



CANADA

INTERNATIONAL DEVELOPMENTS

WHAT ARE RECENT TAX DEVELOPMENTS IN YOUR COUNTRY WHICH ARE RELEVANT FOR M&A DEALS AND PRIVATE EQUITY?

Legislative amendments in the past few years now strongly discourage a foreign acquirer of a Canadian corporation (Target) that itself has foreign subsidiaries from keeping those foreign subsidiaries "under" Canada. These rules effectively force the Canadian Target to sell or distribute its foreign subsidiaries "up" to the foreign acquirer. Canadian tax authorities perceive there as being generally no good reason to have a foreign-controlled Canadian corporation own foreign subsidiaries, largely because in some cases foreign multinationals have caused their Canadian subsidiaries to acquire the shares of foreign group members (so-called "foreign affiliate dumping") either in exchange for cash as a means of earnings stripping or in exchange for debt in order to use the result interest expense to erode the Canadian tax base.

Over the past few years Canada has tightened its "thin capitalisation" rules limiting the extent to which interest expense owing to related non-residents may be deducted against Canadian-source income. See Answer 6, below.

Canada has also introduced various measures to protect its withholding tax regime on interest, royalties and similar payments. In particular, new "back-to-back" rules apply where a Canadian pays such amounts to a recipient that itself has a connection to a non-resident who would, if it were the direct recipient of the payment, incur a greater Canadian withholding tax than the tax exigible on the payment to the actual recipient. These rules support the withholding tax applicable on interest payments to non-arm's length non-resident creditors. See "Canada Releases Revised Back-to-Back Loan Rules," Tax Notes International, October, 2014. These rules were further expanded in 2016 to encompass royalties and comparable arrangements, and also constrain the creation of tax-deductible interest on acquisition financing and repatriation out of Canada by intra-group interest (see Answer 6). While not styled as such, they effectively constitute an anti-treaty shopping provision as regards withholding tax on interest and royalties.

2. WHAT IS THE GENERAL APPROACH OF YOUR JURISDICTION REGARDING THE IMPLEMENTATION OF OECD BEPS ACTIONS (ACTION PLANS 6 AND 15 SPECIFICALLY) AND, IF APPLICABLE, THE AMENDMENTS TO THE EU PARENT-SUBSIDIARY DIRECTIVE AND ANTI-TAX AVOIDANCE DIRECTIVES?

In 2014 Canada released a draft proposal to create a sweeping domestic law anti-treaty shopping rule that would over-ride Canada's tax treaties: see "Canada to Unilaterally Override Tax Treaties with Proposed New Anti-Treaty-Shopping Rule," Tax Notes International, March 2014. The events since the release of the draft proposal for a domestic anti-treaty shopping rule indicate that the Canadian government has since decided not to proceed with such a measure, and instead, work within the framework of BEPS, although Canada continues to negotiate specific anti-treaty shopping provisions in tax treaties (e.g. the recent tax treaties with Israel and Taiwan), as well as enacting the "back-to-back" rules referred to in Answer 1, above. In the federal budget of 22 March 2016, the Canadian government announced its intention to proceed with anti-treaty shopping initiatives, which may involve signing the pending OECD multi-lateral instrument, amendments to bilateral treaties, or both.

The Canadian government confirmed in the federal budget of 22 March 2017 that it either has taken or is undertaking the necessary domestic processes to ensure that the Canadian tax system meets all of the minimum standards agreed to under the BEPS project. With reference to particular BEPS Action items:

- **BEPS Action 13:** Legislation to implement country-by-country reporting by large multinational enterprises has been enacted and is in force.
- **BEPS Action 5:** Canada has begun spontaneously sharing tax rulings involving issues of potential BEPS concern with tax authorities in other countries. Canada Revenue Agency Information Circular 70-6R7 describes the types of tax rulings that Canada spontaneously shares with other countries.



- **BEPS Action 6 and 15:** Canada intends to sign the multilateral instrument dealing with the abuse of tax treaties at the OECD signing ceremony in Paris later in 2017, and is pursuing the necessary domestic action to achieve and implement this decision.
- **BEPS Action 14:** Canada is committed to improving the efficiency and effectiveness of MAP measures in its income tax treaties.
- **BEPS Action 3:** The government believes that Canada's existing CFC regime is robust and meets the BEPS standard.
- **BEPS Actions 8-10:** Canada is already applying revised international guidance in applying its domestic transfer pricing rules.
- **BEPS Action 12:** Canada has existing rules requiring taxpayers, promoters and advisors to report specified tax avoidance transactions to Canadian tax authorities.

