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Taxation of Cross-Border Mergers and Acquisitions

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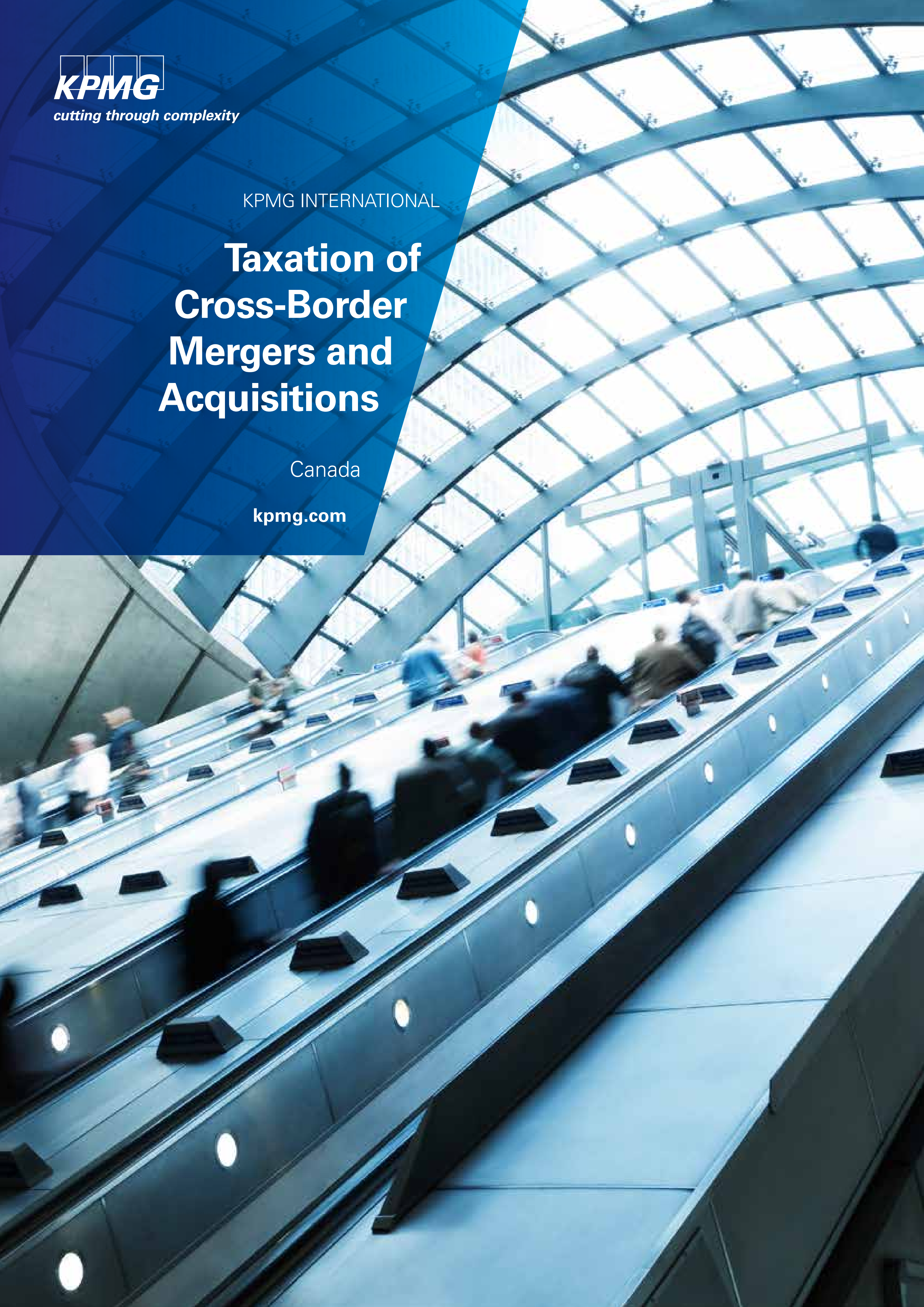

Canada

Introduction

Although not defined by statute, the phrase mergers and acquisitions (M&A) is used in Canada to describe combinations of business enterprises by means of an acquisition or other combination technique, such as an amalgamation that is allowed under applicable corporate law. A merger or acquisition involving shares of a Canadian company or its assets can be completed in a number of ways, depending on the type of consideration to be paid, tax and financings considerations, and corporate law and regulatory issues.

The M&A market in Canada has maintained steady, slow growth. Since the last edition of this chapter, tax developments relating to M&A have been limited. This chapter begins with an overview of recent developments in the Canadian tax environment for M&A, and proceeds by addressing the principal issues that face prospective purchasers of Canadian companies and their assets.

Recent developments

The following is a summary of the significant Canadian tax considerations in the context of M&A.

Foreign affiliate dumping rules

In March 2012, the federal budget proposed foreign affiliate dumping (FAD) rules, which generally apply to transactions that occur after 28 March 2012. The FAD rules aim to curtail the use of Canada's foreign affiliate (FA) system where the relevant Canadian company is controlled by a non-resident corporation (called a CRIC). Generally, the FAD rules apply where a CRIC makes an investment in an FA. The term 'investment' is broadly defined for purposes of the FAD rules. Where a foreign-controlled CRIC makes an investment in an FA, generally one of two results take place. First, the CRIC is deemed to have paid a dividend to its non-resident parent equal to the fair market value of any property transferred (excluding shares of the CRIC itself), obligation assumed or benefit conferred by the CRIC that is considered to be related to the FA investment. Second, if the PUC of the CRIC's shares is otherwise increased because of the FA investment, that increase is deemed not to have occurred. Both results create withholding tax implications. There are a few exceptions to the FAD rules that could apply.

In August 2013, the Department of Finance released proposed amendments to the FAD rules that would, among other things, reduce the application of the FAD rules in the case of a CRIC that invests in a foreign affiliate before control of that corporation is assumed by a non-resident corporation. However, the FAD rules continue to have significant implications for acquisitions of Canadian corporations with significant foreign subsidiaries. The application of the FAD rules to any situation requires an in-depth understanding of the relevant specific provisions.

Thin capitalization

For tax years ending after 28 March 2012, new changes to the thin capitalization regime were enacted, including (among other things):

- the debt-to-equity ratio decreased from from 2:1 to 1.5:1
- debt owed by partnerships (with a Canadian resident is now considered for purposes of the thin capitalization rules
- disallowed excess interest expense is treated as a deemed dividend subject to withholding tax.

In 2013, the federal budget proposed to further broaden the thin capitalization rules to apply to Canadian resident trusts and certain non-resident corporations and non-resident trusts that carry on business in Canada, as well as partnerships where one of the aforementioned entities is a partner. These changes have since been enacted and generally apply for taxation years after 2013.

