

# International Fiscal Association (Canadian Branch)

## International Tax Seminar Recent Transactions of Interest

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## Recent Transactions of Interest

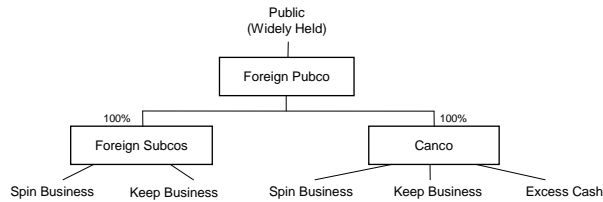
ATR involving cross border spin-off butterfly (ATR 2006 - 0215751R3, dated January 30, 2008)

ATRs involving cross border surplus stripping

- Purchase of Canco and bump to shares of CFA (2006 – 0211381R3, dated September 5, 2007)
- Indirect purchase of Canco followed by a corporate reorganization (2006 – 0217481R3, dated August 1, 2007)

NovaGold Resources Convertible Notes Offering – March 20, 2008

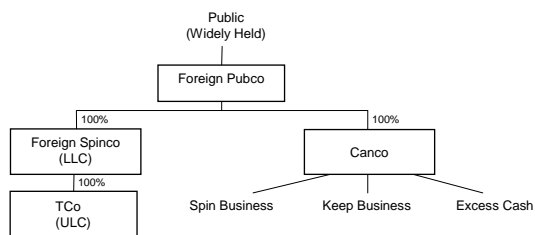
## Cross-Border Butterfly (Ruling 2006-0215751R3)



- Foreign Pubco intends to spin-off its Spin Business as a separate foreign public company ("Foreign Spinco").
- Need to effect a Canadian butterfly to divide the Canadian business on a tax-free basis. A paragraph 55(3)(a) butterfly is not available because of subparagraphs 55(3)(a)(i) and (ii) and paragraph 55(3.01)(e).

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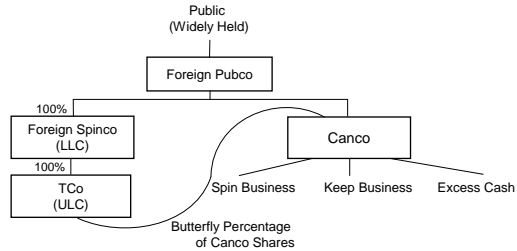
## Cross-Border Butterfly



- Foreign Pubco creates an LLC, Foreign Spinco, which creates a ULC subsidiary, TCo.
- Foreign Pubco needs to transfer the "Butterfly Percentage" of the Canco shares to TCo. This is accomplished through a three-party share exchange where:
  - TCo will acquire the Butterfly Percentage of the Canco shares from Foreign Pubco, and will pay for those shares by issuing common shares to Foreign Spinco;
  - Foreign Spinco will acquire additional TCo shares and will pay for those shares by issuing additional interests to Foreign Pubco; and
  - Foreign Pubco will acquire additional interests in Foreign Spinco and will pay for those interests by transferring the Butterfly Percentage of the Canco shares to TCo.

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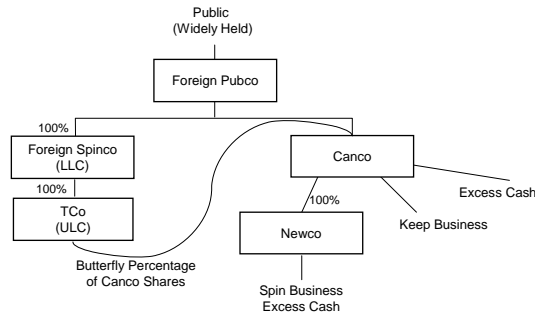
## Cross-Border Butterfly



