The changing landscape of financing U.S. – Canada transactions

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With you today

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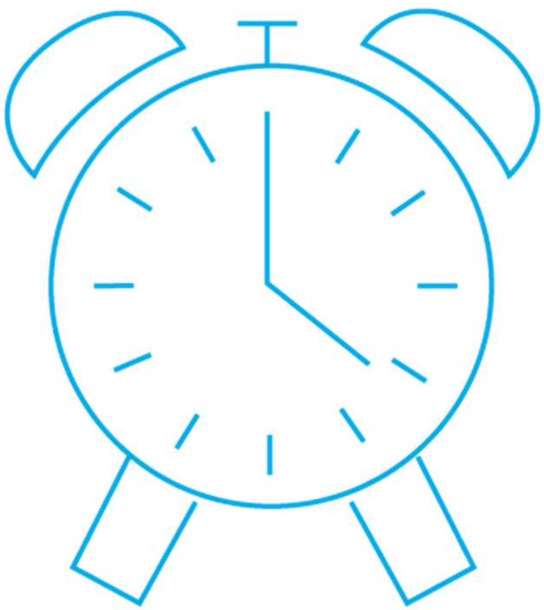
Agenda



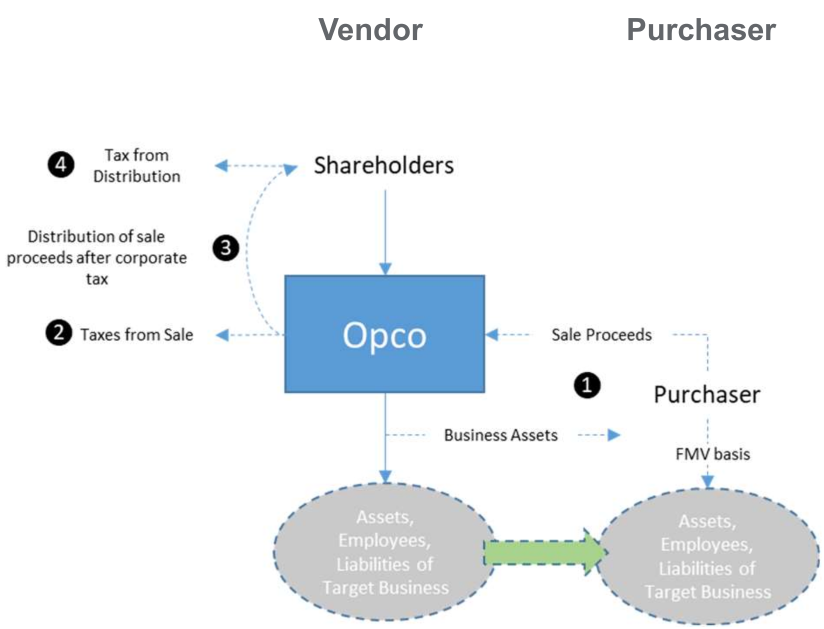
- Potential benefits of utilizing a Canadian acquisition company to acquire a Canadian target
- Impact of the Canadian thin capitalization rules on cross-border financing
- Navigating changes to U.S. debt limitations
- Impact of withholding taxes during the holding period
- Hybrid structures and issues associated with the repatriation of cash
- Implications of Canada's proposed EIFEL rules

Learning objectives

1. Understand common tax issues which generally arise in a U.S.-Canada cross-border transaction
2. Understand common strategies used to optimize a U.S. – Canada cross border transaction
3. Understand common tax issues associated with cash repatriation and debt financing