Corporate loss trading

In March 2013, proposed legislative measures were introduced to further restrict the trading of tax attributes among arm's length persons. The 'attribute trading restriction' is an anti-avoidance rule that supports the existing loss restriction rules that apply on the acquisition of control of a corporation. Under the new rules, an acquisition of control is deemed to occur where a person (or group of persons), without otherwise acquiring control of the corporation, acquires shares of a corporation that have more than 75 percent of the fair market value of all the shares of the corporation, where it is reasonable to conclude that one of the main reasons for not acquiring control was to avoid any of the restrictions that would have been imposed on the corporation's tax attributes. These rules apply to a corporation the shares of the capital stock of which are acquired on or after 21 March 2013 unless the shares are acquired as part of a transaction that the parties are obligated to complete pursuant to a written agreement entered into before 21 March 2013.

The 2013 budget also proposed to extend the loss streaming and related acquisition of control rules to trusts where there is a 'loss restriction event'. A 'loss restriction event' occurs when a person or partnership becomes a majority-interest beneficiary of the trust or a group of persons becomes a majority-interest group of beneficiaries of the trust. The proposed changes have been enacted and generally apply to transactions occurring after 20 March 2013.

Upstream loans

On 26 June 2013, amendments to the upstream loan rules took effect. These rules generally require an income inclusion in Canada where a foreign affiliate (or a partnership of which a foreign affiliate is a member) of a Canadian taxpayer (Canco) makes a loan to a person (or partnership) that is a 'specified debtor' in respect of Canco, and the loan remains outstanding for more than 2 years. Revised coming into force measures provide grandfathered loans with a five-year repayment period. The loan then becomes subject to the regular two-year repayment period, and must be repaid by 19 August 2016 to avoid being subject to the new rules.

Asset purchase or share purchase

An acquisition of a business may take many different forms. The most common way is the purchase of assets or shares. There are many significant differences in the tax implications of an acquisition of assets and shares. The choice largely depends on the purchaser's and vendor's tax positions and preferences. Typically, a vendor would prefer to sell shares, since a sale of assets could result in additional tax from recapture of capital cost allowances (tax depreciation) and double taxation of proceeds when extracting the sale proceeds from the corporation. A purchaser, on the other hand, would typically prefer to acquire assets, since it would receive a higher tax shield from the acquired assets equal to their fair market value, as opposed to inheriting the historical tax shield.

The following sections discuss in more detail some of the major income tax issues that should be reviewed when considering a purchase of assets or shares. Other non-tax issues should also be considered.

In addition, the last section of this chapter summarizes the advantages and disadvantages of an asset versus share purchase.

Purchase of assets

An asset purchase generally results in an increase to fair market value in the cost basis of the acquired assets for capital gains tax and depreciation purposes, although this increase is likely to be taxable to the vendor. Further, an asset purchase enables a purchaser to avoid assuming the vendor's tax liabilities and historical attributes in respect of the assets.

Purchase price

A purchase and sale agreement relating to the acquisition of business assets usually includes a specific allocation of the purchase price between the various assets acquired. To the extent that the acquisition is between arm's-length parties, the Canada Revenue Agency (CRA) generally accepts the purchase price allocation as set out in the purchase and sales agreement. However, where one party to the transaction does not have a vested interest in the allocation of the purchase price, the CRA may adjust the allocation if it believes that it does not reflect the relative fair market values of the assets.

In the case of transfers between non-arm's-length parties, the transaction is deemed to take place at fair market value for Canadian tax purposes. In reviewing such transactions, the CRA would be concerned that the aggregate purchase price and the allocation of the price to specific assets are in accordance with the related fair market values. To avoid possible adverse reassessments, a price adjustment clause is often used in non-arm's length transactions to ensure that any adjustment of the sale price is also reflected in an adjustment of the purchase price. Such a clause may provide for retroactive adjustments to the purchase price if the CRA successfully challenges the fair market value or the related allocations.

Goodwill

For Canadian tax purposes, 75 percent of the amount paid for goodwill and other capital expenditures for similar intangible property on the acquisition of a business as a going concern is deductible on a declining-balance basis. The amortization rate is 7 percent of the unamortized balance at the end of each year. On a subsequent disposal of the goodwill, a recapture of amounts previously deducted can result. Any recapture of previously deducted amounts is fully included in income, and any amount realized in excess of the original cost is included in income at a 50 percent inclusion rate.

Depreciation

The cost of most tangible assets acquired, other than land, can be depreciated for Canadian tax purposes. Each type of property acquired must be included in a particular class of assets. The rates of depreciation, which vary by class, are generally intended to be indicative of the useful lives of the assets included in the specific class. Rates for some of the more common classes of assets are as follows:

Type of asset	Depreciation rate (percent)
Buildings	4 percent declining-balance
General machinery, equipment, furniture and fixtures	20 percent declining-balance
Motor vehicles	30 percent declining-balance
Manufacturing and processing equipment	50 percent straight-line[1]
Computers and software	100 percent

Source: KPMG in Canada, 2014

[1]This applies to M&P equipment acquired before 2016.

Tax depreciation is calculated on a declining-balance basis by multiplying the depreciation rate by the closing balance in the account (essentially, cost less accumulated depreciation and sale proceeds). The amount of depreciation that can be claimed in the year that assets are acquired is generally limited to 50 percent of the amount otherwise determined. In addition, the amount of depreciation otherwise available is pro rated for a short taxation year.

On a disposal of depreciable property, any amounts previously deducted as depreciation could be recaptured and included in income when the closing balance of the account becomes negative. Additionally, any proceeds realized over the original cost are treated as a capital gain that is included in income at a 50 percent inclusion rate.

The cost of intangible assets with a limited life may also be depreciated for tax purposes. For example, the cost of licenses, franchises and concessions may be depreciated over the life of the asset. Patents or a right to use patented information for a limited or unlimited period may be depreciated on a 25 percent declining-balance basis. Alternatively, limited life patents can be depreciated over the life of the asset. Premiums paid to acquire leases or the cost of leasehold improvements are generally deducted over the life of the lease.

Tax attributes

On a sale of assets, any existing losses remain with the corporate vendor and generally may be used by the vendor to offset capital gains or income realized on the asset sale. Likewise, a vendor's depreciation pools are not transferred to the purchaser on an asset acquisition.

