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Two Percent Tax on Share Buybacks by Public Companies

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As part of the 2023 federal budget, tabled on March 28, 2023, the government has introduced draft legislation to implement a new 2% tax on share buybacks that was first announced in November 2022 as part of the government's Fall Economic Statement. This tax (referred to below as the "Buyback Tax") will apply to both normal course issuer bids and substantial issuer bids, among other transactions, and will affect a range of publicly traded entities. The details of the draft legislation suggest that it may (absent further changes before enactment) also apply in unexpected situations. While the tax is similar in some respects to the recently enacted U.S. share buyback tax that apparently inspired it (discussed in an earlier Davies bulletin), there are some significant differences.

The key features of the proposed Buyback Tax can be summarized as follows:

- **Who Will Pay the Buyback Tax.** The Buyback Tax will generally apply to publicly traded Canadian resident corporations, as stated in the Fall Economic Statement. However, the tax will also extend to many other publicly traded entities that are resident in Canada, including most real estate investment trusts, specified investment flow-through (SIFT) trusts and SIFT partnerships. Mutual fund corporations will be excluded from the tax, as will entities with less than $1 million of repurchases in a taxation year. Affected entities are referred to as "covered entities" in the legislation.
- **How the Buyback Tax Is Calculated.** The Buyback Tax will generally be equal to 2% of a covered entity's net repurchases of equity each taxation year. The net repurchases are calculated as the amount by which fair market value of equity repurchased (or redeemed or cancelled) by the covered entity in a taxation year exceeds the fair market value of equity issued from treasury in the year, subject to certain exceptions described below. For the purposes of this calculation, equity acquired by certain subsidiary affiliates of a covered entity may be deemed to be repurchased by the covered entity itself.
- **When It Comes into Force.** The Buyback Tax will apply to repurchases occurring on or after January 1, 2024.

The proposed Buyback Tax is very broad, capturing all manner of share repurchases subject to certain limited exceptions. The Buyback Tax will among other things, generally apply to shares repurchased under both substantial issuer bids and normal course issuer bids. In contrast to its U.S. counterpart, the Buyback Tax will apply regardless of whether the repurchase price is treated as sale proceeds or a deemed dividend for the shareholder. It is possible that a repurchase of equity could be subject to tax under both the Buyback Tax and the U.S. tax, and no credit is provided to offset one tax against the other.

The stated purpose of the Buyback Tax is to encourage businesses "to reinvest their profits in workers and in Canada," though it is unclear how the proposed tax will accomplish that goal. A more plausible explanation may be that the government wants to reduce the relative tax advantages of share buybacks in comparison to ordinary dividends, though even from that perspective, the Buyback Tax is a blunt instrument.

The Buyback Tax will not apply to repurchases (or issuances) occurring under a defined category of "reorganization or acquisition transactions." This would generally include equity repurchased, redeemed or cancelled in the course of amalgamations or equity exchanges whereby a holder receives only equity consideration, winding-ups and so-called butterfly transactions.

However, several common types of transactions would fall outside the reorganization exception and be subject to the Buyback Tax. For example:

- "Amalgamation squeeze out" transactions to remove remaining minority shareholders following a takeover bid do not appear to qualify for the reorganization exception.
- An exchange of shares as part of a triangular amalgamation would appear to fall outside the reorganization exception and be subject to the Buyback Tax.
- A spinoff that does not qualify for tax-free butterfly treatment may be subject to the Buyback Tax where it occurs on a repurchase of equity and not as a dividend or return of capital.
- Due to certain anti-avoidance rules included in the Buyback Tax, it appears that an exchange of publicly listed exchangeable shares (issued as part of a normal exchangeable share structure) could also be subject to the Buyback Tax.

The application of the Buyback Tax to these situations appears to be unintended, and the reorganization exception may be expanded to cover these situations before final enactment.

In contrast, a much wider range of share issuances is caught in the definition of reorganization or acquisition transactions, and therefore cannot be subtracted in the determination of an entity's net repurchases. In general, any issuance of equity by a covered entity will be excluded from the calculation unless the equity is issued either for only cash consideration or to employees of the covered entity's group.

The Buyback Tax does not apply to repurchases (or issuances) of certain debt-like preferred equity, referred to as "substantive debt." To qualify as substantive debt the equity must (i) be non-convertible and non-exchangeable (other than into other substantive debt of the same entity); (ii) be non-voting; (iii) have an annual dividend rate equal to a fixed percentage of its issue price; and (iv) not allow the holder to receive more than the initial issue price plus unpaid distributions upon redemption. Many existing preferred shares may not meet all of these technical conditions, and the proposed rules do not provide for grandfathering of pre-existing equity.

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