CANADIAN and U.S. IFA BRANCHES
Joint Meeting-Seminar

Panel on Mergers & Acquisitions

Nat Boidman, Moderator & Panelist

Ron Durand, Kim Blanchard & Jerry Libin, Panelists

RON DURAND

STIKEMAN ELLIOTT

WHAT DOES A CANADIAN TAX ADVISOR WORRY ABOUT WHEN ADVISING A US ACQUIROR OF A CANADIAN TARGET?

IFA Joint Canada – US Seminar

Mergers & Acquisitions

May 17, 2007

Ron Durand
Stikeman Elliott LLP

Part I. What can you offer the sellers to increase your chances of success?

Part II. How do you want to structure the transaction to achieve your goals?

Part III. Flow-Through Vehicles

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Part I. What Seller Wants

> tax deferral
> choice between capital gains and dividends
> access to safe income

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- tax deferral for Canadian sellers
  - Canadian exchanging Canco shares for shares in US acquiror is taxable
    - October 18, 2000 economic statement – a rollover is under consideration
    - February 2003 ("near future")
March 2004 ("in the coming months")
February 2005 ("near future")
  - exchangeable shares
    - no bump available

- taxable transaction for Canadian sellers
  - how Canada measures capital gains vs deemed dividends on shares
    - proceeds minus *cost* is a capital gain if sold to *third party*
    - proceeds minus *paid-up capital* is a deemed dividend if sold to *issuer* (and in calculating associated capital gain or loss, proceeds are reduced by the amount of the deemed dividend)

- how Canada taxes capital gains vs dividends
  - capital gains at 50% of normal rates
  - dividends to corporate recipients can range from tax free to fully taxable and can be subject to special taxes for both payor and payee
  - dividends to individuals subject to integration rules and rates range from no tax for low income earners to approximately capital gains rate for high income earners

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	eligible dividends general rate income (grip)	non-eligible dividends low rate income (lrip)*
corporate earnings	100	100
corporate tax	36	18.5
dividend	64	81.5
gross-up rate	45%	25%
gross-up amount	28.8	20.4
taxable amount	92.8	101.9
tax rate	46%	46%
gross tax	42.7	46.9
redit	(28.8)	(20.4)
net tax	13.9	26.5
tax rate for top rate ind.	21.7%	32.5%
total tax	49.9	45

*generated by a Canadian controlled private corporation, generally up to 400,000 of active business income per year

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effect of integration rules on lower income taxpayers

	46% taxpayer	31% taxpayer (up to $72,000)
dividend	64	64
gross-up amount	28.8	28.8
taxable amount	92.8	92.8
tax rate	46%	31%
gross tax	42.7	28.8
credit	(28.8)	(28.8)
net tax	13.9	0
rate	21.7%	0

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> offering shareholders a choice between capital gains or deemed dividends
  - shifting paid-up capital on an amalgamation
  - offering low and/or high capital shares on a take-over
  - 116 certificate and Part VI.I tax issues

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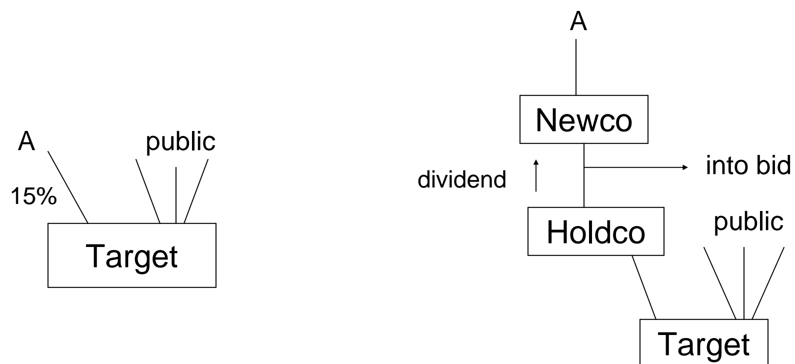
> "safe income" for significant shareholders
  - holdco alternatives (concerns with 52(3)(a))



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- dividend from Holdco to Newco did not originate with Target
- for a non-ccpc as long as it has no lrip, dividends paid by it can be eligible dividends without penalty
- but for a ccpc, dividends cannot be eligible dividends without penalty unless it has grip
- so Newco and Holdco should consider electing under 89 (11) prior to closing not to be a ccpc

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Part II. What Acquiror Wants

- Canadian acquisition corporation
- unwinding sandwiches
- selling redundant assets
- break fee

