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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Foreign spin-offs

As a Canadian resident investor, you might own shares of a foreign corporation. Sometimes, foreign corporations undergo reorganizations where they spin off a subsidiary corporation by distributing shares of the subsidiary to you, the shareholder of the original company. This reorganization is often referred to as a foreign spin-off. For Canadian tax purposes, you will generally have to include the fair market value (FMV) of the spin-off shares received in your income as a foreign dividend. However, under certain conditions, you can make a tax election to not include this amount in income. This article focuses on the tax implications of a foreign spin-off and what can be done to mitigate the impact, including the pertinent information required for filing the tax election.

What is a foreign spin-off?

A foreign spin-off is a form of reorganization under which a foreign corporation (the “original corporation”) distributes shares of another foreign corporation (the “spin-off corporation”) to its shareholders. Foreign spin-offs are typically implemented by the original company to unlock market value, separate businesses to focus on core competencies, or exit non-core business segments.

What are the tax implications of a foreign spin-off?

Spin-off transactions are often completed on a tax-deferred basis under the tax laws in the jurisdiction in which the spin-off occurs. However, as a Canadian resident, you must apply Canadian tax laws

to these spin-off transactions to determine how they should be treated for Canadian tax purposes.

The following tax implications are only of concern if you hold the foreign corporation shares in your non-registered account. The possible impact of a foreign spin-off in a registered account are discussed later in the section, “Registered accounts and non-qualified investments”.

The default tax implications

The default Canadian tax implications of a foreign spin-off are typically not favourable and could increase the total tax on your investment.

The FMV of the spin-off shares you receive must be reported as a taxable foreign dividend in the year you



receive the shares. The FMV of the spin-off shares will be reported to you as foreign income in box 15 of a T5, *Statement of Investment Income*. Foreign dividends are fully taxed at your marginal tax rate. They are not afforded the same preferential tax treatment as dividends from Canadian companies. The FMV of the spin-off shares you receive also becomes the new adjusted cost base (ACB) of these spin-off shares going forward.

Typically, a spin-off transaction results in a shift of value from the original company to the spin-off company. This is often reflected, after the spin-off transaction, as a decrease in the market price of the original company's shares. However, even though there is a reallocation of the original company's value in a spin-off transaction, the ACB of the original company's shares remains the same. This has the potential to result in a smaller capital gain, or even a capital loss on your eventual disposition of the original company's shares, where previously there may have been a capital gain. If disposing of the original company's shares post spin-off results in a capital loss, 50% of the capital loss is deductible against any taxable capital gains you may have realized.

As such, the unfavourable default tax implications of a foreign spin-off is a combination of a fully taxed foreign dividend, as well as a potential capital loss upon selling the original company's shares, which is only 50% deductible.

One point to note is that after the spin-off, although it may appear in your statements that you have an accrued capital loss on your original shares, you may not have a true economic loss. To determine your true economic gain or loss, you would need to compare the FMV of the original company's shares plus the FMV of the spin-off shares less your old ACB of the original company's shares.

What can you do to mitigate the tax impact?

If the default tax implications of the foreign spin-off will have a significant negative impact, you may want to explore ways of mitigating the tax impact. The remainder of this article explores mitigation strategies that are possible both before and after the foreign spin-off. In determining your course of action, tax should be only one of the factors you consider.

Mitigation strategies before the spin-off

When a company declares a spin-off distribution, it sets a record date when you must be on the company's books as a shareholder to receive the distribution. Beginning on or shortly before the record date and continuing through the last trading day before the distribution date, the original company shares may begin trading in two markets: a "regular-way" market and an "ex-distribution" market. Shares that trade in the "regular-way" market will trade

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with an entitlement to receive the spin-off shares. Shares that trade in the "ex-distribution" market will trade without an entitlement to receive the spin-off shares. Therefore, if you sell (trade date) your original shares in the "regular-way" market on or prior to the last trading day before the distribution date, you will be selling your right to receive the spin-off shares. If you own the original shares at the close of business on the record date and sell those shares in the "ex-distribution" market on or prior to the last trading day before the distribution date, you will receive the spin-off shares because of your ownership of the original shares as of the record date.

