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PRACTITIONERS' CORNER

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When a corporation resident outside Canada (Foreignco) distributes to its shareholders the shares that it owns in another corporation (Spinco), the general rule is that Canadian resident shareholders will be subject to Canadian tax on the distribution of Spinco shares unless the transaction meets the requirements of a specific provision of the Income Tax Act (Canada) providing otherwise.¹ This is so even when the transaction is tax deferred in Foreignco's home country. In most cases, the only potential source of Canadian tax relief will be section 86.1 of the ITA, which was enacted roughly 10 years ago to allow certain qualifying foreign spinoffs to be performed without the Spinco shares being treated as a dividend and included in the Canadian shareholder's income for Canadian tax purposes.

The basic concept under section 86.1 of the ITA is to provide elective relief when Foreignco distributes only common shares of Spinco to the holders of Foreignco's common shares, and:

- both Foreignco and Spinco are resident in the same country;
- that other country has a tax treaty with Canada; and
- Foreignco shareholders resident in that other country are not themselves taxable on the distribution under the tax laws of that other country.

¹Canadian tax courts have written a series of conflicting decisions on the appropriate treatment of certain foreign spinoffs; see Marisa Wyse, "Canadian Spinoff Transactions: What a *Morasse*," *Tax Notes Int'l*, Oct. 17, 2011, p. 215, *Doc 2011-18370*, or *2011 WTD 200-21*.

There are additional conditions to relief as well, such as requirements regarding listing, trading, and distribution of Foreignco shares (these rules are more generous for shares registered under the U.S. Securities Exchange Act of 1934); the provision of information to the Canada Revenue Agency; and the filing of an election by the Canadian shareholder.

On September 5, 2012, the CRA issued an updated version of its guidance on the eligibility of foreign spinoffs for relief under section 86.1 of the ITA.² The revised guidance sets out the procedure for the taxpayer to formally elect for relief, as well as the procedure for filing the election. The revised guidance also provides an example illustrating the effect of the election on the following assumed facts:

- Foreignco owns 10,000 shares of Spinco, with an aggregate fair market value of \$100,000 (\$10/share);
- Foreignco distributes all 10,000 of its Spinco shares to the holders of all 40,000 outstanding Foreignco common shares (which are actively traded on a designated stock exchange) by distributing one quarter of a Spinco share on each Foreignco common share; and
- for a Canadian resident holding 400 Foreignco shares with a cost base of \$25/share (\$10,000 in total) and receiving 100 Spinco shares worth

²See PR 2012/09/05, "Information for Canadian Shareholders," Sept. 5, 2012, available at <http://www.cra-arc.gc.ca/tx/bnsns/tpcs/cdnshrhdrs-eng.html>.

\$1,000, the result of elective relief under section 86.1 of the ITA would be as follows for Canadian tax purposes:

- no income inclusion in Canada as a result of the distribution; and
- a reduction of the holder's cost base in the Foreignco shares by an amount that becomes the holder's cost base in the Spinco shares, that is, effectively reallocating the holder's cost base between the existing Foreignco shares and the newly received Spinco shares pro rata to their respective fair market values.

For example, if the post-distribution fair market value of a Foreignco shares was \$40, the Canadian holder's \$25/share pre-distribution cost base would be allocated \$23.53 to the Foreignco share and \$1.47 to each one quarter of a Spinco share.³ This results in the holder having the same \$10,000 of aggregate cost base (\$9,412 in the Foreignco shares and \$588 in the Spinco shares) as before the distribution.

The relevant page on the CRA website also links to other useful information concerning the requirements for the spinoff to qualify for elective relief under section 86.1 of the ITA. In particular, the information and documentation required to be provided by Foreignco to the CRA is set out (which must be received by the end of the sixth month following the distribution date),⁴ and the CRA describes the additional information that it requires when the Spinco shares are the subject of a shareholder rights plan that allows holders of Spinco shares to acquire additional shares on a contingent basis (that is, a "poison pill"). There is also a useful list of past spinoffs involving foreign corporations that have given the CRA permission to publish the fact that their distribution met the conditions of section 86.1 of the ITA.⁵ ♦

³The \$1.47 amount is determined as \$25 of existing cost base multiplied by \$2.50 (being 0.25 of a Spinco share x \$10 value/Spinco share) divided by \$42.50 (the \$2.50 value of 0.25 of a Spinco share + the \$40 value of one post-distribution Foreignco share).

⁴See <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/frgnrcp-eng.html>. Note that the CRA refuses to provide any extension of the six-month deadline.

⁵See <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/spnffs-eng.html>.



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