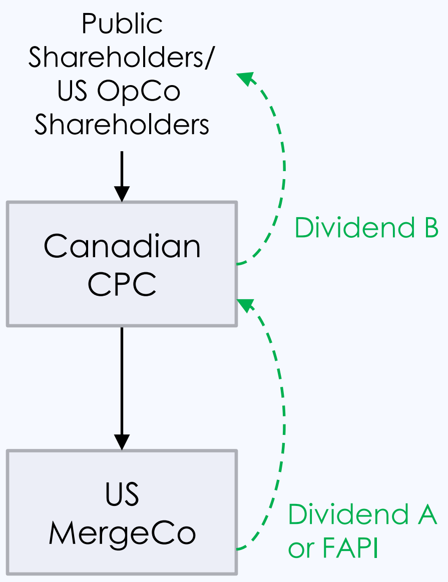
CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- **Dividend A** – provided that the dividend is paid out of exempt surplus, Canadian CPC should receive the dividend from US MergeCo tax-free for Canadian federal income tax purposes (similarly, there should be no US withholding tax or mainstream US tax)



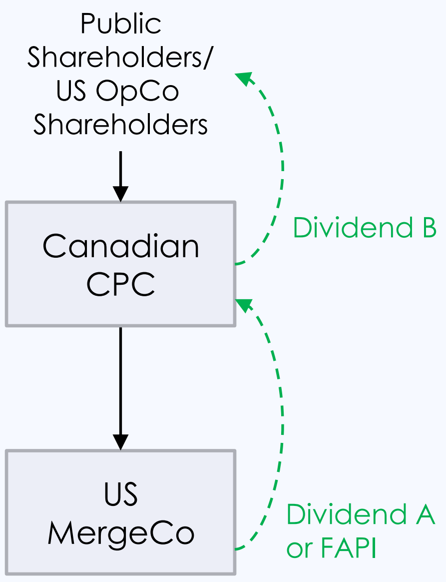
CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- **FAPI** – it is conceivable that US MergeCo may generate foreign accrual property income (FAPI) (e.g. underlying investment business)
  - Consider technical issues in claiming a deduction under subsection 91(4) for foreign tax if the US taxes in respect of that income is legally paid by Canadian CPC (e.g. could be the case where Canadian CPC is the parent company for a US group that files a consolidated return, although the members of the group are jointly liable and generally enter into an internal tax sharing agreement)



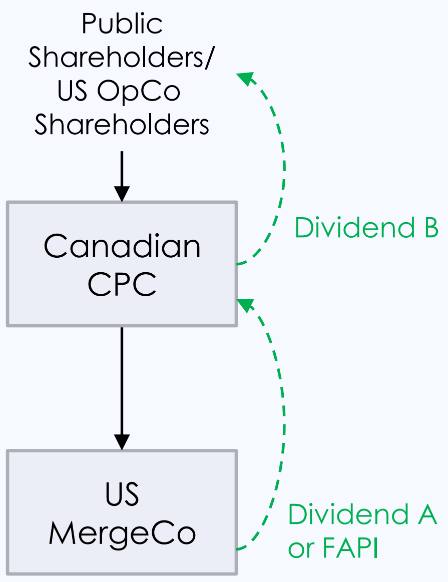
CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- "foreign accrual tax" is generally tax paid by a foreign affiliate of the taxpayer (whether the particular affiliate that generated the income or another foreign affiliate of the taxpayer in certain circumstances)
- The condition that the tax be *paid by* a foreign affiliate would not appear to be met