- Canadian acquisition corporation
  - cross-border capital
  - thin-cap rules
  - repatriate capital
  - bump cost base of non-depreciable assets
  - deduct interest against target's earnings
- importance of the initial structure
  - 212.1
  - CRA's general gaar approach to altering pre-existing structures

- unwinding sandwiches
- disposing of redundant assets
  - potential changes regarding interest deductibility
    - impact on acquisition financing under possible tracing or apportionment theories
  - bump
  - foreign affiliate rules
  - acquisition of control rules

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- bump
  - all cash in a public deal
  - in a private deal former shareholders owning less than 10% in the aggregate could receive substituted property
    - substituted property is bad
      - property the value of which is wholly or partially attributable to property distributed to the parent on the winding-up
      - non-resident debt or shares
      - options
      - bonuses based on performance of assets
  - packaging
  - valuation issues
  - advance tax ruling

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- break fees
  - who do they belong to?
    - US parent or Canadian Acquisitionco
  - taxable?
    - windfall, capital gain, ordinary income
    - restrictive covenant is "an agreement that affects in any way whatever the acquisition or provision of property or services"
  - withholding?
    - 25% rate? (other income article)
    - governing law
    - business profits under Treaty?
    - payable to a Canadian ULC Acquisitionco
  - gross-up?
    - securities law issues

Part III. Flow-Through Vehicles

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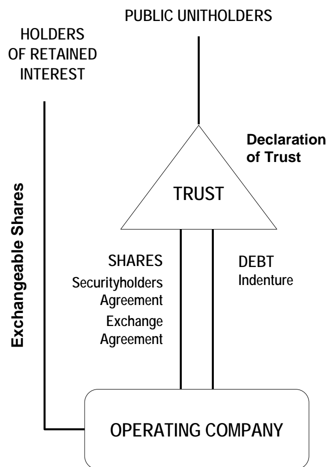
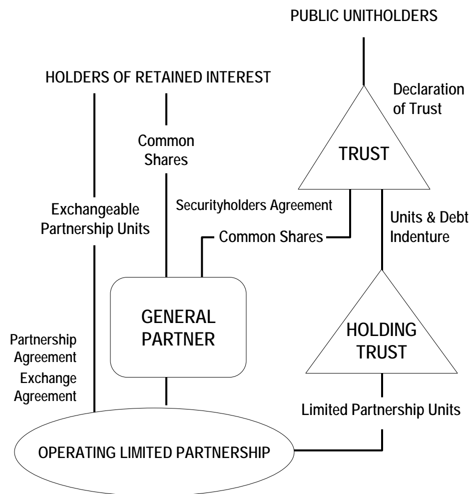
DOMESTIC INCOME TRUSTS – TYPICAL STRUCTURES

Corporate Trust Structure



Limited Partnership Structure



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- new rules for taxation of Specified Investment Flow-Throughs (SIFTs)
  - distribution tax equivalent to corporate level tax
  - distributions taxed as eligible dividends
  - does not extend to direct foreign income
- transitional rules
  - SIFT that existed on October 31, 2006 will be taxed from January 1, 2011

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- acquiring fund units (preferred by non-Canadian sellers)
- acquiring underlying shares of operating company or units of operating partnership
- cash consideration
- exchangeable share consideration

KIM BLANCHARD

WHAT DOES A US TAX ADVISOR WORRY ABOUT WHEN ADVISING A US ACQUIROR OF A CANADIAN TARGET?

IFA Joint Canada-US Seminar
Mergers & Acquisitions
Kimberly S. Blanchard
Weil, Gotshal & Manges LLP
May 17, 2007

1

Part I – Trying to Get the Deal

- There's no use worrying about tax problems in execution or going forward if your client doesn't win the deal in the first place
- If the Canadian target is a public company, shareholder approval will normally be required, so thought must be given to the type of consideration that those shareholders will want to receive, and how they might be taxed
- If the target is private, the shareholders will tell you what they want! In a bid situation, pressure will be on your client to structure tax-efficiently for the selling shareholders
- But in every case there is a trade-off between giving the sellers what they want, and the best answer for the buyer

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Part I – Trying to Get the Deal

- Canadian shareholders who want tax deferral can't accept shares of the US acquiror, leading to frequent use of exchangeables
- US shareholders who want tax deferral will want the deal structured to satisfy US tax-free reorganization rules, requiring generally that at least 40% (and often more) of the consideration take the form of shares
- Even if the US tax-free reorg rules are satisfied, US shareholders may be subject to tax at ordinary income rates, under section 367(b)'s "inbound" rules, if target has unrepatriated E&P