Indirect taxes (value added tax and provincial sales tax)

Canada has a valued added tax (VAT) known as the goods and services tax (GST). GST is a 5 percent tax levied on the supply of most goods and services in Canada. Five participating provinces (Ontario, Prince Edward Island, Nova Scotia, New Brunswick and Newfoundland) have harmonized their provincial sales tax (PST) with GST to create the harmonized sales tax (HST). HST applies to the same base of goods and services as GST, but at a rate of between 13 and 15 percent for supplies made in the harmonized provinces (the rate depends on the province in which the supply is made). The province of Quebec also has a VAT, called Quebec Sales Tax (QST), that is similar but not identical to the GST and HST. The QST rate is 9.975 percent. Three provinces (British Columbia, Manitoba and Saskatchewan) also impose PST on goods and certain services at the rate of between 5 and 8 percent.

The sale of business assets by a registered person constitutes a supply of goods for GST/HST purposes and, as a general rule, the tax would have to be charged. However, where a registered person makes a supply of a business or part of a business and the recipient is a GST/HST registrant and is acquiring all or substantially all of the property that can reasonably be regarded as being necessary to carry on the business or part of the business, no GST/HST is charged on the purchase price, provided an election is made. As long as the assets sold are part of a going concern of the vendor that will continue to be carried on commercially by the purchaser, this relieving provision applies. Where the relieving provision does not apply, the tax is charged based on the consideration for the assets sold. However, not all assets are subject to GST/ HST (such as accounts receivable), and special rules apply to real property and to related-party transactions. Where GST/ HST does apply, the purchaser can recover the tax paid to the vendor as an input tax credit, provided the purchaser is registered for GST/HST at the time the assets are deemed to have been supplied and the purchaser is using the assets in its commercial activities.

The sale of tangible assets located in a PST province may be subject to PST depending on the type and/or use of the tangible asset. Other PST related obligations may apply on the transfer of tangible assets (such as clearance certificates).

Transfer taxes

Most of the provinces impose land transfer taxes on transfers of real property: land, buildings and other improvements. The rates of land transfer tax vary by province and range from 0.25 percent to 2 percent of the consideration for the real property transferred. Certain exemptions from land transfer taxes apply to non-arm's-length transactions (non-arm's length exemption). No stamp or transfer duties are generally payable on the transfer of shares. Some of the provinces may impose land transfer tax if a transfer of shares occurs within a certain period after the transfer of real property that was eligible for a non-arm's length exemption.

Purchase of shares

The following sections discuss some issues that should be considered when acquiring a target company's shares.

Tax indemnities and warranties

A purchaser of a target company's shares assumes the historical tax liabilities of target. Therefore, the purchase and sale agreement usually requires the vendor to indemnify any undisclosed tax liabilities that may exist or may subsequently be identified relating to any period prior to the date of closing. Similar indemnities are normally given for contingent tax liabilities. The indemnity could be for each dollar of potential exposure or up to a specified amount. The indemnity coverage should form part of the negotiation process.

On an acquisition of assets, the total purchase price is allocated to the specific assets acquired, based on their respective fair market value. Depending on the allocation, a step-up in the tax basis of the acquired assets is available. On an acquisition of shares, however, there is generally no increase in the tax basis of the assets of the target company and no goodwill is recognized for tax purposes. However, the tax basis of certain non-depreciable capital properties owned by the target company can be increased if the target company is amalgamated with or wound up into the Canadian acquisition company. This is often referred to as a bump. Properties eligible for the bump include shares of subsidiaries of the target company, partnership interests and land.

The bump cannot exceed the fair market value of the eligible property at the time the target company was acquired. The total bump is limited to the excess of the purchase price of the shares of the target company over the net tax cost of the assets of the target company. Additionally, the bump room on shares of foreign affiliates is subject to specific limitations. Generally, a bump cannot result in the sum of (1) the parent's tax cost of the foreign affiliate shares and (2) the good surplus of the foreign affiliate exceeding the fair market value of those shares. Accordingly, taxpayers need to calculate the surplus balances of foreign affiliates of the Canadian target entity. However, the CRA's administrative position is that it will not challenge surplus calculations or the lack thereof of foreign affiliates that are moved out from under Canada within a reasonable time if certain other conditions are met. Accordingly, this administrative concession will not grind the bump room.

An amendment introduced in 2012 further restricts the amount by which a partnership interest can be bumped. Generally, the amendment reduces the maximum amount of the bump to the extent that the accrued gain on the partnership interest is attributable to accrued gains on non-eligible property owned by the partnership.

The bump rules are extremely complex, and careful planning is required to ensure the bump will be available. In certain cases, obtaining a bump is a critical aspect of the transaction. For example, the target company may operate three lines of business through three subsidiaries. If the non-resident acquirer only desires to acquire and operate two of the businesses, a bump may be desirable to minimize the taxes on the sale of the non-desired assets. Typically, to structure a bump, a Canadian acquisition company could acquire the target company, after which the target would be wound up into or merged with the Canadian acquisition company. The tax basis of the shares of the subsidiary operating the unwanted business could be bumped to their fair market value (subject to the restrictions described earlier) and sold without income tax consequences.

When a bump is to be obtained on the tax basis of the assets of the target, the purchaser may request representations from the vendor that it has entered no transactions that could adversely affect the bump. While such provisions are common in transactions involving private companies, an acquisition of a listed company that is made by a public takeover generally would not involve a purchase and sale agreement. Consequently, it may not be possible for the purchaser to obtain the same warranties or indemnities with respect to contingent liabilities.

Given the potential tax liabilities that may carry over to the purchaser, it is customary for the purchaser to initiate a tax due diligence that would incorporate a review of the target's historical tax affairs even though the vendor may provide indemnities and warranties.

In a public company takeover, concerns over contingent liabilities may result in the target company allowing the purchaser a suitable due diligence period and making available to the purchaser most financial and corporate information. Typically, this due diligence process would include an in-depth review of the tax affairs of the target company by the advisors of the purchaser.

In a hostile takeover of a public company, a due diligence review normally would not be carried out or would be carried out only under restricted circumstances.

Tax losses

A Canadian company may carry forward two primary types of losses: net capital losses and non-capital (or business) losses. Capital losses are incurred on the disposal of capital property. Half of such losses may be deducted against the taxable portion of capital gains (50 percent) realized in the year, with any excess loss being carried forward or back as a net capital loss. Net capital losses may be carried back 3 years or carried forward indefinitely, but may only be used to reduce taxable capital gains in these other periods. Non-capital losses are generally business or property losses that may be carried back 3 years or forward 20 years and applied against income from any source.

On a sale of assets, any existing losses remain with the corporate vendor, which can use them to offset any capital gains or income realized on the asset sale.

On a share sale that results in an acquisition of control of the target corporation, a deemed tax year-end is triggered immediately before the acquisition. A number of specific rules apply that determine the carry forward and use of pre-acquisition losses. Net capital losses may not be carried forward after an acquisition of control. Accrued capital losses on capital assets of the corporation are deemed realized, which results in a write-down of capital property to its fair market value.

