

Canadian Corporations Acquiring U.S. Target Companies in Tax-Deferred Transactions: When Business Activities Outside the U.S. Matter

September 27, 2021 – Cross-Border Counselor

by Kendall R. Fisher and John D. Hollinrake, Jr.

In transactions in which a Canadian corporation seeks to acquire a U.S. target entity for shares of the Canadian acquiror in a transaction intended to be tax-deferred for U.S. federal income tax purposes, the ability of U.S. shareholders of the U.S. target to qualify for tax-deferral may depend on the activities the Canadian acquiror conducts in Canada (or other non-US jurisdictions).

Under the general rule in Code Section 367(a), if a U.S. person transfers stock in a U.S. corporation to a Canadian corporation (as characterized for U.S. federal income tax purposes), such transfer will not be characterized as a tax-deferred exchange for U.S. federal income tax purposes (even if the transaction would otherwise qualify as a tax-deferred exchange).

There are a number of exceptions (and exceptions to the exceptions) to the general rule contained in Code Section 367(a). One of the most important exceptions is the “Active Trade or Business Exception”, which applies where the Canadian corporation directly, or through certain qualified subsidiaries: (i) is engaged in an active trade or business in Canada (or other non-US jurisdiction) for the entirety of the 36-month period immediately prior to the transaction; (ii) at the time of the transaction, has no intent to dispose of or discontinue such trade or business; and (iii) has a fair market value which is substantial as compared to the U.S. target corporation. The Active Trade or Business Exception can be critical to achieving tax-deferral for U.S. owners of U.S. target companies. Each component of the Active Trade or Business Exception is subject to complex rules and interpretations.

Even if the Active Trade or Business Exception is satisfied, if an owner of the U.S. target would own, directly, indirectly or pursuant to certain attribution rules, 5% or more of the outstanding voting power or value of the Canadian corporation immediately after the exchange, the exchange will generally be taxable to such U.S. target owner unless that person enters into a “gain recognition agreement” with the Internal Revenue Service. A gain recognition agreement is an agreement whereby a U.S. target owner agrees that if a

Related People

- Kendall R. Fisher

Related Capabilities

- Canada Cross-Border Transactions

“gain recognition event” occurs within a five-year period following the initial transfer, such U.S. target owner will also recognize at the time of such “gain recognition event” the gain that existed in their equity holdings at the time of the initial transfer.

Code Section 367(a) also does not generally apply to any transfer of property by a U.S. person to a Canadian corporation which is, or will be immediately after such transfer, treated as an “inverted corporation” (i.e., a U.S. domestic corporation for U.S. federal income tax purposes) under Code Section 7874(b). The business activities, employee headcount, and employee compensation of the Canadian acquiring corporation in Canada will also generally be relevant in determining whether a Canadian corporation is, or will be immediately after such an exchange, an “inverted corporation”.

Because determining whether tax-deferral may be available for U.S. shareholders of a U.S. target company can have a significant impact on structure, pricing and other material transaction terms, it is best for Canadian corporations evaluating acquisitions of U.S. target companies to analyze as early as practical whether the Active Trade or Business Exception (or any other exception under Code Section 367(a)) may be available.