GENERAL

3. WHAT ARE THE MAIN DIFFERENCES AMONG ACQUISITIONS MADE THROUGH A SHARE DEAL VERSUS AN ASSET DEAL IN YOUR COUNTRY?

A. Share deal

Sellers of shares will generally realise a capital gain in the amount by which their proceeds of disposition exceed the cost basis of their shares for tax purposes. This is generally advantageous as (1) only 50% of capital gains are included in taxable income, (2) capital gains may be offset by capital losses, and (3) some Canadian shareholders can claim an exemption up to a specified dollar amount on "qualified small business corporation shares."

Non-resident sellers of shares will generally be subject to Canadian tax on a share sale only where (1) the shares have derived their value (directly or indirectly) primarily from Canadian real property and/or natural resource property at any time in the previous 5 years, and (2) no tax treaty relief is available. Where such shares are traded on a public stock exchange, a non-resident seller who (together with non-arm's-length persons) has not owned 25% or more of any class of the corporation's shares at any time in the 5 years preceding the sale will be exempt from Canadian capital gains tax. See "Canada's Section 116 System for Nonresident Vendors of Taxable Canadian Property", Tax Notes International, April 2012.

The buyer's cost basis in the shares of a Canadian corporation it acquires may in some cases be pushed down into the cost basis of land and shares owned by that corporation (see Answer 4 below). See "Tax Issues on Acquiring a Canadian Business," Tax Notes International, August 2015. Foreign buyers typically create a Canadian company to act as the direct purchaser of the acquired shares in order to access this step-up, as well as to maximise their ability to repatriate their Canadian investment as a return of "paid-up capital" that is not subject to Canadian dividend withholding tax.

B. Asset deal

Buyers often prefer to acquire assets rather than shares, as the cost basis of many assets can be deducted from income over time as a tax version of depreciation, whereas the cost basis in shares is generally of benefit only when those shares are sold. Asset transactions may generate sales tax, which is typically borne by the buyer. Canada has a federal multi-stage VAT in which buyers pay the tax (GST) and (if they operate a business) claim a full refund (input tax credit), which a number of provinces have harmonised their sales taxes with, to produce a harmonised sales tax (HST). Other provinces have non-harmonised sales taxes (PST) that can produce actual non-refundable sales taxes (see Answer 13 below). Most provinces have land transfer taxes.



Sellers generally prefer not to sell assets, because (1) sales of depreciable assets that have generated previous deductions from taxable income may produce a reversal of such previously-claimed deductions ("recapture"), and (2) the accrued gain/recapture that a corporation has on its assets is often much greater than the gain that its shareholders have on its shares. The separate tax category of property ("eligible capital property") that previously applied to most intangibles used or created in a business (e.g., goodwill, trademarks, etc.) was eliminated in 2016, and starting in 2017 such properties are now included in the same "depreciable property" regime that governs depreciation for tax purposes on tangible assets (see Answer 5).

BUY-SIDE

4. WHAT STRATEGIES ARE IN PLACE, IF ANY, TO STEP UP THE VALUE OF THE TANGIBLE AND INTANGIBLE ASSETS IN CASE OF SHARE DEALS?

Where one Canadian corporation (Buyer) acquires all of the shares of another Canadian corporation (Target), a cost basis step-up (or "bump") may be available when Target is merged up into Buyer and Buyer acquires all of Target's property (which merger occurs on a tax-deferred basis: see Answer 20). Foreign buyers often create a new Canadian corporation to act as Buyer in part for the purpose of availing itself of this cost basis step-up (an "88(1)(d) bump") where Target owns non-depreciable capital property with significant accrued gains (especially shares of foreign subsidiaries that need to be extracted out from under Canada post-closing, as per Answer 1). Effectively an 88(1)(d) bump is limited to Target's non-depreciable capital property: land, shares and (in some cases) interests in partnerships (this cost basis bump does not apply to goodwill). There are a number of technical constraints on this cost basis step-up, but it is a very valuable provision for foreign purchasers of Canadian corporations. See "Canada's 88(1)(d) Tax Cost Bump: A Guide for Foreign Purchasers" Tax Notes International, December, 2013.