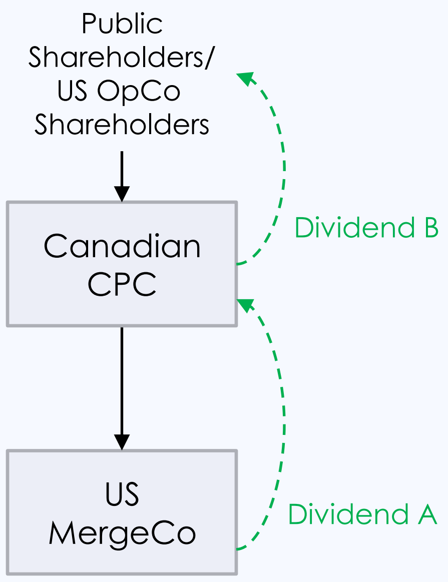
CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- If the U.S. tax on the FAPI is not a foreign accrual tax, the carve-out in subsection 126(1) and 20(12) denying a credit or deduction in respect of non-business income tax that may be claimed by corporations where the tax may reasonably be regarded as having been paid by the taxpayer in respect of income from a share of the capital stock of a foreign affiliate is problematic
- Similar crediting challenge in the US for any Canadian taxes ultimately payable



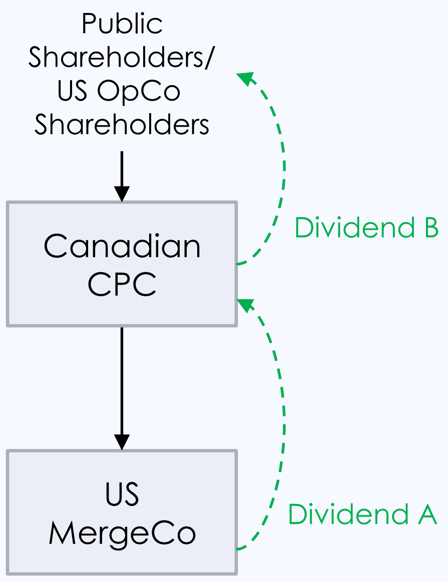
CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- **Dividend B** – Canadian withholding tax applies in respect of dividends paid by Canadian CPC to non-resident shareholders and US withholding tax applies in respect of dividends paid by Canadian CPC to non-US shareholders
  - US withholding tax imposed on a Canadian-resident shareholder should qualify as a "non-business income tax" per subsection 126(1)
  - However, as it is paid by a Canadian corporation the dividend does not qualify as income from a U.S. source as required in the mid-amble of paragraph 126(1)(b)



CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- Unless the Canadian resident shareholder has other unsheltered US-source income, the Canadian resident shareholder may not be in a position to fully monetize the US-withholding tax paid by way of crediting in Canada
- Canadian resident shareholder may be able to partially monetize the US withholding tax paid in the form of a deduction in computing income per subsection 20(12)
- Similar issues may arise for US shareholders domestically in the US, and issues of full monetization and denial may arise for non-Canada/non-US shareholders



CPCs & Cross-Border (US) RTOs – US Inversions

- Inversions are not new, although the US rules have been expanded considerably in recent years and, in particular, via section 7874 of the *Internal Revenue Code*
- In circumstances where Canadian CPC does not earn any income (aside from exempt dividends from foreign affiliates) and does not intend to pay dividends, the consequences of an inversion may be manageable
  - The status of the Canadian CPC as a domestic US corporation for US federal income tax purposes could even prove beneficial insofar as it may facilitate a tax-free business combination for the US OpCo Shareholders participating in the RTO

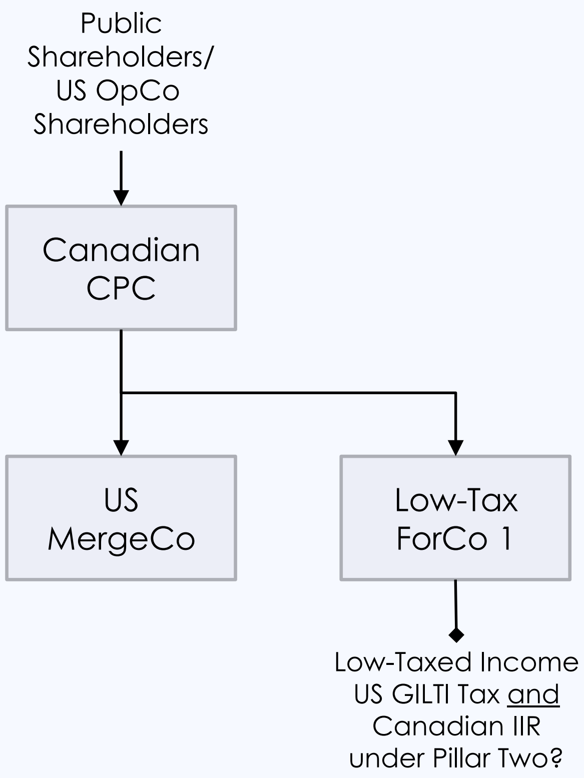
CPCs & Cross-Border (US) RTOs – US Inversions

