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by Steve Suarez and Pooja Samtani

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This article reviews the concept of exchangeable shares, which are often used in cross-border mergers and acquisitions involving Canadian corporations. A significant number of large, high-profile transactions have been effected using exchangeable shares, including Vivendi's acquisition of the Seagram Co. Ltd. in 2000 and the combination of Adolph Coors Co. and Molson Inc. in 2005, forming Molson Coors Brewing Co. Exchangeable share transactions have occurred in both public company and private company transactions, and the exchangeable share structure has been used in a variety of circumstances to optimize the Canadian tax consequences of cross-border mergers and acquisitions involving Canadian corporations.

Exchangeable Shares

Exchangeable shares are used in cross-border mergers and acquisitions because Canada's income tax regime currently does not allow for a nonrecognition transaction, or rollover, when shares of a Canadian corporation are exchanged for shares of a foreign corporation; on such an exchange, the holder of the Canadian shares will realize any accrued gains on those shares based on the fair market value of the foreign shares received.[1] Conversely, a rollover generally is available for Canadian tax purposes on the exchange of shares of a Canadian corporation for shares of another (or the same) Canadian corporation, such that any accrued gain on the old shares is not realized but instead "rolls over" into the new shares.[2] This puts potential foreign acquirers or merger partners of a Canadian corporation at a competitive disadvantage relative to their Canadian counterparts, in that they can only offer their own shares to the Canadian corporation's shareholders on a taxable-transaction basis (that is, with the Canadian corporation's shareholders realizing any accrued gains on their shares), whereas the Canadian corporation's shareholders can exchange their shares for shares of a Canadian acquirer or merger partner on a rollover basis.

This inability to provide Canadian target shareholders with a tax-deferred exchange can often hinder foreign corporations hoping to use their own shares as currency to acquire or merge with Canadian corporations. Exchangeable share structures are designed to minimize this disadvantage for foreign acquirers as much as possible.

What Are Exchangeable Shares?

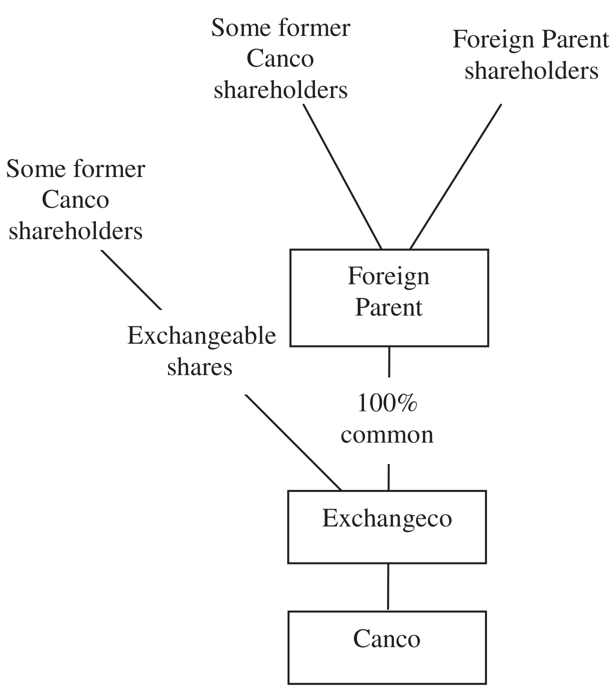
An exchangeable share can be described most simply as a share of a Canadian corporation (Exchangeco) that, together with some ancillary rights, replicates as closely as possible the economics (and to some extent the legal rights enjoyed by holders) of a share of another corporation. In a typical exchangeable share structure, all the common shares of Exchangeco are owned directly or indirectly by the foreign acquirer (Foreign Parent), and an exchangeable share issued by Exchangeco (together with some ancillary rights) will replicate the economics of, and entitle the holder to exchange the exchangeable share for, a common share of Foreign Parent. Shareholders of the Canadian target corporation in the projected cross-border merger or acquisition (Canco) will exchange their Canco shares for shares of Foreign Parent or (for those wanting a rollover) exchangeable shares of Exchangeco. The result (see Figure 1) is that Canco shareholders end up holding either Foreign Parent common shares or

[1] In the October 18, 2000, Economic Statement and Budget Update, Canadian Minister of Finance Paul Martin announced an intention to develop a rollover rule for cross-border share-for-share exchanges. The minister's statement provided no details of the circumstances in which such tax-deferred share-for-share exchanges could occur, but rather indicated that these rules would be developed in consultation with the private sector and would not take effect before the release of draft legislation for public discussion. However, no formal proposal or draft legislation has ever been released, and it seems doubtful that this will occur in the foreseeable future.

[2] Expressed another way, the result of a rollover is that the exchanging shareholder realizes no gain on the disposition of the old shares and, for tax purposes, has a cost in the new shares equal to the holder's previous cost of the old shares.

exchangeable shares of Exchangeco. The holder of an exchangeable share can either sell it to a third party for cash or exchange it for a Foreign Parent common share (both actions will cause any accrued gains to be realized for Canadian tax purposes), and all exchangeable shares will eventually be acquired by Foreign Parent or a subsidiary for Foreign Parent common shares. Canco will effectively become a wholly owned subsidiary of Foreign Parent, and Canco's shareholders will be equity holders of Foreign Parent (either directly or indirectly via exchangeable shares).

Figure 1. Simplified Exchangeable Share Structure



In the Canadian tax regime, transactions are taxed primarily based on their legal substance rather than on their economic substance. The key element of the exchangeable share is that it is, in law, a share of a Canadian corporation, and that the exchangeable share is designed to replicate the economic attributes of a different security is generally not relevant for Canadian income tax purposes. Exchangeable share structures have been employed for many years, and to date, Canadian tax authorities have not challenged (or indicated any intention of challenging) the status of exchangeable shares as bona fide shares of Exchangeco, a Canadian corporation.