On an acquisition of control, accrued losses on depreciable properties are deemed realized and bad debts must be written-off. These deductions from income in the taxation period that ends at the time of the acquisition of control may increase the target corporation's non-capital losses. Non-capital losses are deductible after an acquisition of control within the carry forward period if certain requirements are met. Non-capital losses from carrying on a business are deductible after the acquisition of control if the business that sustained the losses continues to be carried on with a reasonable expectation of profit. The losses are deductible only to the extent of the corporation's income from the loss business or similar businesses. Similarly, on a liquidation of an acquired company or the amalgamation of the acquired company with its parent, the pre-acquisition non-capital losses are deductible by the parent but only against income from the business of the acquired corporation in which the losses arose or from a similar business.

Non-capital losses from property cannot be used after an acquisition of control.

Despite the above-noted rules, the target company may elect to trigger accrued gains on depreciable and non-depreciable capital property to offset any net capital or non-capital losses either carried forward or deemed realized on the acquisition of control that would otherwise expire. The general effect of these rules is to allow a corporation, before the change of control, to convert net capital losses or non-capital losses existing or accrued at that time into a higher cost-base for capital assets that have current values that exceed their tax basis.

Pre-sale dividend

In certain cases, the vendor may prefer to realize part of the value of their investment as income by means of a pre-sale dividend and hence reduce the proceeds of sale. This planning may be subject to the section 55 butterfly deeming rules. If the rules apply, the dividend is deemed to be proceeds of disposal. However, if the dividend, however, is derived from safe income or earnings that have already been subject to tax, the deeming rules should not apply.

Transfer taxes

No stamp or indirect taxes (such as GST/HST or PST) are payable on a transfer of shares.

However, for an asset sale, most provinces impose land transfer taxes on transfers of real property (such as land, buildings and other improvements), and PST and GST/HST may apply.

Tax clearances

The CRA does not give clearance certificates confirming whether a potential target company has any arrears of tax owing or is involved in any audit or dispute relating to prior audits.

Clearance from the tax authorities is not required for a merger or acquisition except in certain circumstances where the vendor is a non-resident. Where a non-resident disposes of taxable Canadian property, the vendor may have obligations under section 116 of the Income Tax Act.

Taxable Canadian property includes: Canadian real property, assets used in carrying on business in Canada, Canadian private company shares that derive more than 50 percent of their value from certain Canadian property, and shares of Canadian public companies where certain ownership thresholds are satisfied (and which primarily derive their value from taxable Canadian property). Unless the disposed taxable Canadian property is a treaty-exempt property, a purchaser would be required to remit funds to the CRA equal to a portion of the purchase price (25 percent or 50 percent), and the vendor would be required to file a tax return and notify the CRA of the disposal.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign purchaser. Tax factors often influence the choice. The following vehicles may be used to acquire either the shares or assets of a Canadian target company.

Local holding company

The use of a Canadian acquisition company to acquire either assets or shares of a Canadian target company is common.

A Canadian acquisition company is commonly used when a non-resident acquires shares of a Canadian target corporation. On a share acquisition, the use of a Canadian acquisition company may be advantageous for financing the acquisition or for deferring Canadian withholding tax on distributions in the form of a return of paid-up capital (as discussed below). In addition, a deferral of withholding tax can be achieved where there are minority Canadian shareholders of the acquired company (such as employees or public shareholders) and dividends are paid on a regular basis. The foreign parent may not require its share of the dividends to be repatriated and can defer Canadian withholding tax by using a Canadian holding company.

A return of paid-up capital (generally, the amount for which the shares were originally issued to the original holder) is not subject to income tax or withholding tax. Therefore, if a non-resident acquires a Canadian target company directly, the amount paid to acquire the shares of the target company can only be returned to the non-resident free of withholding tax to the extent of any existing paid-up capital. However, if the non-resident incorporates a Canadian acquisition company, the tax basis and paid-up capital of the shares of the acquisition company will both be equal to the purchase price (assuming no debt financing). The paid-up capital of the acquisition company can be repatriated to the non-resident parent free of Canadian withholding tax.

After the share purchase, the Canadian acquisition company and the target company may be amalgamated (i.e. merged; see discussion under company law). An amalgamation of the two entities will be useful for debt financing, since Canada does not have tax-consolidation.

An amalgamation of the acquisition and target companies results in deemed year-ends immediately before the amalgamation for both companies. As discussed later in this chapter, a deemed year-end also occurs when control of a company is acquired. To avoid extra year-ends, the amalgamation should be effected on the same day as the share acquisition so that the deemed year-ends coincide.

Foreign parent company

The foreign parent company may choose to make the acquisition directly, perhaps to shelter its own taxable profits with the financing costs (at the parent level). Two main disadvantages of doing this are:

- The parent inherits the historical paid-up capital instead of having a paid-up capital equal to the purchase price.
- It would be more difficult to push debt into Canada or leverage Canada.

As discussed earlier in this chapter, paid-up capital will be advantageous when a distribution is made through a return of capital, since it does not attract Canadian withholding tax. Therefore, an intermediary holding company resident in a favorable treaty country is preferable to a foreign parent company from a Canadian tax perspective.

Non-resident intermediate holding company

A treaty country intermediary shareholder may be advantageous in certain cases, depending on the jurisdiction of incorporation of the non-resident purchaser. Canada has an extensive tax treaty network. The treaty withholding tax rates vary from 5 percent to 25 percent on dividends and from 0 percent to 15 percent on interest. (See this chapter's discussion on withholding taxes on debt.) The Canadian withholding rate is 25 percent for non-treaty countries. Some treaties provide greater protection against Canadian capital gains tax on the disposal of shares of a Canadian company than the normal Canadian taxation rules that apply to disposals by non-residents. As a result, the use of a treaty country intermediary to make the acquisition may be useful in certain circumstances. As with all international tax planning, it is necessary to consider treaty-shopping provisions in the treaties and domestic anti-avoidance rules.

Local branch

The use of a branch to acquire assets of a target company yields similar results to forming a Canadian company, assuming the acquisition creates a permanent establishment in Canada. The rate of federal and provincial income tax is approximately the same for a branch as for a Canadian corporation. In addition, the federal government levies a branch tax that is, in general terms, imposed on profits derived by non-resident corporations from carrying on business in Canada and that are not reinvested in Canada. The branch tax parallels the dividend withholding tax that would be paid if the Canadian business were carried on in a Canadian corporation and profits were repatriated by paying dividends to its non-resident parent. Accordingly, the branch tax base is generally intended to approximate the after-tax Canadian earnings that are not reinvested in the Canadian business. Some of Canada's tax treaties provide an exemption from branch tax on a fixed amount of accumulated income (that is, 500,000 Canadian dollars – CAD). In certain cases, it is advantageous for a non-resident corporation starting a business in Canada initially to carry on business as a branch, because of the ability to use start-up losses on the non-resident's domestic return or the availability of a partial treaty exemption from branch tax. Subsequently, the branch can be incorporated.

