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SPECIAL REPORT

Tax Issues on Acquiring a Canadian Business

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Acquiring a Canadian business invariably raises many Canadian tax issues. This article sets out a framework for understanding the role that taxes play at different stages of the transaction, identifying what Canadian tax issues are most commonly encountered (for both buyers and sellers), and describing ways to address those issues.

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Business acquisitions are significant investments for buyers, in terms of time, resources, and financial exposure. It is especially important to manage the tax aspects of the transaction (both procedural and substantive) because the liabilities involved are often substantial and more difficult to address after the transaction has been completed.

Obtaining tax advice at the earliest possible time offers the best chance to identify risks and opportunities that can be incorporated into the transaction before it takes shape and becomes more difficult to change. Early tax input also provides more time to collect and consider information that can create real value.

While each Canadian business acquisition is different, a framework for this type of transaction can be developed to help buyers identify and address the relevant issues in a logical and disciplined manner. That reduces the risk of overlooking issues or raising them too late to be dealt with properly. This article provides a framework for the acquisition of a Canadian corporation (Target). Statutory references are to Canada's Income Tax Act.

I. Process

It is useful to think of the acquisition of Target as a process that occurs in stages, each with its own issues and priorities. Breaking the transaction down that way

Table 1. Tax Elements of the Acquisition Process

Initial Transaction Structuring	Information Gathering and Analysis	Negotiating Risk Management and Documentation	Final Documentation and Transaction Implementation	Post-Closing Planning and Integration
Key transaction parameters determined: • form of transaction (assets vs. shares); • form of consideration (cash, buyer securities); • critical buyer/seller tax objectives (e.g., cost basis step-up, tax deferral, etc.).	Buyer receives and analyzes Target tax information in due diligence process, to: • identify areas of Target tax risk; • confirm Target tax attributes; • find planning opportunities to optimize Target tax attributes.	Parties allocate tax-related risks using various mechanisms: • representations, etc. in transaction documentation; • advance tax ruling; • opinion of counsel; • factor into purchase price.	Conclusive agreements signed. Buyer financing arrangements put in place. Pre-closing planning implemented. Closing of acquisition completed.	Implementation of post-closing steps to achieve tax and business objectives, such as: • merger or wind-up of entities; • tax elections and Target tax returns filed; • restructuring or sale of Target assets. Transaction descriptions (press release, website, F/S) reviewed.

makes it more manageable and helps prioritize what must be done when and by whom.

A. The Different Tax Stages of the Transaction

In general terms, the acquisition of a Canadian business occurs in the following stages.

1. Initial Transaction Structuring

During the first phase of the transaction, the broad outline of the transaction takes shape, and important high-level decisions are made (at least on a preliminary basis) regarding matters such as (1) the form of the acquisition (sale of Target shares, sale by Target of its assets, combination of share and asset sale), (2) the form of consideration (cash, securities of the buyer, other) to be received by Target security holders, and (3) any buyer or seller tax objectives that are likely to drive the form or economics of the transaction (for example, tax deferral for the sellers, a cost basis step-up for the buyer, the need to spin off Target assets the buyer does not want). If the buyer requires external financing for the acquisition, the likely form of that financing (and any tax aspects thereof) will also be considered.

2. Information Gathering and Analysis

Target assembles and makes available tax data that the buyer is likely to want to see; the buyer reviews that information, identifies questions to answer and information to seek, and analyzes the results. The buyer's analysis looks for (1) areas of Target tax risk that must be quantified and factored into the purchase price or otherwise addressed, (2) confirmation of Target (or Target shareholder) tax attributes that the buyer's planning and pricing is premised on, and (3) opportunities for optimizing existing tax attributes. If Target shareholders will be acquiring securities of the buyer as part of the transaction, the buyer may also be asked to provide information regarding its potential tax risks.

3. Risk Management

The parties will negotiate how tax-related risks will be addressed and allocated between them through the various mechanisms available (including purchase price). If Target is a public company, the buyer will generally need to deal with Target (and potentially any significant shareholders), rather than all security holders directly.

4. Implementation

The parties will enter into conclusive agreements for the acquisition. Between signing and closing, various steps necessary to implement the acquisition will take place — for example, the buyer will put any required external or intragroup financing in place, and the parties will prepare any required communications to Target security holders, obtain any necessary approvals, and complete any desired pre-closing tax planning transactions).

5. Post-Closing Integration and Planning

Following the acquisition's closing, the buyer will carry out any steps necessary to complete its tax planning (for example, a Target liquidation or amalgamation necessary to obtain a section 88(1)(d) cost basis step-up) or achieve the desired business objectives (for example, sell Target property to a third party, put in place service or other agreements between Target and buyer affiliates, and so forth). Target tax returns for the pre-closing period and any transaction-related tax elections will be prepared and filed.

B. Allocating Tax Responsibilities

Determining who will perform those various tasks should be decided as early as possible. While the buyer's own tax and finance personnel play a critical role, in most cases the volume of tax work required exceeds the buyer's internal tax capacity, and external advisers are needed. In cross-border acquisitions, the burden is even greater because the buyer is managing tax planning and compliance in more than one country.

1. Buyer's Tax Director

The buyer's senior in-house tax person is the hub of the tax transaction team. That person often serves as the key link between the tax and nontax members of the transaction team, and therefore must be adept at managing external tax advisers, kept informed by those advisers, and able to manage the tax work plan and liaise with the rest of the buyer management group.

2. Canadian Tax Lawyers

External tax counsel at a Canadian law firm are important members of the tax team. They will usually be intimately involved in the Canadian elements of the tax planning of the transaction and invariably will be responsible for the tax elements of the legal documentation governing the transaction. One of the principal benefits to the buyer of retaining Canadian tax lawyers to advise on tax issues (including diligence work) is that communications between the lawyers and the buyer are protected from disclosure under solicitor-client privilege. That allows for frank discussion about the risks and benefits of different alternatives and for obtaining confidential written advice.

3. Canadian Accountants

In some cases, the buyer will seek tax planning advice from the tax arm of its Canadian accounting firm, either alone or in conjunction with Canadian tax lawyers. Accounting firms are also often used to perform diligence on tax risks associated with Target (for example, underpayment of taxes, deficiencies in filing obligations, and so forth). It is important to be aware that the Canada Revenue Agency is generally entitled to require disclosure of the work product of — or even discussions with — accountants or other non-lawyer advisers,[1] and so attention must be paid to what advice is sought, the form of the work product, and the record of communications created.

4. Foreign Tax Advisers

If the buyer is resident outside Canada, optimal tax planning will include considerations under the tax law of Canada, the buyer's home country, and possibly other countries (for example, if Target has foreign subsidiaries, or if there are or should be third-country holding companies between the buyer and Target). It is essential for the buyer's tax director to ensure that foreign tax advisers work closely with Canadian tax advisers, so that the planning achieves the desired objectives in all relevant jurisdictions.

[1]For more on that topic, see Steve Suarez, ''Canada Revenue Agency Forces Taxpayer to Disclose Discussions With Accountant,'' *Tax Notes Int'l*, May 11, 2015, p. 553.

C. Identifying and Addressing Critical Tax Issues

Successful tax management of a transaction involves identifying and managing tax risks. One important function a tax adviser performs is making the buyer's transaction team aware of the most critical tax issues and the alternatives for dealing with those issues (including the purchase price), as early as possible.

The tax issues that rise to the level of critical vary from deal to deal. In some cases, obtaining a section 88(1)(d) cost basis ''bump'' (discussed below) may be essential to the economics of the transaction. In others, obtaining tax deferral treatment or some other tax advantage for selling security holders may be key. Dealing with a particular tax risk or liability in Target may be critical in other circumstances. Risk of an adverse change in tax law between the time of the agreement and the completion of the transaction is another potential issue. The tax adviser must flag and prioritize those issues and advise the transaction team on how to address them.

1. Advance Ruling

One tool for managing tax risks of an acquisition structure is to obtain an advance tax ruling from the CRA. That involves full disclosure of the relevant facts to the CRA in a formal application for an advance tax ruling and can entail a significant amount of time working through the issues with the CRA in the hopes of obtaining a favorable ruling. This tool may therefore not be feasible in all cases but is an option that should be considered. The benefit of a ruling is certainty of the tax treatment of whichever legal issues the CRA rules on, provided there has been full disclosure of all relevant facts.

2. Adviser Opinion

Another risk management tool is an opinion from a tax adviser on a particular issue. An opinion is obviously not a guarantee that the CRA or the courts will agree with the adviser's conclusion, but it does provide the buyer with some confidence that the issue has been carefully considered and that the critical underlying assumptions have been brought to its attention. The strength of the opinion — that is, ''will,'' ''should,'' ''more likely than not'' — also gives the buyer a good sense of the degree of risk involved, allowing an informed decision to be made.

Because the buyer's accounting auditors, as part of assessing the tax provision on the buyer's financial statements, will often review significant transactions and demand analysis of and support for any tax positions taken, an opinion may involve work that will need to be done in any event.[2] As noted, in Canada,

[2]Indeed, if the transaction involves potentially uncertain tax positions, the buyer is often well-advised to discuss them with its accounting auditors early in the process and ensure that the accounting treatment has been agreed to.

only lawyers — not accountants or other types of professionals — are able to provide advice that is protected from disclosure to tax authorities, and taxpayers should consider carefully the risks involved in receiving unprivileged advice. The CRA can and will demand to see any communications.

3. Due Diligence

Performing due diligence on Target's tax position is another risk management tool. The buyer should discuss the desired level of diligence with the diligence team — the more time and resources the buyer is willing to invest, the more detailed the diligence work can be. In a friendly transaction in which Target agrees to be acquired, tax diligence steps may include:

- posing specific queries to Target management;
- reviewing tax returns, internal and external tax planning memoranda, correspondence with tax authorities, and documentation regarding significant transactions; and
- reviewing Target's provisions for uncertain tax positions taken while preparing its accounting statements and discussing the underlying analysis with Target's auditors.

Tax due diligence is usually performed by an accounting firm, which has the requisite number of people to perform that time-consuming work and often has individuals who specialize in diligence. However, a diligence report prepared for the buyer by an accounting firm will generally not be protected from disclosure to the CRA.

Canadian case law provides that communications with a third party (such as an accounting firm) may be privileged if that party is retained by the client or the lawyer to give the lawyer input in formulating his own advice to the client. For that reason, it is preferable for a tax lawyer to advise the buyer on the diligence work and supervise the diligence team, so that any diligence report is considered the lawyer's own privileged advice to the client regarding potential tax law issues, using the work done by the accounting firm diligence team as an input for that legal advice. Because a buyer is effectively inheriting Target's liabilities, it is not in its interests to create an unprivileged analysis of every possible pressure point in Target's tax positions (however remote) that, if reviewed by an overzealous CRA auditor, could create needless controversy.[3]

4. Sale Agreement

In negotiated transactions, the agreement between the parties is obviously a key risk management tool. The buyer will normally seek various representations from Target that it has accurately filed all required tax returns, paid all taxes on time and in full, and so forth. Other representations will seek to disclose whether there are any latent tax obligations not otherwise apparent.[4] If the buyer is pricing the transaction on the basis that Target has specific tax attributes (for example, undeducted losses available for carryforward), those may also be the subject of specific representations.

There will also be covenants that require Target to do, or refrain from doing, particular things between the time the transaction agreement is signed and the time the transaction closes (for example, to continue to fulfill all tax obligations as they arise). Finally, an especially critical tax issue may be made a closing condition in the relevant agreement, such that the buyer is not required to complete the transaction unless the closing condition is met.

What recourse the buyer has following closing if those representations turn out to be untrue or covenants are not complied with depends on the facts. Because the buyer will own Target by then, having a legal right to pursue Target is of little practical benefit. In the case of a closely held Target with relatively few shareholders, the buyer may enter into an agreement directly with those shareholders under which they indemnify it for losses attributable to a breach of representations and covenants. In some cases, a holdback or escrow of part of the sale price may be a way of providing the buyer with additional security. However, in transactions in which Target's shares are widely held (for example, a public company), there is generally no practical recourse for the buyer if Target representations or covenants are breached and that breach is not discovered until after closing.[5] It is important to understand the practical limitations of the transaction documentation on the facts and to consider the range of risk management tools available.

II. Transaction Structuring

Some key structural elements of the transaction should be determined as early as possible, because they drive much of the planning and documentation that follows. In that regard, it is useful to set out a few key elements of the Canadian tax system:

- Canadian residents are taxable in Canada on their worldwide incomes, whereas nonresidents of

[3]*See*, in this regard, Suarez, ''Canada Revenue Agency Declares Open Season on Taxpayer Information,'' *Tax Notes Int'l*, July 13, 2015, p. 143.

[4]In particular, those that do not constitute an immediate obligation to pay an amount to a tax authority or a ''liability'' for financial statement purposes. If the Target shareholders are receiving securities of the buyer under the transaction, similar representations may be demanded of the buyer. For a list of many representations and warranties typically found in Canadian acquisition agreements, see Jack Bernstein, ''Canadian Tax Representations and Warranties in Purchase and Sale Agreements,'' *Tax Notes Int'l*, July 14, 2014, p. 133.

