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Vertical Short-Form Amalgamations: Consequences to the Non-Resident Shareholder

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In a recently issued Technical Interpretation, the Canada Customs and Revenue Agency (the "CCRA") indicated that, for the purposes of the *Income Tax Act* (Canada) (the "Act"),

Footnote

Unless otherwise noted, all statutory references herein are to the corresponding provisions of the Act.

the shareholders of a parent corporation ("Holdco") are considered to dispose of their Holdco shares when Holdco amalgamates with one or more of its wholly-owned subsidiaries ("Subco") in a vertical short-form amalgamation. This is so notwithstanding that no shares of the new amalgamated corporation ("Amalco") are issued and that the economic position of the shareholders of Holdco remain unchanged as a result of the amalgamation.

Footnote

CCRA Document 2001-0104355, *Disposition of Shares — Vertical Short-Form Amalgamation — Section 248(1)* (November 1, 2002).

Such a position may result in adverse tax consequences to non-resident shareholders of Holdco, where the Holdco shares constitute taxable Canadian property immediately prior to the amalgamation.

Vertical Short-Form Amalgamations from a Corporate Perspective

The corporate statutes of many Canadian jurisdictions permit the vertical "short-form" amalgamation of a Holdco with one or more Subcos. From a corporate perspective, such amalgamations are preferable to "long-form" amalgamations because, under the short-form procedure, Holdco and Subco need neither enter into an amalgamation agreement nor obtain shareholder approval for the amalgamation. These distinctions may be particularly beneficial where Holdco is a public corporation, as they avoid the usual notice requirements and save the cost of holding a shareholders' meeting.

For example, pursuant to subsection 184(1) of the *Canada Business Corporations Act* (the "CBCA"), all that is required for a short-form amalgamation to be effective from a corporate point of view is the approval of the amalgamation by a resolution of the directors of each of Holdco and Subco. Such resolutions must provide that:

- the shares of the Subco will be cancelled without any repayment of capital in respect thereof;

- the articles of amalgamation will be the same as the articles of Holdco;

• no securities will be issued by Amalco in connection with the amalgamation; and

• the stated capital of Amalco will be the same as the stated capital of Holdco.

Footnote

Similar provisions are contained in the corporate statutes of various provinces. See, for example, subsection 177(1) of the *Business Corporations Act* (Ontario) and subsection 184(1) of the *Alberta Business Corporations Act*. Note, however, that the *Company Act* (British Columbia) does not contain a short-form amalgamation procedure.

From a corporate perspective, approval of the shareholders of Holdco is considered unnecessary because the amalgamation of Holdco and Subco does not change the economic position of the shareholders of Holdco. As stated by one commentator, the amalgamation is viewed as a mere matter of "internal housekeeping".

Footnote

Alan M. Schwartz, "Statutory Amalgamations, Arrangements, and Continuations: Tax and Corporate Law Considerations," in *Report of Proceedings of the Forty-Third Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 9:1-77.

"Disposition" under the Act

Section 87 of the Act contains specific rules dealing with the tax consequences of qualifying amalgamations. Pursuant to paragraph 87(1)(*c*), one of the conditions for the applicability of section 87 is that all the shareholders (except any predecessor corporation) of the predecessor corporations immediately before the amalgamation, receive shares of the new corporation by virtue of the merger. The difficulty in respect of vertical short-form amalgamations is that, under corporate law, Amalco does not issue any shares in the course of the amalgamation. This technical difficulty is addressed by subsection 87(1.1) which, for the purposes of paragraph 87(1)(*c*), deems any shares of a predecessor corporation that were not cancelled on the amalgamation (*i.e.*, the shares of Holdco) to be shares of Amalco received by the shareholder by virtue of the merger. Accordingly, vertical short-form amalgamations will generally satisfy the requirements for the application of section 87.

However, subsection 87(1.1) only applies for purposes of paragraph 87(1)(*c*) and does not otherwise deem a shareholder to have received new shares or to have disposed of old shares. Consequently, in determining whether there has been a "disposition" of the shares of Holdco as a result of the vertical short-form amalgamation, reference must be made to the following definition of the term "disposition" set out in subparagraph 248(1)(*b*)(iii):

"disposition" of any property, except as expressly otherwise provided, includes ...

any transaction or event by which, ... where the property is a share, the share is converted because of an amalgamation or merger, ...

Notably, subparagraph 184(1)(*b*)(iii) of the CBCA, and its corresponding provincial equivalents, provide that in a vertical short-form amalgamation, no securities are to be issued by Amalco. The provision does not specifically provide for a conversion of the shares of Holdco into those of Amalco. In particular, the language in subparagraph 184(1)(*b*)(iii) of the CBCA should be contrasted with the language in paragraph 182(1)(*c*) of the CBCA. The latter provision, which deals with vertical long-form amalgamations, expressly provides that the amalgamation agreement must set out "the manner in which the shares of each amalgamating corporation are to be *converted* into shares or other securities of the amalgamated corporation". At corporate law then, the shareholders of Holdco should be considered to hold the same shares after the vertical short-form amalgamation, as they did immediately before the amalgamation. It would seem to follow therefore that Holdco's shares remain outstanding, rather than converted into shares of Amalco.