- The three party exchange ensures that Foreign Spinco is not considered a “transferee corporation”. This would preclude a p. 55(3)(b) butterfly, as the shares of Foreign Spinco are later distributed to the public (see subparagraph 55(3.1)(b)(i)).
- Paragraph 55(3.2)(h) provides that any corporation which is a shareholder and specified shareholder of a distributing corporation at any time during the butterfly series is a transferee corporation. Therefore the Canco shares could not be transferred by Foreign Pubco to Foreign Spinco and then to TCo.
- Foreign Pubco also could not transfer the Canco shares to TCo for TCo shares, and then transfer the TCo shares to Foreign Spinco, as this would not be within the definition of “permitted exchange”.
- The three party exchange falls within the definition of “permitted exchange”. Foreign Spinco is the “acquiror” in the definition even though it does not directly acquire Canco shares.

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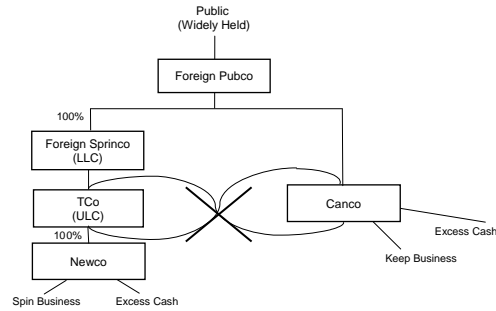
## Cross-Border Butterfly



- Canco transfers the Spin Business and the Butterfly Percentage of the Excess Cash to Newco on a tax-deferred basis.

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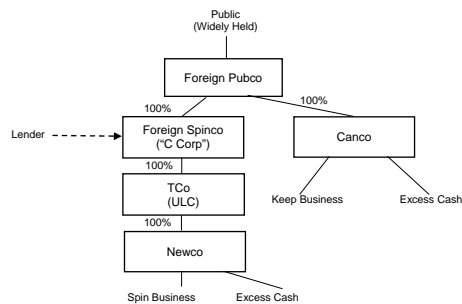
## Cross-Border Butterfly



- Canco transfers the shares of Newco to TCo for preferred shares of TCo, on a tax-deferred basis.
- Canco redeems the Canco shares held by TCo for a note, and TCo redeems the TCo preferred shares held by Canco for a note.
- The notes are set-off and cancelled.

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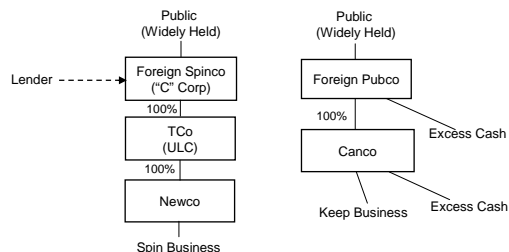
## Cross-Border Butterfly



- Foreign Sprinco converts to a "C" corporation.
- Newco pays a dividend to TCo (funded by the Excess Cash).
- TCo pays a dividend to Foreign Sprinco (and withholds 5%).
- Foreign Sprinco borrows funds to obtain the appropriate amount of leverage pre spin-out.
- Foreign Sprinco uses the TCo dividend, and the borrowed money, to pay a dividend to Foreign Pubco. Foreign Pubco represents that no cash will be directly or indirectly contributed to or transferred to Canco.

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## Cross-Border Butterfly



- Foreign Pubco distributes the stock of Foreign Spinco to its shareholders as a dividend in kind.
- The shares of TCo represent less than 10% of the value of the shares of Foreign Spinco (at all times during the series). For this purpose, the debt of Foreign Spinco is considered to reduce the value of each property of Foreign Spinco, including the shares of TCo, on a proportionate basis.

