PERSPECTIVE

Canadian Spinco Acquisition Transactions

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Strong and rising commodity prices in recent years have sparked a wave of activity in the Canadian stock markets, with larger resource companies acquiring a significant number of smaller, publicly-traded resource companies that require further capitalization to exploit their assets. A number of these transactions have contained a feature not often found in transactions outside the resource sector to date: in the course of being taken over, the target has spun out a new public corporation to its shareholders, owning assets not required by the purchaser.

Commonly, these takeovers occur once some of the target's assets have proven out, while others remain highly speculative. Where the purchaser is interested in acquiring and operating the proven assets, it often will place little or no value on the more speculative assets — and the stock market typically will give it little or no credit for them, either. Target's management, however, may be focused on an earlier stage in the asset development process and often will believe in the prospects of the non-core assets. A ready shareholder base for a smaller, more speculative company often exists — and will be present in the target's shareholder base itself. In these circumstances, a spin-out to the target shareholders of the non-core assets in the form of a new corporation (a "Spinco") as part of the takeover can deliver more value to the vendors at little cost to the purchaser, by allocating exploration or speculative assets and operational assets separately to the capital pools that are seeking each kind of investment. The purchaser may feel that it is appropriate to retain an interest in these assets (in the form of Spinco shares) so as not to simply pass on the upside they may represent, and its interest in Spinco will be quite liquid.

This article discusses how Spinco transactions typically are structured and the relevant Canadian tax considerations. Issues affecting employee stock options are discussed separately, as is the availability of the tax bump to the purchaser of the target shares. In the past two years, there have been 10 of these Spinco transactions in Canada. All but one of them have involved targets in the resource sector. In four of these 10 Spinco transactions, the purchasers took an interest in the Spincos, ranging from 9.9 per cent to 19.9 per cent of their issued capital.

Form of Spinco Transactions

Broadly, a Spinco transaction involves the following steps:

1. the creation and capitalization of Spinco;
2. the exercise or surrender of target employee stock options;
3. the distribution of Spinco shares to the target shareholders through a recapitalization transaction; and
4. the acquisition of the target shares by the purchaser.

Practically, these transaction steps are too involved for a takeover bid, so the transaction is undertaken as a target shareholder approved plan of arrangement. This is a procedure available under Canadian corporate statutes that, with court approval, allows a number of transactions to be undertaken as one series in a pre-arranged plan that takes effect on the filing of articles of arrangement with the appropriate corporate registrar. The steps of the plan typically will include the exercise or surrender of employees stock options, the reorganization of the target's capital to effect the distribution of the Spinco shares and the subsequent acquisition of the target shares by the purchaser.[1]

Packaging Spinco

The assets to be spun out of target are not likely to be conveniently collected in a pre-existing subsidiary. Instead, they will need to be transferred to Spinco, in consideration for Spinco shares and the assumption by Spinco of the liabilities associated with such assets.[2] Where Spinco is a Canadian corporation, the transfer of the assets can occur on a tax-deferred basis to the extent that the non-share consideration given by Spinco (e.g., the assumption of liabilities) does not exceed the tax cost of the assets transferred to Spinco, through an election under subsection 85(1) of the *Income Tax Act* (Canada) (the "ITA").[3] Although, as discussed below, the distribution of Spinco shares pursuant to the plan of arrangement is taxable to the target, a rollover on the transfer of assets to Spinco can avoid potentially higher tax rates that would apply to a transfer of those assets as compared to the capital gains tax rate that is expected to apply on the distribution by the target of the Spinco shares. The trade off for this is that Spinco will acquire the assets with a reduced tax cost as a result of the rollover. The decision whether there is a rollover on the transfer to Spinco will depend on the availability of tax pools that could shelter a taxable transfer, and the significance of those tax pools to the purchaser. Many purchasers place value on these pools, meaning that the short-term efficiencies of a rollover transaction often are required.

The Distribution of Spinco

General Considerations

In a typical spin-off transaction occurring as an internal corporate reorganization rather than as part of a takeover, the corporation being spun off typically can be distributed through: (i) a tax-deferred divisive reorganization (often referred to as a "butterfly"); (ii) a return to shareholders of the distributing corporation of "paid-up capital" (generally the historical amount contributed to the distributing corporation on the issuance of its shares); or (iii) the payment of a dividend-in-kind.

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[1] Occasionally, the transfer of assets to Spinco will also occur pursuant to the plan of arrangement.

[2] The target will also contribute a negotiated amount of cash to Spinco. Where target does not have sufficient cash on hand, the purchaser could make a loan to the target (as part of the plan of arrangement) in amount equal to the shortfall.