Notwithstanding this corporate law position, the CCRA, in the Technical Interpretation referred to above, has espoused the following view:

Since the shareholders of the parent corporation become shareholders of Amalco as a matter of law, and Amalco is not the same entity as the [parent] corporation, we are of the view that the shares of the parent are converted into shares of Amalco because of the short-form vertical amalgamation for the purposes of subparagraph (*b*)(iii) of the definition of "disposition" in subsection 248(1). 

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See also CCRA Document 9214585, *Shares of Predecessor Corporation* (August 25, 1992) and CCRA Document 9226095, *Adjusted Cost Base of Shares* (September 23, 1992), both of which take the same position with respect to the definition of "disposition" formerly contained in clause 54(*c*)(ii)(C) of the Act.

This position is debatable, however, given that, absent a special deeming provision in the Act, the effect of any amalgamation on the shares of the amalgamating corporations should depend upon the governing corporate law. 

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The CCRA seems to have acknowledged this in other contexts. For example, in *Income Tax News*, 96 ITC 169, *Vertical Short-Form Amalgamations*, the CCRA states that whatever attributes the shares of Holdco had prior to the amalgamation remain the same after the amalgamation. Similarly, in CCRA Document December 1991-223, *Effects of Vertical Short-Form Amalgamation on the Application of the 24-month Holding Period Requirement in the Definition of "Qualified Small Business Corporation Share"* (December 1991), the CCRA stated that, for the purposes of paragraph (*b*) of the definition of "qualified small business corporation share" in subsection 110.6(1) of the Act: "... where a particular person is the only owner of a share of a predecessor corporation for a specified period immediately prior to a short-form amalgamation, and the share remains outstanding and owned by the particular person after the amalgamation, the particular person will be considered to have owned the share of the amalgamated corporation for the specified period and the period of time the share was

held after the amalgamation."

Nevertheless, given the CCRA's view that, upon a vertical short-form amalgamation, the shareholders of Holdco will be considered to have disposed of their shares, it would be prudent to take whatever steps possible to minimize the potential adverse tax consequences which might otherwise flow from the CCRA's position.

Adverse Tax Consequences

The potential adverse tax consequences that could result to a non-resident shareholder of Holdco as a result of the CCRA's administrative position can be illustrated by the following example:

• Holdco is a public corporation with its shares listed on a prescribed stock exchange.

• Holdco's shares derive their value principally from real property located in Canada.

• In year 1, Shareholder A, a non-resident of Canada, acquires greater than 25% of the shares of Holdco, which are held as capital property.

• In year 3, Shareholder A disposes of 5% of the shares in Holdco, retaining ownership of 20% of the shares of Holdco.

• In year 4, Holdco and Subco merge by way of a vertical short-form amalgamation to form Amalco.

• In year 10, Shareholder A disposes of the shares in Amalco.

According to the CCRA, Shareholder A will be considered to have disposed of his shares in Holdco at the time of the amalgamation (*i.e.*, in year 4), and to have acquired shares of Amalco at that time. Paragraph (*f*) of the definition of "taxable Canadian property" in subsection 248(1) provides that any share that is listed on a prescribed stock exchange will constitute taxable Canadian property only if the non-resident taxpayer, along with persons with whom the taxpayer did not deal at arm's length, owned 25% or more of the shares of the corporation at any time during the 60-month period immediately preceding the disposition. Thus, as at the time of the amalgamation, the Holdco shares will constitute taxable Canadian property to Shareholder A (*i.e.*, in year 1, which falls within the 60-month period, Shareholder A owned 25% of the Holdco shares) and Shareholder A will accordingly be considered to have disposed of such taxable Canadian property which, in turn, could subject Shareholder A to Canadian tax pursuant to the provisions of paragraph 115(1)(*b*). Under paragraph 87(4)(*a*), however, that disposition will be deemed to occur for proceeds of disposition equal to Shareholder A's adjusted cost base of the Holdco shares immediately before the amalgamation and thus should not result in either a capital gain or capital loss. As well, under paragraph 116(6)(*b*), no section 116 certificate will be required in respect of the disposition, as listed shares are "excluded property". 🖼

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In any event, it is the CCRA's administrative position, as stated in Interpretation Bulletin IT-474R, *Amalgamations of Canadian Corporations* (March 14, 1986), paragraph 50, that a non-resident holder of shares of a predecessor corporation which constitute taxable Canadian property need not comply with the procedures set out in section 116 in respect of the deemed disposition of the old shares on amalgamation to which section 87 is applicable.

