taxnotes® international

Volume 88, Number 5 ■ October 30, 2017

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Reprinted from *Tax Notes Int'l*, October 30, 2017, p. 467

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The *Univar* Appeal: A Pyrrhic Victory For Indirect Acquisitions in Canada

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In this article, the author reviews a recent decision by the Federal Court of Appeal of Canada reversing the tax court's ruling in *Univar* and also looks at related amendments to Canada's Income Tax Act, focusing his examination on the effect of surplus stripping rules and the general antiavoidance rule on foreign parties' recovery of funds invested in indirect acquisitions of Canadian targets.

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Last fall I examined two new interrelated obstacles to the recovery by foreign parties of funds invested to indirectly acquire Canadian targets by purchasing the shares of foreign corporations.[1] The first was the Tax Court of Canada (TCC) ruling in *Univar*,[2] a case involving a U.K. private equity group's takeover of the Dutch-based Univar group for approximately $2 billion and the acquirer's effort to extract $900 million from a Canadian subsidiary of Univar. The second obstacle was a legislation containing proposed amendments to the anti-surplus-stripping rule[3] (section 212.1 of the Income Tax Act)[4] at the heart of *Univar* litigation, an effort to statutorily eliminate the strategy Univar used to try to avoid Canadian tax on the $900 million extraction.

The October 2016 article in this journal discussed the TCC's rejection of Univar's strategy, which involved an exception to section 212.1, using Canada's general antiavoidance rule;[5] examined the questionable aspects of that decision; reviewed the (then-proposed) amendments to section 212.1; and raised concerns about the questionable tax policy choices underlying that proposal.

In this article, I briefly review the TCC's decision, examine the Federal Court of Appeal (FCA) ruling earlier this month[6] reversing the TCC's decision, and discuss why the 2016 amendments to section 212.1 (contained in the March 2016 budget) make the FCA's decision a pyrrhic victory for foreign entities looking to indirectly acquire Canadian targets in the future.

I. *Univar* at the Tax Court

A. The Univar Plan

In October 2007 a U.K. private equity group (purchaser) acquired Univar NV (NV), a publicly

[1] Nathan Boidman, "Judicial and Legislative Developments Threaten Indirect Canadian Acquisitions," *Tax Notes Int'l*, Oct. 10, 2016, p. 163.

[2] *Univar Holdco Canada ULC v. The Queen*, 2016 TCC 159. For ease of discussion, numbers are rounded and some facts are simplified. Dollars refers to Canadian currency unless otherwise noted. At the time of the transaction (October 2007), Canadian and U.S. dollars were of about equal value.

[3] Surplus strip (or surplus stripping) refers to transactions that effectively see retained earnings of a corporation distributed to, or realized by, shareholders using arrangements other than the simple declaration and payment of dividends when those arrangements are designed to reduce or avoid entirely the taxes that would arise if a straight dividend were paid.

[4] Section 212.1 of the Income Tax Act, Revised Statutes of Canada 1985 c.1 (5th Supplement), as amended, deems some payments to nonresidents to be dividends and subject to a 25 percent tax unless reduced by treaty.

[5] ITA section 245.

[6] *Univar Holdco Canada Inc. v. The Queen*, 2017 FCA 207.

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traded Dutch group, for about US $2 billion cash. NV owned a Canadian subsidiary (Univar Canada) through two U.S. subsidiaries (for these purposes, INC). Univar Canada was worth some $900 million with a paid-up capital (PUC) for tax purposes of just under $1 million.[7] This low PUC meant that if the shares of Univar Canada had been redeemed after the takeover for $900 million, there would have been a deemed dividend of $899 million.[8]

That would have also been the case under ITA section 212.1(1) if INC, the direct owner of Univar Canada, set up a Canadian holding company (hypothetically, Canco) and transferred Univar Canada to that holding company for a non-share payment of $900 million. That rule would treat any non-share payment exceeding the PUC of the shares transferred as a deemed dividend and would reduce the PUC of any shares issued by Canco to the excess of $1 million over any non-share consideration.

