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# Judicial and Legislative Developments Threaten Indirect Canadian Acquisitions

by Nathan Boidman

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# FEATURED PERSPECTIVE

## Judicial and Legislative Developments Threaten Indirect Canadian Acquisitions

by Nathan Boidman

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The author would like to thank Angelo Nikolakakis of EY (Canada) for his incisive insights regarding this article (which he did not read before it was submitted for publication). Nikolakakis was a key coauthor of the submission (cited in note 8 of this article) of the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada.

In this article, the author examines new obstacles to the recovery by foreign parties of funds they have invested to indirectly acquire, through foreign companies, Canadian targets, raised by the recent decision in *Univar* and related proposed amendments to certain surplus stripping rules.

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The case of *Univar*,[1] in which the Tax Court of Canada upheld a $30 million tax assessment on an alleged $600 million surplus strip,[2] raises domestic and international surplus stripping issues and highlights controversies swirling around the March 22 and July 29 proposals to amend the particular rule at the core of that June 22 decision.[3]

In October 2007 a U.K. private equity group (purchaser) acquired Univar NV (NV), a publicly traded Dutch group, for about $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 corporate capital (paid-up capital, or PUC) of just under $1 million (see note 6). This low PUC means that if the shares of Univar Canada had been redeemed after the takeover for $900 million, there would be a deemed dividend of $899 million.[4]

That would have also been the case had INC, the direct owner of Univar Canada, set up a Canadian holding company (Canco, in a general case) and transferred Univar Canada to that holding company for a non-share payment of $900 million. Section 212.1(1) of the Income Tax Act would treat any non-share payment in excess of 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.

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[1] *Univar Holdco Canada ULC v. Her Majesty the Queen*, 2016 TCC 159.

[2] ''Surplus strip'' (also referred to as ''surplus stripping'') refers to transactions that effectively see retained earnings of a corporation distributed to, or realized by, shareholders through arrangements other than 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.

(Footnote continued in next column.)

[3] For ease of discussion, the numbers are rounded, and some of the facts and transactions are simplified. ''Dollars'' refers to Canadian currency unless otherwise noted. At the point of the transaction (October 2007), the Canadian and U.S. dollars were of about equal value.

[4] Section 84(3) of the Income Tax Act, Revised Statutes of Canada 1985 c. 1 (5th Supplement) as amended.



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But there was another possibility. Given that some acquisition structures could have freed up the $900 million value of Univar Canada on a tax-free basis,[5] the group could try to adopt, as a self-help measure, a plan to avoid section 212.1(1) by accessing an exception — section 212.1(4) of the ITA — that applies when Canco controls INC at the point that INC transfers Univar Canada to Canco. That is what the parties did. This article explains how that was done and how the government successfully attacked the plan before the court under Canada's general antiavoidance rule. This article also deals with controversial proposed amendments to section 212.1(4), which address the heart of the plan in question.

## I. Surplus Stripping

Canada has long been obsessed with preventing corporate surplus from being removed (stripped) without payment of adequate dividend tax (see also note 2 of this article). This includes a focus on the use of PUC as a tool to protect the corporate asset or surplus base and prevent surplus stripping.[6] That has had its counterpart in the U.S.'s reliance on earnings and profits to protect surplus. In Canada, a payment on redemption or repurchase of a share that exceeds the PUC of the share (that is, the average amount per share for which all shares of a class of shares have been issued) is treated as a dividend (see note 3 of this article). PUC is divorced from the amount that is paid for shares, even when purchased from the issuer in light of the averaging rule. And that dividend treatment is also divorced from the question whether the payer corporation has retained earnings or surplus or, as denominated by U.S. law, E&P.[7]

The Canadian obsession with protecting surplus (and the related tools such as PUC and predecessor mechanics, including designated surplus) is evidenced by the extent of the related legislation and jurisprudence,[8] and was clearly warranted before 1972, when dividends were heavily taxed and capital gains — into which clever tax planners might convert dividends — were tax free. But today, when the spread between the two for Canadian residents might be less than 15 percentage points and might be negative or as little as 5 percent for nonresidents, there is far less reason for fervor or concern. Indeed, there should be far less concern about surplus stripping in Canada than about earnings stripping since the differential (including forgone dividend withholding taxes) between profits that are taxed and those that are not would be about 30 percent for treaty-based multinational corporations and 45 percent for those without treaty protection on dividends. Canada has done a good job at constraining base erosion and profit shifting (with, for example, the world's first thin capitalization rules in place since 1972 and the arm's-length principle for transfer prices in place even before that), so there are far fewer controversies surrounding high-cost earnings stripping than surrounding low-cost surplus stripping.[9]

When, as in the case of *Univar*, a Canadian corporation has asset value in excess of its PUC, merger and acquisition transactions can raise an opportunity to extract that value without triggering the deemed dividend that might otherwise stem from insufficient PUC. The particular transaction and whether a third party is involved may govern the success of the strategies employed. And, as *Univar* shows, it may not be sufficient that an internal transaction could be viewed as completing a third-party transaction.