Key Attributes

The objective of an exchangeable share is to give the holder a security that is a share of a Canadian corporation but that replicates (to the extent possible) the attributes of a share of the Canadian corporation's ultimate foreign parent. The primary features of an exchangeable share that achieves this result are described below:

- *Dividends*. Whenever a dividend is paid on the Foreign Parent common shares, Exchangeco pays a corresponding dividend on the exchangeable shares.
- *Exchange Rights*. Holders of exchangeable shares typically have the right to exchange them on demand for a fixed number of Foreign Parent common shares. Usually the exchange ratio is one Foreign Parent common share for each exchangeable share, and this discussion proceeds on that premise. This exchange occurs primarily via a right in the exchangeable share itself (the retraction right), empowering the holder to require Exchangeco to purchase the share and deliver a Foreign Parent common share in payment.[3] Some events (such as the liquidation of Foreign Parent) may trigger an automatic exchange of exchangeable shares for Foreign Parent shares, and in most cases, the exchange of all remaining exchangeable shares will occur after an agreed-on number of years. Thus, over time all exchangeable shares are eventually exchanged for Foreign Parent shares.
- *Liquidation Rights*. On the liquidation of Exchangeco, a holder of exchangeable shares receives a Foreign Parent share for each exchangeable share and does not receive any other property.
- *Voting Rights*. In many cases, mechanisms are put in place to allow holders of exchangeable shares to vote on matters that Foreign Parent shareholders vote on, as if they actually held Foreign Parent shares. To the extent legally possible, holders of exchangeable shares are generally given no rights to vote as holders of Exchangeco shares.

[3]In practice, the actual exchange is, for reasons explained in the text below, usually made by having another corporation exercise a call right to purchase the exchangeable share and deliver a Foreign Parent share, but the holder's retraction right is what typically initiates the exchange process. In this article, "retraction" refers to the *holder* of a share initiating a process by which the issuer repurchases the share, and "redemption" refers to the *issuer* of the share initiating that process.

Richard B. Levine/Levine Roberts Photography

Molson Coors Brewing Company was formed using exchangeable shares.

These results are achieved through a combination of the terms of the exchangeable shares themselves and other legal mechanisms.

Benefits

There are two principal benefits to using exchangeable shares in a cross-border merger or acquisition such as described in the example above:

- *Gain Deferral*. Canco shareholders can defer the realization of the accrued gains on their Canco shares for Canadian tax purposes by receiving shares of a Canadian corporation (that is, exchangeable shares) instead of Foreign Parent shares. This deferral lasts until the exchangeable shares are exchanged for shares of Foreign Parent or are sold.

- *Dividend Taxation*. Canadian residents are generally taxed more advantageously on dividends received on shares of a Canadian corporation than on dividends received on shares of a foreign corporation.[4] Accordingly, to the extent that Foreign Parent pays dividends following the exchange, Canadian-resident Canco shareholders prefer to receive those amounts in the form of dividends on the exchangeable shares rather than as dividends on the Foreign Parent shares.

In many cases, particularly when Canco's shares trade on a designated stock exchange, nonresidents of Canada are not subject to Canadian tax on gains realized on their Canco shares. Nonresidents also generally do not benefit from receiving Canadian-source dividends. It is therefore common to see exchangeable shares offered only to Canco shareholders who are Canadian residents. Tax-exempt

[4]For a discussion of recent changes in the taxation of Canadian-source dividends, see Manjit Singh and Steve Suarez, "Canada Issues Revised Dividend Tax Credit Legislation," *Tax Notes Int'l,* Oct. 30, 2006, p. 331.

entities (for example, pension funds) are also sometimes excluded from receiving exchangeable shares on the basis that they are not materially disadvantaged by receiving Foreign Parent shares.

When Are Exchangeable Shares Used?

Exchangeable shares are most likely to be useful in the following circumstances:

- when Foreign Parent wishes to offer its own shares (rather than exclusively cash) as all or part of the consideration to be received by Canco shareholders; and
- when a significant portion of Canco's shareholder base consists of Canadian residents who are not exempt from Canadian tax and have material accrued gains on their Canco shares for Canadian income tax purposes, such that deferring the realization of gains benefits a significant number of persons.

Also, since Canadian-source dividends are taxed advantageously for Canadian residents, exchangeable shares are likely to be an especially attractive option for Canco shareholders when Foreign Parent will be paying significant dividends in the years immediately following the transaction.

> ***There are two principal benefits to using exchangeable shares in a cross-border merger or acquisition.***

Depending on the circumstances, exchangeable shares may also be useful in other situations (for example, when Canco shareholders resident outside Canada could be subject to Canadian tax on Canco shares, as may be the case when Canco shares are not traded on a designated stock exchange).[5] However, as a general rule, exchangeable shares are of greatest use in a cross-border merger or acquisition when there are existing accrued gains to be deferred or future dividends to be paid, and when there is a significant Canadian shareholder base that would thereby benefit from the two principal advantages of exchangeable shares.

Foreign Parent must weigh a variety of factors in choosing what form of consideration to offer to Canco shareholders and, if shares, whether to use exchangeable shares. For example, there may be nontax reasons why Foreign Parent would not want external shareholders (even ones holding exchangeable shares) below the Foreign Parent level in its particular circumstances. Moreover, a foreign acquirer often wishes to use the 88(1)(d) step-up to increase the cost (for Canadian tax purposes) of Canco's property following the acquisition of Canco's shares.[6] The use of Foreign Parent shares (either directly or indirectly in the form of exchangeable shares) as consideration will generally disentitle Foreign Parent from using the 88(1)(d) step-up. Foreign acquirers therefore must often choose between competing priorities in structuring cross-border transactions into Canada.

Principal Tax Issues

When exchangeable shares are being used, the Canco shareholders and Foreign Parent must consider several Canadian tax issues. Some of these issues relate to Foreign Parent's initial acquisition of Canco shares and delivery of exchangeable shares to Canco shareholders, while others relate to the subsequent period during which the exchangeable shares are outstanding, and to the ultimate exchange of exchangeable shares for Foreign Parent shares that will eventually occur.

Canco Shareholders

In the vast majority of cases, the primary reason for using exchangeable shares is to defer the realization for Canadian tax purposes of any accrued gains on Canco shares. As noted earlier, since nonresidents are usually not subject to Canadian tax on their Canco shares,[7] deferral is typically most relevant for Canadian-resident shareholders.

Structure of Initial Exchange

The initial exchange of Canco shares for exchangeable shares can be structured in a number of ways (discussed below), some of which may be more desirable than others for Canco shareholders (and for Foreign Parent). As such, choosing the steps by which the exchangeable shares are actually delivered (as distinct from the decision to offer exchangeable shares at all) can be a further tax issue of relevance to shareholders of Canco interested in receiving exchangeable shares. While the different ways of structuring the initial exchange of Canco shares for exchangeable shares have some differences, broadly all of them limit tax deferral to an exchange of Canadian shares for Canadian shares.

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[5]Exchangeable shares are also sometimes used when a Canadian corporation wishes to raise money in foreign equity markets and the cost of migrating the corporation into the foreign jurisdiction would be prohibitive (as is often the case).