- For a brief period in and around 2013, inversions were deliberately triggered in the US real estate space whereby a publicly listed Canadian trust would complete a public offering and acquire a portfolio of US real properties of a US partnership in a manner that would cause the trust to be inverted and treated as a domestic US corporation, facilitating qualification as a US REIT for US federal income tax purposes and a familiar non-SIFT income trust for Canadian purposes

CPCs & Cross-Border (US) RTOs – International Expansion

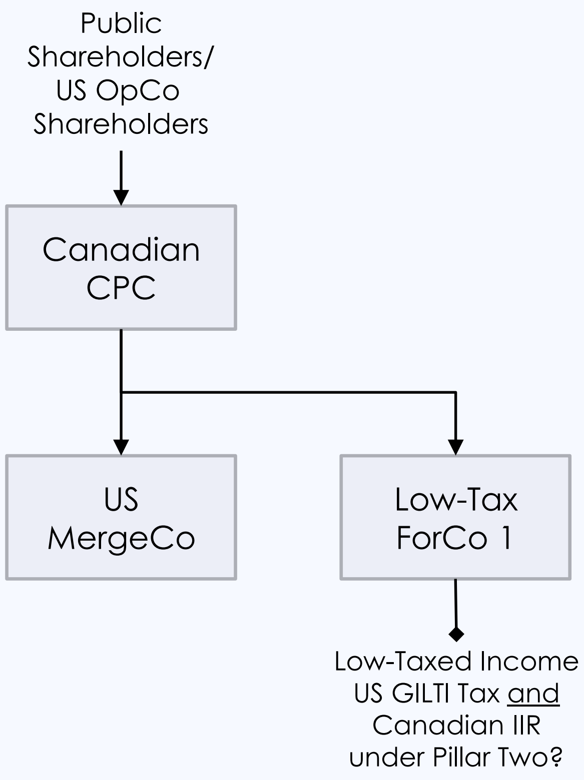
<u>Possible Pillar Two Issues</u>:

- Where is Canadian CPC located for purposes of applying the income inclusion rule (IIR) under Pillar Two?
- If Canada has the right to apply the IIR under Pillar Two on the low-taxed income for Low-Tax ForCo 1 and the US applies its own minimum tax on that same income under its Global Intangible Low-Taxed Income (GILTI) regime:



CPCs & Cross-Border (US) RTOs – International Expansion

- Will one regime take precedence over the other (and, if so, which)?
- If there is no clear ordering, what relief will be available in Canada on account of any US GILTI tax that might be paid at the level of Canadian CPC on the same income of Low-Tax ForCo 1 (and vice-versa)?
  - There would still appear to be a "mismatch" in terms of the source of foreign taxation (e.g. US GILTI tax) and the source of foreign income (e.g. jurisdiction of Low-Tax ForCo 1)



UPDATE ON TAX PROVISIONS IN TRANSACTIONAL AGREEMENTS

CARRIE AIKEN

Representations and Warranties

- Representations: statements about past or existing facts
- Warranties: confirmations that existing or future facts are or will be true
- Allow the parties to identify and allocate business and legal risks
- Recent Developments
  - Section 160 risk
  - CEWS risk
  - Reportable Transactions
  - FAD representation and covenants