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Part I – Trying to Get the Deal

- If the deal is structured to satisfy the US tax-free reorg rules, the acquiror will generally get no step-up in the stock or assets of the target for US tax purposes
- US step-up for target's assets is of indirect use where Canadian target becomes a CFC
- Canadian step-up or "bump" is more important

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Part II – Structuring the Deal

- It may be very difficult or even impossible to get tax deferral for both US and Canadian shareholders
- As noted, it can be possible – though difficult – to get tax deferral for the Canadian shareholders while achieving a taxable purchase of the target for US tax purposes, enabling a basis step-up
  - Exchangeables deal with US 338(g) election

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Part II – Structuring the Deal

- How to get US basis step-up for target's assets
  - Do a "qualified stock purchase" (QSP) and make a Code section 338(g) election,
  - Buy assets for US tax purposes by buying shares of a Nova Scotia or Alberta unlimited liability company, or
  - Use two foreign acquirecos to buy stock and make check the box election

6

Part II – Structuring the Deal

- Requirements for a Section 338(g) election
  - Must acquire 80% of target's stock in a 12-month period
  - Must acquire stock in a "qualified stock purchase" – generally must be for cash
- If election made, acquiror gets US step-up and can cause target to sell assets without subpart F income
- Election also wipes out historic earnings (E&P) and reduces E&P going forward if step-up is depreciable

Part II – Structuring the Deal

- Having been acquired by a US acquiror, the Canadian target will become a CFC
  - its E&P will be subject to tax in the hands of the US acquiror
  - On a current basis, if the CFC earns "subpart F", generally passive, income – including gain on the sale of a subsidiary
  - On disposition of the CFC's shares at a gain, for any E&P not already taken into account as subpart F income

Part II – Structuring the Deal

- How to buy assets for US tax purposes without actually buying assets
  - Have seller check the box on target pre-sale
  - In Canada, will require that target be converted to a ULC
  - Target shareholders will not want unlimited liability, so may need to convert target at exact moment it is purchased by acquiror

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Part II – Structuring the Deal

- Ability to make 338(g) election may be delayed by virtue of having acquired more than 66-2/3% but less than 80% in step one
- If target is a 50% controlled CFC for more than 30 days, a subsequent 338(g) election may generate subpart F income to acquiror
- Solution: use two foreign acquirecos and make a check the box election after the first step
  - The election should be treated as a taxable liquidation with step-up under Code sec. 331

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Part III – Financing the Acquisition

- Given the lack of consolidated return concepts in Canada, US acquiror will want to make sure that any acquisition debt is at the level of the Canadian operating company with taxable income to offset
- Usually this is fairly simple to achieve by capitalizing a Canadian acquireco with debt and amalgamating after the acquisition of target's stock

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Part III – Financing the Acquisition

- Hybrid structures may achieve benefits in both the US and Canada, although they seem to be under increasing attack from all sides
- Traditional hybrid loan made use of Canadian partnership between US parent and its US sub, with partnership owning Canadian opco sub; when partnership was a reverse hybrid, interest qualified under same country exception
- New section 954(c)(6) may present other opportunities

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Part IV – Unwinding Sandwiches

- If Canadian target owns US subs, US acquiror will want to move those subs out from under Canada
  - In order to get US tax consolidation
  - In order to avoid cross-border withholding tax leakage
  - In order to avoid having US operations in a CFC

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Part IV – Unwinding Sandwiches

- If Canadian target owns third-country subs, US acquiror will usually want to spin those out too
  - But after 954(c)(6), this is less awful that it once was
  - And Canada is not a bad holding company jurisdiction for operating subs in various countries (at least until recent changes?)

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Part IV – Unwinding Sandwiches

- How to unwind? Problem is that US will treat gain on any sale or distribution by the Canadian target of stock of a lower-tier affiliate as subpart F income
- Possible solutions include (see slide 6):
  - Making a 338(g) election for the Cdn target
  - Purchasing the subs separately – but then Cdn target may have to pay tax

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Part IV – Unwinding Sandwiches

- In some cases, the US acquiror may wish to sell some of the target's subs - "unwanted assets" – to third parties following the closing
- In these cases, subpart F income might be avoided using "check and sell" for non-US subs, or if the non-US sub has E&P, by relying on section 954(c)(6) by reason of section 964(e)

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Part V – Operating the CFC

- Traditionally, US strategic investors had reason to avoid tiers of CFCs, because payments between CFCs often resulted in subpart F income.
- This was changed by the enactment of section 954(c)(6) in 2006
  - Now, dividends, interest, rents and royalties paid by one CFC to a related CFC, even in different countries, often will not result in subpart F income