The balance of this article considers the following interrelated questions:

- What was the alleged mischief in *Univar* that led to the plan being struck down under Canada's GAAR?
- What is GAAR, and how did it strike down the plan?
- How has the *Univar* plan led to proposed changes to the rule (section 212.1(4)) in issue, and what are those changes?
- How would those changes influence the decision in *Univar*?
- What is the prognosis for the proposed changes?

## II. What Was the Alleged Mischief?

Following the acquisition of NV, the basic PUC limitation rule meant that the maximum property value that could be extracted by INC (the U.S. subsidiary of NV that owned Univar Canada) from Univar Canada via a share redemption or buyback without triggering

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[5]*See* note 9, *infra*.

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

[7]In the U.S., a dividend for tax purposes, upon a share buyback or redemption, arises only when the corporation has current or cumulative E&P at the time of the event and the redemption is not disproportionate.

[8]*See* Angelo Nikolakakis, ''Yes, Virginia . . . Reconciling a Broader Exemption System With Continued Taxation of FAPI and Domestic Gains,'' 45 *International Tax* 12 (Apr. 2009); Nikolakakis, ''*Evans v. Desmarais*: Surplus Stripping After Canada Trustco and Mathew,'' 13(2) *International Tax Planning* 916 (2006); Blake Murray, ''The 1977 Amendments to the Corporate Distribution Rules,'' 16(1) *Osgoode Hall LJ* 155 (1978); and ''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 Respecting Section 212.1 and Back-to-Back Rules'' (the appendix, ''History of Subsection 212.1(4),'' contains extensive citations).

**(Footnote continued in next column.)**

[9]The lack of passion for BEPS in Canada is indicated in Boidman and Michael Kandev, ''Canada Takes First BEPS Steps,'' *Tax Notes Int'l*, Apr. 25, 2016, p. 371.



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deemed dividend treatment was $1 million, even though the purchaser had indirectly paid $900 million for Univar Canada.[10]

The mischief was a plan — described below — to use an exception under section 212.1(4) to the anti-surplus-stripping rule of section 212.1(1) in an attempt to achieve the same favorable tax results as if either of the alternative acquisition structures described in note 10 of this article had been adopted. In other words, it was an attempt at self-help intended to allow a recovery of $900 million of the acquisition price from the Canadian assets acquired.

The direct shareholder of INC sold a portion of the shares of INC having a value of $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. Then INC, under the control of UHC, sold the shares of Univar Canada to UHC in exchange for UHC's giving up (to INC) its shares of INC.[11] 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.

The first transaction (the sale of the shares of INC, a nonresident corporation) did not invoke section 212.1. Although the second transaction (the sale of the shares of Univar Canada) did raise section 212.1(1) issues, the control of INC made the provision of section 212.1(4) applicable and that exception rendered section 212.1(1) inapplicable, unless the GAAR struck down the plan. As discussed in Section III of this article, a GAAR challenge did take place and was upheld, making section 212.1 applicable.

## III. How Did GAAR Defeat the Plan?

Canada's GAAR (section 245 of the ITA) permits the government to disallow a ''tax benefit'' (as defined in section 245(1)), under Canadian tax law or a tax treaty, that arises from a transaction or a series of transactions that was *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.