Tax Indemnity Provisions

- General indemnity vs. tax specific indemnity
- Tax specific indemnities are not usually subject to baskets or caps
- Some SPAs will specify adjustments to indemnifiable amounts to account for tax benefits recognized by the indemnified party for suffering the loss or tax consequences to the indemnified party of receiving the indemnity payment

Scope of Tax Indemnity

- Generally intended to cover “Taxes” and other damages that arise in respect of pre-closing tax periods and vendor pre-closing reorganizations
- Relevant definitions may include “Taxes”, “Damages”, “Loss” or “Liability”
- Standard definition of “Taxes” does not typically cover refundable items (e.g., SR&ED credits) or CEWS
- Consequential or indirect damages are generally covered by the indemnity unless expressly excluded or limited

Boliden Mineral AB v. FQM Kevitsa Sweden Holdings AB, 2021 ONSC 6844

- Boliden sought indemnity from FQM under a purchase agreement (PSA) relating to the 2016 acquisition by Boliden of the shares of Kevitsa
- Kevitsa, a Finnish corporation, had tax losses from pre-closing tax periods
- Under Finnish law, tax losses after a change of control are forfeited, unless the Finnish tax authorities (FTA) grant a permit to use the losses after the acquisition
- Kevitsa applied for and was granted the permit in May 2017 and claimed the losses against income in 2017 and 2018 ("post-closing years")
- 2010 reorganization of Kevitsa was reassessed, resulting in an increase to taxable income in pre- and post- closing years
- Taxes in post-closing years arose because the losses used to shelter income those years were shifted to shelter reassessed income in pre-closing years

Boliden Mineral AB v. FQM Kevitsa Sweden Holdings AB

- FQM gave no specific assurance in PSA with respect to tax losses or the ability to use the losses after closing
- Boliden relied on the representation that "there are no grounds for the reassessment of Taxes of the Corporation" for seeking indemnification
- Definition of "Loss" in PSA included a consequential or indirect loss "to the extent that it is a reasonably foreseeable consequence of the event or circumstance constituting the ground for the applicable indemnification obligation"
- Tax indemnity covered "any Taxes required to be paid or remitted… <u>with respect to</u> any Pre-Closing Tax Period"

Boliden – Was there a breach of representation / warranty?

- FQM argued that there was no breach of rep because it only covered known grounds for a reassessment as of the closing date
- Court held that there was a breach of rep:
  - The representation and warranty was absolute
  - There were no knowledge qualifiers
  - The parties were sophisticated and understood that a potential reassessment could arise after the SPA was entered into
  - The agreement placed the risk of possible reassessments on the vendor and not on the purchaser

Boliden – What was the scope of the indemnity obligation?

- Boliden argued that the indemnity covered the increased taxes in both the pre-closing and post-closing years
- FQM argued that the indemnity only covered taxes in pre-closing periods and taxes in post-closing years were consequential losses that were not reasonably foreseeable

Boliden – What was the scope of the indemnity obligation?

- Court found that the domino effect of the reassessment in the post-closing years was reasonably foreseeable and the taxes in those years were indemnifiable:
  - Vendor knew about the tax losses and that they had value
  - It was reasonable to expect that purchaser would (1) apply for (and be granted) a permit to use the losses, and (2) claim the losses in post-closing years because the company was profitable and taxable
  - Indemnity did not contain an express temporal limitation and covered Taxes “with respect to” any Pre-Closing Tax Period

Boliden – What was the scope of the indemnity obligation?