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Part V – Operating the CFC

- Where the acquiror is not a single US corporation but is a private equity fund –
  - Acquiror will try to avoid target becoming a CFC, even after 954(c)(6), since most investors will be unable to use foreign tax credits for high Canadian taxes paid
  - If target is a “PFIC,” US investors will be subject to punitive tax regime unless a current inclusion election is made
  - If target is a “personal holding company,” there may be current inclusion of certain target income to US shareholders

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Part V – Operating the CFC

- If the Canadian target is a “trust,” additional considerations will arise. Under US tax rules, a “trust” that conducts any business or permits of varying interests is not a trust, but a corporation or partnership
- As the default rule in the absence of an election is probably to corporate status, most acquisitions by US acquirors of Canadian “trusts” will be treated for US tax purposes as corporate acquisitions
- But can target elect to be treated as a partnership for US tax purposes?

JERRY LIBIN

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What Does a U.S. Tax Advisor Worry About When Advising a Canadian Acquiror of a U.S. Target

IFA Canada-U.S. Joint Branch Meeting
Mergers and Acquisitions

Jerome B. Libin
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Washington, DC
May 17, 2007

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- Possible Scenarios Involving Canadian Acquiror of U.S. Target
  - Free-standing U.S. Target
    - Publicly held
    - Privately held
  - U.S. Target as Subsidiary in U.S. Group
  - U.S. Target as a Parent

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- Nature of the Acquisition
  - Stock
  - Assets
- Consideration to be Paid
  - Cash/Notes
  - Stock

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- Structure of the Acquisition
  - Direct (cash or stock acquisition)
  - Triangular (stock acquisition)
- Impact on U.S. Shareholders
  - Taxable (perhaps not a concern if Target is public company with declining stock price)
  - Tax-free

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- Free-standing U.S. Target (assume U.S. shareholders only)
  - Acquisition of Target stock in exchange for cash and/or notes
    - Fully taxable to target shareholders
    - If long-term capital gain, tax on individual shareholders will be 15%
  - Inside Asset Basis Step-up
    - If acquisition constitutes "qualified stock purchase," Acquiror may elect to step up asset basis

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- Acquisition of Target stock for cash (continued)
  - "Qualified Stock Purchase" Election – Sec. 338(g)
    - "QSP" = Purchase of 80% of Target stock (vote and value) within one year
    - Target treated as having sold assets to itself as a "new corporation"
    - Gain/loss to Target determined asset-by-asset
  - Permits sec. 197 (15 year) amortization of purchase price allocable to intangibles (e.g., goodwill and going concern value)
  - Accelerating gain due to election could be more expensive than benefits from increased amortization/depreciation
    - Tax effectively borne by Acquiror
    - Existing NOL to offset gain is best scenario for 338(g)

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- Acquisition of Target Stock for Acquiror's Stock
  - Outbound transfer of stock of U.S. corporation implicates sec. 367(a)
  - Transaction will be tax-free to Target shareholders only if --
    - Target shareholders receive no more than 50% of Acquiror's stock in the exchange
    - No U.S. "control group" owns more than 50% of stock of Acquiror after exchange
    - Acquiror has been carrying on active business outside U.S. for preceding 36 months, with no intention to discontinue

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- Acquisition of Target Stock for Acquiror's Stock (continued)
    - FMV of Acquiror must be at least equal to FMV of Target
    - Each Target shareholder that becomes 5% shareholder in Acquiror must enter into 5-year gain recognition agreement (GRA)
      - Shareholder-by-shareholder requirement
      - If Acquiror sells Target shares in less than 5 years, Target shareholders with GRAs must recognize gain on prior exchange
    - Target must satisfy reporting requirements
    - Any role for "exchangeable" shares in acquisition of a U.S. Target?
  - Need also to avoid "anti-inversion" rules of sec. 7874
    - Requires minimum 60% ownership of Acquiror by Target shareholders

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- Free-standing U.S. Target
  - Acquisition of Target assets
    - If cash acquisition, gain or loss to Target determined asset-by-asset
    - If stock acquisition, outbound asset transfer by Target implicates sec. 367(a)
      - Direct acquisition may not be possible to accomplish tax-free if assets to be used in U.S.
        - Need to use U.S. subsidiary of Acquiror
      - Even if assets used outside U.S., direct acquisition may be taxable – sec. 367(a)(5)