Apart from an 88(1)(d) bump, cost basis increases in Target's property can be achieved in some cases through careful planning to apply any available Target tax attributes (e.g., loss carryforwards, accrued but unrealised losses, etc.) against accrued but unrealised gains on Target property. This kind of planning often requires co-operation from Target and in some cases taking steps before the purchase of Target is completed, since the acquisition of control of Target often reduces or constrains the use of Target's tax attributes following closing (see Answer 9).

5. WHAT ARE THE PARTICULAR RULES OF AMORTISATION OF GOODWILL IN YOUR COUNTRY?

In the 2016 federal budget, the Canadian government announced its intention to proceed with replacing the existing "eligible capital property" regime for amortising goodwill and other business intangibles. Effective 2017, such property will be moved into the existing depreciable property regime that amortises the cost of tangible capital property for tax purposes, with a 5% annual depreciation rate. See "Federal Budget 2016 — A Focus on the Middle Class and Continued Scrutiny of Corporate Tax Avoidance", March 2016.

6. WHAT ARE THE LIMITATIONS TO THE DEDUCTIBILITY OF INTEREST ON BORROWINGS IN THE CASES OF ACQUISITION OF SHARES AND ASSETS?

Interest on borrowed money is generally deductible to the extent used for the purpose of gaining or producing income, and to the extent that the amount paid is "reasonable" (i.e., not in excess of an arm's-length rate). Thus for example, borrowing to buy shares of a corporation, to buy assets to be used in a commercial activity, or to provide working capital for a business generally qualifies. Debt incurred for certain non-income-earning purposes (e.g., paying dividends, repurchasing shares of the debtor) is deductible by administrative practice within limits.

"Thin capitalisation" rules limit the extent to which interest owing to non-arm's-length non-residents may be deducted in computing income, in order to limit cross-border intra-group interest stripping. For example, a



Canadian corporation is effectively limited to USD1.50 of debt owing to such creditors for every USD1 of equity: interest on debt in excess of such amount will be non-deductible (and treated as a dividend for withholding tax purposes). There are a number of subtle nuances in the computation of "debt" and "equity" for these purposes. The thin capitalisation rules are supported by anti-avoidance "back to back" loan rules directed at attempts to circumvent these rules (e.g., a loan from a foreign parent company to an arm's-length bank, made on condition that the bank in turn lends such funds to the foreign parent's Canadian subsidiary). There is no thin capitalisation constraint on debt owing to Canadian lenders or arm's-length foreign lenders, subject to the "back-to-back" anti-avoidance rules previously mentioned.

7. WHAT ARE USUAL STRATEGIES TO PUSH-DOWN THE DEBT ON ACQUISITIONS?

Since Canada does not levy interest withholding tax on debt owing to arm's-length creditors and such debt is not subject to "thin capitalisation" interest expense limitations, it is common to see a Canadian company that is created to effect the acquisition of a Canadian target borrow directly from arm's-length creditors (if necessary supported by a foreign parent guarantee). Alternatively, to the extent that such borrowing is done at the foreign parent level, the foreign parent can capitalise the Canadian acquisition company with a mix of equity and debt owing to the foreign parent within the 1.5:1 debt/equity limitations imposed by the "thin capitalisation" rules described in Answer 6. This will usually carry a withholding tax cost. Since 25% Canadian withholding tax applies on interest paid to a non-arm's-length foreign creditor, reduced to 10% for non-arm's-length creditors resident in most countries with which Canada has a tax treaty. The only Canadian tax treaty providing for a sero interest withholding tax rate on debt owing to non-arm's-length creditors is the Canada-U.S. tax treaty, if the U.S. creditor is entitled to benefits under that treaty (which has a limitation on benefits article).

Where the purchaser uses a Canadian corporation as the buyer of the Canadian Target, those two entities are typically merged (on a tax-deferred basis: see Answer 20) shortly after closing in order to consolidate in the merged entity any interest expense on acquisition debt incurred by the Canadian buyer with the operating income of the Canadian Target.