The capital taxes levied on the branch of a foreign corporation carrying on business in Canada are similar to the capital taxes levied on a Canadian company owned by the foreign corporation. Although the basis for the calculation of taxable capital for provincial capital tax varies between Canadian companies and branches of foreign corporations, the objective of taxing the capital base used in Canada or in a province is the same. Capital taxes have been eliminated in all provinces except Nova Scotia (which will be eliminated by 1 July 2012).

Joint venture

Where an acquisition is made in conjunction with another foreign or domestic party, a special-purpose vehicle, such as a partnership or joint venture, may be considered. However, the use of such a vehicle still requires a fundamental decision as to whether the participant in the joint venture or partnership should be a branch of the foreign corporation or a Canadian company, and whether a treaty country intermediary should be used.

Incorporation offers the advantages of limited liability by virtue of a separate legal existence of the corporate entity from its members. A limited partnership can offer similar protection, but a limited partner cannot participate in the management of the partnership. A general partnership results in the joint and several liability of each partner for all of the partnership liabilities, although limited liability protection can be offered by using a single-purpose domestic corporation to act as partner. The primary advantage of using joint ventures or partnerships to make acquisitions with other parties is that losses realized by a joint venture or a partnership are included in the taxable income calculation of the joint venturers or partners. In contrast, corporate tax-consolidation is not permitted for Canadian tax purposes, so losses incurred by a corporate entity must be used by that entity or transferred to another Canadian company in the group on liquidation, amalgamation or a complex loss-utilization transaction.

Choice of acquisition funding

A purchaser using a Canadian acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt, equity, or a hybrid instrument that combines the characteristics of both. The principles underlying these approaches are discussed below.

Debt

The principle advantage of acquiring shares with debt is the potential tax-deductibility of interest (and other related financing fees).

On an acquisition of shares, the financing details of the acquisition can be significant as the combined federal and provincial corporate tax rates in Canada may be higher than in some other countries. As a result, it may be desirable to have financing costs relating to Canadian acquisitions deductible in Canada against income that would otherwise be taxable at the Canadian rates and subject to Canadian withholding tax on repatriation. In addition, since there is no tax-consolidation, it is important that any financing costs be incurred by the entity that is generating income.

The Canadian rules relating to interest deductibility are flexible enough to allow a purchaser to obtain a deduction for interest expense on acquisition debt. Interest on money borrowed by a Canadian acquisition company to acquire the shares of a target company is generally fully deductible. However, the acquisition company may not have sufficient income against which the interest expense can be deducted, which could result in unused interest deductions. To the extent that the target company is subsequently liquidated into or amalgamated with the acquisition company, the interest on the acquisition debt should be deductible against the profits generated by the business of the target company.

The main restriction on acquisition debt funding obtained from a non-resident related party is in the thin capitalization rules. Interest on the portion of debt owed by a Canadian corporation (target company) to certain non-residents that exceeds 1.5 times the shareholder's equity of the Canadian target company is not deductible. The interest that relates to the portion of the debt below the 1.5:1 debt-to-equity threshold is generally deductible. Interest that relates to the portion of the debt above the 1.5:1 debt-to-equity threshold is treated as a deemed dividend subject to withholding tax.

The thin capitalization rules apply if the shareholder is a specified shareholder, which includes non-resident shareholders and other related parties who together own at least 25 percent of the voting shares or 25 percent of the fair market value of all the shares in the company.

Where shares of a company are redeemed for a value in excess of paid-up capital and retained earnings, or dividends are paid in excess of retained earnings, interest expense incurred to fund the excess amounts relating to such distributions may not be tax-deductible.

Deductibility of interest

Interest is deductible for Canadian tax purposes if it is paid pursuant to a legal obligation to pay interest and relates to:

- borrowed money used to earn income
- an amount payable for property acquired for the purpose of earning income.

In computing business income, accrued interest is generally fully deductible for tax purposes, although compound interest is only deductible when paid. Some financing fees are generally deductible over 5 years for tax purposes while others must be capitalized and amortized at a rate of 7 percent per year on a declining basis.

Interest-free loans made between Canadian corporations generally do not give rise to any adverse tax consequences. Similarly, interest-free loans made by a non-resident shareholder to a Canadian company generally do not give rise to adverse Canadian tax consequences. However, in the case of interest-free loans made by a Canadian company to a related non-resident that remain outstanding for more than a year, interest income will be imputed to the Canadian company, subject to certain exceptions. Further, such a loan to a non-resident shareholder will be treated as a dividend to the non-resident shareholder and will be subject to withholding tax if outstanding for more than one full taxation year. The non-resident shareholder may claim a refund of the withholding tax paid when the interest-free loan is repaid, provided the repayment is not part of a series of loans or other transactions and repayments.

Withholding tax on debt and methods to reduce or eliminate it

Interest paid by a Canadian resident corporation to a non-arm's length non-resident lender is subject to withholding tax. The domestic rate of withholding is 25 percent. However, the rate is generally reduced under Canada's tax treaties to 15 percent or, in some cases, 10 percent. Under the Canada-US tax treaty, the rate could be 0 percent if the recipient qualifies for treaty benefits.

Withholding tax does not apply where the non-resident lender has a fixed place of business in Canada, in which case the lender would be subject to normal Canadian income tax. Withholding tax also does not apply to an arm's length, non-resident lender.

Because Canadian withholding taxes apply only at the time of payment, such taxes can be deferred to the extent that interest is not actually paid. However, interest that is accrued by a Canadian-resident taxpayer and owed to a non-arm's length, non-resident will be disallowed as a deduction to the Canadian-resident corporation if payment is not made within 2 years from the end of the taxation year in which the interest accrued.

Checklist for debt funding

- The use of bank debt may be advantageous for several reasons: no thin capitalization rules, no transfer pricing problems on the interest rate, and no withholding tax on interest payments.
- If the debt is funded from a related party, consider whether the 1.5:1 debt-to equity thin capitalization restrictions apply. Withholding tax may apply on the interest paid.
- Consider whether the level of profits would enable tax relief for interest payments to be effective.
- Consider whether interest-free loans would have interest imputed if loans from a Canadian corporation to a non-resident are outstanding for more than one year.
- Consider whether a deemed dividend exists when debt is borrowed to make a distribution.
- Consider whether there is an income inclusion to the Canadian corporation on upstream loans made by its foreign affiliates.
- If the debt borrowed by the Canadian target company to redeem shares exceeds paid-up capital and retained earnings or dividends are paid in excess of retained earnings, interest expense incurred to fund the excess amounts relating to such distributions may not be tax-deductible.
- Consider whether transfer pricing principles could apply to interest rates charged on related party debts.
- Consider whether there are cash flow issues and whether interest payments made on related party debt may be deferred for 2 years.

