International Mergers & Acquisitions:
Objectives, Strategies, Issues and Obstacles

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Tax considerations respecting "international mergers and acquisitions" give rise to numerous objectives, strategies, issues and obstacles.

OVERVIEW

THE PARAMETERS OF MERGERS AND ACQUISITIONS

A threshold matter is the delineation of the term "mergers and acquisitions." The circumstances of an "acquisition" are often far more clear than those of a "merger." While a cash deal clearly is an acquisition (from any perspective, whether non-tax or tax), the uncertainty of that distinction underlies a suit brought by Mr. Kirk Kerkorian against DaimlerChrysler, which characterized its 1998 stock-for-stock transaction as a "merger of equals." Mr. Kerkorian claims, however, that it was intended by Daimler to have the effect of an acquisition (of Chrysler), but one which was disguised or misrepresented as a merger in order to avoid having to pay stockholder control premiums. He is suing for $1 billion in damages.

The distinction in the international arena can be blurred by the absence, generally, of corporate law for a true legal "merger" or "amalgamation" of corporations from two different countries.[1] There are rare exceptions in North America permitting true cross-border mergers.[2] However, in most other cases, the use of the term "merger," in respect of a cross-border deal, is a term of art, not of law, because it normally entails, at minimum, a two-step process (the second step of which often is not, by reason of tax constraints, carried out). First there would be a share exchange and then a liquidation.

A separate question in defining the parameters of this discussion is whether it should include what, in effect, is the opposite of a merger: namely, a de-merger by way of a *pro rata* spin-off, or exchange (offer) split-off, reorganization. It can also conjure up transactions ("virtual mergers") that are more akin to the formation of a joint venture or partnership (such as the BHP Billiton "dual pillar" or "dual-listed" combination), structured that way to avoid taxable events at the point of combination or post-combination tax inefficiencies, such as multiple cross-border taxation of dividend flows or issues of "sandwich" structures, examined below. The virtual merger approach has responded, in part, to inefficiencies experienced in transactions that have used stapled stock, "tracking stock," "dividend access stock" or "exchangeable stock."

THE PARAMETERS OF THE TAX CONSIDERATIONS

The tax law that governs international mergers and acquisitions comprises a combination of: (i) a domestic tax law system; (ii) applicable double tax treaties; (iii) associated with the latter, the manner in which domestic courts may interpret tax treaties by reference to the OECD model treaty and its commentaries; and (iv) regional tax systems or law, e.g., the European Union (EU). As well, there is the influence of the OECD in other areas, such as transfer pricing and "harmful tax competition" initiatives, etc.

Relevant techniques or tools might include hybrid entities, hybrid instruments, derivatives (e.g., synthetic total return, or equity, swaps), or dual incorporated companies (which can be formed to be governed by both Delaware and Nova Scotia law). The Canadian "income fund" phenomena spawns its own set of cross-border opportunities and challenges, which are beyond the scope of this paper. There are the effects on international M&A of the manner in which the EU law is being interpreted and applied, by the European Court of Justice, to suppress the applicability of domestic law, particularly in the thin capitalization (earnings-stripping) area.[3] Cross-border private equity deals and transactions can raise an inordinate number of tax issues and multiple exercises in tax structuring. Finally, there are ongoing government initiatives to be monitored.[4]

Although the foregoing indicates that the breadth of the parameters of the subject matter is daunting, an orderly review of the objectives, etc., can be facilitated by organizing a study thereof around a three-pronged categorization of international M&A. These are dealt with, each in turn, in the following three sections.

AN INCIDENCE OF THE FIRST CORE CATEGORY: DEALING WITH "SANDWICH" STRUCTURES

OVERVIEW

The base (first) category of international M&A tax issues contains those applicable to cross-border deals (whether merger or acquisition) that see all the stock of one of the parties acquired by the other. An incidence of this category is

examined herein.[5] It deals with the implications where the "acquired" party has foreign subsidiaries in either the country of the other party, or in one or more third countries. The resulting "sandwich" structure gives rise to several challenging considerations in any of the countries involved. This analysis focuses on the country in the middle of the sandwich. First, what is the nature of the tax inefficiencies that would arise if the sandwich were not eliminated? Second, can the sandwich be unwound and rationalized, so as to terminate the ownership of the "foreign sub" by the acquired party, on a tax-efficient basis (i.e., without incurring immediate tax)? Third, if the answer to the latter question is negative, can steps be taken to minimize the tax inefficiencies inherent in such a structure?

