

Share Buyback Transactions: U.S. Tax Consequences may differ for each U.S. Shareholder

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

On Thursday, November 4, 2021, the Office of the Superintendent of Financial Institutions announced that, subject to approval by the superintendent, Canadian banks and other financial institutions may begin repurchasing their own shares. Share buyback transactions by Canadian companies are not novel. However, the U.S. federal income tax treatment of U.S. shareholders participating in a share buyback transaction with a Canadian corporation can often be surprising.

Depending on the U.S. shareholder's particular circumstances, the tendering of shares of a Canadian corporation for cash pursuant to a share buyback transaction will generally either be treated as a "sale or exchange" of such U.S. shareholder's shares or as a "distribution" by the Canadian corporation in respect of such U.S. shareholder's shares. Under Code Section 302, after applying certain constructive ownership and attribution rules, a U.S. shareholder whose shares are sold back to the issuing Canadian corporation for cash will generally be treated as having engaged in a "sale or exchange" of such shares if the transaction:

- has the effect of a "substantially disproportionate" distribution by the Canadian corporation with respect to such U.S. shareholder;
- results in a "complete termination" of such U.S. shareholder's equity interest in the Canadian corporation; or
- is "not essentially equivalent to a dividend" with respect to such U.S. shareholder.

Each of the tests above generally considers the proportion of shares of the Canadian corporation the U.S. shareholder holds immediately prior to, and (if any) immediately after, the share buyback transaction either based upon the aggregate issued and outstanding shares of the Canadian corporation or the shares actually and constructively held by each U.S. shareholder individually.

Provided certain holding period and other requirements are satisfied, a U.S. shareholder that is deemed to "sell or exchange" their shares of a Canadian corporation may be eligible for the lower, more favorable, capital gains tax rates. If the U.S. shareholder is

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deemed to receive a “distribution” with respect to its shares, such U.S. shareholder would generally recognize, as ordinary income, a dividend equal to the amount of any distribution paid on the shares, without reduction for any Canadian taxes withheld from the amount paid, on the date the distribution is received to the extent the distribution is paid out of the Canadian corporation’s current or accumulated “earnings and profits” as determined for U.S. federal income tax purposes. If the distribution exceeds the Canadian corporation’s earnings and profits, the U.S. shareholder’s tax basis in its remaining shares would then be reduced (but not below zero) with any then remaining excess generally treated as capital gains.

However, many Canadian corporations do not maintain calculations of their current and accumulated earnings and profits in accordance with U.S. federal income tax principles. In those instances, U.S. shareholders deemed to receive a “distribution” pursuant to a share buyback transaction may be required to treat the entirety of the proceeds received as a taxable dividend subject to ordinary income tax rates.

The U.S. federal income tax consequences of share buyback transactions are different for Canadian corporations classified as “passive foreign investment companies” for U.S. federal income tax purposes.

In the U.S., recent legislative proposals have included an excise tax, at a rate as high as 2%, on share buyback transactions for public companies in the U.S. It remains uncertain whether any such tax will be adopted and, if adopted, what scope of publicly traded corporations will be subject to that tax.