[6]For a discussion of this issue, see Steve Suarez, "Canada's Tax Cost Step-Up: What Foreign Purchasers Should Know," *Tax Notes Int'l,* Dec. 4, 2006, p. 779.

[7]Shares listed on a designated stock exchange are generally not included in the type of property that nonresidents are subject to capital gains tax on in Canada, and even in the case of unlisted shares, Canadian taxation of nonresidents will often be precluded under a relevant tax treaty.

To the extent that a Canco shareholder receives something other than exchangeable shares (nonshare consideration), there is the potential for realization of accrued gains. For this reason and because it is generally not possible to put all of the rights of the holder of exchangeable shares in the exchangeable shares themselves, Canco shareholders looking for gains deferral are typically interested in limiting the amount and value of nonshare consideration received.[8]

Dividend Treatment

As noted, Canadian-resident shareholders benefit from advantageous tax treatment of dividends on exchangeable shares, relative to receiving dividends on shares of a foreign corporation. That advantageous treatment can take different forms depending on the shareholder: Canadian-resident corporations can often obtain a 100 percent dividends received deduction for Canadian-source dividends, while Canadian-resident individuals may be eligible for a particularly low rate of tax on a Canadian-source dividend, depending, in each case, on certain factors.[9] Canco shareholders interested in receiving exchangeable shares will want to ensure that the necessary steps are taken to achieve these results to the greatest degree possible, and they will also want to satisfy themselves that they will not be subject to any special taxes sometimes applicable to shares that fall within Canada's preferred share tax regime.[10]

Structure of Subsequent Exchange

Ultimately, exchangeable shares will be exchanged for Foreign Parent shares. The manner in which this occurs is highly relevant to the holder of the exchangeable share, because if the exchangeable share is sold to its issuer Exchangeco (for example, via an exercise of the retraction right of the holder of the exchangeable share) rather than some other entity, the excess of the value of the Foreign Parent share received over the paid-up capital (PUC) of the exchangeable share will generally be characterized as a deemed dividend for tax purposes — that is, as a distribution of corporate surplus rather than a capital gain.[11] Because the PUC of the exchangeable share is often significantly less than the shareholder's cost for tax purposes of the exchangeable share, the amount of any such deemed dividend is often larger than the accrued gain on the share. A sale to Exchangeco may therefore produce a materially worse tax result for the holder of the exchangeable share than a sale of the exchangeable share to some other entity.[12]

On an exchange, most holders of exchangeable shares want to receive their Foreign Parent shares from an entity other than Exchangeco. For this reason, Canco shareholders will typically want the exchangeable share structure to include a mechanism whereby someone other than Exchangeco eventually acquires their exchangeable shares and delivers their Foreign Parent shares. As noted below, this is usually effected by establishing a separate Foreign Parent subsidiary (Callco) that exercises a call right to acquire exchangeable shares in any situation in which Exchangeco would otherwise acquire them.

FIE Rules

For the past several years, Canada has been proposing to enact a new system of taxing foreign-source passive income earned by Canadian residents. These rules (the foreign investment entity regime) are highly complex and difficult to apply, but conceptually they target portfolio investment in foreign entities earning predominantly passive forms of income. Canco shareholders will want to ensure that exchangeable shares (and shares of Foreign Parent) are not subject to these rules.

Listing of Exchangeable Shares

Finally, in most transactions in which Canco is a public corporation, the exchangeable shares will themselves be listed for trading on a designated stock exchange. Exchangeable share transactions have been effected using unlisted exchangeable shares, but these can give rise to a number of

[8]In situations when exchangeable shares are made available to tax-exempt entities, nonshare consideration is typically not the type of property that tax-exempts are permitted to own, creating another reason to minimize the amount of nonshare consideration.

[9]It may also be observed that having Canadian shareholders receive dividends from a Canadian entity prima facie eliminates any leakage that would otherwise arise from withholding tax imposed by Foreign Parent's home jurisdiction on Foreign Parent dividends paid to Canadian residents (although, as noted below in the case of the U.S., there is some residual concern).

[10]A more detailed discussion of this issue is beyond the scope of this article; however, it is sufficient for current purposes to be aware that better or worse dividend treatment for holders of exchangeable shares can result depending on the details of the legal agreements that create the exchangeable share structure.

[11]In such circumstances, a capital gain (or loss) is also produced, calculated as the amount by which the value of a Foreign Parent share, net of any deemed dividend, exceeds (is less than) the holder's cost of the exchangeable share. Depending on the circumstances, it is thus possible to realize both a deemed dividend and a capital gain.

[12]Although it is possible that deemed dividend treatment could produce a better tax result for some taxpayers in some circumstances, this is generally not the case.

incremental tax and nontax issues. When exchangeable shares are unlisted, this makes a sale of exchangeable shares to a third party for cash less likely and makes the retraction right the shareholder's principal exit mechanism. From a Canadian tax perspective, using unlisted shares can raise several potential issues, although these mostly affect nonresidents of Canada and tax-exempt organizations (who are often not given the option of receiving exchangeable shares on the initial exchange in any case). It is nonetheless important to be aware of the point.

Foreign Parent

Using an exchangeable share structure raises tax issues for Foreign Parent as well. Some of the more significant of these are described below.

Structure of Initial Exchange

On the initial exchange of Canco shares for exchangeable shares, giving Canco shareholders a rollover reduces the cost to Foreign Parent of the acquired Canco shares for Canadian tax purposes below what would otherwise be the case. Although the initial acquisition transaction can be structured to mitigate some of the effects of this, a reduced tax cost at the Canco share level is generally disadvantageous to some extent, and as a result, Foreign Parent typically seeks to limit the tax deferral to those shareholders who truly need it.[13] Foreign Parent may also have a preference for one of the different provisions offering tax deferral to Canco shareholders over others (described below). Finally, it is generally useful for Canadian tax reasons to employ a Canadian acquisition vehicle to carry out the acquisition of Canco, rather than have Foreign Parent do so directly.[14]

Structure of Subsequent Exchange

Even though the holder of the exchangeable share's formal legal mechanism for initiating an exchange of exchangeable shares for Foreign Parent shares is the use of the retraction right in the exchangeable shares to require Exchangeco to acquire them, in practice Exchangeco virtually never acquires the exchangeable shares. As noted earlier, a deemed dividend results when Exchangeco acquires its own shares, which is usually disadvantageous for both the holder of the exchangeable share and Exchangeco. Under Canada's preferred share rules, which apply to equity shares with debtlike features, a dividend on the exchangeable shares usually gives rise to a special tax (Part VI.1 tax) on Exchangeco. This tax is effectively refundable against Exchangeco's ordinary income tax and so may not pose an insurmountable barrier for those corporations that are paying enough corporate income tax to completely offset any Part VI.1 tax, but even so, it is clearly desirable to avoid it.