But there was another option. Because some acquisition structures[9] could have freed up the $900 million value of Univar Canada on a tax-free basis, the group could try to adopt, as a self-help measure, a plan to avoid section 212.1(1) using an exception — ITA section 212.1(4) — that applies when Canco controls INC at the point that INC transfers Univar Canada to Canco. This is what the parties did.

The direct shareholder of INC sold a portion of the shares of INC valued at $900 million (a majority of INC's shares) to a newly formed holding company (Univar Holdings Canada, or UHC) for a note of roughly $600 million and shares of $300 million. Next, INC (under UHC's control) sold the shares of Univar Canada to UHC in exchange for UHC giving up (to INC) its shares of INC. Then NV was in a position to extract $900 million from UHC (through the note debt and shares) if the plan was not struck down by the courts.

[7] PUC is defined in ITA section 89(1) as the legal capital, except as modified in specific circumstances.

[8] ITA section 84(3).

[9] See notes 10 and 11 and accompanying text for a discussion of these alternative structures.

B. The Tax Court's Ruling

The first transaction (the sale of the shares of INC, a nonresident corporation) did not trigger ITA section 212.1. Although the second transaction (the sale of the shares of Univar Canada) potentially triggered section 212.1(1), UHC's control of INC made section 212.1(4) applicable and that rule made section 212.1(1) inapplicable, unless the GAAR struck down the plan. A GAAR challenge occurred and was upheld, making section 212.1 applicable.

Canada's GAAR empowers the government to disallow a tax benefit (defined in section 245(1)) that otherwise would be granted by Canadian tax law or a tax treaty when the transaction (or series of transactions) was (or were) not undertaken primarily for bona fide purposes other than to obtain the tax benefit (termed an avoidance transaction by section 245(3)) unless, as provided for by section 245(4), the transaction does not misuse a provision of the ITA (or a tax treaty) or abuse the ITA or treaty read as a whole.

In *Univar*, the taxpayer admitted that there was a tax benefit and a tax avoidance transaction. Therefore, it all came down to section 245(4) — the issue of misuse and abuse.

The TCC concluded that the plan constituted misuse and abuse. Some points that the TCC relied upon were, with due respect, puzzling or doubtful. Briefly, the issues raised in the TCC opinion included the following:

- Whether it was relevant that there were two alternative transactions involving the use of a Canadian acquisition company (discussed at greater length in note 10 of the October 2016 article) that the taxpayer could have used to make the acquisition that would have provided access to the $900 million value of the Canadian subsidiary without Canadian tax. As reflected in paragraph 53 of the TCC's judgment, the taxpayer argued that "in the circumstances of this case, it was not practical to use a Canadian acquisition company and a different route was needed to obtain the same result."
- Whether the history of section 212.1(4) suggested it had a narrow scope that precluded the taxpayer's plan, whether that scope could be discerned from the government's comments accompanying the

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introduction of the 2016 amendments, and whether the amendments shed light on the purpose of the rule. A comment in paragraph 75 of the TCC judgment seems to imply that the wording of 212.1(4) as it stood at the time should be read to require that the owner of the transferee Canadian corporation be a resident of Canada. In so finding, did the TCC conflate the existing terms of the rule with the 2016 amendments? Notably, paragraphs 96 and 97 of the TCC's judgment suggest the court accepted the government's explanation that the amendments only clarified the rule (nearly 40 years after it was introduced!) and that it only applied when the transferee Canadian corporation acquired the nonresident corporation (that owns the Canadian target) in an arm's-length sale.

- Whether the taxpayer had abusively manipulated the control of INC. In paragraph 83, the court found the series of transactions fell outside the "narrow circumstances" in which 212.1(4) should operate.
- Whether a narrow ambit to subsection 4 could be discerned by comparing it with a domestic anti-surplus-stripping rule (ITA section 84.1) that, on its face, contains a wider exception.

