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# UPDATE: IMPACT OF U.S. TAX REFORM ON CANADIAN MULTINATIONALS

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*The following is an update of the article entitled "Impact of US Tax Reform on Canadian Multinationals", published in the December 2017 issue of Wolters Kluwer's International Tax Newsletter.*

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (the "**Act**"), representing the most significant U.S. tax reform in the last 30 years, with most changes effective as of January 1, 2018.

As originally anticipated, the Act lowered the federal corporate rate of tax from 35% down to 21%. In addition, new section 11 of the *Internal Revenue Code of 1986* (the "**Code**") eliminates the income tax brackets and graduated rates previously applicable to corporate income.

The Act also retained the general interest limitation outlined in the proposals.[1] Specifically, new section 163(j) of the Code limits the deduction for interest expense

[1] As detailed in our prior article.



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incurred by a business to the sum of (i) the business interest income, (ii) 30% of adjusted taxable income ("**ATI**"), and (iii) floor plan financing interest.[2] For taxation years beginning before January 1, 2022, ATI is the approximate equivalent of EBITDA.[3] For taxation years beginning on or after January 1, 2022, ATI will take into account current year depreciation and amortization expense (i.e., EBIT), thereby producing a more stringent interest deductibility limitation.[4]

This limitation, however, does not apply to businesses having average annual gross receipts of $25 million or less, nor does it apply to a trade or business of performing services as an employee, certain energy productions businesses, and certain electing real property trades or businesses. In addition, the Act retained the Senate proposal that provides for an indefinite carryforward of any interest expense disallowed as a result of new section 163(j) of the Code.

On the other hand, a proposal of both the House and the Senate – which purported to introduce a new world debt cap interest limitation applicable to members of large multinationals – did not find its way into the Act's final version. The same is true of the House proposal which sought to introduce a 20% excise tax on deductible payments made by U.S. corporations to related foreign members within the same corporate group.

The Act did, however, incorporate the Senate's anti-hybrid proposals. Specifically, new section 267A of the Code denies deductions for any "disqualified related party amounts", which have been paid or accrued in the context of hybrid transactions, or by, or to, hybrid entities.

Finally, despite its new nomenclature, the Act retained the Senate's proposal to introduce a "base erosion anti-abuse tax" (the "**BEAT**"). The BEAT's calculation is based on the excess of 10% of the "modified taxable income"[5] over the amount of regular tax liability.[6] However, new section 59A of the Code only applies to a taxpayer that is a corporation subject to U.S. net income tax[7] (i) having average annual gross receipts in excess of $500 million, and (ii) making deductible payments to related parties equal to 3% or more of the sum of all deductible expenses.

## NEW SUBSECTIONS 87(8.4) AND 87(8.5) OF THE INCOME TAX ACT AND TAX IMPLICATIONS FOR U.S. ABSORPTIVE MERGERS

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The *Budget Implementation Act, 2017, No. 2* came into force on December 14, 2017 and added new subsections 87(8.4) and 87(8.5) (the "**New Rollover Rule**") to section 87 of the *Income Tax Act* (Canada) (the "**Act**").[1] The New Rollover Rule provides a mechanism for deferring the recognition of gains from the disposition of certain taxable Canadian property ("**TCP**")[2] as a consequence of certain foreign mergers.

This New Rollover Rule has been revised from the original proposal, released on September 16, 2016, and expanded its scope to not only apply to dispositions of certain TCP that are shares of the capital stock of a corporation, but also

[2] The term 'floor plan financing interest' means interest paid or accrued on indebtedness (i) used to finance the acquisition of motor vehicles (including farm machinery or equipment) held for sale or lease, and (ii) secured by the inventory so acquired.

[3] Section 163(j)(8) of the Code.

[4] *Ibid.*

[5] The definition of "modified taxable income" adjusts corporate net income to include any "base erosion payments". A base erosion payment refers to any amount paid or accrued by a taxpayer to a foreign person that is related to the taxpayer, and with respect to which a deduction was permitted under the Code. Such payments include interest payments, as well as payments made in connection with the acquisition of depreciable property from a foreign person related to the taxpayer.

[6] The 10% rate is reduced to 5% for taxation years beginning in calendar year 2018, and increased to 12.5% for taxation years beginning after December 31, 2025.

[7] All persons treated as a single employer under section 52(a) of the Code (subject to certain adjustments) shall be treated as a single taxpayer for purposes of the BEAT.

[1] All statutory references herein are to the Act, unless otherwise specified.