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## Cross-Border Butterfly - Rulings

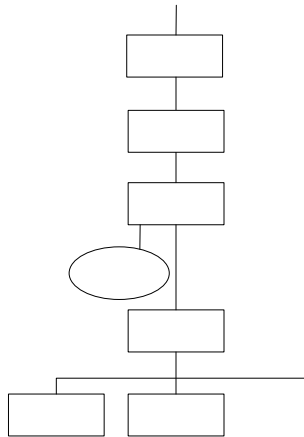
- The three-party exchange does not result in deemed dividends under subsections 212.1(1) or 84(1). Under paragraph 212.1(1)(a), the vendor (Foreign Pubco) does not receive the consideration (Foreign Spinco shares) from the purchaser (TCo); however, the PUC of the TCo shares is reduced to the PUC of the Canco shares transferred to TCo under paragraph 212.1(1)(b) if the increase in PUC occurs "by virtue of the disposition". No dividend, and reduced PUC is the appropriate result (same as if two-step transaction has occurred).
- Standard butterfly rulings, based on the proviso that TCo represents less than 10% of the value of the Foreign Spinco shares – (necessary under subparagraph 55(3.1)(b)(i)).
- The conversion of Foreign Spinco to a C corporation from an LLC will not result in a disposition of Foreign Spinco's assets.
- Opinion that section 143.3 will not apply to reduce the cost to TCo of the Canco shares.

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## Purchase and bump - ATR 2006-0211381R3, dated September 5, 2007

### Facts

### Vendor Group



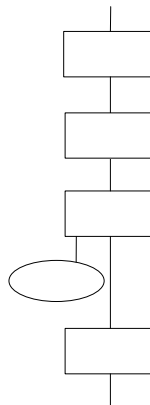
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## Purchase and bump ATR 2006-0211381R3, dated September 5, 2007

### Proposed Transactions

### Vendor Group

- 1) Targetco sells certain business assets to Vendor Group for cash
- 2) Subco 1 sells excluded properties, including shares of Keeperco 1 and Keeperco 2, to Vendor Group for cash
- 3) Targetco increases PUC by amount of cash in excess of PUC and FMV of Canadian operations – withholding tax is payable on this PUC increase.



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Targetco Division  
Cash and other  
assets

Keeperco 2  
(CFA)

Keeperco  
(CFA)

Public

Topco  
(FC)

Holdco  
(FC)

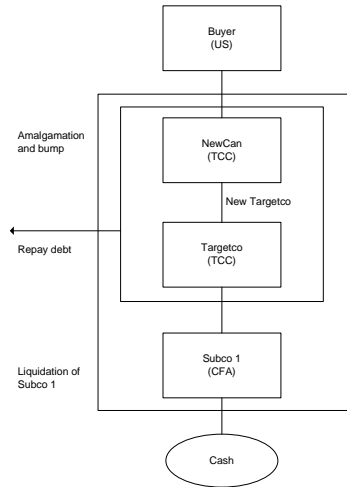
Targetco  
(TCC)

Subco  
(CFA)

## Purchase and bump ATR 2006-0211381R3, dated September 5, 2007

### Proposed Transactions

- 4) NewCan buys Targetco for cash.  
Purchase price includes an amount in respect of the cash held by Subco 1
- 5) NewCan and Targetco amalgamate – bump ACB of Subco 1 shares
- 6) Subco 1 liquidated into New Targetco
- 7) "Temporary" third-party debt repaid



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## Purchase and bump - ATR 2006-0211381R3, dated September 5, 2007

### Purpose of proposed transactions:

Enable Topco to sell its Canadian business to NewCan (arm's length buyer) while retaining Keeperco 1 and 2

### Rulings:

A - Bump of Subco 1 shares, subject to usual provisos

B - Section 212.1 will not apply provided Holdco 1 and NewCan deal at arm's length and proposed transactions are not sufficient to result in NAL relationship

C, D, and E - Subsections 95(6), 245(2), 15(1), 56(2), and 246(1) not applicable

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## Purchase and bump - ATR 2006-0211381R3, dated September 5, 2007

