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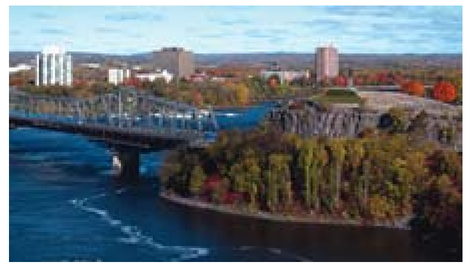
Northern exposure

by Gary Fogler, Fasken Martineau | Published September 2, 2011 at 9:14 AM ET



Canada is an attractive market for U.S. corporations seeking to increase their natural resourcea reserves, partner with an innovative Canadian technology company or perhaps commence their international expansion without venturing too far from home.

Happily, being purchased by a U.S. corporation is often the principal exit strategy for owners of a Canadian business. And where the U.S. acquirer, or USco, has attractive growth prospects, the Canadian sellers frequently wish to exchange their shares of the Canadian target for shares of the buyer in order to ride the U.S. company's future growth.

However, Canadian sellers have a tax problem that will quickly become the problem of the U.S. acquirer. Unlike purely Canadian share exchange transactions where sellers receive shares of the acquirer on a tax-deferred "rollover" basis resulting in tax payable only when the sellers eventually sell the shares of the acquirer, the rollover is not available where shares of USco are the consideration. In such cases, the sellers have a capital gains tax obligation and, even worse, may have to sell the U.S. acquirer share consideration to pay the tax. On this basis, the transaction may fail. A sudden failed transaction is definitely not a pleasant surprise.

But there is a solution: an exchangeable share transaction.

The basic exchangeable share structure involves the U.S. acquirer incorporating a Canadian subsidiary, or Exchangeco, to acquire the Canadian target for "exchangeable shares" of Exchangeco. The sellers enjoy a tax-deferred rollover until these exchangeable shares are "exchanged" at their option for shares of the acquirer (although it's normal for USco to negotiate a "sunset" clause enabling it to force the exchange after five to 10 years).

The "exchange," while commenced as a redemption of the exchangeable shares by Exchangeco, is ultimately completed as a purchase of the exchangeable shares through a call option in order both to provide the sellers with capital gains rather than income tax treatment on the proceeds as well as to avoid certain punitive Canadian tax provisions.

The call option can be exercised by USco, but, where it is expected that there will be significant distributions from Canada to the U.S., USco often assigns the call right to a Canadian subsidiary, or Callco, incorporated to own the voting shares of Exchangeco. A consequence of Callco exercising the call option is that the paid-up capital of Callco's shares is increased, thereby reducing the 5% dividend withholding tax on distributions from Canadian operations to USco.

For U.S. tax reasons, the exchangeable shares are structured to be the economic equivalent of the USco shares, allowing the sellers to immediately participate in the economic success of USco as though they had received USco shares.

Among other things, the sellers are entitled to (a) dividends (cash or stock) equal to, and paid contemporaneously with, the dividends paid by USco to its shareholders; (b) the right to vote at USco shareholder meetings through special voting shares; (c) cash or USco shares on the liquidation or dissolution of USco or Exchangeco; and (d) standard anti-dilution protections in the event of a change in the number of outstanding USco shares.

Fortunately, Canadian and U.S. securities laws do not greatly complicate the structure because there are applicable securities exemptions in the U.S. and Canada, including for the eventual issue of USco shares to the Canadian sellers. While the Canadian sellers may need to rely on U.S. Rule 144 to sell their USco shares, the requisite six-month holding period from the time the shares are acquired will likely not be a problem if the timing of the transaction is properly planned.

Of course each transaction is different, but the structure can be tailored to fit specific facts. For example, it may be more tax effective, particularly where a Canadian seller is a corporation, to create Exchangeco as a Canadian limited partnership rather than as a corporation. And where Canadian sellers hold options in a nonpublic target corporation, there may be advantages to reorganizing the shares of the corporation into two separate classes to ensure the continuation of available tax deferrals for the option holders.

Whatever the final structure, the ability of a USco to acquire the shares of a Canadian corporation will be greatly facilitated by the use of exchangeable shares and certainly level the playing field with competing Canadian acquirers who can take advantage of Canadian tax-deferred rollovers.

And you won't experience any deal-breaking surprises.

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