[2] The New Rollover Rule does not apply to dispositions of TCP that are "treaty-protected property".

interests in partnerships and trusts. The revisions also contain details concerning the joint election mechanism, which were not outlined in the original draft. The New Rollover Rule applies to foreign mergers that occur after September 15, 2016.

## Absorptive Mergers

One of the key types of transactions that would potentially benefit from the New Rollover Rule is an "absorptive merger". An absorptive merger is a common form of merger provided for under corporate laws around the world, whereby two or more corporations combine together and only one of the corporations survives the merger while the others cease to exist. This article focuses on absorptive mergers under U.S. corporate law, which is provided for in many U.S. states, but the relevant principles and the New Rollover Rule should apply to absorptive mergers under other jurisdictions as well.

An absorptive merger involving foreign corporations is very different from an amalgamation of Canadian corporations under Canadian corporate law. The decision of the Supreme Court of Canada in *The Queen v. Black & Decker Manu. Co.*[3] provided guidance on the nature of an amalgamation and its implications for the predecessor corporations. In particular, this case dealt with the issue of whether a new corporation was formed as a result of an amalgamation carried out pursuant to the provisions of the *Canada Corporations Act*[4] (the "**CCA**"). The relevant wording of the CCA provided that two or more companies may amalgamate and continue as one company, and the amalgamated company possesses all the property, rights, and liabilities of each of the amalgamating companies. Dickson J, in rendering the decision of the Supreme Court and reversing the finding of the Ontario Court of Appeal, stated that:

> [I]t would seem that the Court [of Appeal] accepted, as a first step, the proposition that the "new" company (i.e., the amalgamated company) is a different, separate, and distinct company from the "old" companies (i.e., the amalgamating companies). Whether an amalgamation creates or extinguishes a corporate entity will, of course, depend upon the terms of the applicable statute, but as I read the Act [the CCA], in particular s. 137, and consider the purposes which an amalgamation is intended to serve, it would appear to me that upon an amalgamation under the Canada Corporations Act no "new" company is created and no "old" company is extinguished.[5]

Since Canadian corporate law statutes today are generally consistent with the CCA in this respect, as a result of the decision in *Black & Decker*, it could be argued that each predecessor corporation has not disposed of its property as a result of the amalgamation.[6] Similar arguments could also be made with respect to the property of predecessor corporations that merge under foreign corporate law where such law was similar to the CCA.

This type of argument does not seem possible in respect of the property of a non-surviving predecessor corporation in a foreign absorptive merger. While subsection 87(8) provides for a tax deferral for Canadian resident shareholders of predecessor foreign corporations who have undertaken a "foreign merger" (including an absorptive merger),[7] prior to the enactment of the New Rollover Rule, the Canada Revenue Agency (the "**CRA**") had taken the position that an absorptive merger involving foreign corporations would be considered to result in the disposition of property held by non-surviving predecessor corporations. This would typically trigger tax in respect of any accrued gains in respect of such property as well as the notification requirements under section 116 where the property was TCP.[8]

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[3] [1975] 1 SCR 411.

[4] The CCA has been repealed and replaced with the *Canada Business Corporations Act*.

[5] *Supra* note 2, at 416-18.

[6] See, for example, Turner, Graham, "Amalgamations and Continuations" *Canadian Tax Journal*, no. 6, Canadian Tax Foundation, Toronto, 1988.

[7] Subsections 87(8.1) and (8.2).

[8] See, for example, Tax Window File 2000-0034951, "Foreign Merger" dated October 25, 2000.

Subsection 87(8.1) sets out the definition of "foreign merger" for purposes of subsection 87(8), and subsection 87(8.2) sets out certain requirements for a merger to qualify as an "absorptive merger". If such requirements are satisfied, an absorptive merger will qualify as a "foreign merger" under subsection 87(8.1). As a result, provided that all other conditions are met, a U.S. absorptive merger would satisfy the requirements under the New Rollover Rule to enable non-surviving foreign predecessor corporations to make a joint election and defer any gain or loss in respect of certain TCP that would otherwise arise from the absorptive merger. These requirements are discussed below.

## Tax-Deferral Provision under Canada–U.S. Tax Treaty

Prior to the enactment of the New Rollover Rule, corporations undertaking a U.S. absorptive merger could rely on section 115.1 and Article XIII(8) of the *Canada–United States Tax Convention, 1980* (as amended) (the "**Treaty**") to request a tax deferral in respect of the disputation of TCP arising from the merger.

Section 115.1 generally provides that where the Minister of National Revenue (typically through the competent authority branch of the CRA) (the "**Canadian Competent Authority**") enters into an agreement with the competent authority of another country pursuant to the provision of a tax treaty, all determination made in accordance with the terms and conditions of such agreement are deemed to be in accordance with the Act.