The possible inefficiencies resulting from a sandwich structure include at least: (i) potentially two levels of *target* country tax applicable to the ultimate repatriation of the profits of the foreign sub to the acquiror-parent; (ii) potential applicability, to the operations of the foreign sub, of target country corporate level tax under controlled foreign corporations ("CFC") income attribution rules; (iii) potential target country taxation of a future divestiture of the foreign sub; and (iv) potential obstruction of group financing or financing arrangements that might otherwise be put into place.

To avoid such tax inefficiencies, normally it is best to unwind the sandwich structure. But tax obstacles to an unwind may arise. If unwinding is not feasible, what steps can be taken to ameliorate the inefficiencies of not unwinding?

Canada in the Middle of the Sandwich

If Canada is the country in the middle of the sandwich (e.g., where a Canadian group is acquired by, say, a U.K. group and has foreign subs in other countries), Canadian tax inefficiencies of maintaining the structure may not, as a result of the design of Canada's foreign affiliate system, be as severe as might arise in other countries.

First, under Canada's foreign affiliate rules,[6] *undistributed* actual or deemed-passive income of a foreign sub (collectively, "FAPI") is taxed in the hands of the Canadian shareholder parent on an attribution basis. But FAPI does not include a wide range of inter-affiliate financing and licensing transactions. Second, where FAPI does not apply, dividends derived from the active business profits of a foreign sub, resident and operating in a country with which Canada has a treaty (which is the case with some 80 countries) is not subject to Canadian corporate-level tax. Third, there would be ultimate Canadian withholding taxes of 25%[7] on redistribution of profits (to the U.K. parent) received from the foreign sub. A fourth potential inefficiency is the spectre of Canadian corporate-level tax on a future disposition of the foreign subsidiary, which would be governed by the rules discussed below respecting unwinding the sandwich.

Can a sandwich be unwound without Canadian tax? In principle, it can when the acquisition is an all-cash deal (with selling shareholders of the Canadian target receiving cash only). A combination of utilizing a newly-formed Canadian corporation to carry out the acquisition (funded by equity and/or debt by the foreign acquiror) followed by a merger of the acquisition corporation and the Canadian target (by amalgamation or liquidation)[8] generally would provide a full step-up in cost base to fair market value, with respect to all non-depreciable capital assets of the Canadian target, including the stock of its foreign subs.[9] The sandwich could then be unwound without either Canadian corporate level tax or shareholder level distribution (withholding) taxes.

If the deal involves the delivery of stock (which constitutes 10% or more of the overall consideration) to the former shareholders of the Canadian target, no domestic step-up would be available (under section 88[1])[10] and a corporate-level tax-free unwinding would require the existence of sufficient surpluses and the elective rules of section 93 of the Act.

In the latter circumstances, what steps might be taken to ameliorate the potential "tax inefficiencies" of not unwinding the sandwich? A possible solution is a freeze re-organization (effectuated under Canada's corporate re-organization rules) of the foreign sub (or by the foreign sub of its business), intended to limit the future participation of the Canadian target in the growth of the foreign sub.

Other Countries

Turning to the U.S., where a corporation therein is the target and emerges in the middle of a sandwich, if the sandwich is not unwound, there are the types of concerns that arise in Canada, but exacerbated by: (i) generally broader foreign income ("Subpart F" income) attribution;[11] and (ii) unlike Canada (in light of its "exempt surplus" rules), liability to United States tax when a foreign sub's profits are distributed to the U.S. company. As well, there is less flexibility to defer tax on gains realized with respect to a future disposition of the stock of the foreign sub.[12] The absence of a participation-type exemption and limited opportunities to qualify for a basic step-up[13] will often preclude a tax-free unwind, and, if the sandwich cannot be unwound, the prospects for minimizing tax inefficiencies going forward through a "freeze" recapitalization are not bright.

In France, there clearly may be significant tax inefficiencies of not unwinding the sandwich, arising under France's CFC rules and the absence of either a "participation exemption"[14] regime or basic step-up. Moreover, the latter means that a sandwich *cannot generally be unwound* without substantial French tax. Finally, when the sandwich *cannot be unwound*, a "freeze" transaction (noted above) is not a well-developed or effective technique in France.

In contrast to in France and the U.S., in the U.K. there may be both: (i) fewer "tax inefficiencies" of not unwinding a sandwich and (ii) less risk of engaging tax if it is unwound. This is mainly due to a participation exemption regime and the absence of withholding taxes on U.K. corporation distributions. If the sandwich cannot be unwound, the U.K.'s CFC rules could apply to a wide range of the target's activities, and the notion of a freeze (as discussed earlier) is not known or developed in the U.K.