8. ARE THERE ANY TAX INCENTIVES FOR EQUITY FINANCING?

In addition to the discussion on the advantages of a share purchase in Answer 3, Canada also allows the amount used to purchase treasury shares of a corporation to be returned to shareholders as a tax free return of capital. There is no U.S.-style "earnings & profits" rule deeming corporate distributions to be dividends for tax purposes to the extent of E&P. Note that equity financing generally results in the creation of "paid-up capital" (the tax version of share capital), which constitutes "equity" for purposes of the "thin capitalisation" rule described in Answer 6. Canadian-resident shareholders can claim a lifetime exemption of about Cdn. 800,000 on capital gains from the disposition of "qualified small business corporation shares."

9. ARE LOSSES OF THE TARGET COMPANY(IES) AVAILABLE AFTER AN ACQUISITION IS MADE?

Target's capital losses (both realised and accrued but unrealised) do not survive the acquisition of control, making it important to undertake pre-closing planning in order to make the best possible use of these tax attributes. Accumulated operating losses from prior years (and the taxation year deemed to end on the acquisition of control) may be carried forward and used in post-closing taxation years only if (1) throughout the later year in which Target seeks to use the operating losses it continues to carry on the same business as gave rise to the loss (the loss business) with a reasonable expectation of profit; and (2) the post-acquisition income that the losses are used against arises from carrying on either the loss business or a business of selling similar property or providing similar services as were sold or rendered in the loss business. These rules prevent a buyer in, for example, the mining business from purchasing a company with losses generated in a completely different business (e.g., software development) and using those losses. Similar rules apply to various tax credits and resource-sector tax pools.



10. ARE THERE ANY ITEMS THAT SHOULD BE INCLUDED IN THE SCOPE OF A TAX DUE DILIGENCE THAT ARE VERY SPECIFIC TO YOUR COUNTRY?

The following items should be included in the scope of a tax due diligence for Canada:

- Loans to a non-resident of Canada which remains outstanding for one year or longer
- Loans to a shareholder (or person with whom the shareholder does not deal at arm's length) which remains unpaid within one year after the end of the taxation year in which the loan was made
- Intercorporate dividends between Canadian corporations
- # Fair market value and tax attributes associated with any Target subsidiaries (in particular non-Canadian ones)
- Quantum of Target tax attributes (e.g., loss carryforwards, accrued but unrealised losses) adversely affected by an acquisition of control
- in Answer 4 ldentify and estimate accrued gains on non-depreciable capital property eligible for 88(1)(d) bump described
- Determine whether Target shares are "taxable Canadian property" as described in Answer 16, if non-resident sellers exist

11. IS THERE ANY INDIRECT TAX ON TRANSFER OF SHARES (STAMP DUTY, TRANSFER TAX, ETC.)?

12. ARE THERE ANY RESTRICTIONS ON THE CORPORATE TAX DEDUCTIBILITY OF ACQUISITION COSTS?

In general, the deductibility of any cost is subject to the general rule that such amounts be reasonable in the circumstances. In addition, such costs are also governed by the usual rules differentiating between (1) costs that are currently deductible and (2) those that are capital in nature and hence deductible only over time or capitalised in the cost basis of the property acquired.

13. CAN VAT (IF APPLICABLE) BE RECOVERED ON ACQUISITION COSTS?

There is a 5% VAT-style goods & services tax ("GST") in Canada. A number of Canada's provinces levy a corresponding "harmonised sales tax" ("HST", or in the province of Quebec "QST") that is applied alongside the federal GST at rates varying from province to province (e.g., 8% in Ontario). Provincial sales tax ("PST") is a single stage tax and is payable on taxable acquisitions and is not recoverable. Three of Canada's four western provinces (British Columbia, Saskatchewan and Manitoba) have a PST; the fourth (Alberta) has no provincial sales tax of any kind. All other Canadian provinces have an HST.

Where assets are acquired by purchaser that is registered for purposes of GST/HST/QST, and the purchaser is acquiring the assets for consumption, use or supply in taxable activities, any GST/HST/QST paid in respect of the assets or acquisition cost should be wholly or partially recoverable. The purchase of shares is exempt from GST/HST/QST; however acquisition costs may apply and the acquirer may be entitled to a full or partial refund if certain conditions are met. The purchase of shares would not attract PST however legal services and other acquisition costs may be subject to PST which would not be recoverable.