When GAAR applies, the government resets the tax effects of the transactions under section 245(2) and (5), subject to modification by a court. The application of GAAR involves three stages: (1) the government has the burden of showing a tax benefit; (2) the taxpayer has the burden of proving the transaction is not an avoidance transaction; and (3) the government has the burden of showing that the taxpayer frustrated, avoided, or defeated a policy (object, spirit, and purpose) behind a tax rule that it alleges has been abused.[12]

In this case, the taxpayer admitted there was a tax benefit and a tax avoidance transaction. Therefore, it all came down to section 245(4) — misuse and abuse — and the court said at paragraph 47, ''The burden to establish misuse or abuse under subsection 245(4) is on the Respondent (the government).''[13]

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[10]The result would have been different had the purchaser (1) acquired through a newly formed Canadian corporation, funded with cash or perhaps cash and a purchaser note, the shares of Univar Canada from INC for cash or cash and a note (of the acquiring Canadian corporation or the purchaser) of $900 million, and then (2) acquired the shares of Univar NV for cash of $2 billion (or $1.1 billion cash if the $900 million was distributed to the existing shareholders before the balance of the acquisition) at a point when the group would hold the balance of the preexisting assets of $1.1 billion and cash or a note from the acquirer Canco of $900 million. But that would have seen the purchaser laying out $2.9 billion and to rectify that having to extract $900 million from the target, which would raise substantial and perhaps insurmountable obstacles including exposure to U.S. tax on both gain realized by INC on selling the shares of Univar Canada and on distributions by INC. As a Canadian tax matter, the transaction could — if the value of the shares of Univar Canada were not principally derived from Canadian real property or resource property — effectively see the entire $900 million of value of Univar Canada realized by the U.S. corporate seller (INC) and then extracted from Univar Canada without Canadian tax and without that result raising any controversy or dispute. Also, the result would have been different had the purchaser used a Canadian corporation as the vehicle to acquire NV for $2 billion, in which case it could have unwound the structure and effectively removed the value of Univar Canada without Canadian tax.

[11]The context of those transactions is that at the point of takeover, NV — with a value of $2 billion — owned (1) INC, with a value of $1.7 billion (and INC owned Univar Canada, with a value of $900 million, and other assets of $800 million), and (2) other assets of $300 million. The sale by NV left it with $800 million worth of INC stock, $900 million of shares and debt of UHC, and $300 million of other assets. After the first transaction above, UHC controlled INC with $900 million out of $1.7 billion of shares of INC. After INC sold the Univar Canada shares to UHC upon buyback of $900 million of its stock, NV owned $800 million of stock of INC (which had $800 million of assets), as well as $900 million of securities of UHC (which owned Univar Canada) and $300 million of other assets.

[12]*Canada Trustco Mortgage Company v. Canada*, 2005 SCC 54.

[13]Did the GAAR challenge create a disconnect between the transaction that actually triggered section 212.1 and the tax claimed by the government? At paragraph 35, UHC acquires from INC all the shares of Univar Canada in consideration of giving up to INC 273 shares of INC (worth $900 million). The latter is non-share consideration being paid by UHC, and the deemed dividend under subsection (1) — subject to subsection (4) — should be about $900 million. But at paragraph 42, there is the assessment and it is not for $900 million. Instead, it is for $589 million — the note that UHC issued when it bought shares of INC and the assessment reduces PUC of shares issued by UHC by $301 million. Was the Canada Revenue Agency relying

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The taxpayer argued that section 212.1 is concerned with wholly internal, non-arm's-length reorganizations designed to strip surplus, not with "the manner in which a true purchaser structures an arm's-length acquisition" (paragraph 50) and that the plan was merely a more convenient alternative to having the purchaser acquire Univar Canada through a Canadian holding company (as discussed in note 10 of this article). At paragraph 53, the taxpayer argued that "in the circumstances of this case, it was not practical and a different route was needed to obtain the same result."

The government argued that the plan frustrated the purpose of section 212.1. It said that although there is no general surplus stripping prohibition in the ITA, it is integral to section 212.1 in light of the PUC scheme in the ITA. And, of course, the government made no reference to the context as providing a proper policy-linked basis for the plan. The arguments were like two ships passing in the night.

The judge examined the relevant provisions[14] and noted that there is no general policy in the ITA against surplus stripping, but that section 212.1 is intended to be an anti-stripping rule. The judge then sided with the government, finding that the taxpayer's reliance on section 212.1(4) defeated the object, purpose, and spirit of that subsection and section 212.1 generally. Some aspects of the decision are — with respect — still puzzling.

A comment in paragraph 75 seems to imply that the current wording of section 212.1(4) should be read as requiring that the owner of the transferee Canadian corporation be resident in Canada, with the result that "any surplus from the subject (Canadian) corporation would remain in Canada." But that seems to conflate the current terms of section 212.1(4) with the proposed amendment, discussed below.

In paragraph 83, the judge states, in considering the legal context of the issue, that:

> It is my view that section 212.1(4) is aimed at a narrow circumstance where the purchaser corporation actually controls the non-resident corporation without manipulating the corporate structure to achieve that control. Such narrow circumstance does not apply in this appeal.