The situations in Italy and Germany are closer to that in the U.K. than to those in France or the U.S. in light of a 95% participation regime, which would facilitate unwinds. If the sandwich *cannot be unwound*, there could be CFC inefficiencies in either country. The notion of doing a freeze (as described earlier) is simply not developed in German tax law or practice, but could be effective in Italy.

AN INCIDENCE OF THE SECOND CORE CATEGORY: CAN STOCKHOLDERS AVOID TARGET COUNTRY TAX ON A CROSS-BORDER SHARE-FOR-SHARE ACQUISITION OR MERGER?

OVERVIEW

The second core category of international tax issues is those *which only* arise in a transaction which sees shareholders of one of the parties receiving only, or mainly, stock of the other, with a focus on *that* distinguishing characteristic. An

incidence of this category is examined herein. It focuses on whether a shareholder receiving stock of the other party can avoid or defer tax in the country of the relevant target or merger party.[15] The issue arises whether the deal is an "acquisition" or a "merger of equals."

There are three basic questions. Do the rules provide rollover treatment for a straightforward share-for-share deal? Are foreign shareholders treated differently than domestic shareholders? When tax would arise on a straight deal, can rollover treatment be achieved by indirect means, such as the "exchangeable share" deal?

CANADA

In Canada, a straight foreign share-for-share acquisition of (or merger with) a Canadian target would comprise a taxable event for Canadian resident shareholders (other than tax-exempts) and, in certain circumstances, for non-resident shareholders as well.[16] There is, however, an announced intention of the government to enact a rollover rule.[17]

In light of the foregoing (and the abundant foreign acquisitions of Canadian companies in the last 10 to 15 years), the tax and investment banking communities have worked out indirect structures (the "exchangeable share deal") designed to provide rollovers for those who would otherwise be taxable on a straight share-for-share deal. This generally involves a complex transaction (with a variety of highly customized arrangements) where stockholders are offered (as an alternative to stock of the acquirer) stock of a Canadian corporate entity (either the target, or more usually one formed by the foreign party to effectuate the transactions),[18] which is intended to mirror (or mimic) the stock of the foreign party and which can, at the option of the holder (but subject to a sunset date) be exchanged on a preset exchange ratio for the foreign party's stock. Because the exchangeable stock is issued by a Canadian corporation, it is eligible for one of the various (direct) Canadian-to-Canadian rollover rules, under sections 85-88 of the Act.

OTHER COUNTRIES

In the United States, in most cases where the U.S. target or merger party is smaller than the foreign acquirer or merger party and certain other requirements are met,[19] the domestic shareholders[20] of a U.S. corporation will qualify for non-recognition treatment on a straight stock-for-stock deal.[21] However, where non-recognition relief is not available, a Canadian-style "exchangeable share" deal raises uncertainty because, if the exchangeables are calibrated (as is done in Canadian deals) to be an economic mirror of the foreign acquisition's stock, it could well be treated as such, thus rendering the structure ineffectual.[22]

Although Australia's capital gain system, introduced in the mid-'80s, was patterned on the Canadian approach, it does provide rollovers for a straight share-for-share deal. If the requirements for a rollover are not met, there is no well-developed approach to structuring a transaction through the type of exchangeable stock deal seen in Canada.

Belgium, as a normally high-tax country, provides a very broad set of circumstances in which capital gains on disposing of stock of Belgian targets (whether for cash or stock) would be excluded from taxation. As a result, there has been little need to develop exchangeable share deals. Where relevant, in Belgium and the other EU countries noted below, the EU merger directive would mandate rollover treatment where the stock received has been issued by an EU acquiror or merger party.

In France, both resident and 25% or greater non-resident sellers of stock of a French corporation are subject to tax. Since 2001, however, rollovers are generally available where there is a foreign takeover or merger on a share-for-share basis.

Italy may also tax domestic and foreign shareholders on selling stock of an Italian corporation, but unlike France, there are no specific rollover rules applicable to share-for-share acquisitions or mergers. And there is no experience with exchangeable share deals, although one could perhaps be crafted through an EU country.

In the Netherlands, as in Belgium, there is a very wide range of circumstances where both domestic and foreign stockholders of a Dutch company would not be taxable with respect to gain upon a sale of stock of a Dutch company, whether for cash or upon a share-for-share takeover. However, there are no specific rollovers available and if, residually, tax would arise for a shareholder, there is no well-defined exchangeable approach available in the Netherlands.