Canada M&A tax considerations

Tax structuring for a transaction: Asset sale



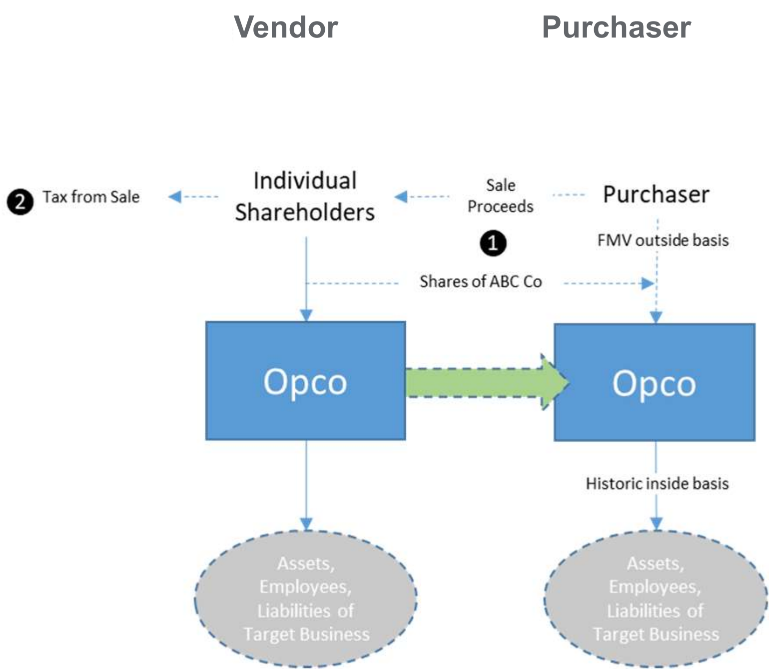
Vendor

- Corporate tax on recaptured depreciation and capital gains with additional layer of tax on distribution of proceeds to individual shareholders
- Cannot claim Canadian lifetime capital gains exemption(s) (LCGE) – approx. $240k of cash tax savings per exemption available
- Responsible for any historic exposure in Opco
- Upfront tax rates of anywhere between 25%–49% depending on personal and Opco tax attributes
- Tax a principal driver for preference for share sale from vendors perspective
- Additional transfer tax and administrative costs re: consents, transfer of employees, contracts, licenses, etc.

Purchaser

- Full FMV step up in tax basis of acquired assets
- Can choose assets to buy/liabilities to assume
- Do not inherit any legacy exposure of Opco
- Additional transfer tax and administrative costs regarding consents, transfer of employees, contracts, licenses, etc.

Tax structuring for a transaction: Share sale



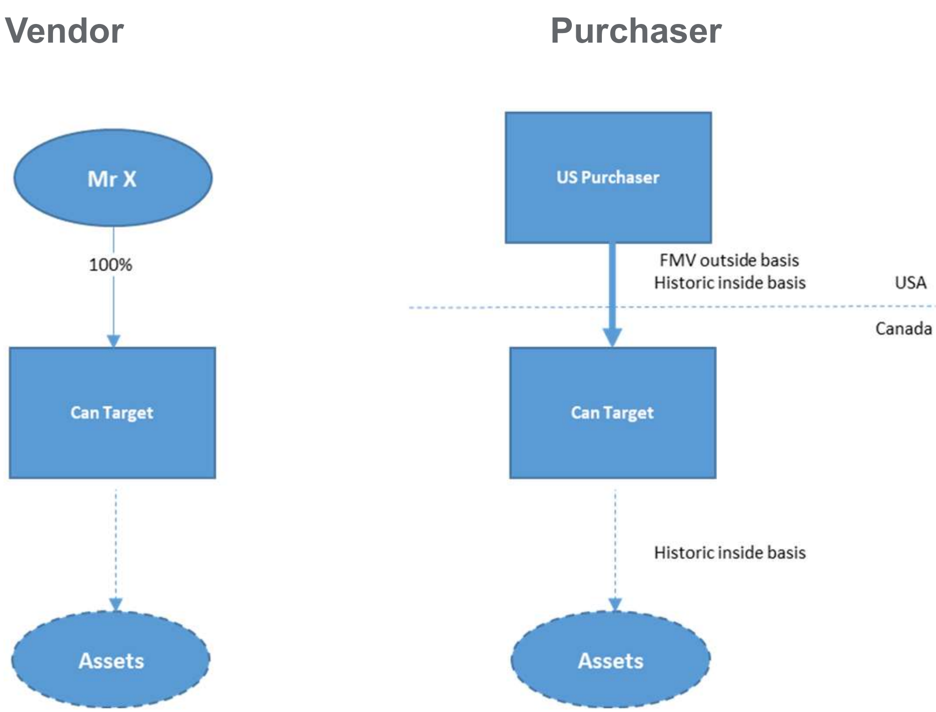
Vendor

- Capital gains only 50% taxable in Canada
- Possibility of claiming LCGE(s)
- Elimination of joint holdings/economics on proceeds (particularly equity proceeds)
- No historic exposure – clean exit
- Limited transfer tax and administrative costs re: consents, transfer of employees, contracts, licenses, etc.

