# THE INVESTMENT FUNDS INSTITUTE OF CANADA

January 28, 1998

DELIVERED

The Honourable Paul Martin
Minister of Finance
L'Esplanade Laurier
140 O'Connor Street
Ottawa, Ontario
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Dear Mr. Martin:

**Tax-free U.S. Reorganizations**

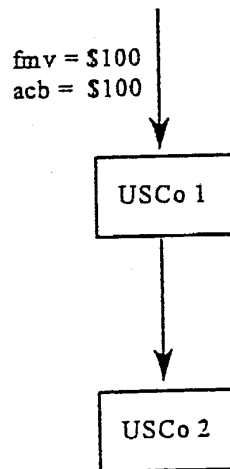
There are two types of U.S. reorganization transactions which IFIC members regularly encounter and which in our view produce unfair and inappropriate results to Canadian taxpayers. Accordingly, we are writing you this letter to request remedial changes to the *Income Tax Act* (Canada).

**U.S. Split-up Transactions**

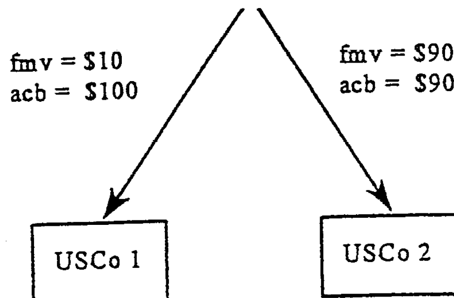
Under U.S. tax law, a parent corporation can be split-up into two or more successor corporations in specified circumstances on a basis that is exempt from U.S. taxation. The legal form of the transaction is a dividend-in-kind by the parent corporation of the shares of one or more of its subsidiaries. Over the years, there have been a number of examples of such transactions. One of the most high profile examples was the court ordered split-up of AT&T in 1984 which resulted in the creation of the various "Baby Bells". This split-up was very similar to the even more famous split-up of Standard Oil at the turn of the century.

The dividends paid in such transactions are completely tax-free to the U.S. shareholders and do not attract U.S. withholding tax. This is because the value of a shareholder's investment does not change, only its legal form. However, Canadian tax law fully taxes such dividends. In the case of individual shareholders and corporate shareholders, this means Canadian income tax is payable at the rates of approximately 50% and 45%, respectively. In our view, this is an unfair result. In addition, the resulting adjusted cost base distortion appears to us to be inappropriate from a tax policy point of view.

Consider the following example. Suppose that a Canadian individual has just purchased the shares of a U.S. company ("USCo 1") for $100 (the "Original Shares"). USCo owns all the shares of a subsidiary company ("USCO 2"). The diagram below illustrates these facts.




Suppose that there is a split-up transaction in which the Canadian individual receives a dividend-in-kind in the form of shares of USCo 2 having a fair market value of $90. Approximately $45 of tax will be payable by the Canadian individual on the dividend-in-kind (i.e., .50 x $90). The Original Shares will now have a value of only $10. However, the Canadian individual will continue to have a cost for such shares of $100. The diagram below illustrates this result.



Upon the subsequent disposition of the shares of USCo 1, the Canadian individual will generally realize a capital loss. However, capital losses can only be offset against capital gains. Thus, it will not be possible to use the capital loss from the subsequent disposition to reduce the $90 income inclusion from the receipt of the dividend-in-kind. Moreover, since only three-quarters of the capital loss from the subsequent disposition will be deductible, its tax refund value will be only $34.20 (i.e., .75 x .50 x $90). This contrasts to the tax liability in respect of the dividend-in-kind of $45. **Thus, even though the Canadian individual may not receive a single dollar of economic benefit from the split-up, there will always be a net tax cost to the Canadian individual of at least 12% of the amount of the dividend-in-kind (i.e., $10.80/$90.00 x 100) and sometimes as much as 50% of the amount of the dividend-in-kind if the Canadian individual does not have capital gains against which to offset the subsequent capital loss (i.e., $45.00/$90.00 x 100).** We do not believe that there is any tax policy rationale for this result.

In 1985, a remission order was granted to the Canadian shareholders of AT&T pursuant to section 17 of the *Financial Administration Act*. In very general terms, the shareholders were granted an exemption from the Canadian income tax that would otherwise have been payable by them and were required to allocate the tax cost of their AT&T shares immediately prior to the split-up to the various new shareholdings on a basis proportionate to the fair market value of such new shareholdings. In our view, this resulted in a fair and reasonable tax policy result. Subsequent to the AT&T remission order, others have applied for a similar treatment. Our understanding is that all such applications have been refused on the grounds that the subsequent split-ups were the result of voluntary decisions by the boards of directors of the affected corporations and not pursuant to a court order. With respect, we do not believe that this is a relevant distinction.