In the U.K., resident sellers of stock (except corporations which qualify for a 100% participation exemption) are subject to tax, but unlike in most countries (except the U.S.), foreign sellers–who are investors–are not generally taxed. Where tax would otherwise arise for a U.K. stockholder, there is a relatively generous rollover scheme. In light of these rules, it has not been necessary to develop exchangeable share alternatives.

AN INCIDENCE OF THE THIRD CORE CATEGORY: BEST TAX HOME FOR A MERGER OF EQUALS?: IMPACT OF CFC REGIMES

OVERVIEW

The third core category of issues are those *which only arise* in a transaction that brings together parties of near or near-equal size, with a focus on that distinguishing characteristic. An incidence of this category is examined herein, one which is a threshold aspect of such a merger. The context is a merger of two or more equally or near-equally sized groups, based in different countries, where at least one of the merging parties has been earning permanently (or deferred) low-taxed profit from foreign operations (that is, profit taxed at rates lower than the standard corporate tax rate of the country of the parent of the group). The objective in such circumstances is to choose the location of the parent (or "Topco") of the merged parties in a fashion which avoids an erosion (ratchet-back) of those permanent tax savings as a result of the operation of CFC rules.[23] The issue and objective will be of particular importance when the stock of the merger parties has traded on an earnings multiple and that is expected to continue after the merger. Any erosion of permanent (or certain deferred) tax savings would affect the bottom line profit and market capitalization.

There are three possible approaches or choices, assuming it is to be a complete combination. Party A could acquire Party B pursuant to a stock-for-stock exchange. Or, Party B could acquire Party A in that fashion. Or, instead, a new corporation could be formed in a third country (i.e., a "Newco" or "Topco"), which acquires, on a stock-for-stock basis, Parties A and B, with all their shareholders emerging as shareholders of that Topco. In principle, the strategy is straightforward: base the merged group in a country that has no CFC-type regime or has the least invasive regime.

CHOICE IN A CANADA-U.S. MERGER

Under either Canada's foreign affiliate rules or the U.S.' CFC rules (abetted by "check-the-box arrangements"),[24] either a Canadian or a U.S. merger party may be earning, through

foreign subsidiaries, low-taxed foreign-source income. In that context, the basic question is which of the CFC regimes of Canada and the U.S. is more likely to ratchet back or erode the pre-merger foreign-income-related permanent (or deferred) tax savings of the two groups. The ancillary question, if there would be such erosion (in whole or in part), regardless of which acquires the other, is whether a third-country Topco that would acquire both companies would avoid any erosion.

In principle, the U.S. CFC rules cast a wider net than do Canada's CFA rules and are more likely, if the U.S. party acquires the Canadian party (than vice versa), to erode pre-merger savings. Such U.S. attribution could apply to Canadian-owned foreign subsidiaries that are earning intercompany interest and royalties, which are excluded from Canada's CFAFAPI attribution rules.[25] As well, even if subpart F attribution would not apply, there is the financial statement reporting factor. Because U.S. tax could arise when a U.S. parent receives dividends from a foreign subsidiary, the question is whether the deferred U.S. tax related to future profits of the Canadian group's foreign sub profit would have to be booked immediately. If so, earnings and stock prices could be adversely affected.

Finally, if, on the facts, there were a risk that the Canadian CFC rules would erode the U.S. savings, thought could be given to merging by way of a third-country Topco, the tax rules of which would not serve to ratchet back or erode the permanent tax savings of either of the Canadian or U.S. groups to the merger. Although a pure tax haven location would obviously provide this result, a prior study of this matter[26] indicates that the Netherlands, certain of its domestic provisions notwithstanding, would provide a hospitable ("onshore") tax environment in relation to the desired objective.

CHOICE IN A MERGER OF A CANADIAN GROUP WITH GROUPS FROM OTHER COUNTRIES?

In principle, it appears that the CFC rules of each of Australia, Belgium, Germany, France, Italy and the U.K. would raise a serious risk of substantial erosion or ratchet-back of the preexisting Canadian tax savings, should a merger party in any of these countries emerge as the parent in a merger with a Canadian party. In principle, the better choice would see the combination carried out through a Canadian stock-for-stock acquisition of the other group or a third country Topco acquisition of all parties.

Australia's CFC rules are possibly the most invasive and comprehensive of all. Belgium has no specific CFC regime but does have a series of rules that would appear to potentially pose a threat to the pre-existing activities of a Canadian group. The CFC regimes of France, Italy and the U.K. entail all-or-nothing attribution systems.[27] Where specific tests are met, all of the income of the CFC is attributed. Although Germany's CFC rules appear to have a more narrow ambit than some of those already noted, they would potentially attribute many types of income excluded from Canada's FAPI rules.

