Cross-Border M&A: Canada & U.S.
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This presentation addressed U.S.-Canada M&A transactions with a particular focus on inversions of U.S. companies. The presentation discussed three high profile transactions: (1) an exchangeable share "merger of equals" (Molson-Coors), (2) a Canadian Topco acquisition (Biovail-Valeant), and (3) a new foreign (Irish) Topco (Endo-Paladin).

Before delving into the case studies, the presenters discussed the preliminary question of how to choose a "TopCo." The slides described a long list of factors, including the possibility of deferral, attractiveness of the CFC regime, or the corporate tax rate, all of which go into deciding which counterparty should be the TopCo and in which jurisdiction the TopCo should be located.

Molson/Coors

The first case study was the 2005 combination of Molson Inc., a Canadian company, with Adolph Coors Company, a U.S. company. This transaction is notable because it is the last high-profile "exchangeable share" deal. It involved the combination of two comparably sized and well-known publicly traded companies. Both Coors and Molson had dual class share structure and had family shareholders that had sizeable stakes in the respective companies with significant built-in gain, and both companies paid regular dividends. The shareholders sought to defer any built-in gain while minimizing potential taxes on future dividends.

From a U.S. perspective, if a Canadian TopCo was chosen, deferral of shareholder level gain was possible on a direct exchange of shares as long as the shareholders received less than 50% of the vote/value of the Canadian TopCo. In addition, any 5% U.S. shareholders would have to enter into a gain recognition agreement ("GRA"). With respect to dividends, either a Canadian or U.S. TopCo would result in dividend withholding tax.

For non-tax reasons a U.S. TopCo was more attractive, and ultimately an exchangeable share structure was chosen where Coors would be the TopCo and Molson shareholders exchanged their shares for their choice of fully taxable Coors shares or exchangeable shares of a new wholly owned indirect Canadian subsidiary of Coors ("ExchangeCo"). This effectively gave the Molson shareholders deferral for those who wanted it, and allowed them to acquire shares of the TopCo when they wanted it. This also allowed the parties to make a section 338 election with respect to the Canadian company, resulting in a step up in basis, which would faciliate the distribution of assets out of Molson. There is some question though as to whether the exchangeable shares should be treated as U.S. stock, resulting in U.S. source dividends paid to Canadian shareholders – although the economics mimic shares in a U.S. company, legally the shares represent that of a Canadian company.

Biovail/Valeant

The presenters next discussed the 2010 combination of Biovail Corporation, a Canadian company, and Valeant Pharmaceutical International, a U.S. company, which ultimately resulted

in a Canadian TopCo and thus an inversion from a U.S. perspective. The presenters prefaced the discussion by describing some of the benefits of a U.S. expatriation, including avoiding U.S. tax on future foreign expansion and earnings stripping. The two main U.S. tax provisions that address inversions are sections 367 and 7874. Section 367 generally imposes a shareholder level tax on the transfer of U.S. stock, but does not impose any corporate level consequences, and generally does not apply at all if the foreign acquirer is larger than the U.S. target. Under section 7874, the shareholders of the U.S. target combining with a foreign acquirer cannot own more than 80% of the combined foreign company, otherwise it is treated as a domestic corporation. Section 7874 does not impose shareholder level tax consequences.

In the Biovail / Valeant transaction, the parties were concerned primarily with shareholder level tax under section 367, rather than the section 7874 anti-inversion rules (due to the relatively large size of Biovail). Since section 367 generally requires the foreign acquirer to be larger than the U.S. target, the parties "slimmed down" Valeant by having it pay a large special dividend, such that at the time of the acquisition, Biovail was more valuable. Although there is a rule preventing "stuffing" the foreign acquirer to make it more valuable, under section 367 a pre-merger dividend appears to be acceptable even if done for the purpose of avoiding section 367. On the other hand, a pre-merger dividend would not work under the anti-abuse rule in section 7874(c)(4).

Because section 367 only imposes shareholder level tax, many taxpayers are still willing to move forward with an inversion as long as they can avoid corporate level tax under section 7874. As a result, section 367 has not created much of a deterrent to expatriation. Furthermore, until very recently, there was a way for U.S. target's shareholders to maintain ownership of more than 50% of the combined company without triggering shareholder level tax. This segued into a discussion of the Endo/Paladin transaction

Endo/Paladin

Before discussing the deal, the presenters gave an overview of the so-called "Killer B" transactions. The strategy required having the foreign parent sell its shares to the U.S. merger sub in exchange for a note; the U.S. merger sub then acquires the U.S. target using the parent stock. This strategy would have created a pipeline for repatriating earnings free of withholding tax, or for earnings stripping, depending on whether the parent and sub were foreign or domestic. Under the so-called "Killer B" regulations, though, the sub's acquisition of its parent stock is treated as a deemed distribution followed by contribution of property prior to the acquisition of the parent stock.

Furthermore, the regulations provide a priority rule that turns off section 367 if the corporate level tax from the deemed distribution exceeds the shareholder level tax that would have resulted under section 367. Prior to a recent IRS Notice, the calculation of the corporate level gain included capital gain that a foreign parent would theoretically realize if the value of the deemed distribution exceeded basis. As a result, a U.S. subsidiary with very little E&P could acquire stock of its foreign parent and trigger the priority rule, thereby turning of section 367, without anyone actually paying corporate level tax.

An IRS Notice issued in April ended the use of this strategy by requiring that any corporate level gain be actually taxable in the U.S., and by broadening the E&P calculation to include the target U.S. company's E&P in certain cases. However, this Notice was issued before the Endo/Paladin transaction, which closed in early 2014.

Endo is a U.S. corporation and Paladin is a Canadian corporation. The two entities were ultimately acquired underneath a new Irish company whereby the former Endo shareholders owned less than 77% and the former Paladin shareholders owned 23% of the Irish company. A subsidiary of the Irish company issued a note to acquire its parent's stock, which it used to acquire Endo. Because the former Endo shareholders ended up with more than 50% of the combined company, section 367 likely would have applied absent the priority rule. Presumably, the transaction was effected such that the deemed corporate level gain would exceed shareholder level gain thereby turning of section 367, but there are various uncertainties as to whether this was successful (for example, E&P will not be known until after 2014). Because the transaction closed this year, not all of the facts surrounding the deal are public yet.

Recent Developments

Finally, the presenters closed with a discuss of recent developments. Several members of Congress have proposed to tighten the anti-inversion rules in part by reducing the 80% threshold for treatment as a domestic corporation to 50%. The presenters pointed out that the more section 7874 is expanded, the more section 367 shrinks as a relevant anti-inversion rule. Once section 7874 is triggered treating the combined company as domestic, then section 367 is no longer applicable.