Tax Deferral for Foreign Spin-offs

May 2022

In recent years, many corporations have undergone corporate reorganizations to rationalize their business activities. These reorganizations are complex due to the corporate, securities and tax law requirements. This article reviews the income tax consequences for Canadian shareholders of a foreign corporation that distributes shares as part of a reorganization.

What is a foreign spin-off?

If you own shares of a foreign corporation that distributes shares of another foreign corporation that it controls (usually as a result of a reorganization), the resulting transaction is referred to as a foreign spin-off.

A foreign spin-off is generally not a tax-deferred transaction for Canadian shareholders. Canadian shareholders who receive foreign spin-off shares are deemed to have received a dividend equal to the fair market value of the shares received. This amount is taxed as a foreign dividend that is not eligible for the Canadian dividend tax credit, and is considered to be the adjusted cost base ("ACB") of the distributed shares.

However, Canadian income tax rules may provide Canadian share-holders (including trusts and corporations) with the opportunity to treat a foreign spin-off as a tax-deferred transaction. Under these rules if the shareholder elects, and the shares meet specific criteria explained in the "What shares qualify?" section on page two, they can exclude from their income the amount that would otherwise be considered a taxable foreign dividend. As a result of this election, the ACB of the original shares would be allocated between the original shares and the spin-off shares.

Calculation of the adjusted cost base

A Canadian shareholder who receives foreign spin-off shares and elects to defer the taxation must recalculate the adjusted cost base of both the original shares and the spin-off shares. As an illustration, let's assume a shareholder of Foreign Co. receives a share of Spin Co. as a result of a foreign spin-off.

The transaction has the following attributes:

Original ACB of Foreign Co. share	$10 (A)
Fair market value ("FMV") of Foreign Co. share after the distribution	$70
FMV of Spin Co. share after the distribution	$30 (B)
FMV of Foreign Co. share plus FMV of Spin Co. share	$100 (C)

If the election is not made, or if the particular foreign spin-off does not qualify for deferral, the ACB of the Foreign Co. share will remain at $10 and the ACB for the Spin Co. share will be $30. The $30 represents the fair market value ("FMV") of the share received, and is considered a foreign dividend which will be taxable at the investor's marginal tax rate.

If an election to defer the tax is made, the ACB of the Foreign Co. share will be recalculated and a portion of its ACB will be allocated to the Spin Co. share.

The original $10 cost of the Foreign Co. share will be allocated as follows:

- ACB of Foreign Co. share: $7.00
- ACB of Spin Co. share: $3.00 (A x (B/C) = $10 x ($30/$100) = $3.00)

Calculation of gain on sale of shares

Now let's assume that both the original share and the foreign spin-off share are subsequently sold. The share of Foreign Co. is sold for $80 and the Spin Co. share is sold for $40.

In this example, without the benefit of the tax deferral, total Canadian income taxes of $35.00 would be paid; whereas the election to defer taxation reduces taxes to $27.50. The savings are a result of converting the deemed dividend that would have been taxable at the shareholder's marginal rate into a capital gain, which is taxable at 50% of the individual's marginal rate.

	No Election		Election to Defer Taxation	
	Foreign Co.	Spin Co.	Foreign Co.	Spin Co.
Receipt of Spin-off Share				
Taxable dividend		$30.00		Nil
Tax @ 50% (A)		$15.00		N/A
Sale of Shares				
Proceeds	$80.00	$40.00	$80.00	$40.00
ACB	$10.00	$30.00	$7.00	$3.00
Taxable capital gain (50% inclusion rate)	$35.00	$5.00	$36.50	$18.50
Tax @ 50% (B)	$17.50	$2.50	$18.25	$9.25
Total Tax Paid (A) + (B)	$35.00		$27.50	

What shares qualify?

Not all shares received as a result of a foreign spin-off qualify for the tax deferral. In order for the Canada Revenue Agency ("CRA") to determine whether the spin-off qualifies for the tax deferral, a corporation that distributes shares must provide specific information to the CRA relating to the spin-off. However, the foreign corporation is under no obligation to make this request to the CRA.

To qualify as a foreign spin-off the following criteria must be met:

- The shareholder must have received the dividend for all the common shares owned by the shareholder in the distributing corporation;
- The distribution must consist only of common shares in another corporation owned by the distributing corporation (i.e., no cash);
- Both the distributing corporation and the spin-off corporation must be residents of the same foreign country at the time of the distribution, and must never have been resident in Canada;
- The country in which the corporations are resident must have a tax treaty with Canada;
- The original shares must generally be included in a class of stock that is widely held and actively traded on a designated stock exchange at the time of the distribution; and
- Shareholders that are resident in the same country as the distributing corporation must not be taxable under the laws of their foreign country in respect of the distribution.

The CRA publishes a list of foreign spin-offs that are eligible for the tax deferral (https://www.canada.ca/en/revenue-agency/services/tax/businesses/topics/eligible-spin-offs.html). The list includes only those corporations that have agreed to have their spin-off made public.

Making an election

A Canadian resident shareholder must include an election with their tax return filed with the CRA for the year in which the distribution is received containing the following information:

- Written notification that the taxpayer is electing to defer tax relating to the distribution of spin-off shares from a foreign corporation, including a description of both the original and the spin-off shares;
- The number, cost amount, and fair market value of their original shares, both immediately before and after the distribution; and
- The number and fair market value of the spin-off shares immediately after the distribution.

Deadline for making an election

The election made by an individual taxpayer for qualifying foreign distributions must be made in writing and included with the individual's paper income tax return for the taxation year in which they receive the distribution. A late filed election may be accepted under the Taxpayer Relief provisions.

The tax considerations involved in filing this election can be complex. Please speak to your tax advisor about the appropriateness of making this election (and proper implementation) with respect to any foreign spin-off dividends you receive.

For more information, please speak with your BMO financial professional.

Note: The provisions outlined herein relate to subsections 86.1(1) to 86.1(5) of the Federal Income Tax Act. Parallel provisions provide similar treatment for Quebec provincial tax purposes, as outlined in articles 578.1 to 578.7 of the Quebec Taxation Act. Please be sure to consult with your external tax advisor for the specific Federal (and Quebec, where applicable) considerations in your particular situation.

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