Equity

A purchaser may use equity to fund its acquisition. The amount of equity depends on the purchaser's preference. Canada does not have any capital or stamp duties.

Dividends paid by a Canadian company to a corporate shareholder resident in Canada generally are not subject to income tax for the recipient or withholding tax for the payer, although a refundable tax applies to private companies receiving dividends on portfolio investments. Special rules may apply to dividends paid on preferred shares, in which case there is a form of advance corporation tax (discussed later in this chapter). Payments of dividends are not deductible by the payer for income tax purposes.

Canadian tax rules permit deferred transfers and amalgamations provided certain conditions are met. Examples of some commonly used tax-deferred reorganizations and mergers provisions are as follows:

- A transfer of assets to a corporation results in a disposition of the assets at fair market value. However, if the transferor and transferee make a joint election, potentially all or a portion of a gain on the transfer of eligible assets can be deferred. Accordingly, this election permits a tax-free transfer or rollover of property to a taxable Canadian corporation as long as the transferor accepts shares as part of the consideration for the transfer. The idea is that the transferor, who is now a shareholder of the transferee corporation, should be in the same economic position they were in before the transfer. Therefore, the adjusted cost base of the shares they receive should equal the adjusted cost base of the assets transferred and the deferred income or capital gain arises only when the shares are sold in an arm's length transaction.
- A separate election is available for a transfer of assets to a partnership. This election is similar in nature to the one in the context of a corporation except that the consideration received by the transferor must include a partnership interest as opposed to shares.
- A rollover is also available for a shareholder of a corporation who exchanges:
  - shares or debt of a corporation for shares of the corporation (no election required)
  - shares of one taxable Canadian corporation for shares of another taxable Canadian corporation (no election required); this provision is most often used in a takeover where a shareholder of one corporation exchanges shares for shares of the purchasing corporation.

The section of the Income Tax Act governing the rollover affects, among other things, the type of property eligible for transfer, whether the transferor can receive anything other than shares in return and whether an election is required.

- In the event of a merger (or amalgamation) of two Canadian taxable corporations, a tax-deferred rollover may be available in which no immediate tax implications would arise for the corporations and the shareholder provided certain conditions are met. If all the conditions are met, the rollover provision applies automatically without an election.

The merger essentially rolls over the tax attributes of the predecessor corporations to the amalgamated entity, but there will be a deemed year-end. The deemed year-end will age by one year of any loss carry forwards and other provisions related to the timing of a year-end should be considered. This tax-deferred rollover allows the corporations and shareholder to be in a tax-neutral position.

If the merger is a vertical amalgamation (between a parent and its wholly owned subsidiary), two additional planning opportunities may be available and they include: utilization of post-amalgamation losses to recover taxes paid by the predecessor parent; and access to the bump (as discussed earlier in this chapter) Certain conditions must be met for those planning opportunities to be available.

- A tax-deferred wind-up is also available if certain conditions are met (i.e. if a taxable Canadian corporation of which at least 90 percent of each class of shares is owned by another Canadian taxable corporation). This tax-deferred wind-up is similar to the tax-deferred amalgamation except there is no deemed year-end.

Hybrids

The Canadian tax treatment of a financial security, either as a share or as a debt obligation, is generally determined by the legal form of the security as established by the applicable corporate law. A dividend payment on a share is generally treated as a dividend regardless of the nature of the share (i.e. common or preferred). An interest payment on a debt obligation is generally considered to be interest for tax purposes, although the tax-deductibility of such interest may be limited.

The Canadian tax authorities generally characterize a financial security issued by a foreign corporation as either debt or equity in accordance with the corporate law of the jurisdiction in which the security is issued. The tax treatment of the security in the foreign jurisdiction, however, is irrelevant when it is inconsistent with the characterization under the relevant Canadian corporate law.

Discounted securities

If a company has issued a debt security at a discount and pays an amount in satisfaction of the debt security that exceeds proceeds received by the company on the issuance of security, all or a specified portion of such excess may be deducted by the company in certain circumstances.

Deferred settlement

To the extent that all or a portion of the purchase price is represented by debt that is not due to the vendor until after the end of the year, a reserve may be available to defer a portion of the gain that is taxable to the vendor. For disposals of shares, the reserve is limited to 5 years. At least one-fifth of the gain must be included in the vendor's income in each year of disposal and the 4 immediately following years. For capital gains arising from a sale of assets, the same type of reserve is available to the extent that a portion of the consideration relating to capital property is not due to the vendor until after the end of the year. This reserve is not available for recaptured depreciation. For non-capital property, a three-year reserve on the portion of the profit from the sale relating to proceeds not yet payable may be available. No reserve is available on the sale of goodwill. Reserves on certain disposals of property among related parties could be denied.

Other considerations

Concerns of the seller

Sale of assets

In an asset sale, a main concern of the vendor is the possible recapture of depreciation if depreciable assets are sold for more than their tax values. As discussed earlier, only 50 percent of the gain on goodwill and other non-depreciable capital properties are included in income. Therefore, the vendor will be concerned with the relative allocation of the purchase price to minimize the recovery of depreciation compared with the gains from capital property or goodwill.

PST, GST/HST and land transfer taxes are generally payable by the purchaser. To the extent these taxes are not charged/collected, the vendor is liable to the appropriate government authority.

Sale of shares

A Canadian-resident vendor is taxable on 50 percent of any capital gains realized on a sale of shares. An exemption may be available to individuals for a portion of the gains realized on shares of qualifying private corporations. Prior to a share sale, shareholders owning more than 10 percent of the outstanding shares of a private company may undertake planning steps to distribute the accumulated earnings of the target company as a tax-free dividend to a holding company. Such a distribution reduces not only the agreed purchase price for the shares but also the vendor's capital gain arising on the sale. Other concerns primarily relate to the negotiating process. The vendor will want to ensure that all intangible and contingent assets are recognized and taken into account in arriving at the purchase price, including any losses in the company that may be used by the purchaser. Similarly, any indemnities and warranties (as discussed earlier) are a significant part of the negotiation process.

Taxable versus deferred sale

In the case of both an asset sale and a share sale, a concern of the vendor will be whether the transaction is to be structured primarily as a taxable disposal or as a tax-deferred disposal. In both an asset and a share sale, the vendor can defer recognition of gains by receiving cash or debt up to the tax basis of the assets or shares disposed of, and shares of the purchaser for the balance of the purchase price. These transactions may be structured in a variety of ways.