Purchaser

- No 338-style internal basis step up in Canada
- Inherit historic exposure
- No indemnity protection if PE/public vendors
- Inherit tax attributes of Opco shares
- Limited transfer tax and administrative costs regarding consents, transfer of employees, contracts, licenses, etc.

Example: Share purchase trap for non-resident buyers



Facts

Suppose U.S. purchaser decides to acquire the shares of a Canadian corporation for cash and without doing any Canadian tax planning.

Results

1. U.S. Purchaser inherits historic tax attributes of the CanTarget shares
   a. Limited ability for tax free profit repatriation post closing without incurring Canadian dividend withholding tax at 25% (subject to treaty relief)
2. U.S. Purchaser inherits historic tax cost of the depreciable assets in CanTarget
   a. No 338 elections in Canada
   b. Limited depreciation deductions post-closing leading to incremental Canadian cash tax liability
   c. DOUBLE TAX RISK – capital gain on post-acquisition disposition of IP AND withholding tax of 25% on IP distribution out of Canada
3. Limited ability to implement interest bearing debt into Canada
   a. Possible mismatch – post acquisition profits earned in Canada but interest expense on acquisition debt likely in U.S

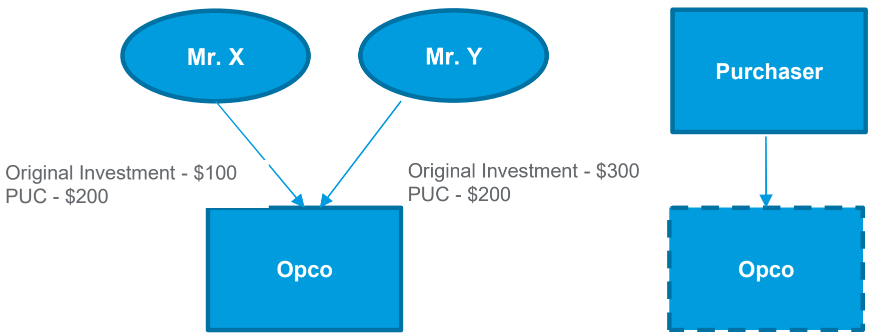
Paid-up capital

Defined term under the Canadian Income Tax Act.

Paid-up capital (PUC) = very valuable tax attribute in Canada since it can be used to:

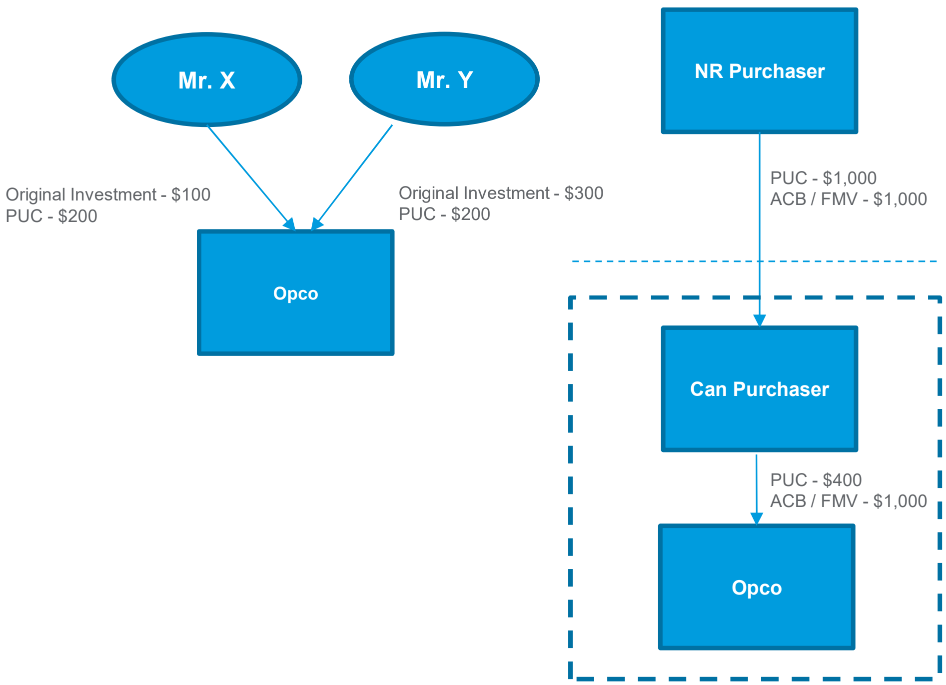
- Repatriate cash from Canada free of withholding tax, and
- Support related party debt into Canada under Canadian thin capitalization rules (discussed later).
- PUC study generally required to compute PUC per class of shares.
- Note that PUC (for tax purposes), legal stated capital (for legal purposes) and share capital (for accounting purposes) may all be the same or different numbers.
- PUC is calculated for a corporation's shares on a class-by-class basis.
- Note only Canadian corporations can have PUC in their shares – there is no PUC in the units of a partnership or a trust.
- To reduce PUC, a legal resolution generally is required which authorizes the company to return capital (subject to solvency tests).