### Principles from GAAR surplus stripping cases

- Where commercial transactions are between unrelated persons, courts usually find arm's length relationships (*McNichol, McMullen – Equilease* an exception)
  - Distinguishing attribute shifting and duplication cases (*Nadeau, Copthorne Holdings*)
  - Distinguishing between cases where a particular surplus stripping rule at issue (eg. s.84.1 in *Desmarais*) and those where a more general surplus stripping principle applied (eg. *Evans, Overs, Geransky*)
  - Taxpayers at greater risk where surplus in cash or near cash form (eg. *McNichol, Equilease, Desmarais*) than if realizing value on sale to arm's length person (*Brouillette, McMullen, Geransky*)
- Legal stated capital increase (deemed dividend subject to Part XIII) equal to cash in excess of PUC of Targetco shares and FMV of Canadian operations (para 19 of ATR)
    - No rules for linking PUC of Targetco shares to ACB, PUC or surplus of underlying Cancos or CFAs
    - If no subsection 84(1) deemed dividend, which provisions or scheme of the ITA would have been abused – ss.212.1(1), 84(2), old 247(1)?
    - Similar to settlements for certain second tier Fincos

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## Purchase and bump - ATR 2006-0211381R3, dated September 5, 2007

### Deemed dividend subject to Part XIII Tax – an acceptable price

- To eliminate risk of NAL relationship and application of subsection 212.1(1) to untaxed value?
- To secure bump ruling?
  - Capital property status of Subco 1 shares
  - Pre sale carve-out of keeper assets that were excluded properties
  - Other bump risks
- Creditable for resident country foreign tax credit purposes?

### Surplus stripping – inbound to and outbound from Canada

- Interaction of the purpose of PUC and the bump, butterfly and foreign affiliate excluded property and surplus rules
- What if Subco 1's properties not extracted by vendor, but shares of Subco 1 bumped on the acquisition and Subco 1's property sold to third parties?

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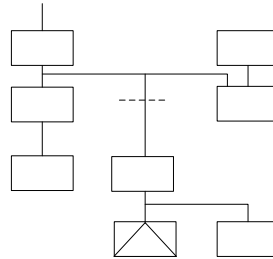


## Corporate Reorganization – ATR 2006-0217481R3, dated August 1, 2007

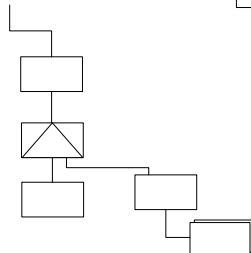
**Facts:**



**Buyer Group:**



**Target Group**



- Buyer Group wants to acquire Target Group and (i) effect a "bump"; and (ii) increase the PUC of the Canco 1 shares to FMV.

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- Disregarded in FC4

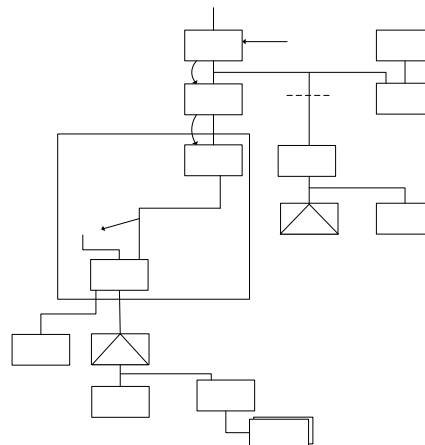
- FC4 likely the US

## Corporate Reorganization – ATR 2006-0217481R3, dated August 1, 2007

**Financing and Acquisition of Foreign Target:**



**Buyer Group:**



Buyer Group funds FCo 2 which then acquires Foreign Target and merges with it to form Foreign Amalco.