As such, perhaps the simplest way to avoid the tax consequences of receiving spin-off shares is to sell (trade date) the original company's shares before the distribution date on the "regular-way" market. In other words the last day to trade your original company shares and not receive the spin-off distribution is one business day before the distribution date.

With that said, advance tax planning is challenging, as there's generally little time to properly analyze whether the foreign spin-off will have a significant negative tax impact. While companies may announce their intention to spin off in a press release in advance, it is often difficult to obtain the necessary detailed information to determine if the foreign spin-off will be eligible for favourable tax treatment in Canada.

If you are able to properly analyze the situation in time, you might consider either of the following strategies to avoid the default tax consequences of an impending foreign spin-off:

1) Contributing the shares in-kind to your registered account

If you would like to retain your investment and the original company's shares are in a gain position, consider contributing the shares in-kind to a registered account, for example, your TFSA or RRSP. You will be

deemed to have disposed of the shares for FMV and will have to pay tax on 50% of the resulting capital gain in the year you contribute them. If the shares are in a loss position, this strategy would likely not be beneficial for you. This is because the capital loss is deemed to be nil and you cannot claim this loss.

In either case, your contribution to the registered account will be equal to the FMV of the investment on the date of transfer, so ensure you have the necessary contribution room before contributing the shares in-kind. Also ensure that both the original company's shares as well as the spin-off shares will be considered a "qualified investment" for your registered account. Otherwise, you may face negative tax implications. For a brief discussion on these tax implications, please refer to the section on registered accounts and non-qualified investments.

2) Selling the shares into the market

If you would like to dispose of your investment or the original company's shares are in a loss position, consider selling your position into the market. If the shares are in a gain position, you will have to pay tax on 50% of the resulting capital gain. If the shares are in a loss position, selling into the market will allow you to realize a capital loss that may be used to reduce capital gains realized in the current year. Any unused net capital losses can be carried back three years and carried forward indefinitely to be used against future capital gains.

Although both of these strategies may trigger a capital gain, if any, realizing a capital gain, which is only 50% taxable, may be preferable to receiving the fully taxed foreign dividend associated with a foreign spin-off.

Mitigation strategy after the spin-off

Under very specific conditions and only if certain steps are taken, section 86.1 of the Income Tax Act (the Act) provides a tax-deferral in respect of eligible foreign spin-offs. The details of these necessary conditions and steps are explained in the following sections. As an overview, if the foreign spin-off meets certain criteria, the original corporation may apply to the Canada Revenue Agency (CRA) and provide the necessary information to have the spin-off approved as eligible. Once approved as eligible, you may file a section 86.1 election with your tax return to treat the foreign spin-off as a tax-deferred transaction.

If you make the election, you wouldn't have to include a taxable foreign dividend in your income. In addition, the ACB of the spin-off shares will not be their FMV on the date of distribution, as would otherwise be the case. Instead, the ACB of the spin-off shares will be based on

In order for a foreign spin-off to be eligible, it must first meet certain conditions. One of the main conditions is that the spin-off must not be taxable under the tax laws of the foreign country for shareholders resident in that country.

the ACB of the original company's shares and will be allocated between the original company's shares and the spin-off company's shares, based on their relative value immediately after the spin-off transaction. For an explanation and an example of how the ACB is reallocated, refer to the section on calculating the ACB when an election is made.

What is involved in making a section 86.1 election?

Eligible foreign spin-off conditions

In order for a foreign spin-off to be eligible, it must first meet certain conditions. One of the main conditions is that the spin-off must not be taxable under the tax laws of the foreign country for shareholders resident in that country. Other conditions include:

- The spin-off is with respect to all of your original company's common shares;
- The distribution consists solely of common shares of the spin-off corporation which were owned by the original corporation immediately before the distribution;
- Both the original corporation and spin-off corporation were never resident in Canada and, at the time of the spin-off, both were resident in the same foreign country.
- The foreign country where the corporations are resident has a tax treaty with Canada; and
- At the time of the spin-off, the original company's shares are widely held and actively traded on a designated stock exchange.

Information provided to the CRA by the original corporation

If the foreign spin-off meets all of the conditions to be considered eligible, the original corporation can choose to apply to the CRA and provide them with specific information within six months following the day on which the spin-off occurred. The specific information required to be submitted by the corporation is beyond the scope of this article.