A final important point about the tax court's approach, particularly as it relates to the then-proposed amendments to section 212.1(4) contained in the March 22, 2016, budget, can be best summarized by quoting from the October 2016 article (at page 167):

> Further, it was noted earlier that the government has the burden of showing the court that there are one or more policies underlying a provision (in this case section 212.1(4)) that the taxpayer has frustrated or defeated. It is therefore curious that nowhere in the judge's discussion of the March 22 budget does she frame her comments in terms of the government — that is, in terms of how the government argued the budget-related points — and nowhere does she refer to any taxpayer rebuttal. That leads one to wonder whether it was the judge rather than either of the litigants who raised the budget issue. If the government did not raise it, then it is difficult to see how the government can be said to have discharged its burden to the extent that the budget weighed heavily in the judge's decision on this point.

Ultimately, the TCC found that the transactions violated the GAAR and thus the tax authority could deny the requested tax benefits. Did the TCC's application of Canada's GAAR fully take context into account? GAAR is about abuse of law. Arguably, when one employs what the Americans would call a bit of self-help to get the right result, that should not be considered abusive. Viewed in isolation, the taxpayer's plan was a pure surplus strip — one that misused ITA section 212.1(4) — and amounted to pure mischief. Viewed in context, was it not merely one way to complete a tax-rational acquisition of Univar and thus a perfectly proper use of section 212.1(4)? In this light, it was no mischief.

Madam Justice Valerie Miller of the TCC viewed the matter differently. However, as discussed in the following section, the FCA did not agree with her ruling.

II. *Univar* at the FCA

A. Relevance of Alternative Structures

The TCC rejected Univar's argument that its plan was not abusive because it simply provided the company with the same results that it would have obtained if the acquirer established a Canadian corporation to acquire Univar Canada from INC and then completed the balance of the acquisition.[10] Paragraphs 104 and 105 of the TCC's judgment implicitly reject the argument that the alternative transaction, which would have produced the desired step-up, is relevant at the misuse/abuse stage of a GAAR analysis. That is puzzling. The judge did not see the plan as self-help. Properly applied, GAAR is an antidote to plans that rest strictly on literal interpretations and take advantage of unintended results. Conversely, when the literal rule would result in a

[10] Another alternative would have been for the acquisition of Univar NV to be carried out through a Canadian acquisition corporation.

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tax that is conceptually inappropriate — as in *Univar*, when the system would have had no problem with the buyer stripping Univar Canada had it bought it from INC — the antidote is the taxpayer self-help response.

In paragraphs 17 to 20, the FCA reverses the TCC's ruling. Paragraph 19 explains:

> If the taxpayer can illustrate that there are other transactions that could have achieved the same result without triggering any tax, then, in my view, this would be a relevant consideration in determining whether or not the avoidance transaction is abusive.

The court continued in paragraph 20, "In my view, the alternative means by which the same result could have been realized is a relevant consideration in determining whether or not the avoidance transaction was abusive." The key point is neither of the alternative cases would have created controversial results.[11]

Tackling the dispute from a different angle, the FCA examines what it believes was *not* the intent of section 212.1 (in paragraph 21):

> Thus, in my view, the purpose of section 212.1 of the ITA was not to prevent the removal from Canada, by an arm's length purchaser of a Canadian corporation, of any surplus that such Canadian corporation had accumulated prior to the acquisition of control.