Vendor's preference regarding assets versus shares

Since a purchaser prefers an asset deal, a vendor may require a higher purchase price to sell assets rather than shares, due to the potentially higher tax cost on the sale of assets. The purchaser may, therefore, pay more for assets but will obtain some relief through higher depreciation and amortization.

Company law and accounting

Although not defined by statute, the term M&A is used in Canada to describe combinations of business enterprises by means of an acquisition or other combination technique, such as an amalgamation, that are allowed under company law. A merger or acquisition involving shares of a Canadian company or its assets can be completed in a number of ways depending on the type of consideration to be paid (generally cash, shares, or other securities), tax and financing considerations, and company law and regulatory issues.

The Canadian federal and provincial company laws provide for the statutory amalgamation of two or more predecessor companies into a single entity, provided each is incorporated in the same jurisdiction. Thus, to amalgamate a corporation incorporated under provincial company law with another corporation incorporated under different provincial company law (or under federal company law), one corporation must, if allowed under its governing company law, be continued from its original jurisdiction into the other. An amalgamated corporation essentially represents a continuation of the predecessor corporations, including all of their property rights and liabilities.

Generally, company law does not require that each shareholder of a predecessor corporation becomes a shareholder of the amalgamated corporation. Thus, it is possible to structure a triangular amalgamation whereby shares of the parent company of one predecessor corporation are issued to shareholders of the other predecessor corporation upon amalgamation.

The applicable company law that governs a Canadian corporation depends on the jurisdiction of incorporation. A corporation can be incorporated under either the federal Canada Business Corporations Act (CBCA) or one of the provincial corporation statutes.

With respect to the accounting treatment of mergers, like International Financial Reporting Standards (IFRS), Canadian accounting standards require the acquisition of a business to be accounted for using business combination accounting, unless it represents a transaction between companies under common control. The net assets acquired are brought onto the consolidated balance sheet at their fair values, and goodwill arises to the extent that the consideration given exceeds the aggregate of these values.

Under both Canadian Generally Accepted Accounting Principles (GAAP) and IFRS, goodwill is not amortized through the profit or loss account, but rather is subject to a mandatory annual impairment test. Business combination accounting also applies to purchases of assets, provided such assets constitute a business. Acquisitions of assets that do not constitute a business, do not give rise to goodwill.

Existing Canadian accounting standards for business combinations are being replaced with new standards, which are aligned with IFRS. Such new standards became effective on 1 January 2011. While the Canadian standards and IFRS both require business combination accounting as described earlier, they differ in respect of the valuation of minority interests, the valuation of equity shares issued as consideration, the definition of what constitutes a business, and the treatment of transaction costs, all of which can affect the amount assigned to goodwill.

Group relief/consolidation

There is no tax-consolidation in Canada. Within a corporate Group, it is important to ensure that a situation does not arise where losses are incurred in one company with profits in another. However, it is possible to effect tax-deferred mergers of companies through liquidations of wholly owned subsidiaries or amalgamations of related companies whereby assets can be transferred at their tax basis and accumulated losses can be transferred to the parent on liquidation or to the amalgamated company. In addition, more complex loss-utilization structures can be implemented within a corporate group.

As discussed earlier, where a Canadian operating company is acquired by a Canadian acquisition company, it may be necessary to merge the acquiring and operating companies so that the interest on any acquisition debt is deductible against the profits of the operating company.

Transfer pricing

Canadian transfer pricing rules require a taxpayer transacting with a non-arm's-length non-resident to use arm's length transfer prices and terms, and comply with certain contemporaneous documentation requirements. Failure to use arm's length transfer prices may result in a transfer pricing adjustment and a penalty for insufficient contemporaneous documentation.

Post-acquisition, intercompany balances and arrangements between a foreign parent and its Canadian subsidiary that do not reflect arm's length terms may be subject to adjustment or re-characterization under Canada's transfer pricing rules.

Dual residency

There is little advantage in seeking to establish a Canadian company as a dual resident company.

Foreign investments of a local target company

Canada has comprehensive rules that impute income to a Canadian-resident shareholder in respect of foreign affiliates of the shareholder that earn investment income or income from a business other than an active business. As a result, a Canadian company is generally not the most efficient entity through which to hold international investments, unless the Canadian entities operate active businesses.

Comparison of asset and share purchases

Advantages of asset purchases

- A portion of the purchase price can be depreciated or amortized for tax purposes.
- A step-up in the tax basis of assets for capital gains purposes and depreciation purposes is obtained.
- A deduction is gained for inventory purchased at higher than book value.
- No previous liabilities of the company, either contingent or actual, are assumed.
- Possible to acquire only part of a business.
- Flexibility in financing options.
- Profitable operations can be absorbed by loss companies in the acquirer's group, provided certain planning is undertaken, gaining the ability to use the losses.

Disadvantages of asset purchases

- Possible need to renegotiate supply, employment and technology agreements.
- An asset sale may be less attractive to the vendor, thereby increasing the purchase price.
- Transfer taxes on real property, GST/HST and PST on assets may be payable.
- Benefit of any losses incurred by the target company remains with vendor.

Advantages of share purchases

- Usually more attractive to the vendor, so the price may be lower.
- Purchaser may benefit from tax losses of the target company.
- Purchaser may gain the benefit of existing supply and technology contracts.
- Purchaser does not have to pay transfer taxes on shares acquired.

Disadvantages of share purchases

- Purchaser acquires unrealized tax liability for depreciation recovery on the difference between original cost and tax book value of assets.
- Purchaser is liable for all contingent and actual liabilities of the target company.
- No deduction for the excess of purchase price over tax value of assets.

Canada – Withholding tax rates

This table sets out reduced WHT rates that may be available for various types of payments to non-residents under Canada's tax treaties. This table is based on information available up to 15 March 2014.

