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Surviving North of the Border: Structuring a Statutory Merger in Canada to Qualify as A U.S. Tax-Free Reorganization

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In Canada, a corporate amalgamation (i.e., an amalgamation of ownership arrangements that are corporations for Canadian corporate law purposes) is generally viewed as involving the amalgamating corporations “continuing” in the amalgamated corporation (i.e., in the corporation existing after the amalgamation). In contrast, U.S. corporate and tax law governing corporate mergers may be based on one of the corporations surviving and absorbing the assets and liabilities of the other merging corporations whose legal existence ceases. (It should be noted that a “corporation” for U.S. tax purposes is not necessarily a “corporation” for U.S. corporate law purposes due to the concept of a “disregarded entity” for U.S. tax purposes.¹ This article will assume that the ownership arrangements involved in the restructurings considered

here are corporations for Canadian corporate and tax law purposes and also for U.S. corporate and tax law purposes.) Where U.S. persons hold shares of Canadian corporations, an amalgamation may have to conform to U.S. tax principles for reorganizations, depending on the desired tax result in the United States. This structuring, however, may raise tax issues in Canada. The Canada Revenue Agency (CRA) has reviewed such mergers in two rulings. In the most recent ruling, CRA reviewed an amalgamation of Canadian corporations which was structured so that one of the corporations survived in order that the reorganization qualified as a reverse subsidiary merger for U.S. tax purposes. The CRA confirmed not only that such a U.S.-style merger could be completed on a tax-deferred basis in Canada under the *Income Tax Act* (Canada) (“the Act”),² but also that the surviving subsidiary was entitled to obtain a “bump” in the assets, which would otherwise be available to the “parent.”

MERGERS UNDER CANADIAN AND U.S. CORPORATE STATUTES

In general, amalgamations under Canadian federal and provincial business corporations legislation are based on each of the amalgamating corporations continuing in the amalgamated corporation.³ The corporate legislation in Ontario is typical. Section 179 of the *Business Corporations Act* (Ontario) (“the

² R.S.C. 1985 c.1 (5th Supplement), as amended.

³ Corporations formed under legislation not modeled on Canada’s business corporations statutes may not be based on the continuation of the amalgamating corporations.

¹ See Regs. §301.7701-2(a).

OBCA”),⁴ for instance, provides that where an amalgamation of Ontario corporations becomes effective, “the amalgamating corporations are amalgamated and continue as one corporation. . .,” “the amalgamating corporations cease to exist as entities separate from the amalgamated corporation. . .” and the amalgamated corporation possesses all of the property and is subject to all of the liabilities of each of the amalgamating corporations. In the view of one court, the result of such provisions is that no “new” corporation is created nor are the amalgamating corporations extinguished.⁵ This is often explained by analogy to two streams flowing into a single river.⁶ This applies to both vertical and horizontal amalgamations. The corporate legislation itself is silent on whether an amalgamation results in a “new” corporation. The Act deems the corporation to be a “new” corporation, at least for certain tax purposes. Case law is mixed.

In contrast, U.S. state corporate law legislation (which originally was the basis for certain U.S. tax-free reorganizations) may be based on one of the merging corporations surviving and absorbing the assets and liabilities of the other corporations whose legal existence ceases. The Delaware corporate statute is illustrative. Under §251 of that legislation, two corporations may merge into a single corporation, “which may be one of the constituent corporations.”⁷ A transaction that is similar to a Canadian-style amalgamation is also available under Delaware law, where a consolidation rather than a merger is utilized. Unlike Canada, however, the Delaware Code refers to the remaining corporation as a “new” corporation. Other states have similar legislation. Modern Canadian corporate statutes, such as the federal and Ontario business corporations acts, do not distinguish between mergers and consolidations.

In the case of an amalgamation involving Canada and the United States, differences in the corporate law characterization of the transaction can raise issues as to whether it can qualify (or can be structured to qualify) for a particular tax treatment under the laws of each jurisdiction. Thus, where U.S. persons hold shares of Canadian corporations, the differences in the characterization of a “merger” under Canadian law may, in certain circumstances, require that a Canadian amalgamation be structured to conform to U.S. principles, depending on the desired tax treatment in the United States. Such structuring may in turn raise issues relating to the taxation of the transaction in

Canada. Similar issues also arise where Canadian residents own shares of U.S. corporations that merge under U.S. law, including whether such a merger qualifies for tax-free treatment as an amalgamation under §87(8.1) of the Act.⁸

This article will focus on issues arising from a Canadian amalgamation structured to meet U.S. tax requirements. U.S. and Canadian corporate law differences have, perhaps surprisingly, not been relevant in determining whether a Canadian amalgamation can qualify for tax-free treatment for U.S. shareholders as a statutory merger or consolidation under §368(a)(1)(A) of the Internal Revenue Code of 1986 (“the Code”). To a large extent, the Internal Revenue Service (IRS) has ignored the characterization of the merger process under foreign law in determining whether the transaction qualifies as a statutory merger under the Code. The two Canadian rulings considered here suggest that the CRA is taking a similar approach. Differences in characterization, however, can be relevant for other purposes of the Code.