[5]For breaches discovered before closing, the agreement could entitle the buyer to adjust the purchase price or refuse to complete the transaction.

Canada are subject to Canadian tax only on (1) gains from the disposition of taxable Canadian property (TCP),[6] (2) some passive receipts — that is, interest, dividends, and royalties — from a Canadian payer to which Canadian withholding tax applies, and (3) income from carrying on business in Canada, employment in Canada, or in some cases, rendering services in Canada.

- Capital gains are taxed advantageously in Canada: Only 50 percent of the gain is included in income. Capital losses may only be used to offset capital gains, not any other form of income.
- Paid-up capital (PUC) is the tax version of stated capital under corporate law; generally, when a corporation issues shares of a particular class, it adds the consideration received to the PUC of that class of shares.[7] When a Canadian corporation redeems or repurchases its own shares, it is deemed to have paid a dividend to the selling shareholder equal to the amount by which the redemption price exceeds the PUC of the redeemed or repurchased share.[8] Because PUC is the same for each share of any class of shares (and may be quite different from what the shareholder's cost base in the share is), when a holder's Target share is acquired by Target (as opposed to another person), (1) that may trigger a deemed dividend instead of a capital gain, and (2) the amount of any deemed dividend could be different than the amount of a capital gain arising on a sale to a third party.
- Subject to some exceptions, dividends paid by one Canadian corporation to another generally flow tax free as a result of a 100 percent dividends received deduction.
- The integration principle underlying Canada's tax system is meant to result in the combined corporate-shareholder tax burden on most forms of income earned by a Canadian private corporation and then distributed to a Canadian resident shareholder to be roughly the same as the tax on that same income if earned directly by a Canadian resident individual (see Section IV, *infra*).

There are different corporate or commercial mechanics to acquire Target (for example, takeover bid, negotiated sale agreement with sellers, and so forth) that may affect what can be achieved from a tax perspective. If tax planning makes it desirable to achieve a precise ordering of sequential steps or to bind several parties that are too large to address through direct agreements, a court-sanctioned plan of arrangement is often used as a way for Target and the buyer to work together to achieve the desired results with a single all-or-nothing vote of Target shareholders (usually two-thirds approval required). Often, a plan of arrangement may also be desirable for nontax reasons, such as to qualify for an exemption under relevant securities law.

A. Seller Tax Objectives

Having a good understanding of who the Target shareholders are and what their tax objectives are likely to be is essential to the structuring process. Important considerations include the following:

- *Fiscal residence*. Identifying the fiscal residence of the Target shareholder base is important. Nonresidents will rarely be subject to Canadian capital gains taxation on a sale of Target shares (unless the shares are TCP), but typically will be subject to Canadian withholding tax on dividends or deemed dividends from a Canadian corporation. They will also have home-country tax considerations. Nonresident sellers and those buying property from them must also consider whether the withholding and notification regime in section 116 applies (see Section III.F, *infra*).

- *Capital gains taxation*. While each shareholder's accrued gain or loss on her Target shares will be different depending on her cost base in those shares, it is usually possible to get some sense of how likely the Target shareholder base is to have significant accrued gains on their Target shares based on financial statements, share capital and financing history, and so forth. Moreover, shareholders with capital losses available to shelter a capital gain from the sale of Target shares or nonresidents whose Target shares are not TCP will find a capital gain relatively attractive. Understanding who has accrued capital gains that will actually result in Canadian tax allows the buyer to assess the importance of nonrecognition or deferral treatment for Target shareholders.

- *Dividend taxation*. Canadian residents who can receive a dividend tax free or at a reduced rate may find that preferable to a capital gain.

- *Tax status*. Target's shareholders may include many tax-exempt entities (for example, pension

[6] In this article, TCP essentially consists of shares of a corporation that at any time in the preceding 60 months have derived more than 50 percent of their value from Canadian real property, directly or indirectly (comparable rules exist for interests in partnerships and trusts). For shares listed on a designated stock exchange, the holder (together with non-arm's-length persons and some partnerships) must also own at least 25 percent of any class of the corporation's shares any time in the previous 60 months for those shares to constitute TCP to the holder. As such, publicly listed shares are rarely TCP.

[7] The PUC of any share of a particular class of shares equals the PUC of the entire class divided by the number of outstanding shares of the class. Subsequent issuances or redemptions of shares of that class will affect the PUC of each share of the class, but the sale of an already issued share to another person does not affect PUC.

[8] The shareholder then computes his capital gain or loss on the disposed-of share as the excess of the redemption price, less the amount of any deemed dividend, over the holder's cost base.

funds and tax-advantaged retirement vehicles).[9] Those shareholders are not subject to normal Canadian income tax on transaction proceeds. However, those Canadian entities are subject to different constraints in terms of the consideration they can receive without jeopardizing their tax-exempt status or incurring special penalty taxes. Nonresident tax-exempt entities may be subject to comparable home-country rules and will want to avoid receiving amounts that would be subject to Canadian withholding tax (for example, dividends not exempt under an applicable tax treaty).

Different shareholders often have different Canadian tax preferences depending on their identity and individual circumstances, and analyzing the Target shareholder base will be useful in structuring a transaction that sellers will find most attractive. The buyer should consider whether the transaction can be structured to offer choices that accommodate the different preferences of different groups of shareholders.

B. Transaction Structure

The most common form of transaction is for all existing Target shareholders to simply sell their Target shares to the buyer. Much of the discussion that follows is premised on a Target share sale. However, it is usually worth considering whether an alternative transaction structure would yield a better result both from tax and nontax perspectives.

1. Asset Sale

A purchase of all of Target's assets is one alternative transaction structure. That would generally result in Target realizing accrued gains on its assets and ''recapture'' of previously claimed depreciation for tax purposes (capital cost allowance, or CCA),[10] with the buyer acquiring each Target property at its fair market value.[11] The tax implications of an asset sale depend heavily on the facts, but as a general matter, the following factors would be the most relevant:

- *Latent taxable income*. Target's immediate tax cost from selling assets depends on Target's tax basis in its assets, the tax character of those assets — that is, depreciable property, inventory, and so forth — the allocation of the purchase price amongst those different assets, and the form and amount of income — that is, capital gains, recapture, and so forth — recognized on a sale.
- *Target tax shelter*. If Target has significant loss carryforwards or other potential tax shelter to absorb income created by an asset sale, this will reduce the tax cost to Target of selling assets.
- *Use of proceeds*. If Target is closely held and its shareholders are willing to keep most or all of the proceeds from an asset sale within Target (or within another Canadian corporation able to receive a tax-free dividend from Target) for use in another venture, this reduces or eliminates any shareholder-level tax otherwise exigible on a Target distribution of sale proceeds to shareholders.
- *Integration*. If Target is a private corporation, particularly a Canadian-controlled private corporation (CCPC; see Section III.E.5, *infra*), and most or all of its shareholders are Canadian residents, the combined corporate- and shareholder-level tax of a Target asset sale followed by a Target distribution of the proceeds to its shareholders may be manageable under the integration features of the Canadian tax system.
- *Tax shield for buyer*. Depending on the value and tax category of Target's property, the present value of the stream of tax deductions created for a buyer of depreciable property at a stepped-up cost base may offset Target's immediate tax cost of selling assets. Taking into account the half-year rule that limits the CCA claimable in the year property is acquired, the present value of a stream of CCA deductions on depreciable property can be expressed by the formula:

$$\frac{\text{property cost x CCA rate x tax rate}}{\text{CCA rate + cost of capital}} \times \frac{1 + 0.05 \text{ x cost of capital}}{1 + \text{cost of capital}}$$[12]

- *Use of purchased property*. If a significant amount of the property being purchased by a nonresident buyer would be more advantageously held outside Canada for tax or other reasons (for example, intellectual property), these benefits may partially offset the immediate tax cost to Target.
- *Inherited liabilities*. If as a commercial matter there are significant liabilities or latent obligations within Target that are difficult to quantify or that the buyer does not want to assume, this makes an asset sale a more logical transaction structure.
- *Unwanted property*. Finally, if the buyer doesn't want all of Target's property or does not ascribe

[9]Registered retirement savings plans (RRSPs), registered retirement income plans (RRIFs), and tax-free savings plans are the most frequently encountered entities in Canada.

[10]Recapture arises to the extent that the purchase price for a depreciable property (up to its original cost amount) exceeds its current undepreciated capital cost. Such ''recapture'' constitutes fully taxable income.

[11]There may also be commodity tax implications created on an asset sale, although under the federal goods and services tax and the harmonized sales tax regimes of most (but not all) Canadian provinces, an exemption exists for the sale of all or substantially all of the assets used in a business. For a discussion of Canada's GST/HST, see Camille Kam, ''Nonresidents and Canada's VAT System,'' *Tax Notes Int'l,* Aug. 20, 2012, p. 771. Provincial land transfer tax may also apply if interests in land are being transferred.

[12]Cost of capital generally reflects the buyer's cost of debt and equity to acquire the property (for example, interest on debt financing is a cost of capital).

the same value to some property that the Target shareholders do, one way to address this is to simply have Target sell the desired assets and keep the remaining property.

An asset sale will often not be an attractive alternative if the shareholder-level tax from a share sale is low on the facts (for example, if shareholders have high tax basis in their Target shares, or are not taxable in Canada on resulting gains, or are entitled to the exemption for qualified small business corporation (QSBC) capital gains discussed in Section IV, *infra*). However, an asset sale should not be dismissed without the costs and benefits having been fairly analyzed relative to a share sale.

2. Hybrid Transaction

Another transaction structure frequently seen in Canada is a hybrid transaction, which includes elements of both an asset sale and a share sale. They are most commonly seen when Target is a CCPC and most or all of its shareholders are Canadian residents, such that the integration principle applies. There are variations of the structure depending on the facts and circumstances, but in general terms, hybrid transactions take the following form:

- A sale by Target of some assets, either to a subsidiary — that is, a non-arm's-length transaction — or to the buyer. That sale steps up the cost base of the relevant assets and causes some or all of the accrued gain on the relevant property to be realized, usually in a form that generates a favorable tax attribute at an acceptable tax cost. For example, if Target realizes a capital gain or gain on some intangibles, 50 percent of that is included in Target's capital dividend account.
- A distribution by Target to its shareholders, usually in the form of a dividend that can be received by a Canadian shareholder at a low tax rate. For example, Target can pay a capital dividend from its capital dividend account, which Canadians receive tax free (see Section IV.A.1, *infra*). A dividend may also arise as a deemed dividend on a repurchase by Target of its shares.
- The acquisition by the buyer of all outstanding Target shares.[13]

3. Spinouts

Another frequently encountered transaction structuring issue is the presence of Target property that the buyer either does not want or does not value as highly as the sellers do. If that cannot be dealt with satisfactorily by a purchase price adjustment or by structuring the transaction as an asset purchase, a spinout transaction to distribute the relevant property to Target shareholders often happens. The essence of a spinout transaction is to cause Target to transfer the relevant property to a wholly owned subsidiary (Spinco) and then distribute the shares of Spinco to Target shareholders immediately before the buyer acquires all Target shares.

The result is that Target shareholders are left with shares of Spinco and the sale proceeds from disposing of their Target shares to the buyer. Because structuring the transaction to include a spinout requires significant planning, the parties should identify as soon as possible whether a spinout will be necessary.[14]

While the rest of this article discusses a sale of Target shares, it is important to remember that there are viable alternatives to a standard share purchase that can achieve better results for both parties by making optimal use of the available tax attributes and preferences.

C. Purchase Price

The form of the proceeds receivable by Target shareholders for their Target shares has a major effect on the transaction structure and the tax consequences to the parties. It is therefore helpful to determine early in the process what each party wants, what they can agree on as a business matter, and the most tax-advantageous way of achieving their goals.

1. Nonrecognition Treatment

If the buyer of Target shares is a Canadian corporation and a Target shareholder is receiving shares of the buyer as payment for his Target shares, the Target shareholder can obtain nonrecognition (or rollover) treatment on the exchange. Essentially, all forms of payment other than shares of a Canadian buyer are treated as cash. As such, providing nonrecognition treatment to Target shareholders severely constrains the form of the purchase price, and foreign buyers are at a disadvantage relative to Canadian buyers if nonrecognition treatment for the Target shareholders is important.

There are basically two potential nonrecognition provisions available in the context of an arm's-length share-for-share acquisition: sections 85(1) and 85.1(1). Table 2 summarizes the salient differences between those provisions. The primary benefits of the section 85(1) rollover relative to a section 85.1(1) rollover are that:

- it can apply even if the Target shareholder receives consideration other than shares of the

[13]For more on hybrid transactions, see Charles P. Marquette, ''Hybrid Sale of Shares and Assets of a Business,'' 62 *Canadian Tax J.* 857 (2014).