Example: Paid-up capital



- Suppose Mr. X forms Opco and capitalizes it with $100.
    - Mr. X has PUC of $100 in his common shares of Opco.
- A year later, Mr. Y decides to invest $300 in Opco in the same class of shares.
    - Because Mr. Y invested in the same class of shares as Mr. X, the PUC of the common shares is averaged.
    - Mr. X and Mr. Y will each therefore have PUC of $200 in their common shares, respectively (regardless of their initial investment).
- Two years later, Mr. X and Mr. Y sell their shares to Purchaser for $1,000.
    - Purchaser will have an adjusted cost base (i.e., outside basis) of $1,000 in the acquired shares, but only $400 of PUC in those shares.
    - Therefore, only $400 can be repatriated free of Canadian withholding tax.
    - Any distributions in excess of $400 will be deemed to be a dividend subject to 25% withholding tax (subject to treaty relief).

Using a Canadian acquisition company

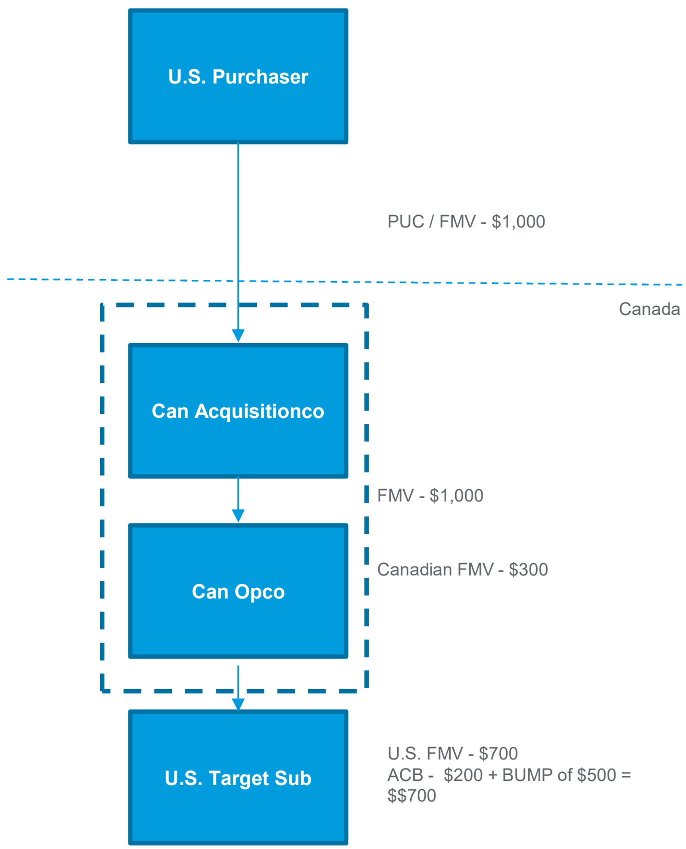


Why should a non-resident purchaser use a Canadian acquisition company when acquiring the shares of a Canadian corporation?