Article XIII(8) of the Treaty provides as follows:

> Where the resident of a Contracting State alienates property in the course of a corporate or other organization, reorganization, amalgamation, division, or similar transaction and profit, gain or income with respect to such alienation is not recognized for the purpose of taxation in that State, if requested to do so by the person who acquires the property, the competent authority of the other Contracting State may agree, in order to avoid double taxation and subject to terms and conditions satisfactory to such competent authority, to defer the recognition of the profit, gain or income with respect to such property for the purpose of taxation in that other State until such time and in such manner as may be stipulated in the agreement.

Therefore, to the extent that a non-surviving U.S. corporation disposes of TCP in the course of an absorptive merger with one or more U.S. corporations and the gain with respect to such disposition is not recognized for U.S. tax purposes and is not exempt under Article XIII of the Treaty (for example, real property situated in Canada or personal property forming part of the business property of a permanent establishment situated in Canada), then the surviving U.S. corporation can make a request to the Canadian Competent Authority under Article XIII(8). Upon receipt of this request, the Canadian Competent Authority may agree to defer the recognition of the gain with respect the disposition of such TCP for Canadian tax purposes according to certain terms and conditions and until the time determined by the Canadian Competent Authority.

Despite the existence of these tax-deferral provisions, the actual application and the manner in which U.S. corporations can apply and receive such a deferral are considerably complex and burdensome. In circumstances where an agreement cannot be reached with the Canadian Competent Authority or if the ongoing terms and conditions to an agreement are not satisfied prior to the end of the tax deferral period agreed to, then the Canadian income tax on the gain arising from the disposition of TCP would be payable.

In making these decisions, the Canadian Competent Authority considers certain conditions[9] to determine if they are satisfied. Below are some examples of these conditions:

- there is evidence that the purpose of the reorganization is commercially motivated;
- a deferral is required to avoid potential double taxation;

[9] Paragraph 76 of Information Circular 71-17R5, *Guidance on Competent Authority Assistance Under Canada's Tax Conventions* (the "**Circular**"), lists the conditions that the Canadian Competent Authority considers when making agreements pursuant to Article XIII(8) of the Treaty.

- a deferral would be available if the acquirer and vendor were residents of Canada (i.e., there is a similar deferral provision in the Act that would be applicable to the particular type of reorganization if it involved only residents of Canada);
- there is no applicable deferral provision in the Act that may be used;
- Canadian tax claims after the reorganization are not placed at a greater risk than before the reorganization; and
- in the opinion of the Canadian Competent Authority, no component of the reorganization or other transaction constitutes an avoidance transaction as defined in subsection 245(3).

The list provided in the Circular is considered to be non-exhaustive and there may be other conditions that, depending upon the details of the transactions, the Canadian Competent Authority would take into consideration when making a decision as to whether to allow for a tax deferral.

There are a variety of drawbacks to the above deferral rule. Firstly, a U.S. corporation requesting such a tax deferral faces a considerable level of uncertainty as to whether such a tax deferral will be granted, due to the existence of unknown factors the Canadian Competent Authority may take into consideration in its decision process. Generally, there is a lack of guidance and clarity as to what is specially required to satisfy each condition set out in the Circular. Essentially, whether the Canadian Competent Authority accepts or denies a request for deferral under Article XIII(8) of the Treaty is largely discretionary even in circumstances where the U.S. corporations may face double taxation, contrary to the stated purposes of the Treaty.

Secondly, the process to obtain an agreement from the Canadian competent authority in respect of an application under Article XIII(8) of the Treaty can be time consuming. Gathering the necessary information and legal opinions necessary to make the application takes significant effort and once the application is submitted, reaching a final agreement with Canadian Competent Authority will generally take at least six months and can take longer than a year.

In addition, a decision by the Canadian Competent Authority not to enter into an agreement is not subject to appeal under the Act or the Treaty, although there may be circumstances where a decision could be subject to judicial review.

The Canadian tax consequences which arise from the disposition of TCP as a result of a U.S. absorptive merger could be significant, and the inability to obtain a Canadian tax deferral on an otherwise tax-free transaction for U.S. tax purposes could be very unfavourable for the U.S. corporations.

