

THE NAVIGATOR



FOREIGN SPIN-OFFS

What is a foreign spin-off?

A foreign spin-off is a special form of reorganization under which a corporation (the parent) issues shares of another corporation that it owns (the spin-off) to its shareholders. Typically this is done by a parent company to unlock market value or to simplify the corporate structure. These complex transactions are often completed on a tax deferred basis under the tax laws in the home country of the parent company.

However, Canadian taxpayers must apply Canadian tax law to these spin-off transactions to determine how these should be taxed for Canadian purposes. Even though a transaction may be structured to be tax deferred in the parent company's home country (such as a demerger in the UK, or a spin-off in the U.S.), these transactions are typically taxable under Canadian tax law.

HOW MUCH NOTICE IS PROVIDED OF A SPIN-OFF?

Unfortunately there is generally little lead time in terms of notification of the official record dates for spin-off events and as such advance planning is problematic. While companies often announce the spin-off in press releases months in advance, often the record date is announced only a few days prior to the spin-off leaving little time to take any action.

WHAT ARE THE TAX IMPLICATIONS OF A FOREIGN SPIN-OFF?

Canadian tax rules require that the fair market value (FMV) of the spin-off shares you receive be reported as a foreign-source taxable dividend in the year received. Therefore, the FMV of the spin-off shares received is included

in box 15 of the T5 tax slip for non-registered accounts. As foreign-source dividends do not benefit from the preferential tax treatment afforded dividends from Canadian companies, these foreign-source dividends are fully taxed at your marginal tax rate. The FMV of the spin-off shares received also becomes the adjusted cost base (ACB) of these spin-off shares going forward for tax purposes.

Typically, a spin-off transaction results in the movement of value from the parent company to the spin-off company. This is often reflected in the decrease in the market price of the parent company shares, roughly in proportion to the amount of value incorporated into the spin-off shares. Even though there is a likely

reallocation of value in a spin-off transaction, the ACB of the parent shares are not changed by the transaction. This has the potential to result in capital losses on the disposition of the parent company shares where previously there may have been capital gains, or smaller capital losses.

If you are holding your parent company shares in a non-registered account, the treatment of the spin-off as a foreign dividend has the result of actually increasing the total tax cost to you. The increase results from the foreign dividend being fully taxable at the shareholder's marginal tax rate, while the resulting potential capital loss (based on the decrease in market value of the parent company shares



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without any change in the ACB of the parent company shares) is only usable for tax purposes at the 50% inclusion rate used for capital transactions.

WHAT CAN BE DONE TO MITIGATE THE TAX IMPACT OF A FOREIGN SPIN-OFF BEFORE THE SPIN-OFF TRANSACTION?

The easiest way to avoid the tax consequences of receiving spin-off shares is to not own the parent company shares at the time that the spin-off occurs (record date) in a taxable non-registered account. Two possible transactions could be to sell the parent shares, or to transfer these to a registered account as an in-kind contribution. In each of these transactions the disposition of the parent company shares may result in a capital gain or loss. Capital gains are taxable, however, if the parent company shares are in a loss position then only an outright sale should be considered as the capital loss is never usable when shares in a loss position are transferred to a registered account.

If you decide to make an in-kind contribution of the parent company shares to your RRSP there is a chance that the spin-off shares could be considered a non-qualified investment for registered plans if they are foreign non-listed securities. There may be penalties associated with holding a non-qualified investment in your RRSP. Ask your RBC Advisor for the article “Tax Implications of Non-Qualified Investments in a Registered Account or TFSA”.

WHAT CAN BE DONE TO MITIGATE THE TAX IMPACT OF A FOREIGN SPIN-OFF AFTER THE SPIN-OFF TRANSACTION?

In October 2000, Canada enacted special tax rules that allow Canadian taxpayers to elect a tax-free receipt

of foreign spin-off shares but only for certain foreign spin-offs where particular conditions are met and the applicable elections are filed on time. These rules only apply to non-registered accounts. The circumstances and steps to use the special election rules are as follows:

- 1) In order for a foreign spin-off to even be considered non-taxable for Canadian tax purposes, it must first meet certain preliminary criteria. A discussion of all of the conditions that must be met is beyond the scope of this article. However, one of the criteria is that the spin-off must be non-taxable under the tax laws of the foreign jurisdiction for residents of that country. In addition, the tax rules require the foreign parent company to file certain information with the Canada Revenue Agency (CRA) for approval within six months of the record date of the spin-off. Only a small percentage of foreign parent companies actually file the needed information. Even if a parent company files for the tax election that might benefit its Canadian shareholders, there is an element of risk that the election will not be accepted by the CRA. CRA posts their approved foreign spin-offs at <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/spnffs-eng.html>. Once approved, the spin-off is called an “eligible spin-off”.
- 2) Once the spinoff is approved by CRA, the taxpayer must file a Section 86.1 election with their tax return for the year in which the spin-off occurred. A sample of what this election may look like is attached to the end of this article in Appendix I. **If this template is used it is imperative that it is reviewed and approved by your qualified tax advisor.**

CRA posts their approved foreign spin-offs at

<http://www.cra-arc.gc.ca/tx/bsnss/tpcs/spnffs-eng.html>.