[14]For more on spinout transactions, see Suarez and Paul Mingay, ''Spin-outs in M&A: Bridging the Valuation Gap'' (Jan. 2013), *available at* http://www.blg.com/en/NewsAndPublications/Documents/Publication_3241.pdf. It is generally not possible to use a ''butterfly'' divisive reorganization (which is tax deferred at the Target level) as part of a series of transactions that includes the acquisition of control of Target or Spinco.

Table 2. Comparison of Section 85(1) and Section 85.1(1)

	85(1)	85.1(1)
Seller	Any	Must deal at arm's length with Canadian corporate buyer
Transferred Property	Almost any (real property held as inventory or by nonresident may be excluded)	Shares of Canadian corporation (e.g., Target) held as capital property
Non-Share Consideration	Permitted	Not permitted (must bifurcate exchange)
Seller's Proceeds	Elected amount: generally between seller's cost of transferred property and fair market value; cannot be less than value of any non-share consideration received	Seller's cost of transferred shares (unless seller chooses to report gain)
Buyer's Cost of Transferred Property	Same as seller's proceeds (elected amount)	Lesser of PUC and fair market value of transferred shares
Seller's Cost of Acquirer Shares	Elected amount less value of any non-share consideration received	Seller's cost of transferred shares (unless seller chooses to report gain)
Other	Requires joint election by seller and acquirer	Applies automatically where preconditions met unless section 85(1) election filed

Canadian buyer (in addition to those Canadian buyer shares);[15]

- it generally results in a higher cost base for the buyer in the Target shares;[16]
- it allows the seller to choose the proceeds of disposition (within limits);[17] and
- it can apply when the buyer does not deal at arm's length with a particular seller.

In particular, section 85(1) allows the seller to receive non-share consideration (for example, cash) up to its cost base in Target shares without realizing any gain — that is, boot to basis. For example, assume that a Target shareholder's shares have an FMV of $100 and a cost of $60. On a transfer of those shares to a Canadian corporation in exchange for cash and buyer shares under section 85(1), the Target shareholder can receive up to $60 of cash (and the remaining consideration as buyer shares) without realizing any gain.

The primary disadvantage of section 85(1) is that it requires the seller and buyer to file a joint election, which can involve cost and inconvenience if a significant number of Target shareholders are involved. While there have been many acquisitions of Canadian public companies in which section 85(1) elections have been offered to shareholders, in others, buyers have either chosen not to offer nonrecognition treatment or have simply opted for the automatic share-for-share rollover in section 85.1(1). A buyer must consider what degree of reduced cost base in the Target shares and administrative cost and inconvenience it is willing to accept by offering nonrecognition treatment to some or all Target shareholders.[18] As noted below, both the form of consideration and reduced buyer cost base in Target shares can affect the availability of a section 88(1)(d) cost basis bump to the buyer.

If a foreign buyer is willing to use shares of itself to pay for Target shares, a direct exchange of Target

[15]If a Target shareholder receives both shares of the Canadian buyer and other consideration, and if the exchange is structured as (1) an exchange of some Target shares for Canadian buyer shares and (2) an exchange of the holder's remaining Target shares for other consideration, section 85.1(1) can apply to provide nonrecognition treatment to exchange (1), and exchange (2) will be subject to full recognition — that is, a partial rollover. If a Canadian buyer is offering shares of itself and is not willing to provide nonrecognition treatment, the transaction is often tainted to prevent section 85.1(1) from applying by structuring it as an exchange of each Target share for an indivisible mixture of a Canadian buyer share plus a nominal amount of cash — for example, $0.01 per share.

[16]In a section 85.1(1) rollover, the buyer's cost of Target shares is limited to the lesser of the PUC of those shares, which could be quite low, and their FMV.

[17]The elected proceeds of disposition cannot be (1) greater than the Target shares' FMV, (2) less than the FMV of any consideration received other than shares of the Canadian buyer (for example, cash), and (3) less than the lesser of the Target shares' FMV and the holder's cost base — that is, an accrued loss must be realized.

[18]It is not uncommon to see transactions structured such that nonrecognition treatment is limited to those shareholders likely to benefit from it — that is, Canadian residents who are not tax exempt. That can be achieved by the buyer simply tainting the section 85.1 rollover as described in note 15, *supra*, and choosing to make section 85(1) elections with some Target shareholders and not others, for example.

shares for foreign buyer shares will cause accrued gains to be realized for Canadian tax purposes. Further, any future dividends on foreign buyer shares will be taxed in Canada at a higher rate than dividends on shares of a Canadian corporation would be. Exchangeable shares were developed to permit Canadian residents to hold shares of the foreign buyer's Canadian subsidiary (Exchangeco) that are the economic equivalent of shares of the foreign buyer, so as to allow:

- nonrecognition treatment on an exchange of Target shares for Exchangeco exchangeable shares, typically using a section 85(1) election; and
- favorable Canadian taxation of dividends paid by Exchangeco.

Under an exchangeable share structure, those Target shareholders who might reasonably benefit from holding a share of a Canadian corporation — that is, Canadian residents — exchange their Target shares for shares of Exchangeco that are exchangeable on demand for foreign buyer shares, while all others exchange their Target shares for shares of the foreign buyer. The key attributes of the exchangeable shares are:[19]

- *Dividends*. Whenever a dividend is paid on the foreign buyer's shares, Exchangeco pays a corresponding dividend on the exchangeable shares.
- *Exchange rights*. Holders of exchangeable shares can exchange them on demand for foreign buyer shares at a preset ratio (usually 1 to 1), with a mandatory exchange of all outstanding exchangeable shares usually occurring after a predetermined number of years.
- *Liquidation rights*. On the windup or liquidation of Exchangeco, holders of exchangeable shares receive a foreign parent share for each exchangeable share (no more and no less).
- *Voting rights*. In many cases, mechanisms are put in place to eliminate exchangeable shareholders' right to vote on matters involving Exchangeco (to the greatest degree possible), and to allow exchangeable shareholders to vote on matters that foreign buyer shareholders vote on as if they actually held the foreign buyer shares receivable on an exchange of their exchangeable shares.

Figure 1 illustrates a simplified version of an exchangeable share structure resulting from a foreign buyer's Canadian subsidiary (Exchangeco) acquiring all the shares of Target, with exchangeable shares being issued to those Canadian Target shareholders wishing to receive them, and all other Target shareholders receiving foreign buyer shares.

2. Reserves

A Canadian resident selling capital property (including Target shares) may be able to recognize the resulting capital gain over time rather than immediately in the year of sale. If the transaction is structured so that some or all of the proceeds of disposition are not receivable until after the end of the year, the seller may claim a reasonable amount of the unpaid portion as a reserve. The maximum possible reserve allows the seller to report 20 percent of the gain in each year of disposition and in the four immediately following tax years.[20] No reserve is available for sellers who are tax exempt or nonresidents of Canada, or if the buyer is a corporation controlled in any way by the seller or related parties.

If the seller has accepted a promissory note as part of the sale, it is important to determine whether the note merely evidences or secures the unpaid balance of sale owing, or conversely, has been accepted as payment of the unpaid purchase price — that is, the seller's rights against the buyer are no longer under the sale agreement but rather under the terms of the note. In the latter case, there are no proceeds of disposition receivable after the end of the year and no reserve can be claimed.[21] A demand promissory note that the holder can enforce payment of at any time has also been held to disentitle the holder from claiming this reserve.[22]

3. Earn-Outs

Some or all of the purchase price is often computed based on Target profits for some period following the acquisition. That type of arrangement (often called an earn-out) can help bridge differences in how the parties value Target. However, earn-outs must be approached carefully from a Canadian tax perspective and should be reviewed by Canadian tax counsel.

The principal tax issue associated with earn-outs is that section 12(1)(g) provides that payments based on the use of or production from property, including as an installment of the sale price, are treated as income, not capital gains, to the recipient. That kind of recharacterization is generally quite negative for a seller of Target shares, because:

- only 50 percent of capital gains is included in income;
- capital losses can be used only against capital gains;

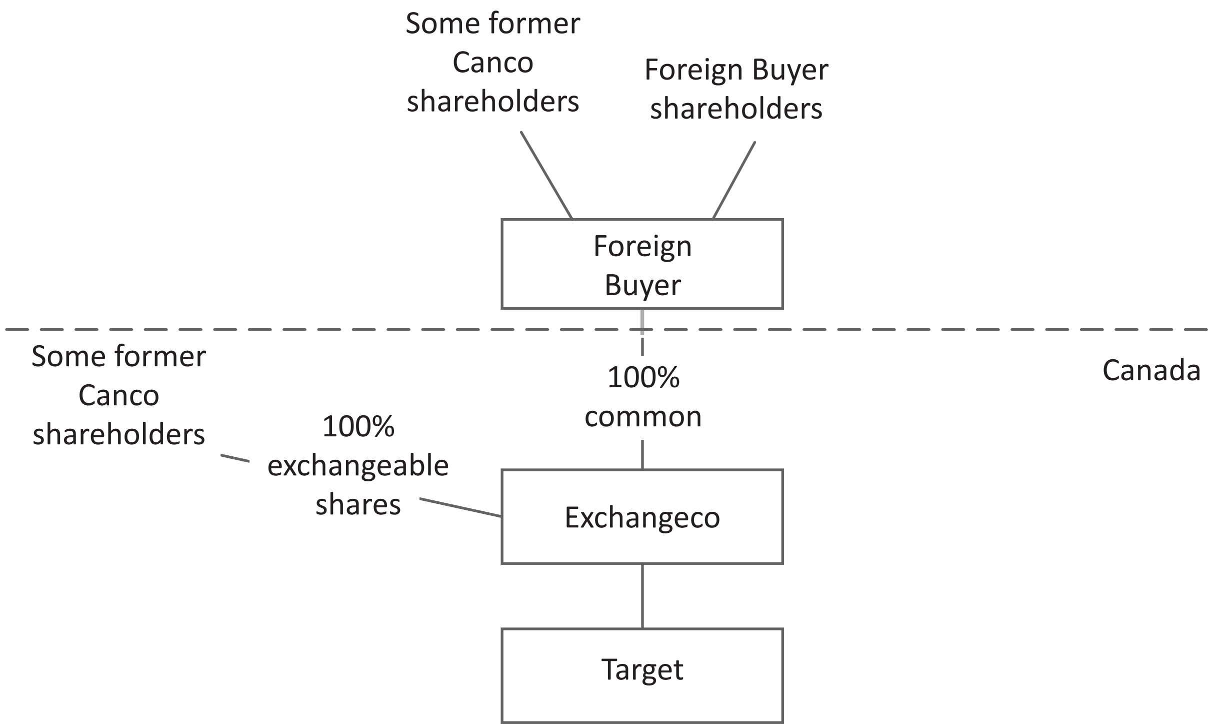
[19]Exchangeable shares are explained in Suarez and Pooja Samtani, "Using Exchangeable Shares in Inbound Canadian Transactions," *Tax Notes Int'l*, Dec. 24, 2007, p. 1281.

[20]That would require that the proceeds of disposition be receivable at no more than 20 percent in each year; if they are receivable at a faster rate, recognition of the capital gain would be accelerated. *See* section 40(1)(a)(iii).

[21]That position has been adopted by the CRA; *see* CRA doc. 2002-0161395 (Jan. 8, 2003).

[22]*The Queen v. Derbecker*, 84 DTC 6549 (FCA).

Figure 1. Simplified Exchangeable Share Structure



- only capital gains can benefit from the QSBC exemption (see Section IV.B, *infra*); and
- nonresident sellers (usually exempt from Canadian capital gains tax) may be subject to Canadian withholding tax under the Part XIII equivalent of section 12(1)(g).

Section 12(1)(g) does not affect the tax position of the buyer; the recharacterization is one-sided.

The CRA has a helpful administrative policy on shares sold subject to an earn-out, which allows the seller to use the cost recovery method to report the sale proceeds and to avoid section 12(1)(g). Under that regime, as amounts of the sale price become determinable, the seller reduces its cost basis in the shares. As such, no capital gain is realized until the amount of the sale price that can be calculated with certainty and to which the seller has an absolute (although not necessarily immediate) right exceeds the seller's cost base. The administrative policy applies if the following conditions are met:

- the seller deals at arm's length with the buyer;
- the earn-out feature relates to underlying goodwill whose value cannot reasonably be expected to be agreed on by the parties at the date of sale;
- the last contingent amount under the earn-out becomes payable within five years of the end of the Target tax year that includes the date of sale; and
- the seller submits a formal request to use the cost recovery method with its year-of-sale tax return.[23]

A reverse earn-out is also frequently used to avoid the application of section 12(1)(g). Essentially, if a property's purchase price is expressed as a maximum considered to be the property's FMV at the time of

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[23] *See* Interpretation Bulletin IT-426R, ''Shares Sold Pursuant to an Earn Out Agreement'' (Sept. 28, 2004). While IT-426R refers to Canadian resident sellers, the CRA has since stated that nonresident sellers who would otherwise be eligible to use the cost recovery method will generally not be subject to the nonresident withholding tax equivalent of section 12(1)(g). *See* CRA doc. 2006-0196211C6 (Oct. 6, 2006). The CRA further says:

- the cost recovery method may not be used on the sale of shares of a holding company whose only assets are shares of another corporation (CRA doc. 2013-0480561E5 (May 14, 2013));
- once a seller has chosen to use a different method to calculate the its proceeds of disposition, it may not thereafter change its mind and file amended tax returns applying the cost recovery method (CRA doc. 2014-0529221E5 (Aug. 27, 2014)); and
- the capital gains reserve described in Section II.C.2, *supra*, cannot be claimed on an earn-out or reverse earn-out (*see* CRA doc. 2013-0505391E5 (Feb. 24, 2014)).

sale subject to reductions if reasonable conditions regarding future earnings are not met, section 12(1)(g) will not apply.[24] Instead, both the seller's proceeds and buyer's cost basis will be treated as the maximum amount owing, subject to appropriate adjustment in post-sale tax years if the relevant conditions are not met and the sale price is reduced. Such post-closing adjustments to the buyer's cost basis can be troublesome if the buyer sells Target shares before the completion of the adjustment period.