While the statement is reasonable enough on its face, is it ignoring the factual context? Here, the taxpayer is merely trying to recover its hard-dollar investment, not strip surplus arising during its ownership of Univar Canada, a recovery that the taxpayer would have been entitled to had a Canco been used to acquire NV or Univar Canada. That suggestion should not, in the writer's view, be considered neutralized by the judge's reference in the next paragraph (84) to a domestic counterpart to section 212.1 — namely, section 84.1 — that specifically condones recovery of hard cost. In a GAAR analysis, that comparison unduly restricts the search for a distinction between abusive and non-abusive tax planning.

Next, the judge sought to determine the purpose of section 212.1(4). The problem is that the rule is expressed in terms that could arise in several different contexts and its wording does not narrow the possibilities. The rule says simply that if a Canco controls a nonresident corporation that owns another Canadian corporation and sells it to Canco, subsection (1) does not apply. The judge did not appear to find a specific basis to reduce that ambit, although she speculated on what the legislation might have intended.

Moreover, the judge acknowledged that the Department of Finance, which drafts Canadian tax law, did not issue any explanatory notes when subsection (4) was tabled in 1978. At paragraph 94, she pointed to commentary of a commercial tax reporting service (De Boo) on the enactment in 1977 of subsection (1) as shedding light on the later enactment of subsection (4) in 1978. That commentary read as follows: "However there is some danger that, unless the legislation is drafted with extreme care it will inadvertently inhibit bona fide sales of shares by one member of a multinational corporate group to another."

The judge went on to write in paragraph 95:

> Seen in this light, the purpose of subsection 212.1(4) was to address the concerns raised by tax lawyers as evidenced in the 1977 De Boo Budget Date Comments. The purpose is to allow for the *bona fide* sale of shares by one member of a multinational corporate group to another while still respecting the purpose of subsection 212.1 (1) of the Act.

No example, however, is given of this situation, one that is difficult to visualize.

The judge then looked to whether the government's March 22 budget proposal to amend section 212.1(4) — discussed elsewhere herein and apparently specifically intended to counter the Univar plan — sheds light on the proper operation of the rule as now enacted. In concept, that quest is puzzling because if the rule now enacted, properly construed with the assistance of GAAR, does not support the Univar plan, why should it be amended in the radical fashion proposed? At paragraphs 96 and 97, the judge seems to accept the government's explanation that the amendment is only clarifying the rule, nearly 40 years after it was introduced. According to the government, the rule was always intended to apply only when control by the top-tier Canadian corporation of the nonresident corporation — the corporation that owns the Canadian subsidiary (which has the surplus that is potentially

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on the basic notion of a sham or some similar doctrine to recharacterize or compress/collapse all the steps into a simple sale of Univar Canada to UHC by INC for the note and shares, or was this a section 245(2) and (5) recasting of the transaction? The latter seems to be the case.

[14]The definition of PUC and sections 84 and 212.1.



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being stripped) — results from a third party selling shares of the nonresident corporation to the top-tier Canadian corporation.[15] This is certainly not what Parliament enacted in 1978. So it is difficult to see how the judge can look at this unfounded view of the government in evaluating whether there has been an abuse of the current rule.

As partially noted in note 15 herein, the quoted notes from the government go on to say that some groups have ''misused this exception by reorganizing the group into the sandwich structure with a view to qualifying for this exception as a part of a series of transactions designed to artificially increase the PUC of shares of those Canadian subsidiaries.'' But that comment is not qualified by reference to whether the reorganization involves a third-party acquisition, as there was in *Univar*. So it is difficult to conclude that the purposes of Parliament in 1978 were defeated or frustrated by the Univar reorganization.

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.

Finally, the judge notes (at paragraph 96) that Finance said:

> Transactions that misuse subsection 212.1(4) are currently being challenged by the Government under the existing provisions including the general anti-avoidance rule. This measure is intended to promote certainty and clarify the intended scope of the existing exception.

That statement cannot be reconciled to either the language of the rule or its history.

In summary, did the GAAR decision fully take context into account? GAAR is about abuse of law. Arguably, when one employs what Americans term ''a bit of self-help'' to get the right result, that should not be considered abusive.[16] Viewed in isolation, the taxpayer's plan was a pure surplus strip — and one that misused section 212.1(4). In that light, it was pure mischief. In context, was it not merely an element added to complete a tax-rational acquisition of Univar and thus a perfectly proper use of section 212.1(4)? There was no mischief, but Madam Justice Miller viewed the matter differently.