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- U.S. Target as Subsidiary in U.S. Group
  - Acquisition of stock for cash
    - Qualified stock purchase – potential gain/loss to selling corporation
    - Asset Basis Step-up
      - Sec. 338(h)(10) election -- permits step up in Target's asset basis as if assets were acquired directly
        - "Deemed sale" tax borne by selling group, but no tax on stock sale by Target's parent
      - Target's parent must join in election – typically affects negotiated purchase price

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- U.S. Target as Subsidiary in U.S. Group
  - Acquisition of stock for stock of Acquiror
    - Sec. 367(a) implicated – avoided in same manner as described for acquisition of stock of free-standing U.S. corporation
      - 50% ownership limit
      - Parent must execute GRA
      - Active business test
      - Acquiror's FMV at least equal to Target's FMV
    - Reporting requirement for Target

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U.S. Target as Subsidiary (continued)

- Acquisition of assets for cash
  - Gain/loss recognized by Target, asset-by-asset
- Acquisition of assets for Acquiror's stock
  - Sec. 367(a) implicated
  - Operating asset exception not available if assets used in U.S.
  - Use U.S. acquisition corp.
    - Treated as indirect transfer of Target stock
    - Parent must execute GRA, etc.

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- Debt-Financed Acquisitions
  - Placing outside debt at operating company level will permit interest expense to offset operating profit
  - U.S. earnings stripping rules affect interest paid to related parties – sec. 163(j)
    - Applicable if debt-equity ratio exceeds 1.5 to 1
  - Use of hybrid entities may maximize tax efficiencies

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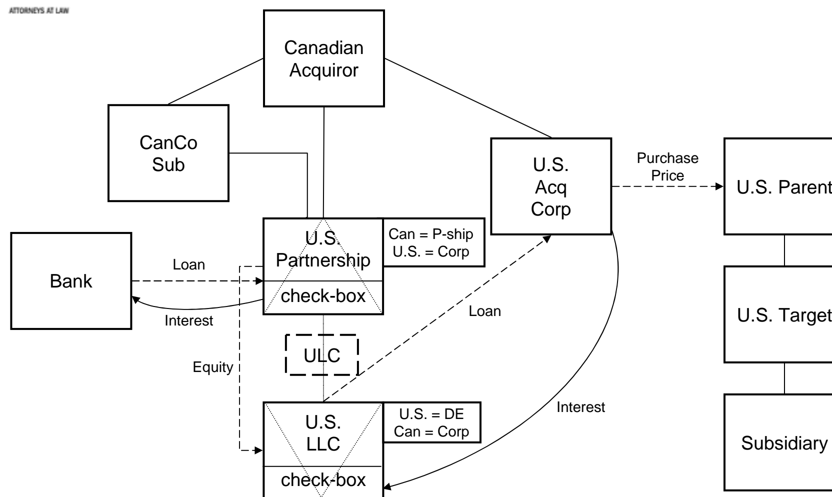
Example – Hybrid Entities



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- U.S. Target as a Parent – Sandwich Structures
  (Assume Target and its parent file U.S. consolidated return)
  - If U.S. Target owns unwanted subsidiary, Acquiror may insist on divestiture before acquisition
    - Sale of unwanted sub to third party
      - Target taxed on gain
      - Target's parent gets basis increase in Target stock equal to gain – reduces gain on sale of Target's stock
    - Distribution of unwanted sub to Target's parent
      - Nontaxable dividend to parent – FMV stock basis in hands of parent
      - Target recognizes gain under sec. 311(b)
      - Parent gets basis increase in Target stock equal to gain recognized

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- U.S. Target as a Parent – Sandwich Structures (continued)
  - Divestiture (continued)
    - Spin-off of unwanted sub
      - Might qualify for tax-free treatment to Target's parent under sec. 355
      - Target likely to recognize gain under sec. 355(c)(2) if spinoff is part of Target acquisition plan
        - » Presumption in sec. 355(e) regarding distribution two years before to two years after acquisition being part of the plan
        - » Various safe harbors available

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- U.S. Target as a Parent – Sandwich Structures (continued)
  - Divestiture (continued)
    - In a spin-off, Target's parent will get basis increase in Target's stock equal to gain recognized
    - Target's parent will allocate portion of its basis in Target stock to unwanted sub acquired through spin-off based on FMV of each entity
  - If divestiture occurs at time of cash acquisition, 338(h)(10) or 338(g) election could be used to increase basis in sub's stock (at price of current U.S. tax as noted earlier)