TAX-FREE STATUTORY MERGERS IN THE UNITED STATES

In general, a transfer of corporate assets or shares in the United States may be tax-free at the corporate or shareholder level if the transaction meets the requirements for being a reorganization under Code §368 and the related regulations and judicial doctrines, and does not trigger gain under §354, 356, 357, or 361 based on the nature of the consideration received. Where any corporation involved in the reorganization is foreign, the requirements of §367 may also have to be met.

A merger under U.S. state law can generally qualify as a reorganization under Code §368(a)(1)(A) as a “statutory merger.” Regs. §1.368-2(b)(1)(ii) generally defines a “statutory merger” as a transaction where, by operation of statute, all of the assets and liabilities (other than certain intercorporate assets and liabilities) of one (or more) merging entities (referred to in the regulations as the “transferor unit”) become the assets and liabilities of the other merging entity (or entities) (referred to as the “transferee unit”) and the separate legal existence of such transferor unit ceases. This definition of a statutory merger under the regulations largely conforms to the related U.S. corporate law characterization of a merger under state law.

Where the corporations involved are foreign with U.S. shareholders, whether the merger qualifies for

⁴ R.S.O. 1990, c. B.16, as amended.

⁵ *The Queen v. Guaranty Properties Limited et al.*, 90 D.T.C. 6363 (F.C.A.).

⁶ *The Queen v. Black and Decker Manufacturing Co.*, [1975] S.C.R. 411.

⁷ Delaware Code, Title 8, Chapter 1.

⁸ The CRA has confirmed in several published interpretations and rulings that a U.S. (or other foreign) absorptive merger qualifies as a “foreign amalgamation” for purposes of §87(8.1) of the Act. *See, e.g.*, Documents 9811305, 1999-0009805, 2002-0166673, and 2009-0330881R3.

tax-free treatment under the Code may be relevant for purposes of both shareholder level gain and, where the corporation is a controlled foreign corporation (CFC), attribution for purposes of “Subpart F.”⁹ The IRS’s position was, historically at least, that a merger under a foreign statute could not qualify as a tax-free reorganization in the United States, at least as a statutory merger.¹⁰ This appeared to apply regardless of whether there were any differences between foreign and U.S. corporate law. Thus, differences in the characterization of mergers under Canadian (or other foreign) and U.S. law appeared to be largely irrelevant, at least for purposes of Code §368(a)(1)(A), as any merger under a foreign statute could not qualify as a statutory merger. In these circumstances, a foreign merger would have had to qualify as an asset reorganization under §368 in order to defer tax in the United States. In practice, this could lead to some issues in structuring transactions given the stricter requirements of the other forms of reorganizations.

Since 2006, the §368 regulations have confirmed, including in both the Preamble and the related examples, that a merger under foreign law can qualify as a statutory merger under §368(a)(1)(A) provided the other requirements for such treatment are met.¹¹ This again appears to apply even if the characterization of the merger under foreign law for its own domestic purposes is different than that in the United States, e.g., where the legal existence of a merging corporation is considered to cease for U.S. tax purposes but foreign law considers the corporation to continue in the merged corporation.¹² The applicable regulation takes the position “that the fact that the existence of the consolidating or amalgamating entities continues in the resulting corporation under foreign law does not prevent a consolidation or an amalgamation from qualifying as a statutory merger or consolidation.”¹³ Thus, a foreign merger should not be disqualified from being a “statutory merger” within the meaning of Regs. §1.368-2(b)(1)(ii) simply on the basis that it is completed pursuant to a foreign statute and there are differences in the characterization of the merger under that statute and U.S. corporate law.