- 3) You should **not** report the foreign dividend relating to the eligible spin-off (which is shown in box 15 of the T5) as income on your General Income Tax return. Instead, the T5 slip reporting the foreign dividend and the 86.1 tax election should be included with your tax return that you file for the year of the spin-off.

If you are filing a Section 86.1 election, you will not be able to electronically file your tax return for that year.

If your T5 contains multiple foreign dividend amounts, you can refer to your *Summary of Investment Income and Expenses* that is included in the same package as the T5 slip, to determine how much of the foreign dividends relate to the spin-off.

THE TAX IMPLICATIONS OF THE SPECIAL RULES FOR ELIGIBLE FOREIGN SPIN-OFFS

If you file the election for an approved spinoff, the cost base of the parent company shares must be allocated between the parent and the spin-off shares based on the relative value of the two shares immediately after the spin-off transaction. The two most often used methods to allocate the original cost base between the parent company shares and the spin-off shares are:

- 1) The parent company may issue

some guidance on how the value should be split. Your qualified tax advisor should ensure that it satisfies the Canadian tax rules (see number 2 below)

- 2) The **total ACB of the spin-off shares** can be calculated using the following formula:

Total ACB of the spin-off shares =
 $A \times [B / (B + C)]$

where,

A = Total ACB of parent shares immediately before the spin-off distribution

B = Total FMV of the spin-off shares (including fractional shares) immediately after its distribution to the shareholder

C = Total FMV of the parent shares immediately after the distribution of the spin-off shares to the shareholder.

The new total ACB of the parent company shares after the spin-off is simply the total ACB of the parent company shares before the spin-off minus the total ACB allocated to the spin-off shares determined in the above formula.

Note 1: The total ACB of the spin-off shares calculated above should be reduced by any cost allocated to cash in lieu of fractional spin-off shares

received. The treatment of the cash received in lieu of fractional spin-off shares is explained below.

Note 2: The above formula is used for the **total ACB, not the ACB per share**. Once the total ACB is determined, the ACB per share is simply the total ACB divided by the number of shares.

Note 3: The FMV of the spin-off shares immediately after its distribution to the shareholder can be based on the closing price on the first trading day of the spin-off shares. Therefore, your advisor can assist you in this regard by viewing the parent company's website to determine what the effective day was for the spin-off distribution. Then the closing price on the first trading day for both the parent company shares and the spin-off shares can be determined. Once these values are determined they can be plugged in the above formula to determine the appropriate ACB allocation.

You should consult with your qualified tax advisor before implementing any of the information just discussed.

For Canadian tax reporting purposes, the above amounts must be converted to the equivalent Canadian dollar amounts using the appropriate foreign exchange rate. One source that can be used for determining historical foreign exchange rates is the Bank of Canada website: **www.bankofcanada.ca**.



You should consult with your qualified Tax Advisor before implementing this strategy.

CASH IN LIEU OF FRACTIONAL SPIN-OFF SHARES

The receipt of cash in lieu of a fractional spin-off share should be treated as proceeds of disposition that will give rise to a small capital gain or capital loss. The total cost amount of any fractional shares for purposes of reporting this capital gain or capital loss is equal to the number of fractional shares received multiplied by the **ACB** per spin-off share immediately

after the distribution as determined with your qualified tax advisor and discussed above.

Alternatively, CRA administratively allows for a reduction in the total ACB of all of the spin-off shares equal to the cash value of the fractional shares received. This can be done if the value of the fractional shares paid out in cash does not exceed \$200.

APPENDIX I: SECTION 86.1 ELECTION

Taxpayer Name: _____

Taxation Year: _____

SIN (or Business Number): _____

The taxpayer elects to have Section 86.1 of the Income Tax Act (Canada) apply to the following eligible distribution that occurred on:

Distribution date: _____

ORIGINAL SHARES

Name of company: _____

Description of shares: _____

Number of shares: _____

Adjusted cost base immediately before the distribution: C\$ _____

Fair market value immediately before the distribution: C\$ _____

Fair market value immediately after the distribution: C\$ _____

SPIN-OFF SHARES

Name of company: _____

Description of shares: _____

Number of shares: _____

Fair market value immediately after the distribution: C\$ _____

PREVIOUS TAX REPORTING SUMMARY

(if applicable, summarize below how the above spin-off was reported on a previous tax return for Canadian tax purposes as well as any dispositions reported on a previous tax return for the original shares and/or spin-off shares after the spin-off distribution)

APPENDIX II: NUMERICAL EXAMPLE

The following is a numerical example of how the ACB of your parent and spin-off shares would be adjusted for an eligible distribution and how the election form would be completed where you are making a Section 86.1 election.

