INTERNATIONAL FISCAL ASSOCIATION

1ST NORTH AMERICAN REGION MEETING

CANADA • MEXICO • USA

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CROSS-BORDER M&A UPDATE

SPEAKERS: **Ricardo Rendón**, Chevez Ruiz Zamarripa, Mexico City
Paul Stepak, Blake, Cassels & Graydon LLP, Toronto
Candice Turner Grant Thornton LLP, New York

MODERATOR: **Devon Bodoh**, Weil Gotshal & Manges, Washington, D.C.

Agenda

I. Overview of Cross Border M&A

II. Cross Border Financing

III. Private Equity

IV. SPACs

MODERATOR: DEVON BODOH SPEAKERS: RICARDO RENDÓN, PAUL STEPAK, AND CANDICE TURNER

I. OVERVIEW OF CROSS BORDER M&A

Basic Cross-border M&A tax considerations

- Taxability of Transaction
- Stock or Assets Being Acquired
- Consideration Used for Acquisition
- Choice of Acquisition Vehicle

Taxability of Transaction

- Can the acquisition be structured on a tax-free basis?
  - Residents
    - Mexican residence rules
    - Availability of a rollover?
  - Non-Residents
    - US Rules on FIRPTA
    - "Taxable Canadian property" rules

Stock or Assets Being Acquired

- Tax implications of acquiring an entity cross-border can be very different than acquiring assets
  - Anti-inversion Rules
  - CFC Rules
  - Branch creation
  - Elections to treat a stock acquisition as an asset acquisition
  - VAT and other transfer tax
  - Inherited tax liabilities

Consideration Used for Acquisition

- Cash
  - Capital Gain
  - Foreign currency gain
- Stock
  - Anti-inversion Rules
  - CFC Rules
  - Tax-deferred rollovers
- Debt
  - Limitations on interest deductibility
  - Treaty Provisions

Choice of Acquisition Vehicle

- Two key decisions:
- Entity Type
  - Corporation
  - Partnership/Flow through
  - Hybrid
- Entity Jurisdiction
  - Parent Country
  - Target Country
  - Third Country

Entity Type

- **Corporation**
  - Subject to tax in country of residence/formation?
    - Corporate tax rate changes
    - Consolidation
    - Other exemptions
  - Payments to shareholders taxed as dividends?
    - E&P Rule vs. Legal form
    - Withholding
    - Participation exemption
- Partnership/Flow through
- Hybrid

Entity Type

- Corporation
- **Partnership/Flow through**
  - Flow through of income and tax attributes
    - Limitations on deductions for interest/NOLs
    - Character of income
  - ECI/COB & PE
    - Increased uncertainty
    - Availability of Treaty
  - Administrative Burden
  - In Canada, lack of debt push down / PUC increase
- Hybrid

Entity Type

- Corporation
- Partnership/Flow through
- **Hybrid**
  - Anti-hybrid rules
  - FTC availability

Entity Jurisdiction

- Corporate Tax Rates
  - US corporate tax rate change to 21%, but expected to increase
  - Leverage limitations
- Structural issues
  - CFC Rules
  - GILTI
  - FAD
- Treaty Availability

Disposition of Mexican stock by a non-resident

- Private entities
  - 25% tax on gross proceeds
  - Optional 35% on net gain subject to comply with several requirements
  - Treaty benefits (25% threshold exemption or reduced rates)
- Portfolio investments in publicly-traded stock
  - Treaty residents - exempt

II. CROSS BORDER FINANCING

Pushing down debt - Issues and limitations (Mexico)

- Absence of effective tax consolidation rules
- Downstream merger of Acquisition Co. and Target Co.
- GAAR - Art. 5-A Tax code
- 3:1 debt to equity (Thin cap rules)
- 30% Tax EBITDA net interest deduction limitation

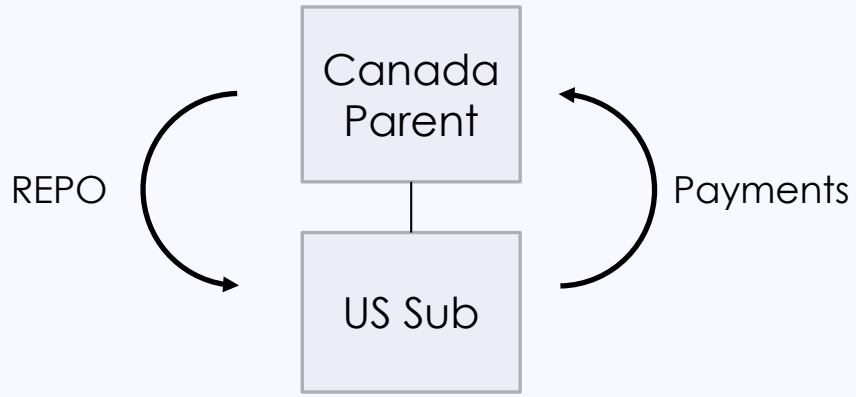
Pushing down debt - Issues and limitations (Canada)