While differences between the characterization of mergers under Canadian and U.S. law do not appear to be relevant to the issue of whether a Canadian merger can qualify as a statutory merger under Code §368(a)(1)(A), such differences can be relevant for other U.S. tax purposes, whether under §368 or otherwise. For example, the ability to identify a survivor in

a transaction will generally determine the party that is acquiring or being acquired, which may be relevant for different purposes under the Code. The two rulings provide different examples of where the existence and identity of the survivor was relevant. While Canada’s corporate statutes do not provide for a survivor in a corporate amalgamation, it may be possible, in certain cases, to achieve a similar result through a court-ordered plan or arrangement where required. The CRA’s views on the treatment of a Canadian amalgamation structured with a survivor are generally set out in a pair of rulings. The first ruling to deal with the issue involved an amalgamation structured to have the parent treated as the survivor to avoid certain adverse U.S. tax consequences. In a more recent ruling, the CRA reviewed the Canadian taxation of an amalgamation where the subsidiary survived in order for the amalgamation to qualify as a reverse subsidiary merger under §368(a)(1)(A) and (a)(2)(E).

THE SURVIVOR RULINGS

The Parent Ruling

A plan or arrangement with a survivor in a Canadian merger appears to have been first reviewed by the CRA in Document 2006-0178571R3 (the Parent Ruling). The Parent Ruling dealt with a pre-sale reorganization to consolidate losses within a corporate group for use prior to an acquisition of control of Parent. In simplified terms, Parent held shares in various subsidiaries with loss carryovers that, either directly or indirectly, owned real property, including real property located in the United States. In order to consolidate losses for Canadian tax purposes, Parent and some of its subsidiaries were amalgamated. The amalgamation was completed under a plan. Under the terms of the plan, Parent and its subsidiaries were merged with the same effect as if amalgamated under the applicable statutory provisions except that the separate legal existence of the Parent did not cease and it survived the merger.¹⁴ The taxpayer indicated that the survivor order was required in order to avoid adverse U.S. tax consequences relating to FIRPTA. No details were provided on the specific issue involved. Though all of the facts relating to the transactions were not published, the U.S. tax issue may have been whether a “new” corporation was created on the

⁹ Code §§951–965.

¹⁰ See REG-117969-00, 2005-7 I.R.B. 533.

¹¹ See Regs. §1.368-2(b)(1)(iii), *Exs. 13 and 14*.

¹² T.D. 9242, 2006-7 I.R.B. 422.

¹³ *Id.*

¹⁴ Under the terms of the plan, the separate legal existence of the subsidiaries would cease on the amalgamation and would continue into the parent, as survivor. The same wording was used in the plan dealt with in the Subsidiary Ruling, except that the survivor was the subsidiary. On its face, this appears to also fall within the wording of the definition of “merger” under the Treasury Regulations.

amalgamation for U.S. tax purposes which could result in the FIRPTA rules' denying the application of the Code's nonrecognition provisions.¹⁵

The Subsidiary Ruling

Document 2010-0355941R3 (the Subsidiary Ruling) dealt with a fairly common structure for acquiring shares of a public corporation. In simplified terms, the plan involved purchaser P acquiring shares of target T from the public for consideration that initially included P shares. The T shares would then be transferred to S, a newly formed wholly owned subsidiary of P, and S and T would then amalgamate. P, S, and T were all taxable Canadian corporations. The actual transactions were more complex. For U.S. tax purposes, the transaction was structured to qualify as a reverse subsidiary merger under §368(a)(1)(A) and (a)(2)(E) to defer tax for T's U.S. shareholders to the extent of the share consideration received.

To qualify as a reverse subsidiary merger, T would have to "survive" the amalgamation. This result was achieved by having the transactions effected by way of a plan. The plan included the provision that S and T merged to form Amalco in accordance with the applicable corporate law "except that the separate legal existence of [T] did not cease and [T] survived the merger." As a result of the merger, P acquired a share of T/Amalco in exchange for its S shares and the shares of S and T were cancelled. The separate legal existence of S ceased without S's being liquidated or wound-up (as required under §87(1)) and the property of S became the property of T. It does not appear that the plan referred to T's assets, though they presumably continued under T/Amalco's ownership. Because the transaction was changed to an all cash deal, the U.S. shareholders became fully taxable in the United States on the gain on their T shares and the survival of T no longer served a U.S. tax purpose. The provision for T's survival, however, remained as part of the plan.

QUALIFYING AMALGAMATION

In the Parent Ruling, the taxpayer requested a ruling that a U.S.-style merger where one of the corporations survived qualified as an amalgamation under §87 of the Act. The taxpayer in the Subsidiary Ruling asked for a more limited ruling, focusing only on whether the merger satisfied the requirements for the "bump" under §87(11). In both cases, however, the CRA had to address the basic issue of whether a U.S.-style merger was a qualifying amalgamation for Canadian tax purposes.

¹⁵ Code §897(d) and (e).