Accordingly, it is typical for Foreign Parent to use a Canadian subsidiary (Callco) to effect any exchanges of exchangeable shares for Foreign Parent shares. Callco is often the same Canadian entity already used in the acquisition structure on the initial exchange to acquire the Canco shares of those persons not receiving exchangeable shares.[15] On the initial exchange, Canco shareholders receiving exchangeable shares grant Callco a call right to purchase their exchangeable shares in the event that they would otherwise be acquired by Exchangeco. Holders of exchangeable shares can normally rely on Callco to exercise that call right whenever an exchange of exchangeable shares for Foreign Parent shares occurs since avoiding a deemed dividend is generally beneficial for both Exchangeco and holders of exchangeable shares.

Foreign Tax Issues

Finally, there will often be tax issues or opportunities in Foreign Parent's home jurisdiction created by the exchangeable share structure. These may affect how the initial transaction issuing the exchangeable shares is structured, the ongoing operation of the exchangeable share structure, or the subsequent exchange of exchangeable shares for Foreign Parent shares. For example, when Foreign Parent is a U.S. corporation, some U.S. practitioners have been concerned that the IRS would seek to apply U.S. withholding tax on exchangeable share dividends on the basis that exchangeable shares are in substance shares of a U.S. corporation.[16] On some Canada-U.S. exchangeable share transactions, the initial exchange has been structured in such a manner as to entitle the U.S. acquirer to make an election under IRC section 338. This can have the benefit of eliminating Canco's earnings and profits for U.S. tax purposes, facilitating a subsequent

[13]This is a reason nonresidents of Canada and tax-exempt entities are often excluded from being able to acquire exchangeable shares on the initial acquisition transaction.

[14]Maximizing the PUC of the shares of the top-tier Canadian entity in the structure is typically the principal tax benefit of using a Canadian acquisition vehicle. The use of a separate acquisition corporation is discussed in greater detail in Nathan Boidman et al., "Role of a Target Country Acquisition Corporation (Special Purpose Vehicle)," *Tax Notes Int'l,* Feb. 21, 2005, p. 663.

[15]*See* the previous discussion under "Structure of Initial Exchange."

[16]One commentator has suggested that a recent IRS private letter ruling indicates that exchangeable shares should be treated as Foreign Parent stock. *See* Willens, "IRS Ruling Clarifies Status of 'Canadian Exchangeable Stock,' " *BNA Daily Tax Report*, No. 96, May 18, 2007.

extraction of assets out of the Canco structure. In some circumstances, a section 338 election may also generate deductions or foreign tax credits in the United States. While a discussion of foreign tax issues is beyond the scope of this article, the interplay of Canadian law with that of Foreign Parent's home country may be an important element of deciding whether to use exchangeable shares, and if so, how to structure the acquisition.

Structure Details

Attempting to create a share of one entity that replicates the entitlements of a share of a different entity in another country is not a simple task. Not surprisingly, the process necessary to make this happen is somewhat complex, and achieving this result requires a number of different legal mechanisms. Although the final product is relatively simple for the exchangeable share holders themselves, the underlying legal machinery is somewhat more complicated.

> ***There will often be tax issues or opportunities in Foreign Parent's home jurisdiction created by the exchangeable share structure.***

Also previously described, the tax deferral sought by Canco shareholders receiving exchangeable shares makes it desirable to minimize the value of any nonshare consideration (property other than shares of Exchangeco) received in exchange for the holder's Canco shares. For this reason, the exchangeable share structure puts as many of the rights of the holders of the exchangeable shares as possible in the exchangeable shares themselves. Since holders of exchangeable shares must have rights against and obligations toward persons other than Exchangeco to make the exchangeable shares as equivalent as possible to Foreign Parent shares, and since it is generally not possible to endow an Exchangeco share with rights that are legally enforceable against persons other than Exchangeco, the exchangeable share structure contains multiple legal instruments:

- the exchangeable shares themselves, issued by Exchangeco;
- *call rights* granted by the holders of the exchangeable shares to Callco;
- a *support agreement* entered into among Foreign Parent, Callco, and Exchangeco, whereby Foreign Parent generally agrees to do such things as are necessary to ensure that Callco and Exchangeco carry out their obligations, and the equivalence of exchangeable shares and Foreign Parent shares is maintained;[17]
- a *voting and exchange trust agreement* between Foreign Parent, Exchangeco, and a trustee appointed to act on behalf of holders of exchangeable shares (the trustee); and
- a Foreign Parent *special voting share*, issued to the trustee.

In transactions involving a publicly held Canco, it is common to employ a corporate law process known as a *plan of arrangement* to effect the implementation of the exchangeable share structure, whereby a court supervises the transaction and issues an order deeming various elements of the transaction to have occurred on particular terms. The plan of arrangement can also be a useful source of legal rights in making the exchangeable share structure function smoothly, particularly when the exchangeable shares will be widely held.

It is perhaps most useful to set out the primary objectives that the exchangeable share structure tries to accomplish and then describe the mechanisms employed to achieve them.

Liquidation Entitlement

The terms of the exchangeable shares provide that on the liquidation or windup of Exchangeco, each exchangeable share entitles the holder to receive a Foreign Parent common share. The holder of exchangeable shares does not otherwise receive any of Exchangeco's property. As such, exchangeable shares derive their value from, and depend on the fortunes of, Foreign Parent shares rather than the value of Exchangeco's assets.

Holder Retraction on Demand

Holders of exchangeable shares invariably want the right to exchange those shares for Foreign Parent shares on demand. Without this right, exchangeable shares lack the economic equivalence with Foreign Parent shares that is the essential element of the transaction. This is achieved primarily through the terms of the exchangeable shares themselves, which give the holder the right (called the retraction right) to require Exchangeco to acquire the holder's exchangeable shares in exchange for an equal number of Foreign Parent common shares — that is, the same consideration that would be received on a liquidation or windup of Exchangeco.

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[17]Holders of exchangeable shares are generally not parties to this agreement out of concern that the rights they would obtain if they were parties would be valuable nonshare consideration that (as discussed earlier) could adversely affect their ability to exchange their Canco shares for exchangeable shares on a tax-deferred basis.