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- Loss Carry Forward Issues
  - If Target has losses, future use will be limited as result of 50% change in ownership – sec. 382
  - Potentially applicable in case of cash purchase or tax-free stock acquisition
    - No change of ownership in pure asset acquisition
    - As noted above, NOL is beneficial if considering sec. 338(g) election

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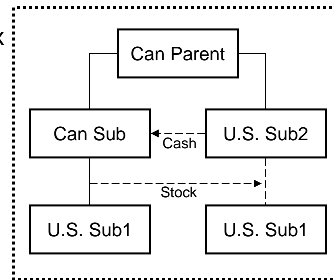
- Repatriation Issues
  - How to get profits back to Canada in most tax-efficient manner
    - Interest payments – 10% U.S. withholding tax
      - Treaty changes forthcoming
    - Dividends – 5% U.S. withholding tax
    - Cross-chain transfers – sec. 304



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NAT BOIDMAN

Canadian and U.S. IFA Branches

Joint Meeting-Seminar
Panel on Mergers & Acquisitions – Segment Four

DAVIES **Davies Ward Phillips & Vineberg LLP**

Nathan Boidman

Toronto
May 17-18, 2007

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

I. OVERVIEW AND CONTEXT

A. The concerns, issues, opportunities, challenges and obstacles are driven by several factors (some of which stem from the U.S. tax considerations raised in the preceding segments).

B. Two threshold Canadian tax dimensions.

(1) Both federal and provincial income tax laws;

(2) The rules, in the context of a foreign subsidiary, incorporate, in part, elements of both Canada's income tax treaties and foreign tax laws.

C. Blend of (1) pure domestic, or (2) pure cross-border or (3) hybrid rules.

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

I. OVERVIEW AND CONTEXT (cont'd)

D. Some rules are mechanical and straightforward, some almost unfathomable, and some without definition:

(1) e.g. uncertainty in determining the appropriate characterization of entities formed in certain jurisdictions for Canadian tax purposes as between corporations (which are taxpayers), trusts (which are taxpayers) and partnerships (which are not taxpayers, but play specified roles).

(a) e.g. partnerships formed under the laws of certain U.S. states [and present informal entente between government and practitioners (don't ask, don't tell)].

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

II. CONCERNS ARISING OUT OF THE FORM OF THE TRANSACTION

A. Baseline – "direct" (see J.L. slides) cash or stock acquisition (often through a U.S. acquisition company) of shares or assets of a U.S. target: no particularly troublesome or nuanced Canadian tax issue.

B. Triangular Merger Technique - Where, however, the acquisition entails a merger technique and payment, at least in part, by stock of the Canadian acquirer, two particular Canadian issues must be addressed.

(1) One issue is securing full-cost base in the target;
- (a) the typical U.S.-driven triangular merger acquisition entails a transitory U.S. acquisition corp. and "surviving" target;
- (b) the elements added to satisfy Canadian cost base requirements: three-party stock subscription;

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

II. CONCERNS – FORM OF THE TRANSACTION (cont'd)

(2) The second issue is securing full addition to "paid-up capital" (PUC) for the shares issued;
- (a) background role of PUC in Canadian tax law;
  - (i) comparative note to U.S. tax law
- (b) element added to secure objective - [see (1)(b)];

(3) Any additional issues raised by current legislative proposals (proposed section 143.3)?

C. Use of Exchangeables Issued by US Target?

(1) See J.L. – generally not used.

(2) If used – Canadian issues?

DAVIES

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

III. CONCERNS RELATED TO FINANCING THE ACQUISITION

A. The parameters and scope of that notion—"financing the acquisition".

(1) Two distinct dynamics traditionally blended into one.

(a) The third-party financing element—and looking to deductibility in Canada.

(b) The internal financing element—and looking to deductibility in the U.S. (i.e. double-dipping).

(c) The relationship between the two.

DAVIES

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

III. CONCERNS – FINANCING THE ACQUISITION (cont'd)

(2) Brief review of pre-existing factors, strategies, structures.

(a) Two-country hybrid entity based;

(b) Three-country;

(c) The ubiquitous role of "95(2)(a)(ii)" – [the forerunner to "954(c)(6)"].

(3) The March 19th Federal Budget hit at element number (1) (a matter to be discussed as well by one or more other panels).

(4) The F/X element in both dimensions and the possible role of future legislative adoption of reporting in functional foreign currency.

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

IV. UNWINDING SANDWICH STRUCTURES

A. Overview

(1) Context – The U.S. constraints – see prior segment.

(2) Unlike the U.S. complexities and occasional blocks in the converse circumstances (see Kim's segment): relatively straightforward and tax-free under current law for three-country sandwiches (and in some cases, for two-country sandwiches).