More fundamental, however, is subsection 87(4) which deems any "new shares" acquired on the amalgamation in exchange for "old shares" that were taxable Canadian property to be taxable Canadian property. Accordingly, because the Holdco shares were taxable Canadian property to Shareholder A, the Amalco shares will also be taxable Canadian property to Shareholder A. The fact that such will be the result even if the non-resident shareholder, together with persons with whom he does not deal at arm's length, has not, in the 60-month period immediately preceding the sale, owned 25% of the shares of Amalco, could lead to a potentially harsh result

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Conversely, if the Holdco shares were not listed at the time of the amalgamation and thus constituted taxable Canadian property pursuant to paragraph (*d*) of the definition of "taxable Canadian property" in subsection 248(1), the "new" Amalco shares would be deemed to be taxable Canadian property. Such characteriation will remain even if the Amalco shares subsequently become listed on a prescribed stock exchange and the non-resident shareholder and non-arm's length parties owned, at all times, less than 25% of such shares.

— that is, when Shareholder A subsequently disposes of the Amalco shares in year 10, Shareholder A will be considered to have disposed of taxable Canadian property, notwithstanding that, absent the deeming rule in subsection 87(4), such shares would not otherwise constitute taxable Canadian property. Thus, Shareholder A would be liable to Canadian tax on the accrued capital gain.

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On this point, the exemption from Canadian tax on capital gains provided for in Canada's network of tax treaties (for example, in Article XIII of the Treaty and Article 13 of the *Canada-U.K. Income Tax Convention*) will not apply, as the Holdco shares derive their value principally (*i.e.*, greater than 50%) from real property situated in Canada.

The foregoing result should be contrasted with that which arises if one does not follow the CCRA's administrative position — *i.e.*, if the Holdco shares are not viewed as having been disposed of on the amalgamation. In such circumstances, Shareholder A's shares in Amalco will be considered to be the same shares as the Holdco shares, and the Amalco shares will not be considered to be taxable Canadian property at the time of their sale in year 10 because Shareholder A will not have owned 25% of the Amalco shares at any time in the 60-month period immediately preceding their sale.

Another adverse tax result that may potentially arise from the CCRA's position applies where Shareholder A is a resident of the United States and has owned the Holdco shares from a time preceding September 26, 1980. Pursuant to Article XIII(9) of the *Canada-U.S. Tax Convention*

1980 (the "Treaty"), where a U.S. resident alienates a capital asset situated in Canada and that asset was owned by that U.S. resident taxpayer from September 26, 1980 until the time of disposition, the portion of the gain that accrued before January 1, 1985 will not be subject to Canadian tax, provided that certain conditions are met.

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This transitional rule arises from the fact that, under Article VIII of the 1942 *Canada-U.S. Income Tax Convention*, gains from the sale or exchange of capital assets were exempt from taxation in the state of source provided the alienator had no permanent establishment in that state.

In the example above, however, because Shareholder A will be considered to have acquired the Amalco shares in year 4 (*i.e.*, at the time of the vertical short-form amalgamation), the relief provided by Article XIII(9) of the Treaty will not be available.

Adverse tax consequences also result where the non-resident shareholder does not own the Holdco shares as capital property, but rather as inventory in a business carried on in Canada. In such a situation, the Holdco shares will constitute "taxable Canadian property" pursuant to paragraph (*b*) of the definition of that term in subsection 248(1). In accordance with the CCRA's view, the non-resident shareholder will be considered to have disposed of its Holdco shares at the time of the vertical short-form amalgamation but, because the Holdco shares will not be considered capital property to the shareholder, the rollover provisions of paragraph 87(4)(*a*) (*i.e.*, disposition of the Holdco shares deemed to be at adjusted cost base) will not be available. Accordingly, the disposition of the Holdco shares will be considered to have occurred, pursuant to paragraph 69(1)(*b*), for proceeds equal to their fair market value. The business income derived from such disposition will then be subject to Canadian income tax under Part I of the Act, unless relief is available pursuant to the provisions of an income tax treaty.

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In this regard, Article VII of the Treaty provides that a U.S. resident will not be liable to Canadian tax on its business income except to the extent that the income is attributable to a permanent establishment in Canada.

Conclusion

Where there are non-residents involved and it is anticipated that one of the above problems may arise, it may, in some circumstances, be preferable to wind up Subco into Holdco pursuant to the provisions of subsection 88(1), rather than to have Subco and Holdco undergo a vertical short-form amalgamation. From a corporate and tax perspective, the results of these two types of reorganizations should be almost identical, but no disposition of the Holdco shares will be considered to have occurred for tax purposes.