In paragraph 22, the FCA uses this point. The court treats the various transactions as part of one larger plan to acquire (at arm's length) Univar — a plan designed to trigger 212.1(4) and thus avoid 212.1(1):

> In this case, the overall effect of the transactions was to allow the purchaser of Univar NV to remove from Canada the surplus that had accumulated in Univar Canada prior to the acquisition of control of that company. The transactions were completed very shortly after the closing . . . . at the time that such shares were acquired, the avoidance transaction was contemplated. Therefore, the avoidance transaction would be part of the series of transactions by which control of Univar Canada was indirectly acquired in an arm's length transaction. Whether the surplus of the Canadian corporation is removed by completing the alternative transactions described in paragraph 17 above or by completing the transactions that were done in this case, the same surplus is removed from Canada. Therefore, in my view, these transactions do not frustrate the purpose of section 212.1 of the ITA.[12]

B. Relevance of the 2016 Amendments

Separately, the FCA also reversed the TCC's finding that the 2016 amendments — which (illogically) make the safe harbor in subsection (4) unavailable when a nonresident buys a Canadian corporation through the acquisition of a foreign corporation (for example, the Univar deal) — were relevant to the GAAR analysis.

At paragraph 23, the FCA writes:

> The Technical Notes and Budget Supplementary Information to which the

[11] In more detail, one of the other transactions is set forth in para. 17 of the decision:

> The taxpayer submitted that, in the context of an arm's length sale of shares, the following transactions could have been completed to achieve the same result as was realized in this case if GAAR did not apply. An American corporation owned by the purchaser (who would be dealing at arm's length with Univar NV and its subsidiaries) could have formed a Canadian corporation (AcquisitionCo) and advanced to AcquisitionCo an amount equal to the promissory note in this case ($589,262,400) and contributed capital to AcquisitionCo in an amount equal to the PUC of the shares in this case ($302,436,000). AcquisitionCo could then have used the funds that it received to purchase the shares of Univar Canada from UNAC (US). The Vendor would have realized a capital gain because the shares were sold to an arm's length purchaser.

Another option is described in para. 18:

> AcquisitionCo could then repay the American parent the amount that it had advanced to AcquisitionCo and reduce the PUC of its shares by paying to its American parent an amount equal to the PUC of those shares without triggering any dividend for the purposes of the ITA (subs. 84(4) of the ITA). The surplus in Univar Canada could have been used to fund the repayment of the amount advanced and reduction of PUC as dividends could flow from a taxable Canadian corporation to another corporation resident in Canada without incurring any tax under Part I of the ITA (sections 82 and 112 of the ITA). Alternatively, Univar Canada could have been amalgamated with or wound up into AcquisitionCo (section 87 and 88 of the ITA).

[12] Admittedly, it is somewhat ironic that the taxpayer benefited from having multiple transactions viewed as part of a series because that type of conclusion usually triggers adverse tax consequences.

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Tax Court judge referred only address non-arm's length sales of shares. They do not identify any concern arising from a removal of surplus if the shares of the Canadian corporation are sold to an arm's length purchaser.

Turning to the 2016 amendments,[13] paragraph 28 declares:

> This case does not support the proposition that subsequent amendments to the ITA will necessarily reinforce or confirm that transactions that are caught by the amendments would be considered to be abusive before the amendments are enacted.

Paragraph 29 continues:

> In the case before us the amendments were enacted approximately 9 years after the transactions were completed. In my view, the transactions did not clearly frustrate the object, spirit and purpose of section 212.1 of the ITA as it was written in 2007 and therefore the 2016 amendments cannot be used to make a finding that the avoidance transaction was abusive.

Likewise, in paragraph 30, the FCA rejects the TCC's use of section 84.1 (the domestic counterpart of section 212.1) to inform the GAAR analysis and the reading of section 212.1.

C. Other Factors Supporting the FCA's Ruling

Wrapping up its analysis, at paragraph 31 the FCA cites the Supreme Court of Canada, which, in another GAAR case,[14] established that any doubt regarding whether the Crown has proven abuse is resolved in favor of the taxpayer and:

> In this case the Minister has not clearly demonstrated that the avoidance transaction completed in this case was abusive. The transactions were completed as part of an arm's length purchase of Univar NV. The purpose of the avoidance transaction was, in effect, to allow the arm's length purchaser to extract the surplus in the Canadian corporation that had accumulated prior to the acquisition of control without triggering any tax under Part XIII. There was an alternative means by which the same result could have been achieved . . . if the shares of Univar Canada would have been sold to an arm's length purchaser and the Minister has not clearly demonstrated that the removal of surplus in an arm's length transaction would be abusive.