If the original corporation does not apply to the CRA, it is not possible for the spin-off to be considered eligible and receive tax-deferred treatment for Canadian tax purposes.

Before filing the election

Before you make the election, you will need to confirm whether the foreign spin-off is eligible. To assist in determining whether a spin-off is eligible, the CRA has provided a list of eligible foreign spin-offs on their website.

Filing the election

Once the spin-off has been approved by the CRA, you can file the election with your income tax return for the year in which the spin-off occurred. There is no prescribed form for the election, so it is recommended that you work with a qualified tax advisor to complete the election.

The election must contain all of the following information:

- That section 86.1 applies to the foreign spin-off;
- A description of both the original and spin-off shares;
- The number, ACB and FMV of the original shares immediately before the distribution; and
- The number and FMV of the original shares and spin-off shares immediately after the distribution.

For Canadian tax reporting purposes, all amounts must be converted into the equivalent Canadian dollar amounts using a foreign exchange rate that was in effect on the day of the transaction.

Since this election must be filed with your income tax return for the year in which the distribution occurred, the deadline for filing this election is generally April 30th of the year following the spin-off, for an individual shareholder. The deadline can be June 15th of the year following the spin-off if you or your spouse earn self-employment income. In some circumstances, the election may be filed late under the taxpayer relief provisions. If you find yourself in a late-filing position, be sure to discuss the appropriate actions you should take with a qualified tax advisor.

If you're filing a section 86.1 election for a particular year, you will not be able to electronically file your tax return for that year. Although you would not report the foreign dividend (shown in box 15 of the T5 slip) relating to the eligible spin-off as income on your tax return, you will still need to attach the T5 slip to your election. If your T5 slip contains multiple foreign dividends, you can refer to your *Summary of Investment Income and Expenses* included in your tax reporting package, to determine how much of the total foreign dividends relate to the spin-off.

Calculating the ACB when an election is made

If you file the election for an eligible foreign spin-off, the ACB of the original shares will need to be allocated between the original shares and the spin-off shares, based on their relative value immediately after the spin-off

If you file the election for an eligible foreign spin-off, the ACB of the original shares will need to be allocated between the original shares and the spin-off shares, based on their relative value immediately after the spin-off transaction.

transaction. To accomplish this, you first need to calculate how much you need to reduce the ACB of an original company's share by, based on the following formula:

$A \times [B \div (B + C)]$ where,

A = The ACB of the original company's share immediately **before** the distribution,

B = The FMV, immediately **after** the distribution, of the spin-off share(s) or fraction of a spin-off share you received for each share of the original company.

C = The FMV of the original company's share immediately **after** the distribution.

The revised ACB of the original company's share, immediately after the spin-off, is the original ACB less the amount determined by the formula. The amount determined in the formula is also the ACB of the spin-off share(s) or fraction of a spin-off share received for each original company share owned.

A numerical example

The reallocation of the ACB between the original shares and the spin-off shares is best explained through a numerical example. All amounts in this example are expressed in Canadian dollars, unless otherwise specified.

Assume you own 400 shares of a widely held and actively traded U.S. corporation, Aco, with a total ACB of \$10,000, or \$25 per share. You had originally purchased Aco at US\$20 per share when the USD/CAD exchange rate was 1.25.

Aco decides to spin off its interest in Bco, a subsidiary, and distributes to each of its shareholders 0.25 (one quarter) of a Bco share for each Aco share held. As a result of the spin-off transaction, you received 100 shares of Bco as a foreign dividend.

The FMV of an Aco share after the distribution is US\$38 per share and the FMV of a Bco share after the distribution is US\$9.50 per share. The USD/CAD exchange rate on that day was 1.053, so the Canadian dollar equivalent FMV of an Aco share and a Bco share is \$40 and \$10 per share, respectively.

Assume that the spin-off meets all of the conditions for an eligible foreign spin-off and you continue to hold all of your Aco and Bco shares. You elect under section 86.1 to not include the dividend in the amount of \$1,000 (100 Bco shares x \$10 per share) in your income. Therefore, you need to calculate the new ACB for both your Aco and Bco shares, as follows:

The ACB of your Aco shares will be reduced by:

$A \times [B \div (B + C)]$ where,

A = \$25 (The ACB of an Aco share immediately **before** the distribution),

B = $0.25 \times \$10 = \2.50 (The FMV, immediately **after** the distribution, of the 0.25 of a Bco share you received for each Aco share held),

C = \$40 (The FMV of an Aco share immediately **after** the distribution).