Trustee Exchange on Extraordinary Event

While each holder of exchangeable shares can exercise her retraction rights on demand, in some highly unusual circumstances, it will be necessary for all holders of exchangeable shares to exchange their exchangeable shares for Foreign Parent shares to achieve the intended economic result. These circumstances include the insolvency of Exchangeco (since Exchangeco becoming insolvent would impair its ability to respond to retractions) and the liquidation of Foreign Parent (since there would be no Foreign Parent shares left to exchange for exchangeable shares were this to occur). These mandatory exchanges are generally provided for in the voting and exchange trust agreement, whereby if such events are imminent, Foreign Parent agrees to purchase all outstanding exchangeable shares for consideration consisting of a corresponding number of Foreign Parent common shares (that is, the same consideration as on a retraction or Exchangeco liquidation). The trustee (acting on behalf of the holders of exchangeable shares) will exercise this right should one of these events become imminent.

These undertakings made by Foreign Parent (often referred to as ancillary rights) to holders of exchangeable shares (via the trustee) constitute nonshare consideration that must be taken into account in determining the tax consequences of the initial exchange to Canco shareholders receiving exchangeable shares. Numerous public transactions have proceeded on the premise (often supported by valuation advice) that these ancillary rights (including the voting rights described below) have only nominal value when they are received, because in most cases, the likelihood of these events occurring is remote.

Exchangeco-Initiated Exchanges

Foreign Parent will generally want some limitation on how long the exchangeable share structure must stay in place. To accomplish this, the exchangeable share terms usually have a redemption right that allows Exchangeco to redeem any outstanding exchangeable shares once a set period of time has passed since the exchangeable shares were first issued. That length of time is established as part of the bargain between Foreign Parent and the Canco shareholders on the initial acquisition of Canco, but most often, in public transactions, it runs within a 5- to 10-year time frame (Molson-Coors would appear to be the high-water mark at 40 years). As with other exchanges, the redemption price is one Foreign Parent common share for each exchangeable share.

It is also common for some other events to trigger Exchangeco's redemption right to have all remaining exchangeable shares exchanged. Again, these events are defined in the terms of the exchangeable shares and are usually negotiated between Canco and Foreign Parent as part of the initial acquisition (assuming that the transaction is a friendly one). An example would be the right to redeem the exchangeable shares if the number of remaining outstanding shares (ignoring any held by Foreign Parent or its affiliates) falls below a specified level.

Capital Gains Treatment

As discussed previously, most holders of exchangeable shares that exchange their exchangeable shares for Foreign Parent shares want to receive their Foreign Parent shares from someone other than Exchangeco to avoid the deemed dividend that arises if Exchangeco repurchases its exchangeable shares. Foreign Parent wants the same thing — to avoid Part VI.1 tax. Since it is generally undesirable to give holders of exchangeable shares nonshare consideration[18] and it is difficult to give holders of exchangeable shares a right contained within an Exchangeco share that will be legally effective against someone other than Exchangeco, this means that holders of exchangeable shares generally do not have a right to require anyone other than Exchangeco to purchase their exchangeable shares on demand.

Instead, exchangeable share structures are typically set up such that Callco has the right (but not the legal obligation) to acquire any exchangeable shares that would otherwise be acquired by Exchangeco, whether on the liquidation of Exchangeco, the exercise of a retraction right by the holders of the exchangeable shares, or the exercise of Exchangeco's redemption right. This is achieved by the holders of exchangeable shares granting Callco a right to allow Callco to purchase any exchangeable share that would otherwise be purchased from them by Exchangeco. The amount payable by Callco is the same as would otherwise be paid by Exchangeco: one Foreign Parent share for each exchangeable share. Although the call right mechanism does not give the holder of the exchangeable share absolute certainty of avoiding deemed dividend treatment on the exchange of his exchangeable share,[19] he can be reasonably confident that Foreign Parent will cause Callco to exercise the call right since deemed dividend treatment on the exchange is generally undesirable for Exchangeco too.

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[18]As noted earlier, on the initial exchange of Canco shares for exchangeable shares, it is desirable to put as much of the value as possible to be received by holders of exchangeable shares in those shares themselves, since too much nonshare consideration may cause a recognition of accrued gains on the Canco shares.

[19]This is because the shareholder cannot force Callco to exercise the call right.

In any event, Foreign Parent shares must be obtained by whichever entity (Exchangeco or Callco) is acquiring the exchangeable shares from time to time so that they can deliver them to holders of exchangeable shares receiving Foreign Parent shares. There are different possible procedures for making this happen, but quite often, the recipient (usually Callco) issues shares of itself to Foreign Parent to pay for the required Foreign Parent shares, which are then delivered to the holder of exchangeable shares in exchange for his exchangeable shares. If structured correctly, this process will occur in such a manner as to maximize the cross-border PUC of the newly issued Callco shares and ensure that Callco has full tax cost in the Foreign Parent shares acquired. Foreign Parent's home country tax law may also have specific issues requiring attention (for example, ensuring that it has full tax cost in the Callco shares it acquires).

Voting Rights in Foreign Parent

In many cases, Canco shareholders being offered exchangeable shares desire the same voting rights accorded to holders of Foreign Parent shares. This desire is typically satisfied by causing Foreign Parent to issue a single special voting share to the trustee who periodically acts on behalf of the holders of exchangeable shares. The special voting share carries a number of votes at Foreign Parent shareholder meetings equal to the number of exchangeable shares outstanding at that time, with each holder of exchangeable shares (other than Foreign Parent or its affiliates) being entitled to instruct the trustee to cast as many of those votes as she has exchangeable shares. Procedures for effecting this are set out in the voting and exchange trust agreement. As with other ancillary rights, these voting rights constitute nonshare consideration received by the holder of exchangeable shares on the initial exchange of Canco shares for exchangeable shares.

Since Foreign Parent shareholders have no voting rights at the Exchangeco level, the exchangeable share terms provide that holders of exchangeable shares similarly have no right to vote at meetings of Exchangeco shareholders. Canadian corporate law, however, gives the holders of each class of a corporation's shares the right to vote on some fundamental transactions whether or not the terms of the shares provide for voting rights. The result is that there will still be some instances in which holders of exchangeable shares as a class can vote at Exchangeco shareholder meetings. This can prove inconvenient for Foreign Parent, and it is one reason why it will want to ensure that the exchangeable shares have a finite lifespan.