- If a non-resident (NR) purchaser acquires the shares Canadian Target directly, that NR purchaser will inherit the historic PUC of the acquired shares (which are often far less than their FMV).
- A Canadian acquisition company capitalized with FMV proceeds, can acquire the 'low PUC' shares of Opco and then amalgamate (i.e., merge) with Opco to form a newly amalgamated corporation (Amalco).

RESULT:
Future profits/property equal to FMV purchase price can be repatriated to the U.S. free of Canadian withholding tax.

What is a basis bump?



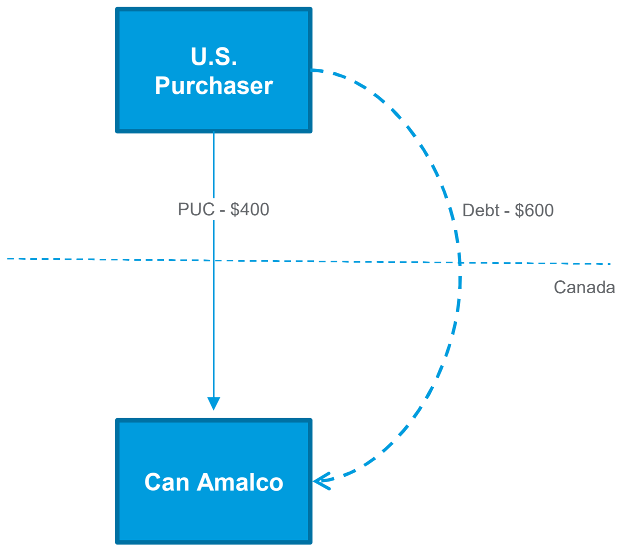
Generally, a basis bump refers to a Canadian tax designation where the tax cost of non-depreciable capital property of an acquired Canadian target corporation is increased or 'bumped' to its FMV following an acquisition of control.

A bump will only be possible if there is first an amalgamation (or liquidation) of a Canadian target corporation and a Canadian acquisition company.

- Essentially, the acquisition company's purchase price for the Target shares is pushed down on a relative basis to the shares of the foreign subsidiary.

Although the concept appears straightforward, there are several "bump denial" rules that can apply which are very technical and complex in nature.

What is debt pushdown?



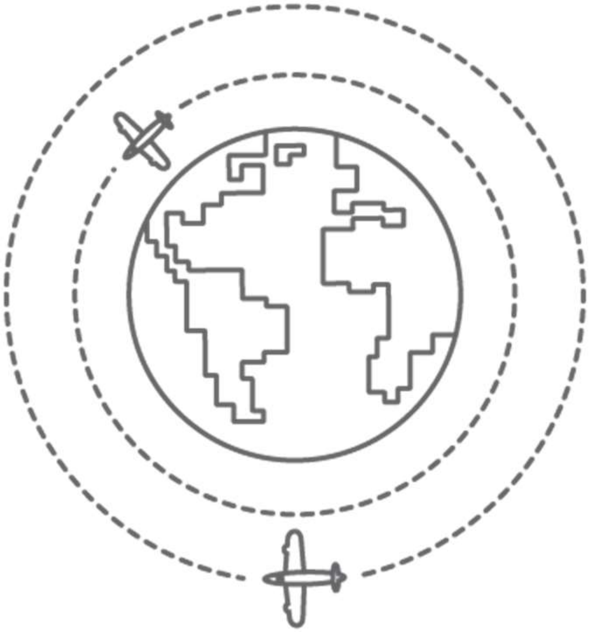
- Generally, where a non-resident shareholder which owns more than 25%. of a Canadian corporation (i.e., a "specified shareholder") introduces (or 'pushes') related party debt into its Canadian subsidiary.
- Under current Canadian 'thin capitalization' rules, a debt-to-equity ratio of 1.5:1 is allowed (though interest may still be denied under the proposed EIFEL rules discussed later).
- Assuming U.S. Purchaser qualifies for treaty relief, there should be no WHT on interest payable from Canada to the U.S.
- Any interest expense in excess of the 1.5:1 ratio is not only denied deductibility, but that denied interest is also treated as a deemed dividend subject to 25% withholding tax (subject to treaty relief).
- Interest rate on the cross-border loan must be reasonable from a Canadian transfer pricing perspective.
- Thin capitalization is generally computed for each taxation year in CAD.