In almost all U.S. split-up transactions, the Canadian shareholders are a small minority with virtually no influence over the board of directors of the company that is being split-up. Thus, the board pays little or no attention to the tax consequences to the Canadian shareholders. As a result, the Canadian shareholders are required to pay Canadian income tax in a situation where the realization of capital gains is forced upon them. Moreover, after the split-up, the Canadian shareholders have an interest in exactly the same assets as before the split-up, subject to the qualification that it is in a different legal form. Thus, from an economic perspective, there is no realization of capital gains by the Canadian shareholders. Canadian taxation in such circumstances is inconsistent in our view with the fundamental principle that capital gains are generally only taxable when they are realized.

The situation of split-ups of public companies with small Canadian shareholders contrasts to the situation where there is a split-up of a foreign affiliate of a Canadian parent corporation. In the latter situation, it will often be possible to structure the split-up so that it occurs on a tax-free basis to the Canadian parent corporation. Thus, the lack of a rule which permits split-

ups to occur on a tax-free basis for small shareholders appears to us to be discriminatory in favour of large and wealthy Canadian investors.

We note that Canadian tax policy appears to be evolving in a direction where capital gains on cross border investments are recognized at the same time for both Canadian and U.S. tax purposes. This is reflected in paragraphs 7 and 8 of Article XIII of the Canada-U.S. Income Tax Convention (the "Treaty"). Paragraph 8 is particularly interesting in that it permits the Canadian tax authorities to defer the recognition of capital gains on U.S. securities in circumstances where U.S. tax law defers the recognition of capital gains. Of course, under the Treaty there is an outright exemption from U.S. taxation for capital gains realized upon the disposition of most U.S. securities. Thus, it is not normally necessary to resort to paragraph 8. However, the policy underlying paragraph 8 was presumably, in part, to ensure that Canadian investors are not placed in a competitive disadvantage relative to U.S. investors in investing in U.S. securities. In our view, this policy should be applied independently of whether the U.S. defers the taxation of the capital gains realized by Canadian investors or exempts the taxation of such gains.

We believe that the reporting practices in Canada in respect of U.S. split-up transactions are often inconsistent. Because the transaction is tax-free for U.S. purposes, Canadian shareholders often do not become aware that they have an income inclusion in respect of the transaction.

Having regard to the foregoing, we strongly urge you to introduce legislation at the earliest possible opportunity to remedy the unfairness encountered by Canadian shareholders. Should you wish, we would be pleased to assist your officials in drafting such legislation. We would also be pleased to discuss alternative approaches with them. It may also be that your officials identify avoidance concerns during the course of their analysis. If this occurs, we would be pleased to discuss with them how to best address such concerns.

<u>Triangular Amalgamations</u>

Where two taxable Canadian corporations amalgamate to form a single successor corporation, the amalgamation is tax-free to the Canadian shareholders under Canadian tax law. Similarly, where one taxable Canadian corporation amalgamates with a second taxable Canadian corporation and the Canadian shareholders of the first taxable Canadian corporation receive shares of the parent of the second taxable corporation, the amalgamation is tax-free to such shareholders under Canadian tax law. This second form of amalgamation is often referred to as a triangular or Delaware merger.

Where two foreign corporations amalgamate or merge, the transaction is generally tax-free to the Canadian shareholders by virtue of subsection 87(8) of the *Income Tax Act* (Canada). This provision was added to the Act in 1981. However, the Act has never been amended to

accommodate triangular mergers of foreign corporations. We have considered whether there is any policy reason for not accommodating such transactions and cannot think of any.

Triangular mergers are commonly used in the United States to implement the take-over of a target corporation. The bidder establishes a wholly-owned subsidiary. The bidder then offers to acquire the shares of the target corporation in exchange for its own shares and, on some occasions, cash. If the offer is acceptable to the shareholders of the target corporation, the transaction is completed by means of the merger of the target corporation with the newly incorporated subsidiary. Although this form of transaction is feasible in Canada, it is less common than in the United States.

Where there is a triangular merger of U.S. corporations, the Canadian shareholders will as before generally be unable to influence the form of the transaction and thus are likely to be innocent victims of U.S. tax law requirements.

Because the U.S. form of a triangular merger is substantially identical to the Canadian form of a triangular merger and because the Canadian form can be carried out on a tax-free basis to the Canadian shareholders, we believe that the Act should be amended so that the U.S. form of such transaction occurs on a tax-free basis to the Canadian shareholders.

Once again, we would be pleased to work with your officials in drafting legislation to accommodate triangular mergers of U.S. corporations, in discussing alternative forms of legislation with them and responding to any avoidance concerns that they may identify.

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This letter has discussed only U.S. reorganization transactions. Similar problems can obviously occur in reorganization transactions in other countries. We believe that the appropriate time to deal with other country reorganization transactions is when your officials have established a general framework for dealing with U.S. reorganization transactions.

Thank you very much for your consideration of the issues raised by our letter.

Yours sincerely,

Honourable Thomas A. Hockin
President and Chief Executive Officer
Investment Funds Institute of Canada