Source: International Bureau of Fiscal Documentation, 2014

	Dividends		Interest[1] (%)	Royalties (%)
	Individuals, companies (%)	Qualifying companies[2] (%)		
Domestic rates				
Companies:	25	25	0/25	0/25
Individuals:	25	N/A	0/25	25
Treaty rates				
Treaty with:				
Algeria	15	15	15	0/15[3]
Argentina	15	10	0/12.5[4]	3/5/10/15[5]
Armenia	15	5	10	10
Australia	15	5[6]	10	10
Austria	15	5	0/10[7]	0/10[8]
Azerbaijan	15	10	10	5/10[9]
Bangladesh	15	15	0/15	10
Barbados	15	15	15[10]	10[11]
Belgium	15	5	10	0/10
Brazil	–[12]	15	15[13]	15/25[14]
Bulgaria	15	10	0/10	0/10
Cameroon	15	15	15	15
Chile	15	10	15	15
China (People's Rep.)	15	10	10	10
Croatia	15	5[15]	10	10
Cyprus	15	15	0/15	10
Czech Republic	15	5	0/10	10
Denmark	15	5	0/10	0/10
Dominican Republic	18	18	0/18	18
Ecuador	15	5	15	10/15[16]
Egypt	15	15	15	15
Estonia	15	5	10	10

	Dividends		Interest[1] (%)	Royalties (%)
	Individuals, companies (%)	Qualifying companies[2] (%)		
Finland	15	5	10	0/10
France	15	5	0/10	0/10
Gabon	15	15	0/10	10
Germany	15	5	0/10	0/10
Greece	15	5	0/10	0/10
Guyana	15	15	15	10
Hong Kong[1]	15	5	10	10
Hungary	15	5	0/10	0/10
Iceland	15	5	0/10	0/10
India	25	15	15	10/15
Indonesia	15	10	10	10
Ireland	15	5	0/10	0/10
Israel	15	15	15	0/15
Italy	15	15	15	0/10
Ivory Coast	15	15	15	10
Jamaica	15	15	15	10/12.5[17]
Japan	15	5	10	10
Jordan	15	10	10	10
Kazakhstan	15	5	10	10
Kenya	25	15	15	15
Korea (Rep.)	15	5	10	10
Kuwait	15	5	10	10
Kyrgyzstan	15	15	15	0/10
Latvia	15	5	10	10
Lithuania	15	5	10	10
Luxembourg[18]	15	5	0/10	0/10
Malaysia	15	15	15	15
Malta	15	15	15	0/10

	Dividends		Interest[1] (%)	Royalties (%)
	Individuals, companies (%)	Qualifying companies[2] (%)		
Mexico	15	5	0/10	0/10
Moldova	15	5	0/10	10
Mongolia	15	5	10	5/10
Morocco	15	15	0/15	5/10
Netherlands	15	5	0/10	0/10
New Zealand	15	15	15	15
Nigeria	15	12.5	12.5	12.5
Norway	15	5	0/10	10
Oman	15	5	0/10	0/10
Pakistan	15	15	0/15	0/15
Papua New Guinea	15	15	10	10
Peru	15	10	15	15
Philippines	15	15	0/15	10
Poland[2]	5	15	10	5/10
Portugal	15	10	10	10
Romania	15	5	10	5/10
Russia	15	10	10	0/10
Senegal	15	15	15	15
Serbia[3]	15	5	10	10
Singapore	15	15	15	15
Slovak Republic	15	5	10	0/10
Slovenia	15	5	0/10	10
South Africa	15	5	0/10	6/10
Spain	15	15	15	0/10
Sri Lanka	15	15	0/15	0/10
Sweden	15	5	0/10	0/10
Switzerland	15	5	0/10	0/10
Tanzania	25	20[19]	0/15	20
Thailand	15	15	15	0/15
Trinidad and Tobago	15	5	0/10	0/10
Tunisia	15	15	15	0/15/20[20]
Turkey	20	15	0/15	10
Ukraine	15	5[21]	0/10	0/10[22]
United Arab Emirates	15	5	10	0/10
United Kingdom	15	5	0/10	0/10

	Dividends		Interest[1] (%)	Royalties (%)
	Individuals, companies (%)	Qualifying companies[2] (%)		
United States	15	5	10[23]	0/10
Uzbekistan	15	5	10	5/10
Venezuela	15	10	10	5/10
Vietnam	15	5/10[24]	10	7.5/10[25]
Zambia	15	15	15	15
Zimbabwe	15	10	0/15	10

Notes:

1. Many treaties provide for an exemption or special rate for certain types of interest, e.g. interest paid to the state, local authorities, the central bank, export development institutions or in relation to sales on credit. These are not indicated in the column.
2. Unless indicated otherwise, the lower rate applies if the recipient company owns at least 25 percent of the capital or the voting power of the paying company, as the case may be. Special conditions may apply.
3. The lower rate applies to patents (excluding rental and franchise agreements) and computer software.
4. The lower rate applies, inter alia, to interest paid by a public body.
5. The 3 percent rate applies to news; the 10 percent rate applies to patents, trademarks, etc., to equipment leasing, to know-how and to technical assistance.
6. The lower rate applies if the recipient company owns at least 10 percent of the capital or the voting power of the paying company, as the case may be. Special conditions may apply.
7. The lower rate applies, inter alia, to interest paid to pension funds, etc.
8. The lower rate applies to copyright royalties (excluding films), computer software, patents and know-how.
9. The lower rate applies to computer software, patents and know-how.
10. This rate applies (these rates apply) only if the payment is taxable in the other country; otherwise, the domestic rate applies.
11. The lower rate applies to copyright royalties, excluding films, etc.
12. The domestic rate applies; there is no reduction under the treaty.
13. This rate applies if the recipient is a company. For individuals, the domestic rate applies; there is no reduction under the treaty.
14. The given rates apply if the recipient is a company; the 25 percent rate applies to trademarks. For individuals, the domestic rate applies; there is no reduction under the treaty.
15. The lower rate applies if the recipient company owns at least 10 percent of the voting power or 25 percent of the capital of the paying company.
16. The lower rate applies to equipment leasing.
17. The higher rate applies to management fees and rentals of movable property. Both rates apply only if the payment is taxable in the other country.
18. The treaty does not apply to income paid to exempt Luxembourg holding companies.
19. The lower rate applies if the recipient company owns at least 15 percent of the voting power of the paying company.
20. The zero rate applies to copyright royalties, excluding films, etc. The 20 percent rate applies to patents, trademarks and equipment leasing.
21. The lower rate applies if the recipient company owns at least 20 percent of the capital of the paying company.
22. The lower rate applies to computer software.
23. The 0 percent withholding tax rate on interest applies to arm's length lenders and is subject to certain exceptions. Withholding tax on interest payments from Canada to non-arm's length US lenders was phased out over a 3-year period. The rate was reduced from 10 percent to 7 percent as of 1 January 2008 and to 4 percent as of 1 January 2009. It was completely eliminated as of 2010.
24. The 5 percent rate applies if the recipient company owns at least 70 percent of the voting power of the paying company; the 10 percent rate applies if it owns at least 25 percent but less than 70 percent of the voting power.
25. The lower rate applies to fees for technical services.

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Designed by Evalueserve.

Publication name: Canada – Taxation of Cross-Border Mergers and Acquisitions

Publication number: 131036

Publication date: May 2014