14. ARE THERE ANY PARTICULAR TAX ISSUES TO CONSIDER IN THE ACQUISITION BY FOREIGN COMPANIES?

Foreign buyers will typically make Canadian acquisitions through a Canadian acquisition company in order to (1) create paid-up capital equal to the full amount of their equity investment (see Answer 3(a)), (2) merge that Canadian company with the Canadian Target to consolidate the interest expense on any Canadian acquisition debt incurred with the Target's operating income (see Answer 7), and (3) obtain the 88(1)(d) cost-basis step-up described in Answer 4 (which is often especially important for foreign buyers). Foreign buyers are subject to greater constraints than are Canadian buyers on the use of the 88(1)(d) bump. Where Target has foreign subsidiaries, planning will be needed to prevent adverse consequences from the "foreign affiliate dumping" rules described in Answer 1. Foreign buyers must also consider potential planning for repatriating assets from their Canadian acquisition (e.g., dividends, royalties, interest, management fees, etc.), as well as dealing with potential Canadian capital gains tax on an eventual sale of their investment. Transfer pricing rules will apply to transactions between the Canadian subsidiary and non-Canadian members of the foreign buyer group.

15. CAN THE GROUP REORGANISE AFTER THE ACQUISITION IN A TAX NEUTRAL ENVIRONMENT THROUGH MERGERS OR A TAX GROUP?

No group relief or consolidation system exists in the Canadian tax regime: each taxable entity pays tax separately. Canadian corporations can merge on a tax-deferred basis (see Answer 20), and in fact Canadian buyers of Canadian Targets typically merge post-closing in order to (1) consolidate their income and deductions and (2) claim the 88(1)(d) bump described in Answer 4. By using such tools and making the best use of available Target tax attributes (often in cooperative pre-closing transactions undertaken by Target prior to closing), opportunities for post-closing reorganisations without adverse tax results are maximised.

16. IS THERE ANY PARTICULAR ISSUE TO CONSIDER IN CASE OF TARGET COMPANIES OF WHICH MAIN ASSETS ARE REAL ESTATE?

As described in Answer 3 above, non-residents may be subject to Canadian capital gains tax upon a sale where the shares of a company derive their value primarily from Canadian real property and/or natural resource property, in particular where no tax treaty relief is available to the non-resident. A number of Canadian tax treaties offer some degree of relief where the real property in question is used in an operating business, so careful planning can be very beneficial. A withholding regime applies to buyers of such "taxable Canadian property" from non-residents, which effectively requires buyers to withhold and remit to the Canada Revenue Agency (CRA) a portion of the sale price on account of the non-resident's potential Canadian capital gains tax liability, unless the non-resident obtains pre-clearance from the CRA that no such withholding is required. See "Canada's Section 116 System for Nonresident Vendors of Taxable Canadian Property", Tax Notes International, April 2012.

17. IS FISCAL UNITY/TAX GROUPING ALLOWED IN YOUR JURISDICTION AND IF SO, WHAT BENEFITS DOES IT GRANT?

Fiscal unity/tax grouping is not allowed in Canada. As mentioned in Answer 15 above, each corporation in a corporate group is taxed separately.



SELL-SIDE

18. HOW ARE CAPITAL GAINS TAXED IN YOUR COUNTRY?

The taxation of capital gains for both residents and non-residents is described in Answer 3, above (see also Answer 16). No participation exemption per se exists, although the tools described in Answers 4 and 15 can often be used to reduce or eliminate accrued gains on Target property acquired (directly or indirectly) through an acquisition. Where Target has foreign subsidiaries, Canada generally will not tax dividends received from such foreign entities to the extent attributable to active business income earned in a country with which Canada has a tax treaty, and an election can be made to reduce capital gains on the shares of such foreign subsidiaries by the amount of such exempt dividends. This acts as a limited form of participation exemption on investments in foreign subsidiaries.

19. IS THERE ANY FISCAL ADVANTAGE IF THE PROCEEDS FROM THE SALE OF SHARES ARE REINVESTED?

There are no specific rules governing the reinvestment of proceeds from a sale of assets or shares, other than in very limited situations that are rarely encountered as a practical matter. It generally is possible to transfer property to a Canadian corporation in exchange for shares of that corporation on a tax-deferred basis.