Dividend Equivalence

Although not all Foreign Parents are regular dividend payers, many are, and in any case, whether or not regular dividends are expected to be paid, holders of exchangeable shares will want to be sure that they will receive equivalent amounts should any Foreign Parent dividends occur. This is provided for in the terms of the exchangeable shares themselves. The support agreement essentially obligates Foreign Parent to do what is necessary to ensure that Exchangeco pays corresponding dividends on the exchangeable shares whenever a Foreign Parent dividend is paid.

When the usual legal mechanisms (for example, a support agreement) are employed, dividends on exchangeable shares will trigger the Part VI.1 issuer tax on Exchangeco (described above). As discussed, this tax is effectively refundable to Exchangeco if it (or a related Canadian corporation) is paying sufficient corporate income tax.

The rights and obligations of the various parties in the exchangeable share structure are summarized in Figure 2. (This diagram reflects the share-for-share exchange version of the exchangeable share structure, described in the next section.)

Implementing the Structure

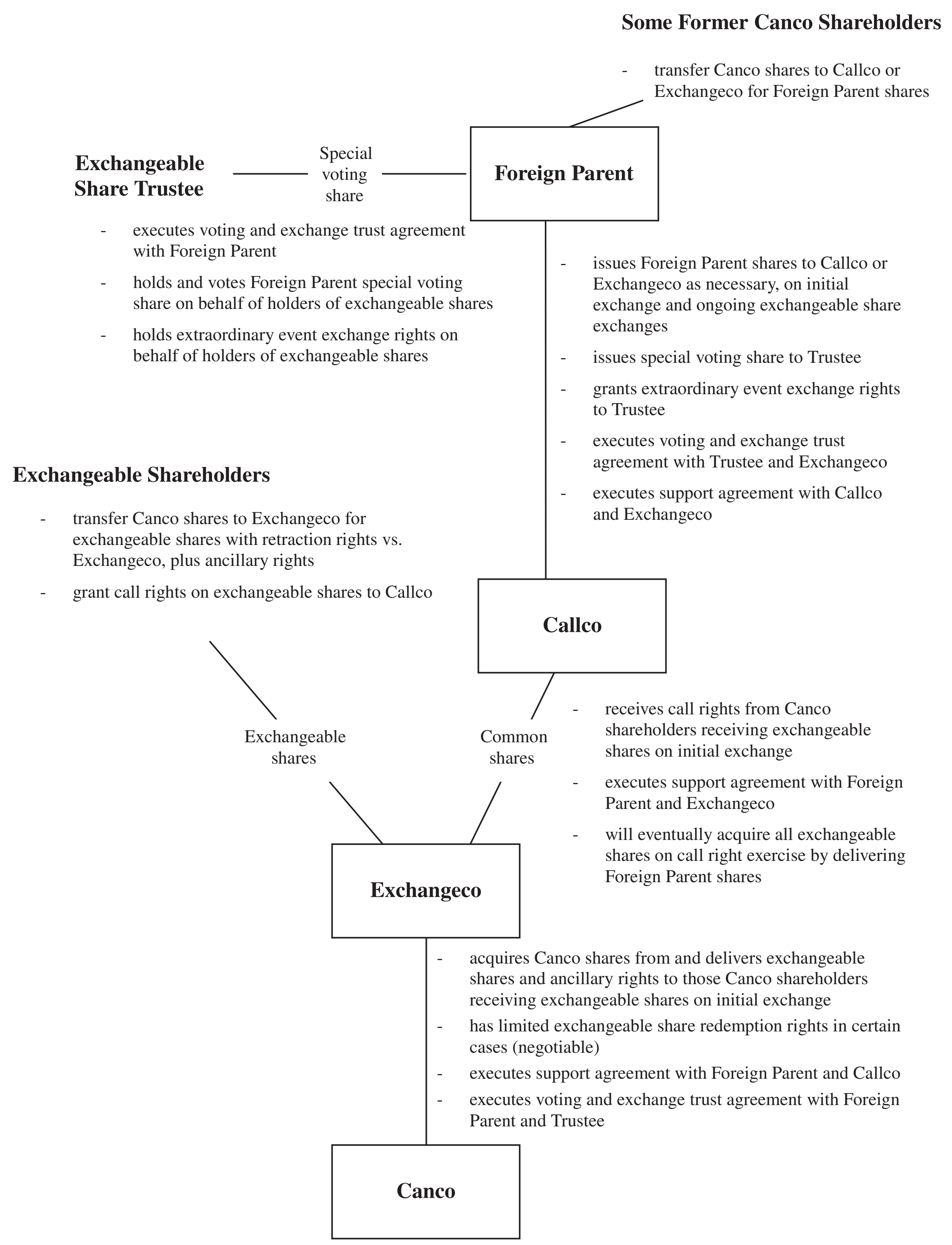
The last portion of this article describes the different methods by which Canco shareholders exchange their Canco shares for exchangeable shares and by which the exchangeable share structure is put in place. The differences between the methods are essentially based on which Income Tax Act provision is used to achieve a rollover for Canadian tax purposes.

Exchangeable share transactions are typically structured in one of three ways to achieve the desired tax efficiencies: (i) a reorganization of capital of Canco in which Canco issues the exchangeable shares (that is, Canco and Exchangeco are the same entity); (ii) a share-for-share exchange (an exchange of Canco shares for exchangeable shares of Exchangeco or Foreign Parent shares); or (iii) an amalgamation[20] of Exchangeco and Canco followed by a reorganization of capital. These alternative structures are illustrated and discussed below. The selection of which structure to use is generally influenced by a combination of tax, corporate, and securities law considerations, depending on the particular circumstances of each case.

All of the structures involve entities other than Foreign Parent delivering Foreign Parent common shares to Canco shareholders. Further, such deliveries occur after the initial exchange, when holders

[20]An amalgamation is the merger of two corporations to form a single entity that is a continuation of both predecessors.

Figure 2. Summary of Rights and Obligations



of exchangeable shares begin to exercise their retraction rights. There are different ways of ensuring that Exchangeco, Callco, or any other affiliate of Foreign Parent gets the Foreign Parent shares it needs to deliver them to Canco shareholders or holders of exchangeable shares in a tax-efficient manner (for example, maximizing cross-border PUC or ensuring full tax cost).