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(FC 4;

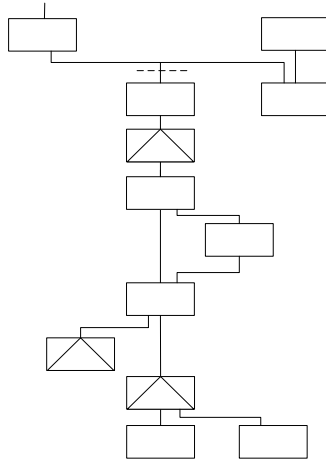
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Subsidiaries

## Corporate Reorganization – ATR 2006-0217481R3, dated August 1, 2007

### Corporate Reorganization – Interpose Canco 2 and Extract Canco 1:

- Upstream ownership restructuring/financing
- Create Canco 2
- Transfer interests in FCo 1 to Canco 2 (which now controls FCo 1)
- Foreign Amalco distributes Canco 1 to FCo 1
- FCo 1 transfers Canco 1 shares to Canco 2 as dividend in kind.

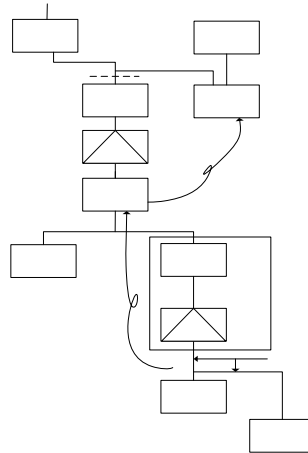


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## Corporate Reorganization – ATR 2006-0217481R3, dated August 1, 2007

### Corporate Reorganization – Bump, Extract and Sell:

- Canco 2 and Canco 1 amalgamate – shares of FA #1 and FCo 6 bumped to FMV
- FA #1 shares transferred to FCo 8 for a note
- FCo 8 sells FA #1 shares to NRCO 3 (an unrelated person) for cash.



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## Corporate Reorganization – ATR 2006-0217481R3, dated August 1, 2007

### Purposes of completed transactions:

- Strategic acquisition of Foreign Target by NRCo 1
- *“Upon the acquisition, NRCo determined that it had inherited various organizational and inefficiencies with the structure of Foreign Target...”*

### Rulings:

- Exclusion of capital gains under p. 95(2)(f)
- Bump, without taking into account sale of FCo8 to NRCo 3 (see August 13, 2007 comfort letter)
- GAAR will not apply to completed transactions

### Opinions:

- Covering proposed amendments to p.95(2)(f) and 88(1)(d.4)
- GAAR will apply to reduce PUC of Amalco's shares to PUC of Canco 1 shares
- P.95(6)(b) may apply to deem disposition of FA 1 shares to FCo8 not to have taken place

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## Corporate Reorganization – ATR 2006-0217481R3, dated August 1, 2007

### Application of GAAR to cross border surplus stripping:

- Determining whether the object, spirit and purpose of section 212.1 has been defeated or frustrated
- Purpose of subsection 212.1(1)
  - Arm's length cost
  - P.251(5)(b) carve out
  - Specific conditions – absence of 'directly or indirectly' language
- Purpose of subsection 212.1(4)
  - Facilitate indirect acquisition of Canco or repatriation of a Canco from a CFA?
  - Purchaser Canco must control NR Corp before disposition – otherwise no restrictions, conditions, series test, etc.
- Interaction of subsections 212.1(1) and (4)
  - Compatible and mutually reinforcing or distinct purposes?

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## Corporate Reorganization – ATR 2006-0217481R3, dated August 1, 2007

If Canco 2 acquired Foreign Target, would GAAR apply to limit the PUC of Canco 2 shares?

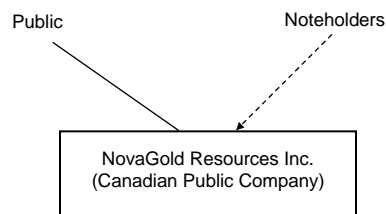
- Relevance of CFAs beneath Canco
- Relevance of foreign countries above Canco
- Relevance of cash or near cash property in Canco or below

Should it matter that Canco 2 was inserted after Foreign Target was acquired?