4. Section 88(1)(d) Bump

As noted in Section III.B, *infra*, many buyers will want to take advantage of the potential cost basis step-up in Target's nondepreciable capital property provided for by section 88(1)(d). That provision includes a bump denial rule that limits the consideration receivable by Target shareholders and their affiliates, especially property such as buyer securities that (post-closing) derives a material portion of its value directly or indirectly from Target's property.[25] In particular, foreign buyers seeking this step-up are effectively unable to use their own securities as consideration for Target securities, except when Target represents less than 10 percent of the value of the foreign buyer post-transaction. Buyers intending to use a section 88(1)(d) bump must stay within those rules when determining what to offer Target shareholders.

5. Tax-Exempt Entities

Various entities qualify for tax-exempt status under the ITA, including pension funds and tax-advantaged retirement vehicles (such as registered retirement savings plans (RRSPs) and registered retirement income plans (RRIFs)). Specific rules govern what assets those entities may own, and those rules must be considered when structuring the purchase price those entities receive (shares and debt of closely held buyers in particular require careful analysis).

6. Safe Income Strips

Because dividends paid by one Canadian corporation to another generally flow free of tax as a result of a 100 percent intercorporate dividends received deduction, Canadian corporations owning shares with an accrued gain on them would benefit from receiving the value of those shares as a dividend rather than as a capital gain.[26] To prevent transactions that strip out Target's corporate surplus as a tax-free intercorporate dividend, an antiavoidance rule recharacterizes a dividend received by one Canadian corporation from another as a capital gain, if one of the purposes of the relevant series of transactions[27] is to reduce the capital gain that would otherwise be realized.

That dividend recharacterization rule does not apply to the portion of the shareholder's accrued capital gain on the Target share that is attributable to ''safe income'' earned by Target (directly or indirectly) during the shareholder's period of share ownership. Essentially, safe income is consolidated tax-paid retained earnings. The basic concept is that if the accrued gain on the holder's Target shares is attributable to income that has borne tax at the corporate level during the holder's period of share ownership,[28] allowing that portion of the accrued gain to be received by a Canadian corporation as a tax-free dividend is not objectionable.[29]

As such, if Target has significant safe income on hand, some sellers may want to use ''their'' portion of that income. Because each shareholder's safe income varies with its period of share ownership and dividends can only be paid on any class of shares pro rata, using safe income often requires the buyer's active participation to structure the sale transaction so that Target does not have to pay an actual dividend to all shareholders.

For example, a safe income tuck under transaction involves a particular Target shareholder transferring Target shares to the shareholder's new Canadian holding company on a tax-deferred basis under section 85(1), the triggering of a tax-free safe income deemed dividend by that holding company that results in an increase in the cost base of its shares, the sale of all the shares of the holding company to Target in exchange for new (higher-basis) Target shares (which are then sold to the buyer), and then the windup of the holding company into Target. Safe income utilization transactions can be complex and are generally used only by significant shareholders willing to bear the cost of computing their share of Target's safe income and implementation of the required steps. However, when structuring the transaction, the buyer should consider potential safe income transactions if significant Target safe income will exist by the date of the sale.

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[24]*See, e.g., Pacific Pine Co. Ltd. v. M.N.R.*, 61 DTC 95 (TAB). The CRA has expressed acceptance of reverse earn-outs in Interpretation Bulletin IT-462 (Oct. 27, 1980) and has issued favorable advance tax rulings on them (*see, e.g.,* CRA doc. 2009-0337651R3 (Sept. 9, 2009)).

[25]The CRA accepts that a bona fide earn-out or price adjustment solely intended as an FMV mechanism is generally acceptable. S*ee* CRA doc. 2007-0243261C6 (Oct. 5, 2007).

[26]*E.g.*, as a dividend paid by Target in cash or as a promissory note that reduces the value of (and accrued gain on) Target shares, or as a deemed dividend arising on a repurchase by Target of its own shares. *See* Section IV.A, *infra*.

[27]Or for a deemed dividend arising on a share repurchase by Target, if one of the results of the series of transactions is to reduce the capital gain otherwise realized.

[28]As opposed to accrued but unrealized gains on Target's property, for example.

[29]The CRA has ruled favorably on several safe income extraction transactions. *See, e.g.,* CRA doc. 2010-0370551E5 (Aug. 12, 2010). A refundable anti-deferral tax under Part IV of the ITA may apply to the dividend (or deemed dividend) in some circumstances. *See* Section IV.A.2, *infra*.

III. Buyer Planning

Numerous tax planning issues can exist for buyers of Target depending on the facts. This portion of the article discusses some of the most common buyer planning issues.

A. Acquisition Vehicle

It is normally advantageous for the buyer (especially a buyer resident outside Canada) to ensure that a Canadian corporation (''Canco'') is the direct acquirer of Target's shares. Canadian tax law allows one Canadian corporation to be wound up into or vertically amalgamated with another Canadian corporation that owns all of its shares on a tax-deferred basis. That type of consolidation typically occurs shortly after closing and is helpful because Canada does not have a group relief tax system. Winding up or amalgamating Target into Canco allows interest expense on acquisition financing incurred by Canco to be deducted against Target's operating income.[30] Moreover, a section 88(1)(d) cost base step-up on Target's eligible property also requires the windup or amalgamation of Target into a Canco (see Section III.B, *infra*).

It is especially important for a foreign buyer to use a Canco to purchase Target to maximize the cross-border PUC of its investment into Canada. PUC is a particularly valuable tax attribute for a foreign buyer because:

- a Canadian corporation can choose to distribute property to shareholders as a nondividend return of capital up to the amount of its PUC[31]; and
- PUC forms part of the equity base that supports interest deductibility under Canada's thin capitalization rules (see Section III.C, *infra*).

If a foreign buyer acquires Target directly, its cost basis in the Target shares will reflect the full FMV of its investment, but the PUC of Target's shares will remain unchanged (usually well below their FMV). Conversely, if the foreign buyer funds Canco in exchange for equity and has Canco purchase Target, the PUC of the Canco shares will reflect the full value of its investment (Target's low-PUC shares are eliminated on its windup or merger into Canco). Unless the PUC of Target's shares exceeds the purchase price, using a Canco maximizes cross-border PUC for a foreign buyer.

Special considerations apply to a foreign buyer using a Canco if more than 75 percent of the value of Target's shares is attributable to shares of foreign affiliates Target owns. In that case, Canco's acquisition of shares of Target can give rise to a deemed dividend or a reduction in Canco PUC under the foreign affiliate dumping (FAD) rules. Foreign buyers acquiring a Target that has significant investments in foreign affiliates must consider whether the initial acquisition of Target itself will trigger adverse results under the FAD rules.[32]

U.S. buyers have often used unlimited liability companies (ULCs) as Cancos for U.S. tax planning reasons (ULCs have no particular Canadian tax benefit). Payments by ULCs may be denied treaty benefits under the anti-hybrid rule in Article IV(7)(b) of the Canada-U.S. tax treaty in some circumstances, so the use of a ULC should be reviewed carefully.[33] Similar caution should be exercised if Canco's immediate shareholder is a limited liability company, given the CRA's historical administrative position of refusing to grant tax treaty benefits to an LLC unless its members are all U.S. residents entitled to claim treaty benefits through the LLC under Article IV(6) of the Canada-U.S. tax treaty.[34]

B. Section 88(1)(d) Bump

Disposing of some of Target's assets following the acquisition may be desirable for various reasons. For example:

- a buyer may want to sell to a third party Target property that is unwanted or that must be sold to finance the buyer's acquisition of Target or meet antitrust divestiture requirements; or
- a foreign buyer will generally want to extract foreign subsidiaries out from under Canada.[35]

If the relevant Target property has high accrued gain and Target does not have an offsetting tax shelter,[36] a disposition of that property may trigger significant tax. Section 88(1)(d) provides for a cost base step-up when one Canadian corporation (Target) is wound up or merged into another Canadian corporation that owns all of its shares (Canco). That cost base bump that is limited to Target is nondepreciable capital

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[30] If Target has accumulated loss carryforwards or similar tax attributes, this merger also makes those losses available to Canco (Canco may have items of income independent of Target's business).

[31] That is, there is no rule deeming distributions to be dividends to the extent of the corporation's earnings and profits.

[32] *See* Suarez, ''An Analysis of Canada's Latest International Tax Proposals,'' *Tax Notes Int'l,* Sept. 29, 2014, p. 1131. Even if the 75 percent threshold is not met so as to engage the FAD rules on the initial acquisition of Target, foreign buyers will generally want to avoid ongoing post-closing FAD issues by extracting Target's foreign subsidiaries out from under Canada.

[33] *See* Matias Milet and Peter Repetto, ''Canada-U.S. Tax Treaty Issues: Anti-Hybrid Rules, the GAAR, and the U.S. Dual Consolidated Loss Rules,'' *Tax Notes Int'l*, Sept. 19, 2011, p.889.

[34] *See* Kristen A. Parillo, ''Canada Will Litigate U.S. LLC Questions Under Fifth Protocol,'' *Tax Notes Int'l,* Oct. 4, 2010, p. 7.

[35] Extraction avoids various costs and inefficiencies created by sandwich structures, such as cross-border withholding tax and the FAD rules.

[36] A tax shelter might consist of Target losses available for use as described in Section III.E.2, *infra*, or, in the case of shares of foreign subsidiaries, sufficient ''good'' surplus accounts described in Section III.E.3, *infra*.

property — that is, shares of corporations, partnership interests, or land — owned by Target when the buyer acquires control of Target and continuously thereafter until the windup or merger.

Using that cost base bump to eliminate accrued gains on Target property can be an important tax planning tool, particularly for foreign buyers. Figure 2 illustrates a simple example in which a non-Canadian buyer (Foreign Buyer) creates and funds a Canco that purchases all the outstanding shares of Target for $100. Target's property consists of shares of a foreign subsidiary (Foreign Subco) that are bump-eligible and have an accrued gain of $40 and other (ineligible) property with an accrued gain of $10.

Following a windup or merger of Target into Canco, Canco acquires Target's property on a tax-deferred basis and (absent section 88(1)(d)) inherits Target's cost basis. However, if the relevant rules are followed, section 88(1)(d) allows Canco to increase the cost base of the Foreign Subco shares up to their FMV, in effect pushing the $100 cost base that Canco has in its Target shares down into Target's bump-eligible assets. That permits Canco to distribute the Foreign Subco shares to Foreign Buyer as a return of share capital (PUC) without any gain being realized.

The section 88(1)(d) bump rules are complex and include an overarching bump denial rule that disqualifies all of Target's property from a cost base bump if the relevant series of transactions (a broadly defined term) includes an acquisition of specific property by various persons (essentially, former Target shareholders and extensions thereof). That bump denial rule restricts those persons from receiving Target property or property (such as buyer securities) that will derive its value from Target's property. In particular, foreign buyers cannot use their own securities as payment for Target securities unless Target represents less than 10 percent of the value of the foreign buyer post-transaction.

Careful planning is required to ensure that an acquisition is structured to qualify for the section 88(1)(d) bump, and covenants will frequently be obtained from Target to restructure its property before the closing date to maximize the benefit of that provision (often referred to as prepackaging).[37]

C. Debt Financing

Canadian buyers have few tax limitations in deciding how to finance the acquisition of Target. Interest on borrowed money used to acquire property for the purpose of gaining or producing income — that is, Target shares — will generally be tax deductible to the buyer for Canadian tax purposes if the interest rate is reasonable — that is, arm's length. The CRA has stated that shares will generally constitute a valid basis for interest deductibility so long as there is some reasonable (if not immediate) prospect of earning dividends on those shares at some point.[38] No thin capitalization restriction or withholding tax exists on debt financing from arm's-length or Canadian creditors.