The Capital Reorganization

When an exchangeable share structure is implemented by way of a capital reorganization of Canco, the issuance of exchangeable shares is accomplished in reliance on subsection 86(1) ITA. This provision gives a shareholder a tax-deferred exchange when, in the course of a reorganization of a corporation's capital,[21] that corporation acquires all of the shares of any class of its shares owned by a shareholder and in exchange issues new shares (with or without nonshare consideration) to that shareholder. An example of an exchangeable share transaction using a reorganization of capital under subsection 86(1) ITA is the acquisition of Newbridge Networks Corp. (Canada) by Alcatel in 2000, implemented under a plan of arrangement.

Exchangeable share transactions are typically structured in one of three ways to achieve the desired tax efficiencies.

While there are different variations on the capital reorganization structure, the principal steps are essentially as follows:

1. Foreign Parent incorporates a Canadian subsidiary (Callco).

2. Canco amends its articles of incorporation to authorize the issuance of an unlimited number of exchangeable shares.

3. All Canco common share holders transfer their shares to Canco for a number of Canco exchangeable shares (and the ancillary rights described above) based on the negotiated Canco share/Foreign Parent share exchange ratio. This exchange occurs on a tax-deferred basis under subsection 86(1) ITA. Simultaneously, Canco issues one voting common share to Callco for nominal consideration, leaving Callco as the sole common share holder.

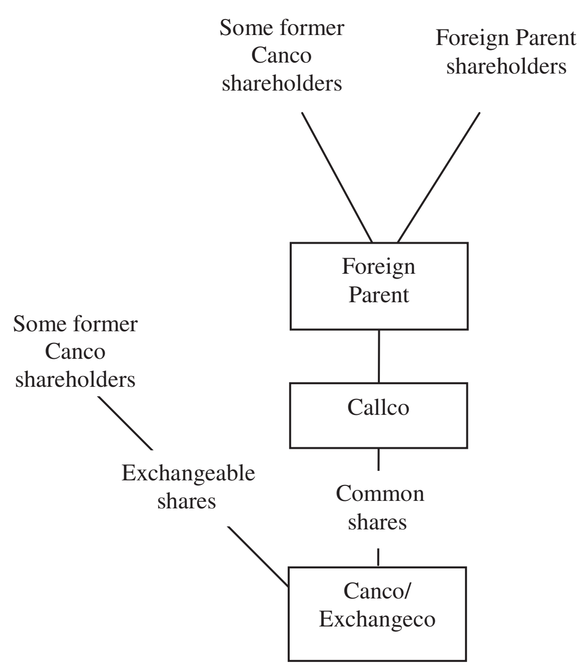
4. Holders of Canco exchangeable shares who choose not to (or are not permitted to) retain their exchangeable shares transfer them to Callco in exchange for Foreign Parent shares on a one-for-one basis. This exchange is a taxable event, although most nonresidents would typically be excluded from Canadian taxation on any accrued gains.

5. Any Canco exchangeable shares owned by Callco are exchanged for more common shares of Canco.

6. Foreign Parent issues a special voting share to the trustee, and the support, voting, and exchange trust agreements are entered into.

The result is illustrated in Figure 3. There are different variations of this structure, depending on whether exchangeable shares are to be limited to only some types of Canco shareholders (for example, taxable Canadian residents).

Figure 3. Capital Reorganization



In step 3, subsection 86(1) ITA allows the exchanging shareholder to receive nonshare consideration without any capital gain or deemed dividend being realized, as long as the value of that nonshare consideration does not exceed either the PUC or the holder's cost of the shares being exchanged; nonshare consideration is applied first as a reduction of the PUC and basis of the newly issued shares. This

[21]The reorganization of capital requirement is typically satisfied through an amendment to the share terms and classes set out under the articles of incorporation of Canco.

means that if the value of the nonshare consideration received by a Canco shareholder (that is, the ancillary rights, plus any cash received in lieu of a fractional exchangeable share) is kept below the PUC and holder's tax cost of his Canco shares, no capital gain or deemed dividend will occur and the exchange can be made on a complete rollover basis. As noted earlier, exchangeable share transactions usually proceed on the basis that the value of the ancillary rights described above is nominal (professional valuation advice on this point is desirable), and as a result, the exchangeable shares can be delivered to Canco shareholders on a nonrecognition basis.

The Share-for-Share Exchange

Another Canadian rollover provision often used in exchangeable share transactions is subsection 85(1) ITA. Like subsection 86(1) ITA, this provision allows nonshare consideration to be received up to the holder's tax cost of the disposed share without any gain being realized (that is, boot to basis), thereby accommodating the receipt of ancillary rights. Whereas subsection 86(1) ITA applies only if shares are disposed of to the corporation that issued them, subsection 85(1) ITA may apply to shares (or most other property) disposed of to any taxable Canadian corporation (whether or not the issuer of the shares) for consideration that includes shares of the corporation. Two important differences are that subsection 85(1) ITA requires both the buyer of the share and the seller to file a joint election in order for the provision to apply (which can entail some administrative cost when Canco is widely held), and it allows the seller to choose to recognize proceeds of disposition essentially anywhere between her cost of the shares and their FMV.[22] Examples of exchangeable share transactions effected using a subsection 85(1) share-for-share exchange are the combination of Molson Inc. and Adolph Coors Co. in 2005 and Vivendi's acquisition of the Seagram Co. Ltd. in 2000.

A number of variations of share-for-share exchanges are possible, depending on the particular objectives being sought (in particular any foreign tax constraints). However, a relatively straightforward version of the share-for-share exchange would work as follows:

1. Foreign Parent incorporates a Canadian subsidiary (Callco).

2. Callco creates Exchangeco as a new Canadian subsidiary.

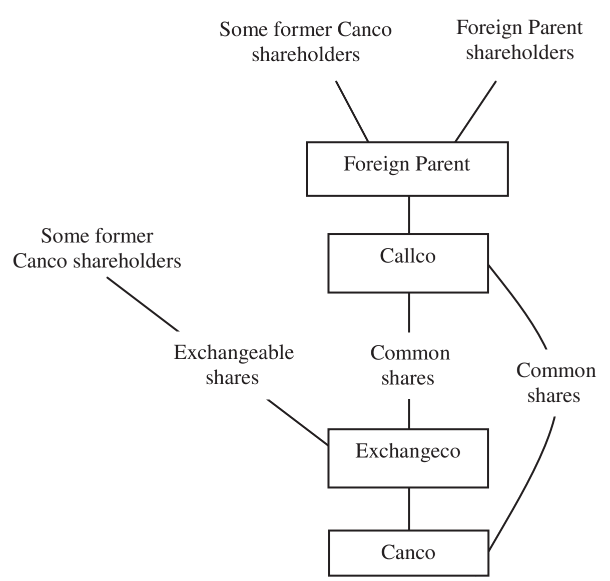
3. Those Canco shareholders who want (or are required) to receive Foreign Parent shares on the initial exchange deliver them to Callco in exchange for Foreign Parent shares based on the negotiated exchange ratio. This exchange is a taxable event, although most nonresidents would typically be excluded from Canadian taxation on any accrued gains.