[3] Unless otherwise noted, all statutory references herein are to the ITA.

A butterfly transaction is not permitted as part of a series of transactions that includes an acquisition of control of either the distributing corporation or the corporation that was spun out. Accordingly, in a takeover, the distribution of Spinco by the target must either occur as a distribution of paid-up capital or the payment of a dividend-in-kind. In either case, the target will be considered to dispose of the Spinco shares for fair market value proceeds of disposition. To the extent the target has any losses, they can be used to offset all or a portion of any capital gain it realizes on the distribution of the Spinco shares. Any capital losses or non-capital losses from a property source that the target may have will not survive the acquisition of control by the purchaser in any event.[4]

The choice between a return of capital and a dividend-in-kind affects the tax treatment of the distribution to the target shareholders. Various classes of shareholders (individuals, corporations, non-residents, others) will have different tax preferences. In general, the receipt of a paid-up capital distribution is less likely to disadvantage any of these shareholder groups than a dividend distribution.

Where the target shareholders receive the Spinco shares as a distribution of paid-up capital, the tax cost of their target shares will be reduced by the fair market value of the Spinco shares received.[5] The reduction in tax cost in the target shares will manifest itself in an increased capital gain (or reduced capital loss) on the sale of the target shares to the purchaser.

If, instead, the shareholders receive the Spinco shares as a dividend-in-kind, the fair market value of the Spinco shares will be a dividend receipt. Canadian-resident individual shareholders will in most Canadian provinces be subject to tax at a rate that is greater than the capital gains rate. In addition, if a shareholder has a capital loss on the sale of target shares to the purchaser, the capital loss cannot be applied against the dividend income (capital losses can only be set off against capital gains). For shareholders not resident in Canada, a dividend will generally be subject to Canadian withholding tax at a rate of 25 per cent, subject to reduction under an applicable income tax treaty. Non-resident shareholders would generally not be subject to tax in Canada on a capital gain in respect of the disposition of the target shares to the purchaser.[6] Accordingly, both Canadian resident and non-resident shareholders will generally be worse-off where they receive the Spinco shares on a dividend instead of a distribution of paid-up capital. As a result, the distribution typically is effected as a return of capital.

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[4] The distribution of Spinco and the acquisition of the target shares by the purchaser will generally occur on the same day under a plan of arrangement (and usually minutes apart). Subsection 256(9) deems an acquisition of control to occur at the commencement of the day that the purchaser acquires the target shares unless the target elects to have subsection 256(9) not apply. Where losses of the target that would otherwise expire on the acquisition of control are to be applied against any gain arising on the distribution of the Spinco shares, a subsection 256(9) election is required so that the acquisition of control does not occur until after the Spinco distribution.

[5] If the fair market value of the Spinco shares received by a shareholder exceeds the tax cost of a shareholder's target shares, the shareholder would have a deemed capital gain in the amount of the excess.

[6] A non-resident of Canada will only be subject to tax under the ITA in respect of a capital gain where the property disposed of is "taxable Canadian property" to the non-resident and the taxation of the gain is not exempt under an applicable income tax treaty. Generally, the shares of a publicly listed Canadian corporation would only be taxable Canadian property to a non-resident person where during the 60-month period immediately preceding that time (i) the non-resident (together with persons with whom the non-resident did not deal at arm's length) owned 25 per cent or more of the issued shares of any class of the corporation, and (ii) more than 50 per cent of the fair market value of the shares was derived, directly or indirectly, from real property situated in Canada, Canadian resource properties, timber resource properties, and/or options or rights in respect of such property.

Distribution Mechanics

Under subsection 84(4.1), an amount paid by a Canadian public corporation to its shareholders on a reduction of its capital is deemed to be a dividend except in limited circumstances. One of the exceptions to this general rule is a reduction of capital by the public corporation that occurs on a share exchange that qualifies as a reorganization of the corporation's capital under section 86. Section 86 provides for a tax-deferred share exchange where, among other things, a taxpayer disposes of capital property that is all of its shares of a particular class of a corporation to the corporation in the course of a reorganization of capital and the consideration received by the taxpayer includes new shares of the corporation. Although there is no definition of the term "reorganization of capital" in the ITA, the Canada Revenue Agency generally accepts that material changes to the share capital of a corporation (such as reclassifying outstanding shares into newly created shares) effected by corporate articles of amendment will constitute a reorganization of capital for the purposes of section 86.[7]

In the vast majority of the Spinco transactions to date, the distribution of Spinco has been structured to fit within the section 86 exception from the general deemed dividend rule. However, this does present issues for employee stock options that should be addressed, as discussed below.