(a) But see spectre of pending changes adversely affecting this matter.

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

IV. UNWINDING SANDWICH STRUCTURES (cont'd)

B. Unwinding three-country sandwiches (e.g.-Canada-U.S.-the U.K.)

(1) Two distinct elements have to be considered:

(a) attributable "foreign accrual property income" ("FAPI") gain?

(b) tax on receipt (in one way or another) by the Canadian acquirer of the illustrative spun-out U.K. subsidiary?

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

DAVIES

IV. UNWINDING SANDWICH STRUCTURES (cont'd)

(2) With respect to FAPI: two shields

(a) The first, but (time-sensitive) rule is section 95(2)(f) excludes pre-acquisition value.

(i) Therefore, unwind before value change of U.K. subsidiary;

(ii) Comment on proposed FA rule amendments.

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DAVIES

IV. UNWINDING SANDWICH STRUCTURES (cont'd)

(b) The second (and not time-sensitive, *per se*), rule is that gain from "excluded property" is excluded from FAPI

(i) "Excluded property": where all or substantially all of the property of the U.K. subsidiary comprises certain types of property (including directly-held property used in carrying on a "active business" or shares of lower-tier subsidiaries with that property profile);

(ii) Moreover, under the proposed revisions to the foreign affiliate rules, [starting with a detailed set issued in February 2004 and augmented by certain informal statements and letters from the Department of Finance], "internal" sales or disposition would apparently not in fact give rise to a gain for the purposes of these rules, but instead would be suspended.

DAVIES

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

IV. UNWINDING SANDWICH STRUCTURES (cont'd)

(3) With respect to tax on receipt of the spun-out U.K. sub - the situation under current law is quite clear.

(a) Nil tax can be achieved

(i) role of "exempt surplus", or "taxable surplus" bearing sufficient underlying foreign tax credits, or "pre-acquisition surplus" and/or capital reductions.

DAVIES

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

IV. UNWINDING SANDWICH STRUCTURES (cont'd)

(b) However, the proposed changes may create tax. See so-called "comfort" letters issued by the Department of Finance, including one in April of 2006.

(i) In most cases, tax-free receipt should arise;

(ii) The potential issue: an apparent forthcoming requirement to recognize, upon distributions (regardless of form chosen) any existing surplus pots - without the flexibility, under current law, of by-passing low-taxed "taxable surplus";

(iii) Where would such surplus stem from?

(iv) But - as noted - no surplus should arise from the spin-out itself.

DAVIES

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

IV. UNWINDING SANDWICH STRUCTURES (cont'd)

C. Unwinding a two-country sandwich: that is Canadian acquirer-U.S. target-second-tier Canadian sub of U.S. target.

(1) In principle, there are two potential additional issues - in comparison to unwinding three-country sandwiches.

(2) First (staying with the foreign affiliate rules under current law), the "excluded property" exception to FAPI has no application to shares of a Canadian corporation. [Instead, reliance could only be had on section 95(2)(f).]

(a) But would the proposed rules deem no gain to arise?

DAVIES

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

IV. UNWINDING SANDWICH STRUCTURES (cont'd)

(3) Second, would the U.S. target itself realize a taxable gain taxable in Canada upon disposing of shares of its Canadian sub.

(a) Under the Act - yes, but, exemption may arise under Article XIII(4) of the Canada-U.S. treaty.

(4) The issues with respect to the receipt by the Canadian acquirer would be the same as with unwinding a three-country sandwich.

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

DAVIES

V. PARTICULAR CANADIAN ISSUES ON PLANNING TAX MANAGEMENT OF GO-FORWARD OPERATIONS?

A. In principle, the exempt surplus system together with the re-characterization rules of section 95(2)(a)(ii), as well as rules for tax-free inter-foreign subsidiary (inter-foreign affiliate) dividends augur well for go-forward tax management.

(1) Pre-tax profit strategies;

(2) Distribution strategies.

(a) Comment on J.L. slide #19 – cross-chain tranfers.

(3) But see below respecting any unwound third-country operations.

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

DAVIES

VI. SHOULD CANADIAN ACQUIRER PLAN AT THE POINT OF ACQUISITION FOR AN ULTIMATE, IF ANY, DIVESTITURE OF THE U.S. TARGET?– OR SHOULD IT "TAKE A CHANCE" AND LOOK TO SECTION 85.1(3) AT A LATER TIME BUT WITH THE POTENTIAL HAMMER OF SECTION 85.1(4) COMPRISING A CONSTRAINING FACTOR?