Foreign buyers have significantly more Canadian tax issues to consider when financing the acquisition of Target. If external debt financing is being used, one must consider which country (the buyer's home country or Canada) the related interest expense is most useful in and whether a deduction in both countries could be obtained through a double-dip financing arrangement. Moreover, if the foreign buyer's Canco is being financed with cross-border intragroup debt, additional withholding tax and interest deductibility issues arise.

Canadian domestic law imposes nonresident interest withholding tax only on (1) interest paid to nonresidents who do not deal at arm's length with the debtor; and (2) participating interest. The relevant rate of Canadian withholding tax on interest paid to a non-arm's-length nonresident will generally be:

- 25 percent for recipients resident in a country with no Canadian tax treaty;
- 0 percent for U.S. residents entitled to benefits under the Canada-U.S. tax treaty; and
- 10 or 15 percent for recipients resident in any other country with a Canadian tax treaty.

Canada's thin capitalization rules limit the extent to which Canco[39] can incur interest expense payable to a nonresident who is either a 25-plus percent shareholder of Canco (by votes or value)[40] or someone not dealing at arm's length with that shareholder (in either case, a specified nonresident). If the amount of debt Canco owes to specified nonresidents in a given year exceeds 150 percent of Canco's equity,[41] the thin capitalization rules apply to the interest on the excess debt.

For example, if Canco owes $100 million to its foreign parent and has $50 million of equity for thin capitalization purposes, it will be able to deduct interest

[37]The section 88(1)(d) bump is described in detail in Suarez, ''Canada's 88(1)(d) Tax Cost Bump: A Guide for Foreign Purchasers,'' *Tax Notes Int'l*, Dec. 9, 2013, p. 935.

[38]*See* Income Tax Folio S3-F6-C1, ''Interest Deductibility,'' at para. 1.70.

[39]The thin cap rules apply not only to Cancos, but also to Canadian resident trusts and to corporations and trusts not resident in Canada that either carry on business in Canada or elect to be taxed as Canadian residents. Partnerships in which entities like that are members are also generally included.

[40]For that purpose, a person is deemed to own any shares owned by non-arm's-length persons, and some rights to acquire more shares or to cause the corporation to redeem shares are deemed to have been exercised.

[41]Equity for that purpose generally consists of Canco's unconsolidated retained earnings, the PUC of Canco shares held by nonresident 25-plus percent shareholders, and contributed surplus attributable to those shareholders.

Figure 2. Basic Bump Transaction and Foreign Subsidiary Extraction

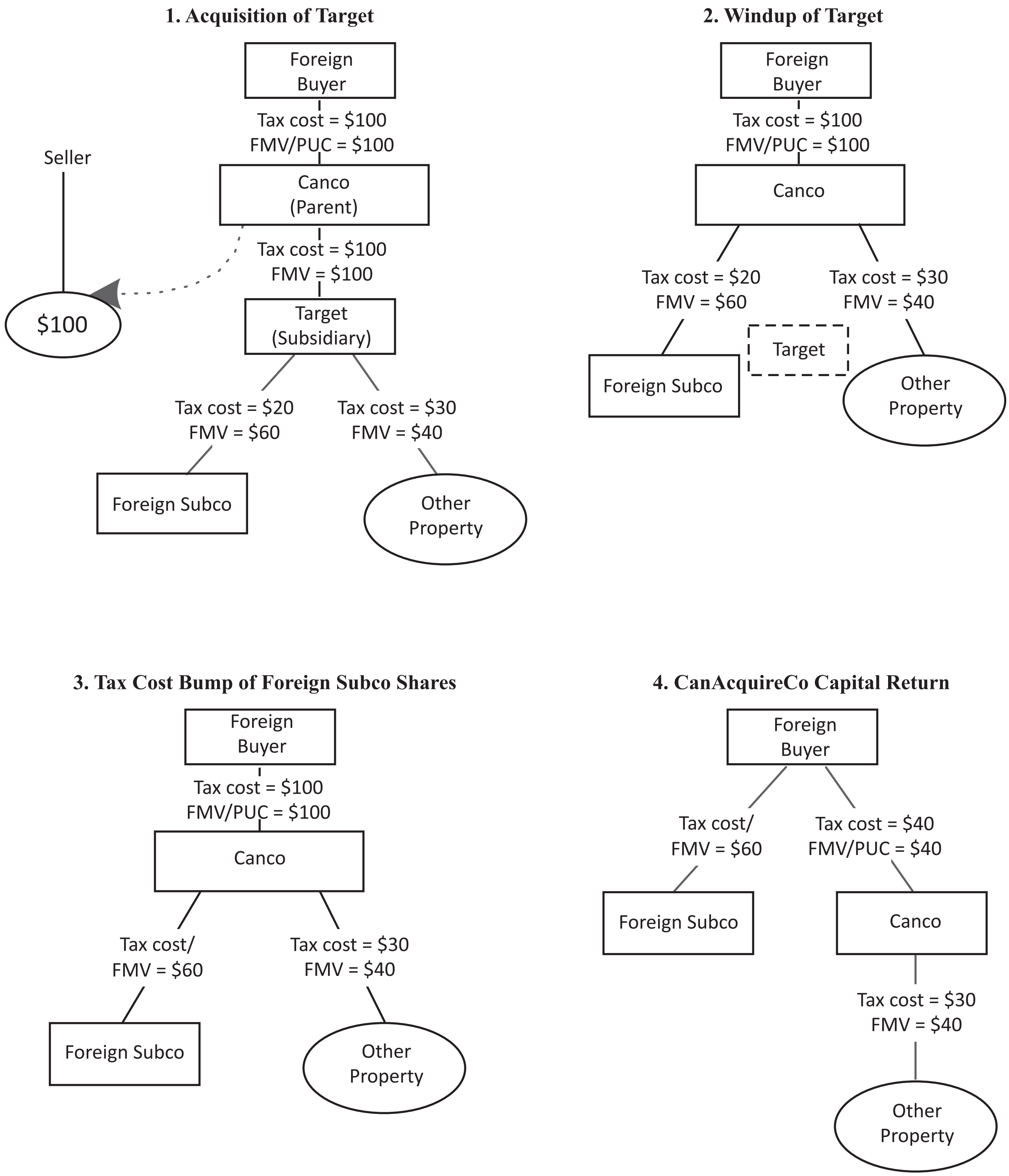

Table 3. Debt Financing Issues for Foreign Buyer Using Canco

Interest Deductibility	Interest Withholding Tax
Requires borrowed money be used for income-earning purposes, e.g., purchase of Target shares	Applicable to interest paid to non-arm's-length nonresidents* (and ''participating interest'')
Rate of interest cannot exceed arm's-length rate	0% rate for qualifying U.S. residents
Thin capitalization limit (1.5-1 debt/equity ratio) on debt owing to ''specified nonresidents''*	10-15% rate for residents of other treaty countries
	25% for residents of non-treaty countries

*Including deemed owing/paid under back-to-back loan rules.

expenses relating to only $75 million of that debt. Interest on the remaining $25 million of debt will be nondeductible for Canadian tax purposes and will be recharacterized as a dividend to which Canadian dividend withholding tax applies at a 25 percent rate (subject to reduction under an applicable tax treaty).

The thin capitalization and interest withholding tax rules are supported by back-to-back loan rules effective starting in 2015. Those rules may apply if a connection exists between (1) a debt Canco owes to a ''good'' creditor (for example, an unrelated bank) from a thin capitalization or interest withholding tax perspective; and (2) specific arrangements between that ''good'' creditor and a nonresident not dealing at arm's length with Canco. If applicable, those rules effectively deem the non-arm's-length nonresident to be Canco's creditor, potentially causing higher Canadian interest withholding tax or the thin capitalization rules to apply when they otherwise would not.[42]

Table 3 summarizes the main debt financing issues faced by a foreign-buyer-controlled Canco.

Finally, if Canco incurs external or intragroup cross-border debt financing, the buyer should consider the foreign exchange implications. A Canco borrowing in a foreign currency will typically have a foreign exchange gain or loss based on the number of Canadian dollars required to repay the debt on maturity relative to the exchange rate when the debt was incurred. In some cases, Canco may be able to elect under section 261 to compute its taxes in a currency other than the Canadian dollar, which would change the foreign exchange analysis on debt maturity. The CRA's administrative policies on foreign exchange gains and losses (including hedging arrangements) are a frequent source of disputes with taxpayers,[43] and therefore strategies to manage foreign exchange risk should be carefully considered with a Canadian tax adviser.

D. Repatriation or Sale by Foreign Buyer

Foreign buyers have incremental Canadian tax issues in terms of the repatriation of funds out of Canada and the eventual sale of their investment. A Canco can effect a distribution to shareholders as a return of capital up to the amount of its PUC, which simply reduces the shareholder's cost base in the shares, or as a dividend, to which Canadian dividend withholding tax will apply at the rate of 25 percent (subject to reduction under a tax treaty between Canada and the shareholder's home country). Neither distribution is deductible to Canco. A return of PUC will reduce Canco's equity for thin capitalization purposes; a dividend will have the same effect if it reduces Canco's retained earnings.[44]

Foreign buyers may charge management fees to Canco if services of genuine value are provided and the amount charged does not exceed what an arm's-length person would pay. Canco can also loan money to its foreign parent, subject to various rules on the amount of interest that must be charged and time limits for repayment (failing which the loan will effectively be recharacterized as a dividend).[45] Table 4 summarizes the Canadian tax aspects of different options a foreign buyer has to repatriate funds from its Canco.

Canadian capital gains tax will apply on an eventual sale of shares only if those shares are TCP.[46] The capital gains articles of Canada's tax treaties vary widely regarding when Canada can tax nonresidents on a sale of shares that are TCP:

- *No relief*. In a few treaties, there is essentially no relief from Canadian taxation of capital gains.

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[42]Those rules are discussed in Suarez, ''Canada Releases Revised Back-to-Back Loan Rules,'' *Tax Notes Int'l*, Oct. 27, 2014, p. 357.

[43]For further discussion, see Suarez and Byron Beswick, ''Canadian Taxation of Foreign Exchange Gains and Losses,'' *Tax Notes Int'l,* Jan. 12, 2009, p. 157. The Tax Court of Canada overturned some of the most objectionable of those CRA administrative policies in *George Weston Ltd. v. The Queen*. *See* Timothy Hughes and Milet, ''*Weston*: CRA Position on Hedging Derivatives Is Toast,'' *Tax Notes Int'l,* Mar. 2, 2015, p. 746.

[44]A retained earnings deficit is treated as nil for thin cap purposes.

[45]Those are reviewed in Suarez, ''Canadian Tax Planning Deadlines for 2014,'' *Tax Notes Int'l,* Dec. 8, 2014, p. 911.

[46]*See* note 6, *supra*, for a description of TCP.

Table 4. Summary of Repatriation Options for Foreign Buyers

	Dividend	PUC Return	Interest	Loan	Management Fee
Withholding Tax	25%: treaty-reduced as low as 5%	None, to the extent of Canco PUC	25%: treaty-reduced as low as 10% (0% for qualifying U.S. residents)	None if repaid within permissible time limit and Canco is paid enough interest	25%: often treaty-exempt if provider has no Canadian permanent establishment
Deductible to Canco	No	No	Yes, subject to thin cap rules	No	Yes
Effect on Canco Thin Capitalization	R/E decrease reduces equity in following year	PUC decrease reduces equity in current year	R/E decrease reduces equity in following year	None	R/E decrease reduces equity in following year
Other	Corporate law limits on payment; consider whether interest deductible if paid using borrowed money	Corporate law limits on payment; consider whether interest deductible if paid using borrowed money	Transfer pricing or benefit issue if rate exceeds arm's-length rate	Transfer pricing or benefit issue if interest too low; consider whether interest deductible if paid using borrowed money	Transfer pricing and deductibility issues if in excess of arm's-length standard, potential withholding issues if services rendered in Canada

- *Taxed if derived primarily from Canadian real property*. Some treaties simply allow Canada to tax shares if the value of the corporation's assets consists primarily (directly or indirectly) of real property in Canada, or if those shares derive their value primarily from real property in Canada.

- *Property used in business excluded from real property*. Many treaties use the same ''primarily derived from Canadian real property'' test but exclude property in which Canco carries on its business from the definition of real property.

- *Taxation limited to Canadian corporations*. Several treaties effectively preclude Canada from taxing gains on shares of corporations not resident in Canada — that is, ''above'' Canco — even if deriving their value primarily from Canadian real property.

- *Publicly listed shares excluded*. Under some treaties, Canada may not tax gains on shares that are listed on an approved stock exchange either in Canada, or in some cases, either in Canada or the other treaty country.

- *Ownership threshold*. Some treaties allow Canada to tax gains on shares that derive their value primarily from Canadian real property only when the holder meets a minimum percentage ownership level (often but not always 10 percent of any class of the corporation's shares).

Those variations make it important to consider the fiscal residence of Canco's shareholders when setting up the acquisition structure (subject to treaty-shopping and similar antiabuse considerations).