Ontario Superior Court of Justice held:

> *Contrary to the position advanced by FQM, the applicants are not claiming for the "inability" to use tax losses carry forwards. They are claiming for taxes required to be paid, which flow directly from the FTA's reassessment. The tax losses carried forward by Kevitsa post-closing were not lost, eliminated, or rejected by the Finnish tax authorities. Rather, the FTA reassessed and recognized income in Pre-Closing Tax Periods which resulted in a cascading effect of substantially higher taxes payable by Kevitsa. All of those additional taxes are payable in respect of the reassessment of Pre-Closing Tax Periods… There is no question this increased income tax cost is "with respect to" Pre-Closing Tax Periods, since it arises directly from reassessed income in those years.*

Rep / Warranty Insurance in M&A

- Insurance product for managing undiscovered risks in a transaction
- Replace vendor's indemnification obligations for breach of representation and warranties
- Insurance may be useful in M&A deals where parties are unwilling or unable to provide protection under an indemnity (e.g., widely held targets, private equity vendors, vendors with limited resources)
- Insurance may also reduce or eliminate holdbacks on closing
- Covers standard tax representations and warranties, common tax risks (e.g., residency, status of corporations, etc.) and pre-closing tax indemnities

Rep / Warranty Insurance in M&A

- Typically excludes:
  - Pre-closing reorganizations
  - Tax losses
  - Transfer pricing
  - SR&ED claims
  - Off-market or overly broad representations and warranties
  - Issues identified in due diligence
- Tax insurance may provide protection for specific identified risks (e.g., taxable Canadian property, withholding tax issues, permanent establishment issues)

Insurance / Indemnification and Reportable Transactions

- Mandatory reporting regime in s. 237.3 for "reportable transactions"
- Proposed changes will broaden the application of the regime
- Taxpayers that realize a "tax benefit" as defined for purposes of the GAAR from a "reportable transaction", and certain other persons, must report details of the transaction to the CRA
- A transaction is caught by the rules if it (a) is an "avoidance transaction" (being a transaction if one of the main purposes of the transaction or series of transactions is to obtain a tax benefit), and (b) has at least one out of three "hallmarks" of aggressive tax avoidance
- Definition and interpretation of the hallmark of "contractual protection" is concerning for tax insurance and tax indemnities

Insurance / Indemnification and Reportable Transactions

Contractual protection is defined as:

(a) any form of insurance (other than standard professional liability insurance) or other protection, including, without limitation, an indemnity, compensation or a guarantee that, either immediately or in the future and either absolutely or contingently,

(i) protects a person against a failure of the transaction or series to achieve any tax benefit from the transaction or series, or

(ii) pays for or reimburses any expense, fee, tax, interest, penalty or similar amount that may be incurred by a person in the course of a dispute in respect of a tax benefit from the transaction or series

Insurance / Indemnification and Reportable Transactions

- Definition of contractual protection is extremely broad
- Concern that it may cover:
  - Tax indemnity provisions and tax insurance products
  - Covenants for assistance in tax disputes
- Draft legislation adds an important carve-out from the definition of contractual protection for "insurance, protection or undertakings <u>offered to a broad class of persons</u> and in a <u>normal commercial or investment context</u> in which parties deal with each other at arm's length and act prudently, knowledgeably and willingly"

Insurance / Indemnification and Reportable Transactions

- The carve-out is only available if the protection is (1) offered to a "broad class of persons" and (2) in a "normal commercial or investment context"
- Who is a "broad class of persons"?
- Should the carve-out apply to typical share purchase indemnities for historic tax liabilities?
- Does the indemnity go beyond what is ordinary commercial practice?
- Department of Finance explanatory notes indicate the carve-out is intended to exclude contractual protection offered in the context of normal commercial transactions to a wide market

Break Fees – *Glencore Canada Corporation v. The Queen*, 2021 TCC 63

- Tax Court held that fees received by Falconbridge on a failed merger were income
- Fees were calculated as 2.5% of transaction value and included:
  - Commitment fee of $28.2M on execution of merger agreement
  - Break fee of $73.3M payable on a failure to complete the merger
- Falconbridge was interested in DFR for its indirect interest in a valuable mineral deposit in Voisey Bay

Break Fees – *Glencore Canada Corporation v. The Queen*

- Tax Court concluded that:
  - The acquisition of Voisey Bay was part of Falconbridge's strategy for earning income
  - Falconbridge was carrying on business when it negotiated the merger agreement
  - The fees were received by Falconbridge in the conduct of its business and were ancillary business income