In general, §87 of the Act provides a deferral of tax at the corporate and shareholder levels for certain qualifying amalgamations and the flow-through of specific tax attributes to the Amalco. Section 87(1) of the Act defines an "amalgamation" for purposes of §87 of the Act as a merger of taxable Canadian corporations to form a corporation (referred to in the provision as a "new" corporation) in such manner that all of the assets and liabilities (other than certain intercorporate amounts) become the assets and liabilities of the amalgamated "new" corporation by virtue of the merger and all of the shareholders of the amalgamating corporations receive shares of the amalgamated "new" corporation by virtue of the merger, otherwise than as a result of purchase of property or as a result of a distribution of property on the winding-up of the corporation. There is no requirement, however, that the amalgamated corporation be a "new" corporation under corporate law. The provision applies to both vertical and horizontal amalgamations. In the case of a vertical amalgamation, §87(1.1) deems the shares of the predecessor parent corporation to be shares of the "new" corporation received on the amalgamation. On its face, a merger that produces a survivor involves largely issues of form rather than substantive policy. As such, the main issue arising from such a merger is whether the transaction can fall within the formal requirements of §87(1) that all of the assets and liabilities of the amalgamating corporations "become" the assets and liabilities of the amalgamated corporation where a corporation survives the merger, because its assets and liabilities, notionally at least, remain those of the survivor.¹⁶

The CRA position in the Parent Ruling was that §87(1) of the Act applied to the U.S.-style merger that resulted in a survivor. While no analysis was provided, the CRA's position appears to be based on the view that the reference in §87(2)(a) to "new corporation" referred to the amalgamated corporation, whether it was a continuation of the amalgamating corporations or, in the case of the ruling, a survivor. This is, perhaps, more explicitly stated in the Subsidiary Ruling which includes a specific reference to that provision. Under §87(2)(a), the corporation formed on the merger is ". . .deemed to be a new corporation, the first taxation year is deemed to have commenced at the time of the amalgamation. . ." and deems the taxation year of the predecessor corporations to end im-

¹⁶ Section 87(1) of the Act also includes the requirement that the assets and liabilities of the amalgamating corporation not become the assets and liabilities of the amalgamated corporation as a result of a purchase or on a distribution on a winding-up. This formal requirement was dealt with specifically in the plan where the court order specified that there was no winding-up or liquidation.

mediately before that time. While there has at least been an issue over whether that provision deemed the amalgamated corporation to be a “new” corporation only for purposes of determining taxation years or for all or some other tax purposes, recent case law, such as *CGU Holdings Canada Ltd. v. The Queen*,¹⁷ appears to take the broad interpretation that the provision applies for all purposes of the Act. The Parent Ruling suggests that CRA is also taking a broad interpretation of the provision.

Under this approach, §87(2)(a) deems a “new” corporation to exist for at least some Canadian tax purposes, regardless of its status under corporate law. Based on the tax fiction that there is a “new” corporation, all of the assets and liabilities of the predecessor corporation can be said to have “become” the assets of the “new” corporation for tax purposes even if, for non-tax purposes, each corporation arguably continues into the merged corporation and accordingly continues to own or be liable for its assets and liabilities throughout. Based on the Parent Ruling, this fiction would seem to apply equally where one of the corporations survives and continues to own its assets. The survivor would be deemed to be a “new” corporation and all of its assets and liabilities would be considered to have become the assets and liabilities of such new corporation as required under §87(1), even if, in the case of the survivor’s assets and liabilities, they remained under the survivor’s continued ownership throughout.

Though this approach would appear to apply regardless of the identity of the survivor, the Parent Ruling left unclear whether the same analysis applied where the survivor in a vertical amalgamation was the subsidiary or to a horizontal amalgamation. In the Parent Ruling, the ruling referred to documents filed with the court in support of the plan which included a factum from the Director under the Canada Business Corporations Act (CBCA), the governing statute, that confirmed that the taxpayers had represented that the proposed merger where the parent was the survivor was similar in effect to a vertical short form amalgamation under the CBCA. The Director also submitted that the proposed merger was similar to a parent-subsubsidiary merger under U.S. statutes and that this type of merger was the basis for the short form amalgamation provisions in the CBCA. It is unclear, however, how much the CRA drew comfort from these comments in issuing the Parent Ruling.

The Subsidiary Ruling appears to confirm that, in the case of a vertical amalgamation, the same result applied regardless of whether the survivor was the parent or subsidiary. In the case of the Subsidiary Rul-

ing, the CRA ruled that a merger where the subsidiary survived qualified as an amalgamation under §87(1) for purposes of §87(11)(b) of the Act. This appears to be a reasonable result as there is nothing in the §87(2)(a) analysis that would be limited to cases where the parent is the survivor. Both of these results also appear consistent with the CRA’s general position that an absorptive merger of U.S. corporations is a “foreign merger” under the Act.