As an example of a section 86 reorganization of capital, in the recent acquisition of Fronteer Gold Inc. by Newmont Mining Corporation: (i) Fronteer's articles of incorporation were amended to create a new class of shares ("class A shares") that had a fixed redemption amount equal to the cash purchase price to be paid by Newmont on the purchase of the Fronteer shares;[8] and (ii) each Fronteer share (other than those held by Newmont) was exchanged with Fronteer for one new Fronteer class A share and a share of Pilot Gold Inc. (i.e., Spinco). Newmont purchased all the Fronteer class A shares as a subsequent step in the plan of arrangement, for the agreed purchase price.

Where the distribution of Spinco is undertaken in this manner, a deemed dividend will only arise to the extent that the fair market value of the Spinco shares exceeds the paid-up capital of the target shares disposed of on the share exchange. Typically, it is expected that the fair market value of the Spinco shares will be less than the paid-up capital of the target shares so that no deemed dividend will arise. However, there is usually an element of uncertainty given that the valuation of Spinco typically is based on valuations, estimates and an agreement between purchaser and target. If there is material risk that Spinco's value may be underestimated, it is necessary to consider whether a deemed dividend could arise. In any event, the plan of arrangement will generally provide a mechanism for funding the withholding obligation in respect of non-resident shareholders in the event a deemed dividend did arise.

Under a section 86 reorganization, the target shareholders will: (i) acquire the Spinco shares with a tax cost equal to their fair market value; (ii) acquire the new target shares with a tax cost equal to the amount by which the tax cost of their old target shares exceeds the fair market value of the Spinco shares received; and (iii) have deemed proceeds of disposition for the old

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[7] See, for example, Advance Tax Ruling, ATR-33, dated October 7, 1998.

[8] Where purchaser shares are being issued in consideration for the target shares, the new shares issued on the reorganization of capital will generally be common shares (with slightly different terms than the existing common shares) instead of shares with a fixed redemption amount as it is difficult to choose an appropriate redemption amount given that the purchaser's acquisition is a barter transaction.

target shares equal to the aggregate of the tax cost of the new target shares and the fair market value of the Spinco shares received (otherwise than as a deemed dividend). As a result, the target shareholders will only realize a capital gain on the share exchange if the fair market value of the Spinco shares received exceeds the tax cost of their target shares.

UTS/Total Transaction

In the acquisition of UTS Energy Corporation ("UTS") by Total S.A. ("Total") in 2010, the distribution of Spinco (Silver Birch Energy Corporation ["SilverBirch"]) was structured in a manner that provided Canadian resident shareholders with a rollover in respect of the receipt of SilverBirch shares.[9] This additional structuring likely was undertaken because the value of SilverBirch was quite high relative to typical Spinco transactions. It was estimated that the SilverBirch shares represented 10 per cent of the total fair market value of UTS. The key tax features of this transaction were:

- UTS transferred the spin-off assets to SilverBirch in consideration for the assumption of liabilities related to the spin-off assets and a SilverBirch preferred share with a redemption amount equal to the net fair market value of the spin-off assets. This transfer occurred on a tax-deferred basis under subsection 85(1). The SilverBirch preferred share was subsequently redeemed for a promissory note with a principal amount equal to the redemption amount of the preferred share (i.e., the net fair market value of the spin-off assets). The redemption of the preferred share likely resulted in a capital gain to UTS equal to the amount that was deferred under subsection 85(1).[10] These steps avoided incremental taxes that would have applied on a taxable contribution of assets to SilverBirch.
- The UTS shares were exchanged for new shares of UTS, consisting of UTS class A shares and UTS class B shares. The UTS class A shares were common shares and the UTS class B shares had a redemption amount equal to the net fair market value of the spin-off assets. The total amount added to the paid-up capital of the new UTS shares was equal to the paid-up capital of the old UTS shares, with an amount equal the redemption amount of the UTS class B shares being added to the paid-up capital of that class and the balance added to the paid-up capital of the UTS class A shares. This share exchange occurred on a tax-deferred basis under section 86, with each shareholder's tax cost of its old UTS shares being apportioned between the UTS class A shares and the UTS class B shares based on their relative fair market values.
- The Canadian resident UTS shareholders transferred their UTS class B shares to SilverBirch for SilverBirch shares. This exchange of UTS class B shares for SilverBirch shares occurred on a tax-deferred basis under section 85.1, with the UTS shareholders having deemed proceeds of disposition equal to their tax cost of the UTS class B shares (which they acquired on a tax-deferred basis in the previous step) and SilverBirch acquiring the UTS class B shares with a tax cost equal to the paid-up capital of the UTS class B shares (which was also equal to the redemption amount of the UTS class B shares).
- The UTS class B shares held by SilverBirch were redeemed by UTS in consideration for the cancellation of the SilverBirch promissory note held by UTS. No deemed dividend

[9] Since non-resident shareholders were not expected to be taxable under the ITA, it was not necessary to also provide a rollover to such shareholders.