E. Effect of Transaction on Target

An important part of the buyer's planning is assessing the effect on Target of the buyer acquiring *de jure* control of it — that is, ownership of sufficient shares to elect the majority of Target's board of directors. Some of the most important Canadian tax consequences on Target of an acquisition of control (AOC) are set out below.[47]

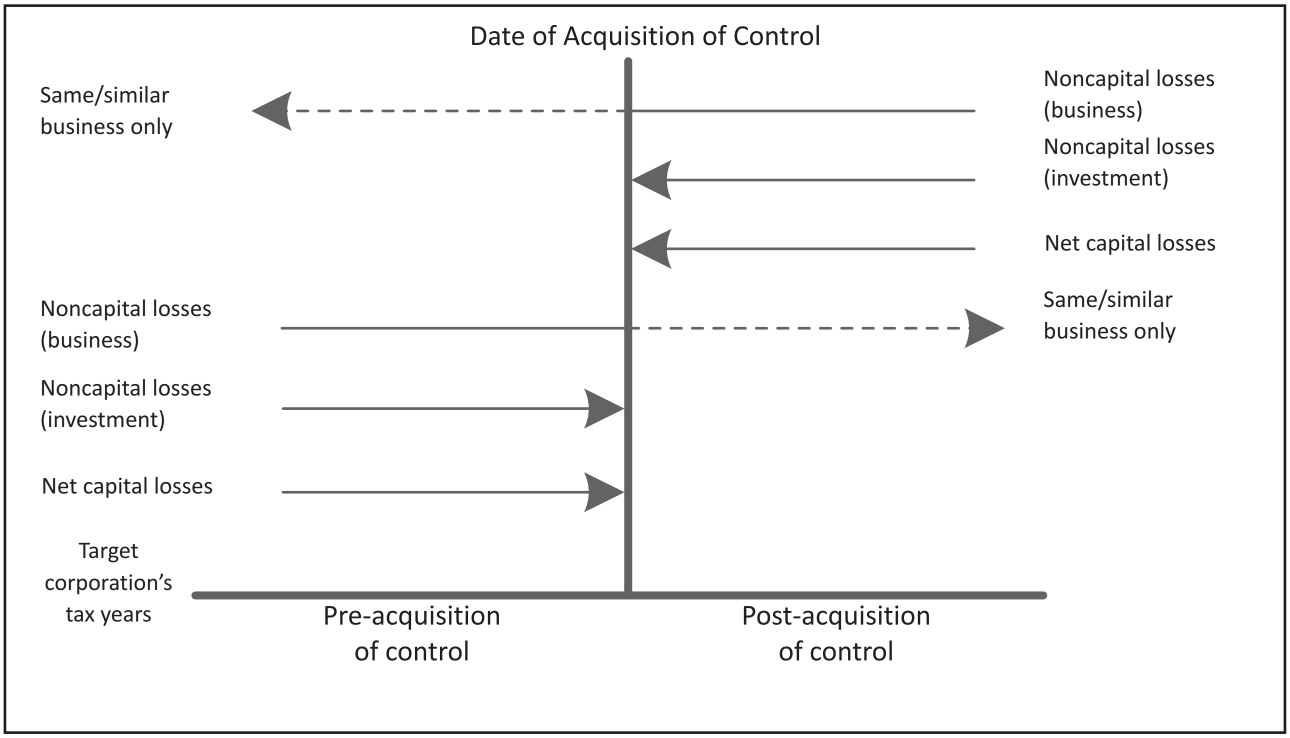
1. *Deemed Year-End*

The AOC of Target generally triggers a deemed year-end for Target immediately before the AOC, and a new tax year is deemed to commence after. A short tax year caused by the deemed year-end will accelerate the time for filing tax returns and paying taxes, and shorten the life of reserves and carryforward periods for some tax attributes and prescribed periods for paying amounts owed to employees and non-arm's-length nonresidents and for repaying loans made to shareholders. A short tax year may be avoided if the AOC coincides with the start of Target's next tax year, or occurs within seven days after the end of its most recent tax year and an election is made to extend that tax year to the AOC time.

For most ITA purposes, an AOC is deemed to occur at the first moment of the day on which the buyer acquires *de jure* control of Target, unless Target elects for it to occur at the particular moment of that day when *de jure* control is acquired (that election is often the subject of negotiation between the parties).

[47]For a more detailed discussion of the effects of an AOC, see Ronit Florence, ''Acquisition of Control of Canadian Resident Corporations: Checklist,'' V(4) *Bus. Vehicles* 262 (1999).

Figure 3. AOC Loss Utilization Restrictions



2. Loss Streaming

To prevent undue trading in losses and similar tax attributes, the ITA contains rules eliminating or restricting the post-AOC use of those attributes generated in the pre-AOC period (and vice versa). Target must recognize various accrued losses (for example, on capital property, inventory, receivables, and so forth) immediately before the AOC, so that accrued losses cannot be carried over to the post-AOC period and are instead crystallized before the deemed tax year-end either to be used in the tax year ending on the AOC or added to Target's net capital loss or noncapital loss for that year and in some cases made subject to the streaming rules described below. The rules governing the treatment of losses on AOCs are summarized below and depicted in Figure 3:

- *Capital losses*. Target's pre-AOC net capital losses cannot be used post-AOC and effectively expire.
- *Noncapital business losses*. Target's unused pre-AOC noncapital — that is, operating — losses from a business can be carried forward and used in post-AOC tax years (and vice versa) only if (1) throughout the later year in which Target seeks to use the losses it continues to carry on that same business with a reasonable expectation of profit; and (2) the post-AOC income that the losses are used against arises from carrying on either the loss business or a business of selling similar properties or rendering similar services as were sold or rendered in the loss business.[48] (Similar rules apply to scientific research and experimental development deductions, tax credits, and resource-sector tax pools.)
- *Noncapital investment losses*. Any Target pre-AOC operating losses from investments cannot be used in the post-AOC period and effectively expire.

If Target has tax attributes that may be harmed by an AOC, the buyer will want to consider how best to use them. For example, Target can trigger a corresponding amount of accrued capital gains or recapture on property by a pre-closing sale to a subsidiary governed by a section 85(1) election (this requires Target cooperation) or via a special one-time post-closing election, thereby using expiring tax losses to increase the tax basis in that property. Because the relevant gains and losses must be in the same entity (Canada does

[48]It is a question of fact whether the loss business continues to be carried on. The CRA has identified several factors it will generally consider, including the location of the business carried on before and after the AOC, the nature and name of the business, the nature of income-producing assets, the existence of a period or periods of dormancy, and whether the original business constituted a substantial portion of Target's activities in terms of time and financial resources.

not have a consolidation or group relief corporate tax system), planning and Target cooperation are often required to use losses that will otherwise expire.

3. Foreign Affiliates

If Target owns shares of foreign affiliates, an AOC can produce various results. To prevent perceived duplication of favorable tax attributes, Target's exempt surplus in a foreign affiliate may be reduced if the FMV of its shares of the foreign affiliate is less than the sum of its cost base in those foreign affiliate shares and its tax-free surplus balance. Depending on the facts, some pre-AOC amounts may be excluded from the relevant post-AOC foreign accrual property income attributable to the Canadian taxpayer. For foreign buyers, the FAD rules will make it difficult to keep any foreign affiliates under Target (or the Canco that acquires it) following the AOC.[49]

4. Suspended Losses

The ITA contains various rules that suspend the recognition of Target losses otherwise realized, typically on transactions between affiliated persons. An AOC generally results in the ''un-suspension'' of those losses.

5. Change in Tax Status

For ITA purposes, a Canadian resident corporation may be a public corporation, a private corporation (including a CCPC), or a corporation that is neither public nor private. An AOC of Target may change Target's status for ITA purposes, which may in turn affect various matters such as its tax rate and ability to generate specific tax attributes.

Public corporation status is generally disadvantageous.[50] A buyer of a Target that is a public corporation will generally want to make the post-closing election required for Target to shed its status as a public corporation.

A Target that is a private corporation is entitled to create valuable tax pools such as capital dividend and refundable dividend tax on hand (RDTOH) accounts, discussed in Section IV, *infra*. If the buyer is a public corporation, Target will thereby cease to be a private corporation and will lose those tax attributes.

A CCPC is entitled to many tax benefits in addition to those available to all private corporations, including:

- its shares may be eligible for the QSBC capital gains exemption (see Section IV.B, *infra*);
- CCPC employee stock options qualify for special benefits (see Section V, *infra*); and
- CCPCs are entitled to a reduced rate of tax on active business income (up to a specified amount) and some enhanced investment tax credits.

A Target that is a CCPC will cease to be such if one or more nonresidents or public corporations control it in any way whatever (de facto control) or collectively acquire shares representing voting control. Because a person with the right to acquire shares is treated as owning those shares for purposes of the CCPC definition, the mere signing of a binding agreement to sell a majority of a CCPC's voting shares to a buyer that is (or is controlled by) a public corporation or a nonresident may cause an immediate loss of CCPC status (which in turn triggers a deemed tax year-end).[51] The buyer should understand the tax consequences of Target ceasing to be a CCPC or private corporation, and if Target is a CCPC, the timing of signing of any sale agreement should be carefully considered.

F. Section 116 Compliance

When a nonresident of Canada disposes of taxable Canadian property,[52] the disposition may create obligations under section 116 for both the buyer and the seller, whether or not any Canadian tax is owed.[53] The buyer (whether Canadian or foreign) may be required to remit a specified percentage of the purchase price (usually 25 percent) to the CRA, which is credited toward the vendor's Canadian tax liability, if any. Failure to remit the specified amount (which a well-advised buyer will typically withhold from the purchase price) to the CRA exposes the buyer to liability for the amount that should have been remitted, plus interest and penalties. There is no statutory time limit on the CRA's ability to assess the buyer for those amounts.

The principal section 116 issues for a buyer are:

- *Taxable Canadian property*. If the property being sold is not TCP, there are no section 116 obligations.
- *Seller's fiscal residence*. A buyer has no liability to remit funds if, after making reasonable inquiry, it had no reason to believe the seller was a nonresident of Canada. For that reason, in nonpublic transactions, a buyer will typically ask sellers to formally represent that they are Canadian residents for ITA purposes and in some cases may require an opinion from Target's legal counsel. Obtaining that kind of representation generally

[49]*Supra* note 32.

[50]In particular, distributions by a public corporation as a return of capital may be deemed to be dividends in some cases. Conversely, shares and debt of a public corporation will be qualified investments for Canadian tax-exempt entities such as RRSPs and RRIFs.

[51]In some cases, that issue is addressed by causing the signing and closing of the sale agreement to be contemporaneous.

[52]*See* note 6, *supra*, for a description of TCP.

[53]The section 116 obligations of buyers and sellers of taxable Canadian property are discussed in detail in Suarez and Marie-Eve Gosselin, ''Canada's Section 116 System for Nonresident Vendors of Taxable Canadian Property,'' *Tax Notes Int'l,* Apr. 9, 2012, p. 175.

relieves the buyer from liability under section 116 unless there is reason to doubt its veracity.

- *Excluded property*. Some forms of TCP (most notably shares listed on a recognized stock exchange) do not create a buyer remittance obligation when acquired.
- *Certificate of compliance*. The buyer's remittance obligation is relieved if the seller obtains a certificate of compliance from the CRA.

If one or more sellers may be nonresidents of Canada and there is any risk that Target securities could be TCP subject to section 116, the buyer should develop a plan as early as possible for addressing its potential section 116 obligations, including simply advising the sellers that it will withhold from the purchase price in the absence of suitable protections.

IV. Seller Planning

As noted in Section II, *supra*, Target shareholders will have tax preferences that vary from person to person (depending on their particular circumstances) that should at least be considered in structuring the transaction and the purchase price, including:

- *Nonrecognition treatment*. Shareholders with significant accrued capital gains on their Target shares that are subject to Canadian tax may want a rollover transaction if the purchase price includes shares of a Canadian corporation (see Section II.C.1, *supra*).
- *Reserves*. When a capital gain is being realized and some of the purchase price is payable post-closing, Canadian residents may be able to defer realization over up to five years if a reserve can be claimed (see Section II.C.2, *supra*).
- *Earn-outs*. When the purchase price varies depending on Target's post-closing performance, sellers will want to avoid an earn-out that causes what would otherwise be capital gains to be treated as regular income (see Section II.C.3, *supra*).

Moreover, planning for sellers who are subject to Canadian tax on capital gains on Target shares will often include:

- Target dividends (or transactions deemed to be dividends for tax purposes) to realize value as a dividend rather than as a capital gain when doing so is advantageous; and
- claiming the capital gains exemption for QSBC shares.

Finally, if one or more sellers give specific restrictive covenants (for example, agreements not to compete with the buyer or Target) as part of the transaction, the tax treatment of those will be an issue.