## IV. Proposed Revision

The basic purpose of section 212.1 is to guard against turning distributions in excess of PUC from dividends into capital gains through an intercompany sale by a nonresident of one Canadian company to another. The basic rule (subsection 212.1(1)) is reasonable enough — it taxes, immediately or eventually, the payments made by the acquiring affiliated Canadian company. But, recognizing that a reorganization transaction is sometimes not aiming to strip surplus but rather to provide a reasonable basis for a buyer to access the property of a Canadian target owned by a foreign corporation, section 212.1(4) provides an exception when the Canadian company to which the Canadian target is sold controls its nonresident parent.

This exception provides the basis to unwind the sandwich corporate structure when a purchaser establishes a Canadian corporation to acquire a foreign corporation that owns a Canadian corporation. And in that context, the use of subsection (4) is a straightforward matter, under current law. But the March 22 budget (and specific legislative proposals issued July 29) drastically narrows the scope of the exception. In particular, the exception will not apply when a nonresident both (i) owns, directly or indirectly, shares of the Canadian purchaser corporation, and (ii) does not deal at arm's length[17] with the Canadian purchaser corporation. In this author's opinion, it is radical, uncalled for,

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[15]This comes out of the extensive extract by the judge in paragraph 96 that is taken from the March 22 budget in which the government states that the exception found in section 212.1(4) applies ''where a Canadian corporation acquires the shares of a non-resident corporation that itself owns shares of a Canadian corporation. . . . Some non-resident corporations with Canadian subsidiaries have misused this exception by reorganizing the group. . . . Budget 2016 proposes to amend the exception in subsection 212.1(4) *to ensure that it applies as intended*'' (emphasis added). Then, in paragraph 97, the judge writes that: ''The proposed amendment does not retroactively change the law but simply amends the subsection *while embodying its underlying rationale as it existed at the time of the transactions in this appeal*'' (emphasis added).

[16]Paragraphs 104 and 105 of the judgment implicitly reject the argument that the alternative acquisition structure that would have produced the step-up is relevant at the misuse or abuse stage of a GAAR analysis. That is puzzling. The judge did not see the plan as a form of self-help. GAAR properly applied is an antidote to a plan that rests strictly on literal interpretations and unintended results. *Conversely*, when the rule would result in a tax that conceptually is not appropriate — as in *Univar*, in which the system would have had no problem with the buyer stripping Univar Canada had it been able to buy it from INC — the antidote is the taxpayer self-help response.

[17]Section 251(1) of the ITA automatically deems that related persons do not deal at arm's length. Related persons are defined in section 251(2) to include commonly controlled corporations.

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and totally detached from the scope of the rule. Moreover, it in no way gives the judge any relevant basis to decide the case.[18]

When the sandwich is created by way of an internal reorganization, it takes on additional complexity. There are two very different contexts in which the internal reorganization can arise. One context is when the parties have long been part of a multinational, and the reorganization to access the (current) section 212.1(4) exception clearly targets a surplus strip. In that context, a GAAR attack and an amendment to make subsection (4) unavailable would be reasonable. That is the effect of the July 29 proposal.

But the other context — when the reorganization is designed to complete a third-party acquisition (as arose in *Univar*) — should not see a GAAR attack (as unfortunately was successfully made by the government in *Univar*). And it also should not be the target of a statutory amendment to subsection (4) as it is under the July 29 proposals. The proposed amendment will attack not only an internal reorganization concerning a third-party acquisition, but also a sandwich created upon an acquisition by a third party that is a nonresident.[19]

The overall ambit of the proposal can be considered in terms of the *Univar* matter. In *Univar*, a U.K. group acquired all the shares of NV for $2 billion. NV owned a Canadian subsidiary, worth $900 million, through a U.S. subsidiary. Univar Canada's PUC was $1 million.