Pre Spin-Off: Assume you owned 100 shares of a corporation (the parent) with a total ACB of C\$7,000 (i.e. C\$70 per share, originally purchased at US\$50 per share when the USD/CAD. exchange rate was 1.40 before the corporation issued shares in another corporation that it owns (the spin-off)).

Post Spin-Off: After the spin-off you received 69.893 shares of the spin-off company for the 100 shares of the parent corporation. The 0.893 fractional shares were immediately disposed of on your behalf and you received cash of approximately C\$18. Assume you have not sold your parent corporation shares or the newly acquired spin-off shares since the spin-off transaction.

Other Assumptions: Assume the closing price on the first day that both the parent and spin-off shares were trading was US\$69 per share for the parent and US\$19.625 per share for the spin-off. The closing U.S./Canada exchange rate on that day was 1.02 USD/CAD. Therefore, the Canadian equivalent FMV per share of the parent and spin-off on the close of business on that day was C\$70.38 and C\$20.02 respectively. The total FMV of the parent and spin-off is C\$7,038 [C\$70.38 x 100 shares] and C\$1,399.38 [C\$20.02 x 69 shares + C\$18] respectively.

Calculating the new ACB's: Using the cost adjustment formula discussed previously, the total ACB of the parent and spin-off shares (before the cash in lieu allocation) is calculated as follows:

$$\text{Total spin-off ACB} = A \times \frac{B}{(B + C)}$$

where,

A = C\$7,000 (Total ACB of parent corporation immediately before the spin-off)

B = C\$1,399 (Total FMV of spin-off shares immediately after the spin-off)

C = C\$7,038 (Total FMV of parent corporation immediately after the spin-off)

Therefore,

$$\text{Total spin-off shares ACB} = C\$7,000 \times \frac{C\$1,399}{(C\$1,399 + C\$7,038)}$$

$$\text{Total spin-off shares ACB} = C\$1,161 \text{ (before cash in lieu cost allocation)}$$

$$\text{New spin-off shares ACB per share} = C\$16.61 \text{ per share } [C\$1,161 / 69.893]$$

Note that the total ACB of the spin-off shares of C\$1,161 must be reduced by any cost allocated to the cash in lieu of the 0.893 fractional spin-off shares received. The cost allocated to the 0.893 fractional spin-off shares is calculated as follows:

$$\begin{aligned} \text{Total ACB of spin-off fractional shares} &= 0.893 \\ \text{shares} \times C\$16.61 \text{ per spin-off share} &= C\$15 \text{ (after rounding)} \end{aligned}$$

The Results:

- 1) As a result, the capital gain to be reported for the receipt of cash in lieu of fractional spin-off shares would be C\$3 [C\$18 - C\$15].
- 2) The new total ACB of the remaining 69 spin-off shares would equal C\$1,146 [C\$1,161 - C\$15].
- 3) The new total ACB of the parent corporation shares = C\$5,839 [C\$7,000 - C\$1,146 - C\$15]

Other required Information:

For purposes of the election, you are also required to indicate the FMV of the parent shares immediately **before** the distribution. A reasonable price for the FMV of the parent corporation shares immediately before the distribution could be the closing price on the day before the distribution. Assume the closing price of the parent corporation shares on that day was US\$82.875 per share. The closing U.S./Canada exchange rate on that same day was 1.02 USD/CAD. Therefore, the total FMV for the 100 parent corporation shares immediately before the distribution would be C\$8,453 [US\$82.875 x 100 shares x 1.02].

Furthermore, the election also requires any details of how the parent/spin-off distribution was reported on a previous income tax return.

Appendix III illustrates a sample Section 86.1 election that you would file with the CRA for this eligible distribution. For ease of determining cost adjustments of an eligible distribution, we have referenced the applicable "A", "B" and "C" amounts of the cost adjustment formula on the sample election.

As evident by the above calculations, the ACB adjustments and required shareholder election information will involve some detailed research by you, your qualified tax advisor and possibly your RBC advisor.

APPENDIX III: SAMPLE SECTION 86.1 ELECTION

Taxpayer Name: Joe Doe

Taxation Year: 2013

SIN (or Business Number): 999-999-999

The taxpayer elects to have Section 86.1 of the Income Tax Act (Canada) apply to the following eligible distribution that occurred on:

Distribution date: February 15, 2013

ORIGINAL SHARES

Name of company: Parent Corporation

Description of shares: common shares

Number of shares: 100

Adjusted cost base immediately before the distribution: C\$ C\$7,000 [A]

Fair market value immediately before the distribution: C\$ C\$8,453

Fair market value immediately after the distribution: C\$ C\$7,038 [C]

SPIN-OFF SHARES

Name of company: Spin-off Corporation

Description of shares: common shares

Number of shares: 69.893

Fair market value immediately after the distribution: C\$ C\$1,399 [B]

PREVIOUS TAX REPORTING SUMMARY

(if applicable, summarize below how the above spin off was reported on a previous tax return for Canadian tax purposes as well as any dispositions reported on a previous tax return for the original shares and/or spin-off shares after the spin-off distribution)

Please contact us for more information about the topics discussed in this article.

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