A. Pre-Sale Dividends

A dividend paid by Target (whether in cash, other property, or as a promissory note) reduces the accrued capital gain on Target shares. Other transactions deemed to be dividends for tax purposes but that do not involve an actual extraction of assets from Target (for example, capitalizing Target retained earnings as PUC) have a similar effect by increasing the shareholder's cost basis in their Target shares. A share repurchase by Target also creates a deemed dividend for tax purposes if the purchase price exceeds the PUC of those shares.

A nonresident will be subject to normal dividend withholding tax (25 percent, subject to treaty reduction) on dividends. Unless the nonresident is subject to Canadian income tax on the capital gain on Target shares and the applicable dividend rate is reduced under a treaty, nonresidents generally will not want to receive dividends for Canadian tax purposes.

1. Capital Dividends

Capital dividends are part of the integration principle in Canada's tax system. The basic concept is that a private corporation can distribute the nontaxable half of its net capital gains to Canadian resident shareholders tax free. A dividend is a capital dividend if paid by a private corporation that files the required election to designate the dividend as a capital dividend. Capital dividends are not included in recipients' income and hence are received tax free by Canadian residents (nonresidents will be subject to normal dividend withholding tax). As such, capital dividends are a way to distribute value from Target to Canadian resident shareholders free of Canadian income tax while reducing the accrued gain on their Target shares.

If the amount Target designates as a capital dividend exceeds its capital dividend account (CDA) at that time, Target is liable for a penalty tax under Part III equal to 60 percent of the excess. Target may avoid the penalty tax if it files the required election to have the excessive capital dividend effectively treated as an ordinary taxable dividend, and all dividend recipients concur with the election. A prudent buyer will generally seek to have all recipients of a pre-sale Target capital dividend (1) deliver a written concurrence to making that election on closing, and (2) indemnify Target for any liability incurred as a result of an excessive capital dividend.

The computation of Target's CDA can be a complex exercise depending on the facts, particularly if Target is realizing income or gains as part of the sale planning, such as on a hybrid transaction (see Section II.B.2, *supra*). Generally, Target's CDA consists of (1) capital dividends received from other corporations, (2) the nontaxable half of capital gains realized by Target if accrued while it is a private corporation, less half of corresponding capital losses, and (3) 50 percent of the gains Target realized on a sale of intangibles that constitute eligible capital property as of its most recent tax year-end, less (4) previous capital dividends paid. The rules are complex, and careful planning is required in terms of timing tax year-ends and the realization of gains and losses to achieve optimal results.

2. Taxable Dividends

A Target dividend (or deemed dividend) that is not a capital dividend will be a taxable dividend. A Target shareholder may prefer to receive a taxable dividend if the holder's applicable rate of tax on the dividend is less than the rate of tax on the same amount received as a capital gain. Different recipients have differing tax consequences of receiving a taxable dividend.

A Canadian corporation includes a taxable dividend in income and is generally entitled to an offsetting deduction that results in no net taxable income. That general rule is subject to some important constraints, most notably:

- the section 55 antiavoidance rule applicable to taxable dividends on shares received by a Canadian corporation in excess of safe income that reduce the holder's capital gain on those shares (Section II.C.6, *supra*); and
- the 33⅓ percent anti-deferral tax in Part IV of the ITA applicable to taxable dividends received by a private corporation from payer corporations that (1) are unconnected with the dividend recipient,[54] or (2) receive a refund of RDTOH as a result of paying the dividend.

A safe income dividend received by a Canadian corporate shareholder is the principal example of using a dividend to realize value on a tax-preferred basis. Target shares not already held by a Canadian corporation can be transferred to that corporation on a tax-deferred basis under section 85(1) in anticipation of the sale without losing the accrued safe income entitlement.

A Canadian resident individual includes a Target dividend in income and is subject to Canadian tax at a preferential effective rate. That effective rate depends on whether the dividend is designated as an eligible dividend, which is subject to a lower effective tax rate. If Target is a CCPC, it may designate the dividend to be an eligible dividend up to the amount of its general rate income pool (basically, income that has borne tax at nonpreferential rates). If Target is not a CCPC, any dividend it pays may be designated as an eligible dividend[55] in excess of its low-rate income pool balance.

Similar to capital dividends, if Target inadvertently designates an excessive eligible dividend, Target is liable for a Part III.1 penalty tax equal to 20 percent of the excessive portion of the dividend; the penalty tax may increase to 30 percent in more egregious cases. Target may avoid the 20 percent penalty tax if:

- it files the required election to have the excessive eligible dividend effectively treated as an ordinary taxable dividend; and
- all dividend recipients concur with the election (no election can be made if the 30 percent penalty tax applies).

Again, prudent buyers should seek to have dividend recipients deliver a written concurrence to a Part III.1 election on closing and indemnify Target for any liability incurred as a result of an excessive eligible dividend designation. Careful attention is required to ensure that all eligible dividend designation requirements are met and that the amount designated as an eligible dividend is not excessive.

Also, if Target is a private corporation that has an RDTOH balance, a pre-sale taxable dividend (or deemed dividend) may trigger an RDTOH refund. RDTOH is a notional account used to calculate a private corporation's entitlement to a refund of taxes it has paid on certain investment income earned by the corporation as part of the integration principle. Generally, Target's cumulative RDTOH balance will consist of:

- 26.67 percent of aggregate investment income[56] earned while Target was a CCPC; plus
- any Part IV tax Target has paid on dividends received; less
- any previous RDTOH refunds received.

Each $3 of taxable dividends paid by Target will generate a $1 refund up to the amount of Target's RDTOH. Those dividends in turn create a Part IV tax liability for recipients that are private corporations, which may require planning to manage. Table 5 provides an overview of the tax consequences of dividends and deemed dividends occurring as part of the sale planning.

B. QSBC Capital Gains Exemption

A seller who is an individual (other than a trust)[57] resident in Canada throughout the year of sale may

[54]A dividend payer is connected with the dividend recipient if (1) more than 50 percent of the dividend payer's shares that have full voting rights in all circumstances are owned by the dividend recipient or persons not dealing at arm's length with the dividend recipient, or (2) the dividend recipient owns shares of the dividend payer representing more than 10 percent of the value and voting rights attributable to all dividend payer shares. Canadian resident corporations controlled by or for the benefit of one or more natural persons are also subject to Part IV tax. As noted below with reference to RDTOH, Part IV tax is refundable on the payment of taxable dividends.

[55]As part of the pre-sale planning, a CCPC may elect not to be a CCPC for some purposes to maximize its ability to pay eligible dividends. The desirability of making that election depends on the facts and requires careful analysis. *See* Crystal Taylor and **(Footnote continued in next column.)** Bryant Frydberg, ''Structural Challenges for Selling a Business,'' Prairie Provinces Tax Conference (2014).

[56]Essentially, that consists of income from property (for example, interest, rental income) and the taxable half of net capital gains.

[57]If a trust owns shares, any capital gain it realizes on a sale of those shares can be allocated to a beneficiary who is a Canadian resident individual, such that the individual is deemed to realize the gain and may potentially use the individual's LCGE.

Table 5. Target Dividends/Deemed Dividends

	Capital Dividends*	Taxable Dividends*
May be paid by	"Private corporations" to extent of capital dividend account	All Canadian corporations
Received by Canadian corporations	Free of tax If recipient is a "private corporation," added to its capital dividend account	Generally free of tax unless: • section 55 applies to deem to be a capital gain (exceeds recipient's share of payer's "safe income"); or • recipient is a "private corporation" and 33⅓% refundable Part IV tax applies
Received by Canadian individuals	Free of tax	Taxed at reduced rate due to dividend tax credit; effective rate depends on whether or not an "eligible dividend"
Triggers RDTOH refund for payer?	No	Yes, if payer is a "private corporation" with RDTOH balance

*Part XIII withholding tax applies to all dividends received by nonresidents.

wish to claim the seller's lifetime capital gains exemption (LCGE) when she disposes of Target shares that are QSBC shares at the time of disposition. The LCGE allows each individual to shelter up to $813,600 (indexed to inflation after 2015) of qualifying capital gains during her lifetime.[58]

While compliance with the LCGE exemption and planning to optimize it can be complex, the rules can be generally summarized as requiring three tests to be met for Target shares to qualify as QSBC shares. First, Target must be a small business corporation, defined as a CCPC,[59] all or substantially all[60] of whose assets (including goodwill) are:

- used principally in an active business carried on primarily in Canada by Target or a related corporation; and/or
- shares or debt of one or more small business corporations that are connected with Target.[61]

Second, for any particular seller's Target shares to qualify, throughout a 24-month holding period immediately preceding the time of disposition (the 24-month period), the Target shares in question must not have been owned by anyone other than that seller, or a person or partnership related to that seller. Shares issued from treasury by Target within the 24-month period are deemed not to meet that test unless one of three exceptions in these rules applies.

Finally, throughout the 24-month period, Target must be a CCPC,[62] and more than 50 percent of the FMV of its assets must be attributable to (1) assets used principally in an active business carried on primarily in Canada by Target or a related corporation, and/or (2) shares or debt of one or more connected corporations. Shares or debt described in (2) are subject to additional rules on ownership during the 24-month period and the asset composition of the connected corporation. Further requirements apply if during the 24-month period Target meets the more than 50 percent test but less than an all or substantially all standard.

Planning around the LCGE exemption typically focuses on:

- purification steps to achieve compliance with the QSBC share definition (for example, removing passive nonbusiness assets such as excess cash); and
- multiplication strategies to allow persons related to any particular shareholder (for example, family members) to acquire shares that permit them to use their own LCGEs.

That planning is often complex and requires careful analysis. It is generally advisable for Target's shareholders to be proactive in ensuring that Target shares

[58]In some cases, a seller claiming the LCGE exemption may be liable for alternative minimum tax.

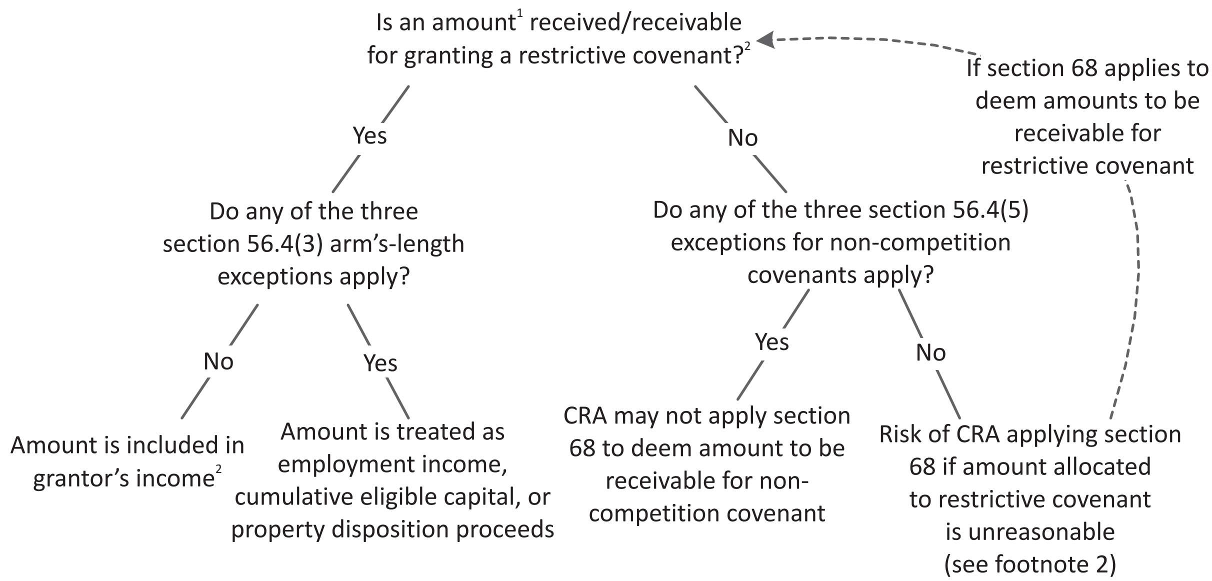
[59]For that purpose, (1) one ignores rights to acquire shares created by a signed agreement of purchase and sale, which can result in a loss of CCPC status for other purposes (*see* Section III.E.5, *supra*), and (2) the election not to be a CCPC described in note 55, *supra*, does not apply. The CRA takes the position that an option agreement does not constitute an agreement of purchase and sale for that purpose. *See* CRA doc. 2007-0243371C6 (Oct. 5, 2007).

[60]The CRA generally uses 90 percent as a quantitative rule of thumb for that purpose.

[61]This element is intended to include some holding corporations as small business corporations. Despite the word "small," no size limitation exists on a small business corporation.

[62]For that purpose determined using the same rules described in note 59, *supra*.

Figure 4. Restrictive Covenant Regime



1. For this purpose, an amount of $1 is ignored.
2. Includes an amount deemed received/receivable due to the application of section 68 to an unreasonable amount allocated to the restrictive covenant by the parties.

qualify as QSBC shares (for example, regular purification of nonqualifying assets), and it is common for shareholders to crystallize the desired amount of gain on their QSBC shares before an arm's-length sale to effectively convert the LCGE into increased additional cost basis in their shares.