[10] The redemption of the preferred share would give rise to a deemed dividend, but the deemed dividend is likely re-characterized under subsection 55(2) as a deemed capital gain.

arose on the redemption of the UTS class B shares since the redemption amount of the shares was equal to their paid-up capital, and no gain was realized by SilverBirch on such redemption since SilverBirch had a tax cost in the shares equal to the redemption amount of such shares.

- The Canadian resident UTS shareholders transferred their UTS class A shares to Total for the cash purchase price. This was a taxable transaction to such shareholders.
- As a result, the UTS shareholders transferred a portion of the inherent gain in their UTS shares into their SilverBirch shares and reduced the amount of the gain on their disposition of UTS shares. However, it required a significantly more complicated transaction (and description of steps in the public disclosure). These additional steps are likely to be warranted only where the amount of gain that can be deferred in this way is significant — which requires that Spinco represent a significant portion of target's total value.

Interestingly, on January 9, 2012, it was announced that Teck Resources Limited will acquire the shares of SilverBirch and SilverBirch shareholders will receive $435 million and shares of a Spinco.

Dealing with Stock Options

It is common in takeovers to accelerate the vesting of the target stock options, and to provide that any unexercised stock options will be surrendered to the target in consideration for a payment equal to the in-the-money value of the options. In the case of a Spinco transaction, the in-the-money value of the options is generally calculated based on the aggregate of the purchase price to be paid by the purchaser for a target share and the fair market value of the Spinco shares (or fraction thereof) that will be distributed on each target share. If it is desired that surrendering optionholders receive Spinco shares on an option cash-out, as they would if they exercised their options, the optionholders can be allowed to surrender their options for a combination of cash and Spinco shares with an aggregate value equal to the options' in-the-money amount, or for target shares with an aggregate value equal to the in-the-money amount (which then participate in the balance of the plan of arrangement).[11] In most cases, employees will choose to surrender their options rather than exercise them in order to avoid the need to fund the exercise price under the options.

The surrender or exercise of employee stock options gives rise to cash withholding requirements. Where no cash is paid to the employees at the time of the exercise or surrender of their stock options (or where there will be insufficient cash to fund the withholding requirement), the target can require that the employees cash-fund the withholding payment (in addition to the option exercise price, where the options are being exercised). Alternatively, where the purchaser is paying cash for the target shares and the employees are receiving target shares on the exercise or surrender of their options, the plan of arrangement can provide that the cash withholding be funded from the cash payable to the employees for their target shares.

An employee resident in Canada who exercises or surrenders a stock option recognizes a taxable benefit equal to the amount by which the fair market value of the share acquired on exercise exceeds the exercise price or, where the option is surrendered, the fair market value of

[11] Where the exercise price of an option is greater than the purchase price to be paid by the purchaser for a target share but the option is in-the-money because of the value of the Spinco shares, the plan will normally require that the optionholder pay to the target the amount by which the exercise price exceeds the target share purchase price.

the consideration received on the surrender of the option. One-half of the benefit is deductible where:

- the stock option was issued with an exercise price not less than the fair market value of the underlying share at the time the option was granted;
- at the time the option is exercised or surrendered, the share under option is a “prescribed share”; and
- where the option is surrendered, the employer elects that no deduction will be claimed in computing income for the amount paid on the surrender of the stock option.[12]

The one-half deduction provides the employee with a tax rate equivalent to the Canadian tax rate on capital gains. Public company stock options are generally intended to qualify for this deduction, and a target’s management will generally want comfort that the Spinco transaction will achieve this.