= $\$25 \times (\$2.50 \div \$42.50) = \1.47 per share.

As a result, the revised ACB of your Aco shares is \$23.53 ($\$25 - \1.47) per share. Since you have 400 shares in total, the ACB of all of your Aco shares is \$9,412 ($400 \times \23.53).

Since you only received 0.25 (one quarter) of a Bco share for each Aco share you held, each 0.25 share of Bco will have an ACB of \$1.47. As such, the ACB of each Bco share after the election is \$5.88 ($\1.47×4). Since you have 100 Bco shares in total, the ACB of all of your Bco shares is \$588 ($100 \times \5.88).

In total, the revised ACB of all of your shares is \$10,000 ($\$9,412 + \588), which is the same as the ACB of the Aco shares that you owned before the spin-off distribution ($400 \times \$25 = \$10,000$).

Cash in lieu of fractional spin-off shares

In order for a foreign spin-off to be eligible, the original corporation must distribute only common shares of the spin-off corporation and the distribution must not include non-share consideration. That said, the CRA has indicated that a foreign spin-off may still be eligible where the payment of cash in lieu of fractional spin-off shares is not made by the original corporation but rather by a depository or broker who has received and sold the fractional shares on behalf of the shareholder.

If you receive cash for your fractional spin-off shares, it will be treated as proceeds of disposition that may give rise to a capital gain or capital loss. The total cost amount of the fractional shares would be equal to the number of fractional shares you would have received multiplied

If you hold the original foreign corporation's shares in a registered account — for example, your TFSA, RRSP or RRIF — you will need to ensure that both the original company's shares as well as the spin-off shares will be considered a “qualified investment” for your registered account.

by the ACB per spin-off share immediately after the distribution. As such, the total ACB of the spin-off shares you receive should be reduced by any cost allocated to the cash in lieu of fractional spin-off shares received.

Registered accounts and non-qualified investments

If you hold the original foreign corporation's shares in a registered account — for example, your TFSA, RRSP or RRIF — you will need to ensure that both the original company's shares as well as the spin-off shares will be considered a “qualified investment” for your registered account. Qualified investments include, among other securities, most shares listed on a designated stock exchange. However, in some instances, the spin-off shares may not be listed on a designated stock exchange and therefore may not be a qualified investment.

Tax implications of non-qualified investments

If you acquire a non-qualified investment in your registered account or an existing investment becomes non-qualified, significant adverse tax consequences apply. You will be subject to a 50% tax on the value of the investment, which will apply at the time you acquire the non-qualified investment or when the investment becomes non-qualified. In addition, the plan is taxable on any income earned on the non-qualified investment.

The 50% tax is generally refundable if you dispose of the investment from your registered account before the end of the year following the year in which the tax applied (or by such later time as the CRA considers reasonable). However, if you knew, or ought to have known, that the investment was non-qualified, the 50% tax will not be refundable. In addition, if the non-qualified investment is not publically traded, it may have no valuation and therefore be difficult to remove from your registered account or to sell.

These penalty taxes are quite complex and undesirable, so if you become aware of an impending foreign spin-off, you should consult with a qualified tax advisor as soon as

possible, to assist you in determining whether both the original company's shares and the spin-off shares will be a qualified investment for your registered account. If there is a chance the shares will be non-qualified, there may be some planning opportunities to consider, such as selling your shares within the registered account before the spin-off occurs.

Conclusion

The default Canadian tax implications of a foreign spin-off are unfavourable and could increase the total tax on your investment. However, if it is a CRA-approved eligible foreign spin-off, and you make an election in your tax return under section 86.1 of the Act, you can treat the transaction as a tax-deferred rollover. You should consult

with a qualified tax advisor to determine if it makes sense, in your circumstances, to file the section 86.1 election. If you decide to file a tax election, remember to notify your RBC advisor of any necessary ACB adjustments so that the adjusted ACBs can be properly reflected in your account statements going forward.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.



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