4. Those Canco shareholders receiving exchangeable shares transfer their Canco shares to Exchangeco for exchangeable shares issued by Exchangeco (and ancillary rights).

5. Foreign Parent issues a special voting share to the trustee, and the support and voting and exchange trust agreements are entered into.

The result is illustrated at Figure 4. While this shows Canco's shares being held partially by Exchangeco and the remainder by Callco, Callco may choose to transfer its Canco shares to Exchangeco for more Exchangeco common shares.

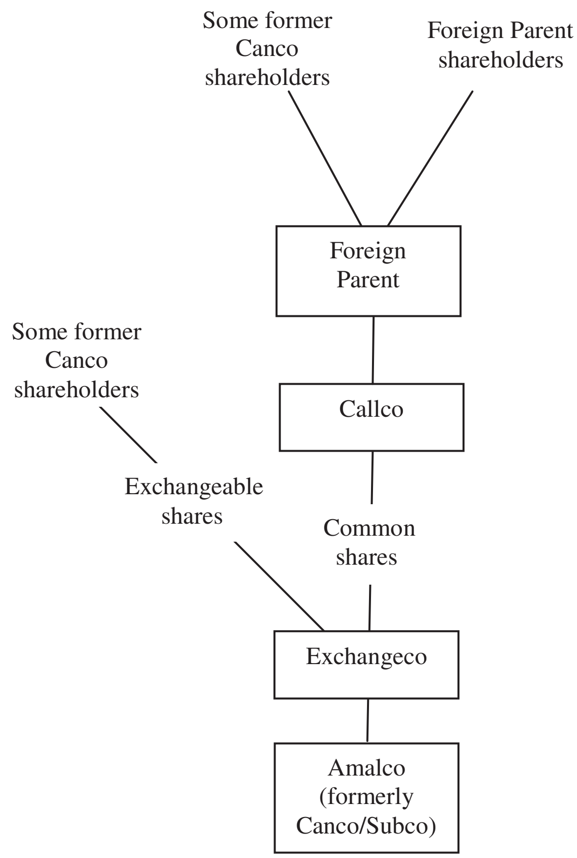
Figure 4. Share-for-Share Exchange



On the exchange of Canco shares for exchangeable shares and ancillary rights in step 4, a rollover for Canadian tax purposes will occur if the parties file a joint subsection 85(1) ITA election within the required time and the value of the ancillary rights does not exceed the holder's cost of the Canco shares for tax purposes. Notwithstanding the procedural formalities required under subsection 85(1) ITA, many public transactions have been structured using this share-for-share exchange model.

[22]Recognizing part of the gain might be desirable, for example, to use available losses from other sources.

Figure 5. Amalgamation and Capital Reorganization



Amalgamation

It is also possible to implement an exchangeable share structure by way of an amalgamation of Canco with either Exchangeco or a Canadian subsidiary of Exchangeco (Subco), whereby both corporations amalgamate into a single entity (Amalco) that is the successor of both predecessors. Nonrecognition treatment is possible for both the predecessor corporations and their shareholders on the amalgation under section 87 ITA.

The key difference between nonrecognition treatment under section 87 ITA and the other rollover provisions previously discussed is the treatment of nonshare consideration. To qualify for a rollover under section 87 ITA, shareholders of the amalgamating corporations (Canco and either Exchangeco or Subco) cannot receive *any* consideration for the disposition of the old shares on the amalgamation other than shares of the amalgamated company (or its postamalgamation Canadian parent). Even a nominal amount of nonshare consideration would completely taint the rollover (both for shareholders and the amalgamating corporations).

Since exchangeable share structures routinely include ancillary rights (even if only of nominal value) for Canco shareholders receiving exchangeable shares, amalgamations are not, on their own, sufficiently accommodating. Exchangeable share transactions structured in reliance on section 87 ITA will therefore virtually always proceed in two stages: an amalgamation followed by another form of tax-deferred transaction in which the ancillary rights are delivered. The Uniphase Corporation-JDS Fitel combination of 1999 is an example of one such exchangeable share structure, and took the following form:

1. Foreign Parent incorporated a new Canadian subsidiary (Callco).
2. Callco incorporated Exchangeco as a new Canadian subsidiary.
3. Exchangeco incorporated Subco as a new Canadian subsidiary.
4. Subco and Canco amalgamated to form Amalco, with Canco shareholders receiving special shares of Exchangeco (Subco's parent)[23] and Exchangeco (the only Subco shareholder) receiving Amalco common shares.
5. Those Canco shareholders who were to receive Foreign Parent shares delivered their Exchangeco special shares to Callco in exchange for Foreign Parent shares.[24] This exchange was a taxable event, although most nonresidents would typically be excluded from Canadian taxation on any accrued gains.
6. Canco shareholders to receive exchangeable shares transferred their Exchangeco special shares to Exchangeco in exchange for exchangeable shares and ancillary rights. This qualified as a capital reorganization of Exchangeco eligible for rollover treatment under subsection 86(1) ITA (described above).
7. Foreign Parent issued a special voting share to the trustee, and the support, voting, and exchange trust agreements were entered into.

Because the amalgamation itself did not accommodate the delivery of ancillary rights, these were instead distributed to holders of exchangeable

[23]This form of merger, whereby shareholders of a participating corporation receive shares of Amalco's postamalgamation parent corporation (Exchangeco) instead of Amalco, is called a triangular amalgamation.

[24]Callco would later exchange these special shares for more Exchangeco common shares.

shares on the subsequent capital reorganization. The result is depicted in Figure 5.

Conclusion

As long as the Canadian tax system does not provide for a deferral of tax on the exchange of a share of a Canadian corporation for a share of a foreign corporation, exchangeable share structures will continue to be used. The gain deferral and favorable dividend treatment they offer represent meaningful benefits to Canadian shareholders. This makes them a useful tool for foreign entities seeking to acquire or combine with a Canadian corporation that has a significant Canadian shareholder base in a transaction that is not all cash. This is particularly so when the foreign acquirer may be competing with a Canadian corporation for the Canadian target, since exchangeable shares help to level the playing field in terms of the Canadian tax implications to shareholders. ◆