In a Spinco transaction, the principal challenge in achieving the preferred tax treatment for the options will be satisfying the prescribed share requirement. This requirement ensures that the shares acquired upon an exercise of stock options are ordinary common shares, and that there are no fixed or guaranteed distribution or liquidation entitlements. The prescribed share rules require that, among other things, it cannot reasonably be expected that, within two years after the time the option is exercised or surrendered, the issuer will acquire the share. However, the typical Spinco transaction involves the distribution of the Spinco shares on a target capital reorganization that involves the exchange of the outstanding target shares. In these cases, if, at the time the stock options are exercised or surrendered, they represent the right to acquire a target share that will participate in this reorganization, the optionholders may not be entitled to the capital gains equivalent treatment.[13]

One alternative to deal with this issue is to provide that any shares that would be acquired on the exercise of stock options will not participate in the reorganization of capital. For example, the plan of arrangement could provide that any shares acquired on the exercise of stock options are transferred to the purchaser prior to the reorganization of capital in consideration for the target share purchase price payable to other shareholders plus cash equal to the fair market value of a Spinco share (“Spinco Cash Amount”). The plan could provide that the optionholders use the Spinco Cash Amount to purchase Spinco shares from the target. Alternatively, the purchaser could acquire a sufficient number of Spinco shares from the target and transfer those shares to the employees on the acquisition of their target shares acquired under the stock options instead of the Spinco Cash Amount. The reorganization of capital could then occur for the other shareholders. In either case, it is unlikely that an optionholder will exercise options and require that these additional steps be undertaken — rather, they provide comfort that the beneficial tax treatment is available to optionholders surrendering their options.

Tax Bump Considerations for the Purchaser

The purchaser may seek the “tax bump” provided by paragraphs 88(1)(c) and (d), to increase the tax cost of the shares of the target’s subsidiaries. Where available, the tax bump allows a qualifying Canadian corporate buyer of a Canadian corporate target to “push-down” its tax cost

[12] Where the option is exercised, no deduction is available to the employer.

[13] Clearly, this would be an inappropriate result.

in the target shares to increase, or "bump", the tax cost of the target's non-depreciable capital property (most typically, shares of subsidiaries or other corporations and partnership interests) upon an amalgamation with or wind-up of the target. In the case of a non-resident purchaser, it will generally incorporate a Canadian corporation to acquire the target shares in order to, among other things, obtain the tax bump.

The tax bump rules include convoluted provisions (often referred to as the "bump denial rules") that will deny the bump to the purchaser where, as part of the series of transactions that includes the wind-up or amalgamation, any "restricted property" is acquired by a "restricted person".[14]

In addition to the usual complexities of the bump denial rules, a Spinco transaction may present its own issues. It may be proposed that the purchaser provide Spinco with certain indemnities (for example, for pre-closing taxes). However, these indemnities could bring the bump denial rules into play, because Spinco will be a restricted person and the indemnities could be considered to be restricted property.

Restricted persons include a corporation of which any collection of former target shareholders that held in aggregate 10 per cent or more of a class of target shares acquired 10 per cent or more of the shares of any class of the corporation as part of the series of transactions. Since all the target shareholders will generally acquire shares of Spinco as part of the series of transactions and together they would hold 10 per cent or more of the Spinco shares, Spinco will be a restricted person.

Subject to certain exceptions, restricted property includes any property the fair market value of which is wholly or partly attributable to property directly held by the target at the time it is wound-up into, or amalgamated with, the purchaser. The ability of the purchaser to make good on any indemnities given to Spinco could at least partially be affected by the value of such property and therefore the indemnities could constitute restricted property.

Accordingly, where the bump is important to a purchaser, the purchaser will generally resist providing, or allowing the target to provide, any covenants or indemnities to Spinco that will survive the closing of the acquisition of the target shares by the purchaser. The purchaser also will likely require that Spinco provide covenants that it will not acquire any restricted property (such as securities of the purchaser) within a specified period of time. These will be in addition to similar representations and covenants that are normally sought by the purchaser from material target shareholders in connection with any takeover transaction where the bump is important to the purchaser.

Conclusion

Spinco transactions can been used to provide the target shareholders with additional value in respect of their target shares at little cost to a purchaser who does not value the spin-off assets. These transactions to date have been concentrated in the resource sector, and they will continue to have appeal in that sector because of the nature of the assets and business models

[14] In general terms and subject to certain limited exceptions, the bump denial rules prohibit any group of target shareholders (whether or not connected) that collectively held 10 per cent or more of target shares from acquiring an interest in any target property that is distributed on the amalgamation of target with, or the wind-up of target into, purchaser, or any property that derives any part of its value from such property, where that interest continues after the acquisition of control of the target by the purchaser.

found there. However, there is nothing about Spinco transactions structurally that limits them to this sector, and they have the prospect of adding value in other transactions where a subset of target assets are valued differently by the purchaser and the target's management and shareholders.

If you have any questions regarding the foregoing, please contact Ian Crosbie (416.367.6958) or Raj Juneja (416.863.5508) in our Toronto office, or Brian Bloom (514.841.6505) or Michael Kandev (514.841.6556) in our Montréal office.

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