## New Rollover Rule and its Applicability to U.S. Absorptive Mergers

While relief from double taxation in respect of a tax-free merger under Article XIII(8) of the Treaty is not guaranteed given the discretionary nature of application process, the New Rollover Rule, in comparison, could offer a more effective and efficient mechanism for a tax-deferred rollover for dispositions of certain types of TCP resulting from U.S. absorptive mergers. Although not an automatic rollover, the New Rollover Rule allows non-resident taxpayers to elect for dispositions of TCP that are shares of the capital stock of a corporation or an interest in a trust, to occur on a tax-deferred basis, where the disposition results from a foreign merger that meets certain conditions. Where this joint election is made, a disposition of TCP that is an interest in a partnership that fulfils these conditions is deemed not to be a disposition other than for purposes of subsection 87(8.4). The New Rollover Rule, in the U.S. context, would provide a tax deferral in respect of gains arising from the disposition of shares of corporation and interests in a partnership or a trust by a U.S. resident where such shares or interests derive their value principally from real property situated in Canada. Notably, the New Rollover Rule does not apply to gains arising on the disposition of TCP that is personal property forming part of the business property of a permanent establishment situated in Canada.

Unlike Article XIII(8) of the Treaty, subsection 87(8.4) provides a relatively clear and exhaustive set of conditions to be satisfied in order to qualify for the New Rollover Rule. The conditions are generally described as follows:

- There is, at that time, a foreign merger of two or more predecessor foreign corporations that were, immediately before that time, resident in the same country and related to each other (without reference to paragraph 251(5)(*b*)). The terms "foreign merger" and "predecessor foreign corporation" are defined in subsection 87(8.1), but for purposes of determining whether these conditions are satisfied, subsection 87(8.1) and (8.2) are to be read without reference to their exclusions for wind-ups.
- Because of the foreign merger,
  - a predecessor foreign corporation disposes of TCP (other than treaty-protected property) that is: (i) a share of the capital stock of a corporation; (ii) an interest in a partnership; or (ii) an interest in a trust (collectively, the "**Subject Property**"), and
  - the Subject Property becomes property of a corporation that is a new foreign corporation for the purposes of subsection 87(8.1).
- No shareholder (other than a predecessor foreign corporation) that owned shares of a predecessor foreign corporation immediately before the foreign merger received consideration for the disposition of the shares on the merger, other than shares of the new foreign corporation.
- If the Subject Property is shares of a corporation or an interest in a trust, the corporation or trust (the shares of, or interest in, which are disposed of as a result of the foreign merger) is not, at any time in the 24-month period ending after that time, as part of a transaction or event, including the foreign merger, subject to a loss restriction event (as defined in subsection 251.2(2)).
- The new foreign corporation and the disposing predecessor foreign corporation jointly elect for tax-deferred treatment, in writing under paragraph 87(8.4)(*e*) in respect of the foreign merger, and file the election with the CRA on or before the filing due date of the disposing predecessor foreign corporation for the taxation year that includes that time.

The section 116 notification procedures in respect of the disposition of TCP by a non-resident are still required even where a joint election is made under paragraph 87(8.4)(*e*). While the CRA will issue a section 116 certificate of compliance for the disposition of qualifying TCP occurring after September 15, 2016 as a result of an absorptive merger, the non-resident corporation is not required to provide a valuation of the TCP. However, the non-resident will be required to support the adjusted cost base calculation included in the election.[10]

In terms of the applicability of the New Rollover Rule to U.S. absorptive mergers, since the deeming rules in subsection 87(8.2) generally permit an absorptive foreign merger to constitute a foreign merger within the meaning of subsection 87(8.1), and the surviving corporation of a foreign merger would be considered a "new foreign corporation" (even though such a merger does not legally result in a "new" foreign corporation being created), absorptive foreign mergers may, depending on the circumstances, satisfy the conditions set out in subsection 87(8.4).

## Conclusion

The enactment of the New Rollover Rule should be an effective mechanism for common forms of foreign mergers, including U.S. absorptive mergers, involving dispositions of certain TCP, to occur on a tax-deferred basis. In comparison to the mechanism provided under Article XIII(8) of the Treaty, the New Rollover Rule should generally be viewed as a step forward in establishing a more clear and efficient manner whereby parties undertaking a U.S. absorptive merger may elect tax-deferred dispositions of TCP. Unfortunately, the disposition of personal property forming part of the business property of a permanent establishment situated in Canada is excluded from the New Rollover Rule, so where a non-surviving U.S. corporation disposes of such property in connection with an absorptive merger, the surviving

[10] Canadian Tax Foundation Annual Conference - CRA Routable - Official Response, Question 14, November 21, 2017.

U.S. corporation may still be required to apply to the Canadian Competent Authority under Article XIII(8) to avoid double taxation.

Nonetheless, the New Rollover Rule helpfully expands a tax-deferred rollover of TCP in a foreign merger to jurisdictions where Canada either does not currently have a tax treaty, or has a tax treaty without the tax-deferral provisions found in Article XIII(8) of the Treaty.