20. ARE THERE ANY LOCAL SUBSTANCE REQUIREMENTS FOR HOLDING COMPANIES?

No specific rules apply to holding companies. In all cases, Canadian tax authorities will wish to be satisfied that a holding/finance company (1) is in fact acting as a principal and not as an agent for another entity, and that it has the requisite capacity to do what it claims to be doing, (2) is in fact the beneficial owner of the property it purports to own (i.e., it has the indicia of ownership that the jurisprudence establishes as the hallmarks of beneficial ownership of property), and (3) is indeed fiscally resident where it claims to be (the location of the company's central management and control is often relevant in this regard). The back-to-back rules and pending anti-treaty shopping rules described in Answer 1 will make the use of holding companies in inbound planning more challenging going forward. Canada has a general anti-avoidance rule that allows transactions to be recharacterised in situations of abuse or misuse, and some Canadian tax treaties contain specific anti-avoidance rules.

21. ARE THERE ANY SPECIAL TAX CONSIDERATIONS REGARDING MERGERS/SPIN-OFFS?

Two or more Canadian corporations can generally merge ("amalgamate") to form one Canadian corporation on a tax-deferred basis (for both the participating corporations and their shareholders), so long as the merged corporation acquires all of the property and inherits all of the liabilities of the participating corporations, and shareholders receive nothing in exchange for their shares of the participating corporations except shares of the merged corporation.

Conversely, de-mergers and spin-offs of Canadian corporations are possible on a tax-deferred basis only within a fairly narrow set of rules. As a very general statement, these rules allow a Canadian corporation holding multiple properties or businesses to restructure such that the same properties or businesses are held through two Canadian corporations rather than only one (i.e., some properties/businesses in one such corporation, and the remainder in the other corporation), so long as the existing shareholders maintain the same pro rata shareholdings of both corporations, the demerger is not part of a larger series of transactions including certain prohibited events, and certain limitations on the division of property between the two corporations are observed.

There are no provisions in Canada that allow a Canadian corporation to distribute property to its shareholders on a tax deferred basis: a distribution of property by a Canadian corporation to shareholders will result in a deemed disposition of such property by the Canadian corporation, such that any accrued gains will be realised.



This may or may not result in tax payable, depending on whether the corporation has offsetting shelter (e.g., loss carryforwards) available to absorb such gains. If the value of the distributed property is less than the paid-up capital of the shares on which such distribution is being made, it is generally possible for the distribution to be made to shareholders as a return of paid-up capital, which is not treated as a dividend and instead simply reduces the cost basis of the shareholders' shares of the distributing corporation. For more information see Spin-Outs in M&A: Bridging the Valuation Gap. Otherwise, the distribution will generally be treated as a dividend.

MANAGEMENT INCENTIVES

22. WHAT ARE THE TAX CONSIDERATIONS IN YOUR JURISDICTION FOR MANAGEMENT INCENTIVES?

The granting of a stock option by a Canadian corporation (the "Grantor") is not a taxable event for the recipient employee at that time (the "Grant Date"). The time at which the employee is taxed on the stock option depends on whether the Grantor is a Canadian-controlled private corporation ("CCPC"), a private Canadian corporation that is not controlled by any non-Canadian residents or public companies.

If the Grantor is not a CCPC, a taxable employment benefit is only recognised by the employee at that date on which the shares of the corporation have been acquired through the exercise of the options. The taxable employment benefit is equal to the difference between the fair market value of the shares acquired and the exercise price of the options. However, provided that the shares acquired are common shares and the strike price is not less than the fair market value of the shares at the Grant Date, the employee may claim a deduction of 50% of the ensuing taxable employment benefit employment.

Conversely, if the Grantor is a CCPC, the employee may further defer the recognition of the taxable employment benefit to the taxation year in which the employee disposes of the shares acquired through the exercise of the options. If the employee of the CCPC holds the shares for at least two years before disposition, the employee may claim a 50% deduction of the ensuing taxable employment benefit employment, regardless of the strike price or whether the shares are common shares.

Generally, even though the recipient employee is taxed upon the exercise of the stock option (or sale of the shares acquired under a stock option in the case of a CCPC), the Grantor is not allowed a corresponding deduction.

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