ELIGIBILITY FOR THE “BUMP”

The taxpayer in the Subsidiary Ruling only requested a ruling relating to the “bump.” In general, §88(1)(c) permits a parent to acquire capital property, other than certain ineligible property, on the winding-up of a 90%-or-more-owned subsidiary and “bump” up the adjusted cost basis of one or more such properties, within certain limits and subject to certain anti-avoidance rules. The provision is intended to permit a parent, subject to certain limits, to step up the tax cost of the assets of a subsidiary to the extent that outside basis exceeds inside basis to reflect the purchase price paid by an arm’s-length purchaser for the subsidiary’s shares by winding up the subsidiary. The result is similar to a §338 election under the Code, but without the corporate-level tax and generally limited to capital properties such as land, shares, or partnership interests.¹⁸ The same “bump” is also available on a vertical amalgamation of a parent and a wholly owned subsidiary. In those circumstances, §87(11)(b) permits a “bump” of the cost to the “new corporation of each capital property of the subsidiary *acquired* on the amalgamation [which] is deemed to be the amount that would have been the cost to the parent if the property had been distributed by the subsidiary to the parent on a winding up of the subsidiary. . .” to which §88(1) applied.

In the case where the amalgamation results in a survivor, the issue under §87(11)(b) is whether a “new” corporation “acquired” property of the subsidiary on the amalgamation. In the Subsidiary Ruling, the CRA accepted that the “bump” applied to step up the tax cost of the subsidiary’s assets. Again, no analysis was provided, other than the reference to §87(2)(a) of the Act. In the case where the subsidiary was the survivor, there was no real argument that it actually “acquired” its own property on the amalgamation. If one accepts the view, which appears to underlie the CRA’s position in both rulings, that any corporation resulting

¹⁷ 2009 DTC 5044 (F.C.A.).

¹⁸ A §338 election can also be made with respect to a qualified stock purchase of a Canadian (or other) foreign corporation to step up the basis of its assets for U.S. tax purposes (but without a corporate-level tax unless it was a CFC), though some of the benefits of such an election have now been restricted.

from an amalgamation under Canadian corporate law, including a survivor, is deemed for purposes of the Act to be a “new” corporation under §87(2)(a), then the same fiction that property “becomes” property of the new corporation could also apply to satisfy the requirement that property of the subsidiary was “acquired” by the parent, as the new corporation.

In the context of the “bump,” however, the fact that the subsidiary rather than the parent was the survivor in the Subsidiary Ruling may have raised other issues. In general, the “bump” regime in §88(1) of the Act applies to a subsidiary being wound up into its parent. The provisions include complex anti-avoidance rules to ensure that the “bump” is not available in inappropriate circumstances. These rules are then applied to an amalgamation, which presumably only contemplated Canadian-style amalgamations when drafted. While the presence of a survivor likely does not raise any policy concerns, the CRA would have had to be comfortable that no anomalies resulted from the fact that the subsidiary was the legal entity that survived the merger under complex rules that were drafted to apply to a winding-up or a vertical amalgamation, without a survivor. The Subsidiary Ruling appears to confirm that such anomalies were not a concern, at least based on the facts of that ruling.

Though the Parent Ruling did not address the issue of the “bump” where the survivor was the parent, the same analysis should apply and would arguably be

more straightforward. If anything, if the parent was legally the survivor, the merger could arguably meet the requirement of §87(11)(b) that the new corporation “acquired” property of the subsidiary on the amalgamation without any fiction. Based on the terms of the plan, the parent could be said to have “acquired” the subsidiary’s property as the parent, as survivor, held such property after the amalgamation and the separate legal existence of the subsidiary ceased. As well, because the parent-as-survivor structure is similar to a winding-up to which the “bump” rules were to apply, there would appear to be fewer concerns over anomalies.

CONCLUSION

U.S. and Canadian corporate law take different approaches in characterizing a merger for legal purposes. Depending on the statute, a U.S.-style merger can produce a survivor. Where U.S. persons hold shares of Canadian corporations, such differences may be relevant when structuring a cross-border reorganization in order to obtain a desired tax result in the United States. Where Canadian amalgamations are structured with a survivor to obtain a desired U.S. tax result, the CRA has generally taken the position that such transactions can qualify for tax-free treatment in Canada under §87 of the Act.