Given the foregoing suggestion of utilizing the Netherlands as a potentially effective location for a third-country Topco, it is obvious that the parameters of Dutch tax rules should not pose a threat of erosion and ratchet-back of the pre-merger current tax savings of a Canadian group, should a merger with a Dutch group see the latter acquire Canco.

CONCLUDING COMMENTS

Planning international mergers and acquisitions from the tax standpoint entails an intricate synthesis of tax, corporate and securities laws of at least two, if not more, countries, as well as business and capital market factors. The foregoing brief review of the parameters of, as well as specific illustrations of, each of the three core categories of international M&A issues simply scratches the surface of the challenges inherent in advising and providing effective counsel in this complex arena, and of the dynamic process such challenges spawn. ■

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1 Some countries (e.g., the U.K.) do not even provide for domestic mergers. See, however, the E.U. Mergers Directive and the newly developed Sociataea Europea. For detailed discussions (precluded herein by space limitations) of this and other matters in the article, see "M&A Forum; International Mergers & Acquisitions: A Forum for Discussion" (organized and coordinated by this writer, and in collaboration with 20 leading international M&A tax lawyers from eight countries); Nathan Boidman, "Introduction to the Forum-A Preview of Things to Come," *Tax Notes International*, Vol. 34, No. 2, April 12, 2004, p. 185; as well as subsequent instalments in the Forum.

2 See the combined corporate laws of Alberta and certain U.S. states (e.g., Delaware). See Nathan Boidman, "Cross-Border Amalgamations," *Report of the Proceedings at the 52nd Tax Conference, Canadian Tax Foundation (2000)* Conference Report, at p. 26:1.

3 See *Lankhorst-Hohorst GmbH v. Finanzant Steinfurt* (C324/000) (2002).

4 See for example, the U.S. domestically spawned "inversions" controversy, which can affect cross-border M&A involving the U.S.

5 See note 2 and *Tax Notes International*, May 10, 2004, p. 603.

6 See, *inter alia*, sections 90-95 and 113 of the *Income Tax Act* (Canada), R.S.C. 1985, Chap. 1 (5th supp.), as amended (herein "the Act" or "ITA").

7 Section 212(2) of the Act, subject to treaty reduction.

8 Either would be tax-free under section 87 or 88 of the Act.

9 See section 88(1)(c) and (d) *et seq* of the Act.

10 See the "ineligible property," "substituted property," "specified property" and "specified shareholders" rules in sections 88(1) and 248(1).

11 Code sections 951-964 of the *Internal Revenue Code*, 1986, as amended (the "Code").

12 See Code section 1248.

13 Under Code section 338 elective procedures, a tax-free step-up may be available where a U.S. target is purchased from a U.S. corporate parent or where it has sufficient prior unused losses.

14 Note, however, that the French government has announced an intention to adopt such a regime.

15 See note 2 and *Tax Notes International*, Vol. 34, No. 10, June 7, 2004, p. 1017.

16 See exclusions for less-than-25% shareholders of listed Canadian corporations and under many of Canada's treaties.

17 See Department of Finance, *Economic Statement*, Oct. 18, 2000. To date, none has been issued, but has been promised "soon".

18 For a detailed discussion, see *Kathleen V. Penney, Lewis R. Steinberg and Richard M. Nugent*, "Recent Developments in Exchangeable-Share Transactions," *Report of the Proceedings at the 52nd Tax Conference*, Canadian Tax Foundation (2000) Conference Report.

19 U.S. Treas. Reg. § 1.367(a)-3(c)(1)(i) and (3)(iii).

20 Foreign stockholders are generally excluded from U.S. tax on gains arising from U.S. corporate stock.

21 Code section 368(a)(1)(B) or 351.

22 For a discussion, see note 18.

23 See note 2 and *Tax Notes International*, Vol. 35, No. 3, July 19, 2004, p. 235.

24 Code section 7701.

25 In HR 4520, signed into law on October 22, Congress failed to adopt a proposed relevant exclusion.

26 See Nathan Boidman, Maarten Ellis, Gary J. Gartner and Nick Pantaleo, "CFC Rules in the Context of International Mergers and Acquisitions," *International Tax Seminar*, International Fiscal Association (Canadian branch), May 7, 2001, Montréal, Québec, Text of Seminar Papers (Canadian Tax Foundation).

27 But note that, however, such systems could also lead to Canadian attribution, should it become the parent.