Navigating changes to U.S. debt limitations

U.S. debt limitations

- When financing U.S. operations, the limitations on deductibility of business interest need to be considered.
- IRC section 163(j) generally limits interest deductibility each year to the sum of interest income and a percentage of adjusted taxable income.
- The limit on net interest expense was generally 30% of adjusted taxable income (the Cares Act increased the limit to *50%* for tax years beginning in 2019 or 2020).
- Adjusted taxable income is derived from taxable income with addbacks for depreciation, depletion and amortization for years beginning *before* Jan. 1, 2022.
- For years beginning after Jan. 1, 2022, the limitation will be based on taxable income before interest. This new limit significantly reduces allowable net interest expense.

Structuring considerations



- The current U.S. debt limitations coupled are causing PE Funds to re-consider their financing options when acquiring or adding to portfolio companies that have multinational operations.
- In order to separately allocate debt to the U.S., the U.S. entity(s) generally have to be acquired separately.
- Structuring and tax modelling (including the projected tax deductibility of acquisition debt) is often undertaken at the start of the acquisition process.

Impact of withholding taxes during the holding period

General overview

Dividends and Interest

Dividends

- Dividends generally subject to withholding tax rate of 25%. However, this can potentially be reduced under the Canada-U.S. tax treaty.
- If beneficial owner of dividend is a company which owns at least 10% of voting stock of payor, withholding tax rate can sometimes be reduced to 5% (assuming all relevant tests are met).
- If beneficial owner owns less than 10% of voting stock of payor, withholding tax rate can be reduced to 15% (assuming all relevant tests are met).

Interest

- Subject to withholding tax rate of 25%. However, this can be reduced to 0% under Canada-U.S. tax treaty (assuming all relevant tests are met).

Rents and royalties

- Subject to withholding tax rate of 25%. However, this can potentially be reduced under Canada-U.S. tax treaty.
- If beneficial owner of such amounts is tax resident in the other state, then the applicable withholding tax rate can sometimes be reduced to 10%.
- In some cases, withholding tax (WHT) on royalties can be reduced to 0% under domestic Canadian rules.
- Definition of 'royalties' under the Canadian ITA is broad and also includes 'similar payments' (may include licensing fees).

Management fees

- Management fees may not be subject to withholding taxes under Canadian domestic rules if a reimbursement for a specific expense (i.e., no markup).
- If markup applies, Canadian WHT at 25% could apply.
- Under Canada's treaties, reasonable management fees are considered 'business profits', and as such, can generally not be taxed by Canada if the payee does not have a Canadian permanent establishment.
- Canada Revenue Agency (CRA) will scrutinize the costs and methodology associated with such fees.
- Taxpayers need to ensure amounts are reasonable and appropriate documentation is in place to substantiate fees.