- Title of redacted Ruling suggests that subsequent insertion was a corporate reorganization, not part of an arm's length acquisition
- No discussion of subsection 212.1(4)
  - Distinguishing formation and financing of Canco 2
    - i) from arm's length acquisition
    - ii) at time of acquisition in the course of an internal reorganization, or
    - iii) years later in the course of an internal reorganization
  - Proposed amendments to p.95(2)(f) dealing with a relevant non arm's length entity (October 2, 2007)
- Price for bump ruling?

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## NovaGold Resources Inc. Convertible Notes Offering - March 20, 2008



- NovaGold issues convertible notes:
  - Interest at 5.5% per year, paid semi-annually
  - Mature on May 1, 2015
  - Convertible at holder's option into common shares
  - Structured to comply with former subparagraph 212(1)(b)(vii)

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## Convertible Note Issue Under 214(7)

- Subsection 214(7) is applicable where a non-resident person assigns or otherwise transfers to a person resident in Canada, a debt obligation issued by a person resident in Canada.
- The amount by which the price for which the obligation was assigned or transferred exceeds the issue price (the "Premium") is deemed to be a payment of interest made by the person resident in Canada to the non-resident person for the purposes of Part XIII of the Act.
- Subsection 214(7) will not apply if the debt obligation is an "excluded obligation" within the meaning of subsection 214(8) of the Act.
- Prior to January 1, 2008, an "excluded obligation" included a debt obligation, the interest on which was exempt from tax because of subparagraph 212(1)(b)(vii). Effective January 1, 2008, an "excluded obligation" includes an obligation on which the interest would have been exempt under subparagraph 212(1)(b)(vii) as it applied to the 2007 taxation year.

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## Convertible Note Satisfying Subparagraph 212(1)(b)(vii)

- On conversion or transfer of the note, the Premium will not be deemed to be interest because paragraph 214(8)(a) applies. As a result, the Premium will not be subject to withholding tax.

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## Convertible Note Not Satisfying Subparagraph 212(1)(b)(vii)

- If the convertible note is not structured to satisfy subparagraph 212(1)(b)(vii), the Premium will be deemed to be interest under subsection 214(7).
- Consider whether paragraph 214(8)(c) may apply to preclude the application of subsection 214(7). What is the “principal amount” and “yield” on a convertible note?
- Consider what the “price for which the obligation was assigned” means where the note is converted into shares – is it the value of the shares issued or the amount added to stated capital?

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## Participating Debt Interest

- Effective January 1, 2008, amendments to paragraph 212(1)(b) of the Act eliminated withholding tax on interest or deemed interest (other than participating debt interest) paid by a Canadian resident to an arm's length non-resident lender, regardless of the country of residence.
- “Participating debt interest” includes “interest...that is paid or payable on an obligation...all or any portion of which interest is contingent or dependent on...or is computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion or by reference to dividends paid or payable to shareholders of any class of the capital stock of a corporation.”

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## Participating Debt Interest

- The amount deemed to be interest under subsection 214(7) upon the conversion or transfer of a convertible note may constitute “participating debt interest” on the basis that it is computed by reference to the value of the shares of the issuer (which depends on revenue, profit, cash flow, commodity price or similar criterion), or is computed by reference to the dividends paid or payable on the shares (through anti-dilution clauses).
- Previous CRA positions relating to the postamble to subparagraph 212(1)(b)(vii) indicate that the Premium could be considered to be participating debt interest.

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## Periodic Interest Payments

- Query whether all of the interest on the convertible notes (as opposed to only the deemed interest realized on conversion) could be subject to withholding tax as a result of the words “all or any portion of which” in the definition of “participating debt interest”.

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## Application of Protocol

- The Protocol to the Canada-U.S. Treaty imposes a 15% withholding tax on interest which is *“determined with reference to receipts, sales, income, profits or other cash flow of the debtor or a related person, or to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor to a related person...”* Will the Protocol exempt the Premium or the periodic interest from Canadian withholding tax?