The transaction the parties carried out (a post-acquisition reorganization to create the sandwich) qualified for current subsection (4) but was struck down under GAAR. That transaction would be mechanically addressed by the proposed amendments; new subsection (4)'s exception would not apply, so subsection (1) would apply. If the U.K. buyer had first acquired Univar Canco from its direct U.S. parent, owned by NV, through a new Canco and then acquired NV from the public, would subsection (1) apply? That turns on whether the parties dealt at arm's length at the point of the first transaction and that probably would also turn on the exact relationship between the two transactions. If subsection (1) applied, there would not be any possible eligibility for new subsection (4). Finally, if the buyer acquired NV from the public through a special purpose vehicle (SPV) Canco and then had the direct U.S. owner of Univar Canco sell it to the SPV, new subsection (4) would not be available and therefore subsection (1) would apply.[20] That result is clearly inappropriate. The proposal discriminates against foreign buyers because a domestic buyer would be eligible for subsection (4) in these circumstances.[21]

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Section 251(1) also provides that whether unrelated persons are dealing at arm's length is a matter of fact.

[18]The July 29 draft on section 212.1 seems exactly the same as the Budget Day announcement. Finance did not incorporate recommended changes from the Canadian Bar Association (CBA) and Chartered Professional Accountants of Canada (CPA) joint committee submission (*see supra* note 8) or other observers who suggested that Finance rein in its attempt to extend section 212.1 by narrowing the exception provided by section 212.1(4). In this respect, the following passage from the CBA-CPA submission is significant. The submission provides the following excerpt from the budget papers:

> Budget 2016 proposes to amend the exception in subsection 212.1(4) to ensure that it applies as intended. In particular, it will be clarified that consistent with the policy of the anti-surplus- stripping rule, the exception does not apply where a non-resident both (i) owns, directly or indirectly, shares of the Canadian purchaser corporation, and (ii) does not deal at arm's length with the Canadian purchaser corporation.

The CBA-CPA joint committee then states:

> While we agree with the proposition that the Exception is intended to apply "where a Canadian corporation . . . acquires shares of a non-resident corporation that itself owns shares of a Canadian corporation," we respectfully submit that the proposed restriction, as currently drafted, is not consistent with the policy of the Main Rule and cannot reasonably or accurately be characterized as a clarification of the law.
>
> Rather, it is submitted that this proposed restriction, as currently drafted, would introduce unwarranted and unintended discrimination — a form of protectionism — into the application of the Exception in relation to *bona fide* arm's length acquisition transactions. In addition, we are concerned that this proposed restriction could produce inappropriate consequences both in contexts where there is a *bona fide* arm's length acquisition and in contexts where there is a *bona fide* reorganization transaction.

[19]The amendment makes the subsection (4) exception inapplicable when the acquiring Canadian corporation has a non-arm's-length nonresident shareholder. That obviously would be the case when a foreign multinational is acquiring a foreign group that has a Canadian sub and uses a Canco to make the whole acquisition. *But see infra* note 20.

[20]If the buyer is a private equity group that acts in a form of co-ownership and each deals at arm's length with the SPV, new subsection (4) should be available. But that would be rare. The proposed exclusion would apply to corporations that have non-arm's-length nonresident shareholders even when the foreign ownership is de minimis. For example, the exclusion will apply if a Canadian resident individual owns 99 percent of an acquiring Canadian corporation and a nonresident sibling owns the other 1 percent. There will be uncertainty in applying the proposal when the Canadian acquiring corporation is owned in whole or in part by a "designated partnership," which is, according to section 212.1(3)(e), a partnership of which either a majority interest partner or every member of a majority interest group of partners (as defined in subsection 251.1(3)) is a nonresident person, because the definitions of non-arm's-length persons and related persons (*see supra* note 17) do not deal with partnerships.

[21]The CBA-CPA joint committee, *supra* note 8, focused on this point but was ignored. In particular, at page 20 and following, the submission explains why there is no difference to the Canadian tax base whether purchasers are Canadian or foreign or whether they deal at arm's length or not (as shareholders) with the Canadian corporation that acquires the nonresident corporation.



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Several observers, including the CBA-CPA joint committee, have been critical of the proposal. The CBA-CPA's primary recommendation in its submissions is twofold. First, the current rule should be retained in the sense that the (non-) residency of shareholders of the holding company should not be a disqualifying factor for subsection (4) (and the government should not make claims that the current rule has any like limitation). Second, the exception in subsection (4) should be available to a direct buyer of a foreign company to do exactly what Univar did.

## V. Concluding Comment

Planning to recover investments that foreign parties make to acquire Canadian companies can be challenging when the target is acquired directly. As the foregoing discussion shows, it can, however, become even more challenging and difficult when they are acquired indirectly by purchasing the shares of foreign companies that own the Canadian targets. The issues have been intensified by the recent decision in *Univar* and the proposals to restrict the scope of the safe haven rule under section 212.1(4). ◆

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