A. As already noted (in section IV) - no FAPI on the sale by one foreign sub (affiliate) of shares of another which comprise "excluded property".

B. Does that mean that, at inception, a non-Canadian holding company should be included in the acquisition structure?

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

VI. (cont'd)

(1) a third-country corporation?

(a) Query the effectiveness of the derivative treaty benefit rule in the new U.S.-Dutch treaty.

(2) a U.S. limited liability company (LLC) which has not checked the box to be treated as a U.S. corporation for U.S. tax purposes?

(a) But, by reason of the 1997 enactment of Code section 894(c), dividends paid by a U.S. operating subsidiary to a U.S. LLC would be excluded from Article X(2) treaty benefits (now 5%).

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

VI. (cont'd)

C. Or, defer, at point of acquisition, the insertion of a foreign holding company, and rely on section 85.1(3) for future non-recognition transfer to a holding company?

(1) The difficulty here is that such tax-free rollover under subsection (3) is denied where the anti-avoidance rules of subsection (4) apply.

(a) That is intended to prevent rolldown which is part of a series of transactions giving rise to a sale of the U.S. target (in this case) to a third party.

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

VI. (cont'd)

(b) This rule is untested before the courts;

(c) What would constitute relevant elements of a relevant series of transactions?

(d) Having regard to the overall context of the rule, as well as the Technical Notes issued by Finance when the rule was enacted, it should be restricted to a rolldown at a point that there is a more-or-less done deal.

What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

VI. (cont'd)

(i) This would be a form of "common law series" originally defined in U.K. caselaw—and adopted by Canadian courts - entailing a transaction which is pre-ordained at the point that another transaction takes place.

(ii) However, the enactment of an extended notion of "series" in section 248(10) - [subsequent to the enactment of section 85.1(3) and (4)] could give rise to interpretational disputes with CRA respecting the inter-relationship of these various concepts.

(2) Therefore, perfect choices in this area may be hard to come by - choose your poison?

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What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

VII. CERTAIN SPECIFIC CONCERNS OR ISSUES ARISING OUT OF RULES –AS PRESENTLY ON THE BOOKS

A. The highly mechanical nature of the foreign affiliate and certain other rules are such that there could be a number of other factors to think about in advance, but the scope of this discussion leaves room to mention only two.

B. First, there is the question of the effect of recognizing good ("exempt") surplus (as can be received tax-free by the Canadian acquirer) in relation to the time in a year in which an acquisition is completed and associated questions of year-ends from the standpoint of both Canadian and U.S. tax laws and their role in measuring surplus.

C. Second, certain rules and consequences related to "financial institutions" could raise their undesirable head should the U.S. target have somewhere in its group, an entity (perhaps a captive insurance company) that qualifies as a "financial institution" under Canadian domestic law.

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What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

VIII. CONSIDERATIONS ARISING OUT OF THE MARCH 19th BUDGET IN RELATION TO ANY THIRD-COUNTRY OPERATING SUBSIDIARIES OF THE U.S. TARGET

A. If U.S. Target has subs in any country with which Canada does not have a tax treaty (and the "sandwich" cannot be unwound), the March 19, 2007 Budget could have either a salutary effect or an adverse effect—all tied into "Tax Information Exchange Agreements" (TIEA).

[This will be dealt with more fulsomely by other panels later.]

B. If, within a specified time frame, a TIEA is entered into with such non-treaty country, such sub's active business income will be accorded advantageous "exempt surplus" treatment.

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What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

VIII. CONSIDERATIONS – MARCH 19th BUDGET – THIRD-COUNTRY OPERATING SUBSIDIARIES OF THE U.S. TARGET (cont'd)

C. If, instead, such TIEA is not entered into within a specified time frame, the other extreme will arise.

(1) The sub's active business concern will be deemed to comprise FAPI, and be attributed to the Canadian acquirer.

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What Does a Canadian Lawyer Worry About in Advising a Canadian Acquirer of a U.S. Target?

IX. OTHER SITUATIONS

A. Canadian "Income Trusts" targeting US businesses.

(1) The implications of the proposed "SIFT" rules?

B. "Canadian" private equity acquisitions of US targets.

(1) Canadian-based private equity groups?

(2) Canadians in US-based private equity groups.

(a) Partnership format

(b) LLC format

(i) Proposed foreign investment entity rules issues?

Canadian and U.S. IFA Branches

Joint Meeting-Seminar
Panel on Mergers & Acquisitions – Segment Four

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