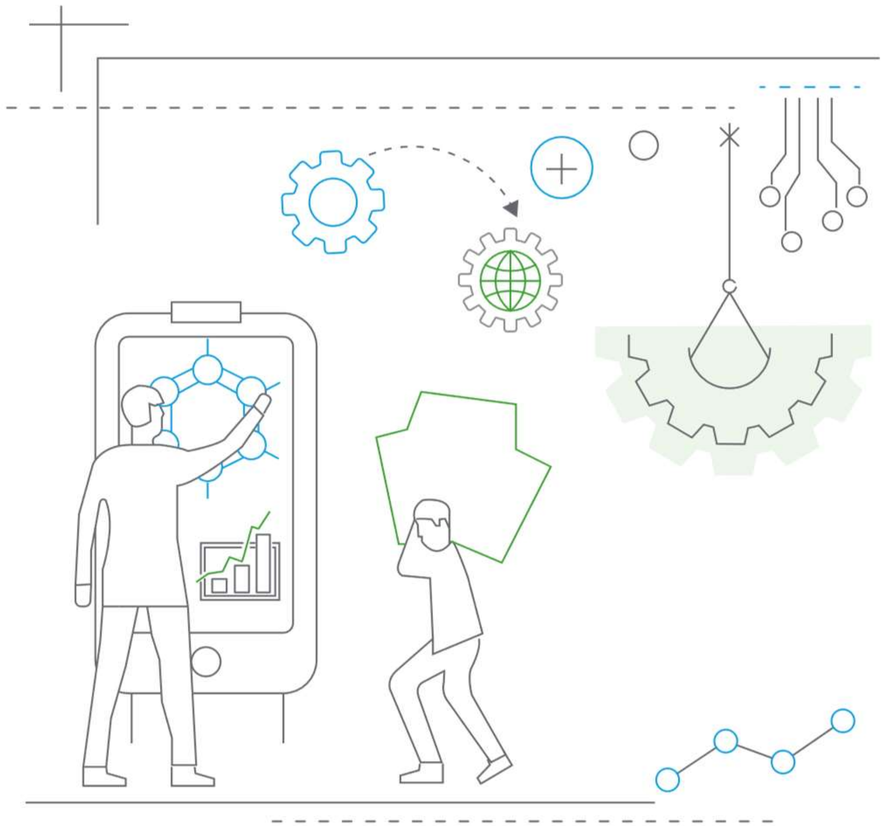
Compliance considerations

- The withholding taxes must be collected and remitted by the Canadian resident payor.
- Must remit withholding taxes on or before the 15th day of the month following the month the amount was paid or credited to the non-resident, otherwise considered late.
- Must report all such types of payments made in a Calendar year through a prescribed information return to the CRA known as the NR4.
- The NR4 must be filed by March 31, after the applicable Calendar year.
- If late, can be subject to penalties, minimum of $100, maximum of $2,500 per NR4 slip.

Hybrid structures

And issues associated with the repatriation of cash

General overview



- Hybrids generally refers to entities that are taxpayers in one state and fiscally transparent in the other state.
- A Canadian Unlimited Liability Company (ULC) is one such example.
- ULCs are considered taxable corporations in Canada. However, they may be treated as fiscally transparent under U.S. tax rules.
- Access to treaty benefits for hybrid entities is generally limited and, in some cases, denied.

General overview (continued)

- Where the dividends are paid by a disregarded ULC to a disregarded LLC, there is generally no relief available under the treaty .
- The CRA does not consider disregarded LLCs as U.S. tax residents under Article IV (e.g., not subject to comprehensive tax on their worldwide income). Therefore, because the treatment of these hybrid entities is not the same in both Canada and the U.S., treaty benefits are generally denied under Article IV(7)(b).
- In some situations, treaty access may be available where a U.S. resident (e.g., C corp.) owns a transparent U.S. entity (e.g., LLC partnership) which owns a Canadian corporation (Article IV(6) of the Treaty).
- Payors of amounts subject to Canadian withholding tax should prepare certain disclosure forms which need to be kept on file in order to support access to treaty relief on future distributions (NR301, NR302, NR303).

Implications of Canada’s proposed EIFEL rules

- EIFEL rules expected to limit interest deductibility to 40% of adjusted taxable income (ATI) in transitional year (October 2023 to December 2023) and 30% of ATI thereafter (2024 onwards).
- The 30% fixed ratio to ATI may be exceeded to the extent the ratio of group net interest expense to group consolidated EBITDA is higher (subject to certain limitations).
- Will apply in addition to the thin-capitalization rules (not replace them).
- Originally proposed to be effective for tax years ending after Jan. 1, 2023, now delayed to Oct. 1, 2023.
- Anti-avoidance rules exist that penalize taxpayers which seek to trigger short tax year ends to postpone application of these rules.
- Similar to section 163(j) limitations in the U.S.

Who do the EIFEL rules apply to?

The EIFEL rules generally apply to corporations and trusts (including corporations and trusts that hold an interest in a partnership, similar to current thin-capitalization rules) except **'excluded entities'**.

Excluded entities have been defined to include:

1. Canadian-controlled private corporations (CCPCs) that, together with any associated corporations, have taxable capital employed of less than C$50 million in Canada;
2. Groups of corporations and trusts whose aggregate net interest expense among their Canadian members is C$1,000,000 or less;
3. Certain standalone Canadian-resident corporations and trusts, and groups consisting exclusively of Canadian-resident corporations and trusts that carry on substantially all of their business activities in Canada.

QUESTIONS AND ANSWERS

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