Considering the entirety of the decision, is it possible that the FCA is suggesting that the Univar transaction does not actually trigger subsection (1), thus making subsection (4) irrelevant? Unfortunately, no, as paragraph 10 makes evident:

> The 2016 amendments changed the wording of subsection 212.1(4) of the ITA applicable in respect of dispositions that occur after March 21, 2016. The result of these amendments is that the exception in subsection 212.1(4) of the ITA would no longer be available in the circumstances of this case.

This holding is a useful transition to the final aspect of this article — the illogical amendments of section 212.1(4).

IV. 2016 Amendments to Section 212.1(4)

The March 22, 2016, budget (and related legislation) drastically narrows the scope of the exception in subsection (4). Specifically, under the new rule, the exception will not apply if a nonresident (i) owns, directly or indirectly, shares of the Canadian purchaser corporation; and (ii) does not deal at arm's length[15] with the Canadian purchaser corporation. These amendments are radical, uncalled for, and totally detached from the scope of the previous rule.

The transaction in *Univar* (a post-acquisition reorganization creating a sandwich structure)

[13] As a reminder, the Univar transactions occurred in 2007. The 2016 amendments were proposals when the TCC released its opinion and were enacted during the period between the TCC and FCA rulings.

[14] *Copthorne Holdings Ltd v. Canada*, 2011 SCC 63.

[15] Under ITA section 251(1), parties do not deal at arm's length if they are related. Section 251(2) explains that this includes commonly controlled corporations. Also, under section 251(1)(c), unrelated persons may not deal at arm's length as a matter of fact.

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qualified for subsection (4) as it stood at the time. The transaction would be mechanically covered by 2016 amendments — post-amendment, 212.1(4)(b) would not apply, and thus subsection 1 would govern.

This result is clearly inappropriate. It discriminates against foreign buyers because a domestic buyer would be eligible for subsection (4) in these circumstances.[16] Several observers, including the Canadian Bar Association/Chartered Professional Accountants of Canada Joint Committee on Taxation, criticized the proposal. The committee's primary recommendation was twofold. First, the original rule should be retained in the sense that the residence of shareholders of Canholdco should not be a disqualifying factor for 212.1(4) (and the government's claim that the original rule had that limitation should be rejected). Second, 212.1(4) should be available to a direct buyer of a foreign company looking to do exactly what Univar did. Neither recommendation was followed.

V. Concluding Comment

While the FCA's decision in *Univar* is a positive development for the taxpayer involved, it is of no use for future taxpayers looking to attempt similar plans because of the 2016 amendments. However, the FCA's ruling is still good for taxpayers who wish to use U.S.-style self-help measures to obtain equitable treatment under the ITA should they face a GAAR challenge. Paragraph 31 is also a helpful reaffirmation of the Minister of National Revenue's burden in GAAR challenges. ■

[16]While the Canadian Bar Association/Chartered Professional Accountants of Canada Joint Committee on Taxation submission of July 25, 2016, to the Department of Finance of Canada on the "Federal Budget 2016 — Amendments to Back-to-Back Rules and Section 212.1" emphasized this point, it was ignored. The submission explains that whether purchasers are Canadian or foreign and whether they deal at arm's length with the Canadian corporation that acquires the nonresident corporation are irrelevant to Canada's tax base. For an interesting discussion about whether treaty nondiscrimination rules might override the limitation, see Angelo Nikolakakis, "*Univar* — Abusive Surplus Stripping or Legitimate Arm's Length Acquisition Planning?" *International Tax Newsletter* (forthcoming).

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