If a seller wants to take advantage of both the seller's share of Target's safe income and the LCGE, it is important to remember that the CRA generally allocates a shareholder's share of Target's safe income proportionately to each share owned, including those shares on which the QSBC exemption is claimed. The potential loss of a portion of the seller's share of safe income when the LCGE is claimed has been the subject of frequent controversy with the CRA.[63]

C. Restrictive Covenants

Court cases holding that noncompetition payments received by a seller from the buyer of a business were not taxable prompted the Canadian Department of Finance to introduce a complex regime addressing restrictive covenants. Those rules go far beyond the original concern of noncompetition covenants to encompass virtually any undertaking made to affect the acquisition of property or services.[64] However, those rules have two basic elements (see Figure 4):

- *Rule 1 — Deemed Income Treatment*. If an amount is receivable in exchange for granting a restrictive covenant, that amount is deemed income to the recipient, subject to three specific exceptions for certain arm's-length transactions providing for alternative treatment.[65]
- *Rule 2 — Deemed Reallocation*. If the CRA establishes that an amount stated by the parties to be receivable for something else should in fact reasonably be considered receivable for the granting of a restrictive covenant — that is, the amount allocated by the parties to the restrictive covenant is unreasonably low — that amount is deemed receivable for the restrictive covenant, thereby causing Rule 1 to apply. This deemed reallocation

[63] *See, e.g.,* Janette Pantry and Bill Maclagan, ''Issues and Updates — Safe Income,'' British Columbia Tax Conference (2008).

[64] A detailed review of that regime is beyond the scope of this article. For further detail, see Michael Coburn, ''Practical Strategies for Dealing with Restrictive Covenant Provisions,'' 2014 Annual Conference (2015).

[65] The most relevant exception is one applicable to a noncompetition covenant given on a sale of shares when the grantor deals at arm's length with the buyer and the parties file a joint election under paragraph 56.4(3)(c), in which case the amount receivable for the restrictive covenant is simply added to the grantor's proceeds of disposition from the share sale.

Table 6. Employee Stock Options

	Employee Realizes Taxable Benefit	Employee Can Deduct 50% of Taxable Benefit	Employer Can Deduct Option Expense	Employer Has Payroll Remittance Obligation
Exercise Options	Yes	Yes, if certain conditions are met (two alternatives for CCPC options)	No	Yes
Cash-Out Options	Yes	Yes, if certain conditions are met and employer parties elect to forgo deduction	Possible in some cases, but not if election to forgo deduction is filed	Yes
Exchange Options	No, if a qualifying exchange	N/A	No	N/A if no benefit realized

rule is excluded for noncompetition covenants (only) if any of three exceptions apply.

The receipt of an amount as fully taxable income is generally the worst possible result for the grantor of the restrictive covenant, while the tax recognition given to the buyer for amounts paid to obtain a restrictive covenant in most cases is not particularly generous. As such, in the context of an arm's-length sale of a business, as a practical matter the parties will usually address Rule 1 by:

- allocating no amount (or a nominal amount, such as $1)[66] to the restrictive covenant; and
- if possible, trying to come within one of the three exceptions for arm's-length transactions in case the CRA tries to allocate some higher amount to the restrictive covenant under Rule 2.

In terms of Rule 2, CRA challenges to amounts allocated to restrictive covenants by arm's-length parties have been rare, which is appropriate given the high standard established in the jurisprudence for the CRA to apply the reallocation rules in section 68.[67] When a noncompetition covenant is involved, the parties will often seek to come within one of the three exceptions to Rule 2, including agreeing to make any required elections. All three exceptions require that no proceeds be receivable by the grantor for granting the noncompetition covenant[68] and that the grantor and the buyer deal at arm's length.

The favorable treatment of noncompetition covenants under both the share sale exception to Rule 1 and the three exceptions to Rule 2 is frequently important to the grantor (and potentially the buyer)[69] in addressing the restrictive covenant rules. The CRA has stated that a noncompetition covenant may be considered to include a related undertaking (such as a nonsolicitation covenant) that is ''an integral component of the covenant not to compete,''[70] and the parties should consider that potential integration when drafting the sale agreement.

V. Employee Stock Options

The parties must consider how to address any outstanding stock options held by Target employees. There are generally three alternatives (apart from doing nothing), the consequences of which are summarized in Table 6. The availability of these alternatives depends on what the option plan documentation permits (many have change-of-control provisions) and what other mechanisms exist to encourage or require option holders to participate.[71]

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[66]In some cases, commercial lawyers seek to allocate $1 as specific consideration for the granting of the restrictive covenant to eliminate any concern that the covenant is unenforceable for lack of consideration.

[67]The leading case in that regard is *TransAlta Corp. v. The Queen*, 2012 FCA 20, citing the Exchequer Court's statement in *Gabco Ltd. v. Minister of National Revenue*, 68 DTC 5210:

> It is not a question of the Minister or [this] Court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or the Court coming to the conclusion that no reasonable business man would have contracted to pay such an amount having only the business consideration of the appellant in mind.

For that purpose, the court in *TransAlta* found that ''longstanding regulatory and industry practices, as well as auditing and valuation standards and practices, are relevant.''

[68]The CRA has stated that allocating consideration of $1 to a noncompetition covenant to ensure contractual enforceability will be administratively accepted as no proceeds. *See* CRA doc. 2014-0547251C6 (Dec. 2, 2014).

[69]If the grantor is a nonresident of Canada, any amount paid (or deemed paid) for a restrictive covenant may be subject to nonresident withholding tax for which the buyer could bear withholding liability.

[70]CRA doc. 2013-0495691C6 (Oct. 11, 2013).

[71]The parties should be careful in making amendments to an existing stock option plan agreement that the CRA might assert are so fundamental as to amount to a disposition of the holders' existing stock options.

(Footnote continued on next page.)

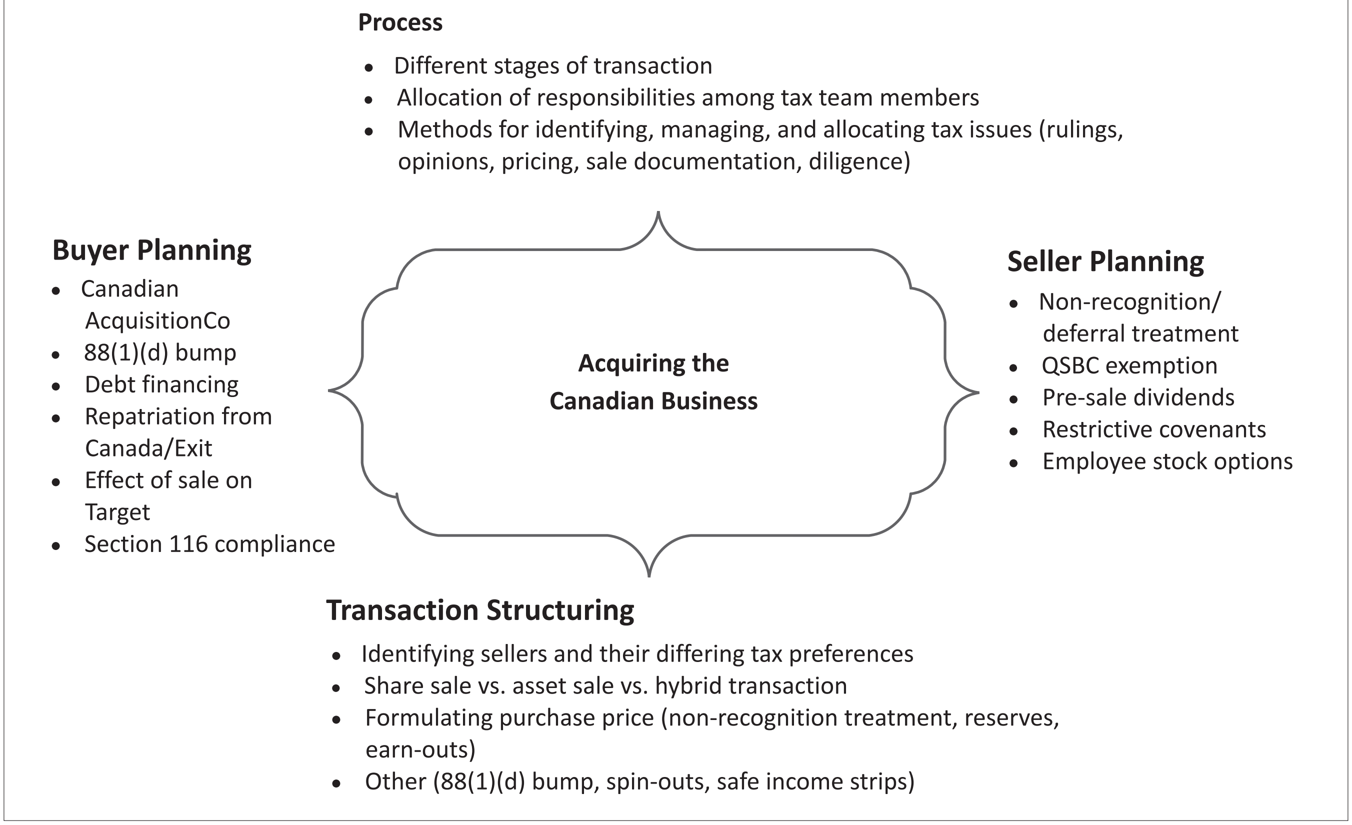

Figure 5. Overview of Canadian Tax Issues

- *Exercise*. Before or at closing, employees can exercise their options to acquire Target shares that they then sell to the buyer (this may require the acceleration of the option vesting periods).
- *Cash out*. Employees can surrender their options in exchange for a cash payment (usually equal to the in-the-money amount of the options).
- *Exchange*. Employees can exchange their Target options for options to acquire buyer shares.
- *Do nothing*. Target options can be left in place (this is rarely acceptable to the buyer from a commercial perspective and generally has no Canadian tax consequences for the employee).

A. Option Exercise

When an arm's-length employee exercises an option to acquire a share of a corporation, the employee realizes a benefit equal to the excess of the share's FMV when the option was exercised over the amount paid by the employee to acquire the share (and the option, if any) — that is, the in-the-money value. That benefit is included in the employee's income in the year of exercise; if the option/share issuer is a CCPC, the income inclusion is deferred until the year in which the employee sells the shares acquired on the exercise of the option.

If specific conditions are satisfied, the employee can deduct 50 percent of the option benefit from taxable income, which effectively results in only half the benefit being taxed (that inclusion rate is comparable to a capital gain). To qualify, generally the shares receivable under the options must be ordinary common shares with no fixed entitlements under the share terms or any related agreements, and the option exercise price cannot be less than the FMV of the shares at the date of the option grant — that is, the options must not have been in-the-money when granted.[72]

In the case of options to acquire CCPC shares, the employee can also qualify for the 50 percent deduction by holding the acquired shares for two years. The exercise of options does not produce a deductible expense for Target.

If option holders are also (or become) Target shareholders, the manner in which Target options are dealt with should also be analyzed in terms of the bump denial rule described in Section III.B, *supra*.

[72]The details of those qualifying conditions are more complex and should be reviewed carefully.

In the year of the option benefit income inclusion, the option issuer is required to make normal payroll remittances to the CRA on the taxable income arising from the options even if the employee received no cash consideration. The buyer should ensure that adequate mechanisms are in place to comply with that payroll withholding obligation, because by buying Target, the buyer is effectively inheriting that obligation.

For example, the funds to satisfy the required payroll remittances may be withheld from other cash compensation payable to the employee, the employee may be required to deliver the extra cash when the options are exercised, or some of the shares issued to the employee may be retained and sold for cash. In any case, the buyer will want to know if Target proposes to make payroll remittances on the basis that the 50 percent deduction is applicable, and if so, assess the strength of that position.

B. Option Cash Out

The tax consequences to an employee of cashing out options are quite similar to those of exercising non-CCPCs options. The employee generally realizes a benefit equal to the amount of the cash payment — that is, typically equal to the in-the-money amount — which is included in income in the year of the cash out (there is no deferral for cashed-out CCPC options). The same employer payroll remittance obligations described above apply.

The employee may deduct 50 percent of the benefit from taxable income if the same conditions described above regarding the exercise of non-CCPC options are met. However, a further condition exists on cashed-out options: The employee deduction will not be available unless Target files an election on behalf of itself and all non-arm's-length persons (which typically includes the buyer) agree not to claim any deduction for the option cash-out payment. Most buyers agree to make that election because employees generally expect to claim the 50 percent deduction on stock option benefits and in most cases an option cash-out payment is a capital expenditure.[73]

C. Exchange Options

An employee may exchange Target options for options issued by the buyer (or an affiliate) on a tax-deferred basis provided that the in-the-money amount of the new options does not exceed the in-the-money amount of the Target options. No other consideration may be received by the holder on the option exchange. ◆

[73] *See* Suarez, ''Supreme Court Will Not Hear Appeal in Stock Options Case,'' *Tax Notes Int'l,* June 4, 2012, p. 911.