- Absence of effective tax consolidation rules
- Amalgamation of Acquisition Co. and Target Co.
- 1.5:1 significant shareholder debt to equity (Thin cap rules)
- Newly proposed 30% Tax EBITDA net interest deduction limitation
  - No draft legislation yet
  - For taxation years beginning on or after January 1, 2023

Pushing down debt - Issues and limitations (US)

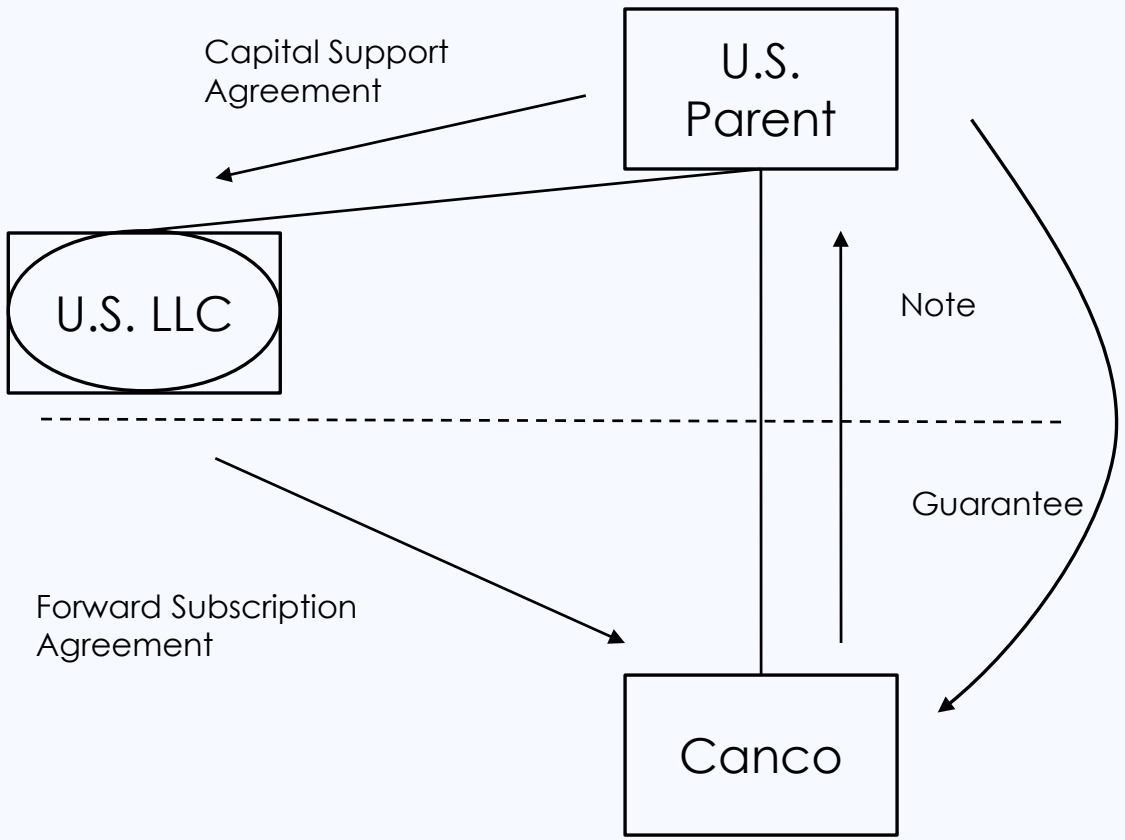
- Tax consolidation rules
- Section 385 Overhang
- Myriad of debt to equity authority (Thin cap rules)
- 30% Tax EBITDA net interest deduction limitation (changing to EBIT in 2022)

Outbound Hybrid Debt (Canada)



- Cross border Repo Transactions
  - US Sub sells shares of its sub to Canadian Parent subject to fixed price repurchase obligation
  - Shares subject to repo pay dividends
- Historically, payments by US Sub were treated as deductible payments of interest to Canadian Parent
- However, Section 267A will prevent such deduction
- Canadian Parent treats payments as exempt surplus dividends on shares subject to the Repo
- Consider structure in which there is some inclusion by the payee such that there is not a D/NI result (Swiss branch structure)

Inbound Hybrid Debt (Canada)



- Under Section 245A(e), the dividend will not qualify for the dividends received deduction in the US as it is a hybrid payment.
- Newly proposed Canadian hybrid mismatch rules to be released and apply in two stages:
  - First, rules implementing neutralization of D/NI mismatches arising from a payment in respect of a financial instrument, effective July 1, 2022, and
  - Second, everything else including double deductions and D/NI for hybrid entities and imported hybrid arrangements, to be released after 2021 and effective no earlier than 2023.

III. PRIVATE EQUITY

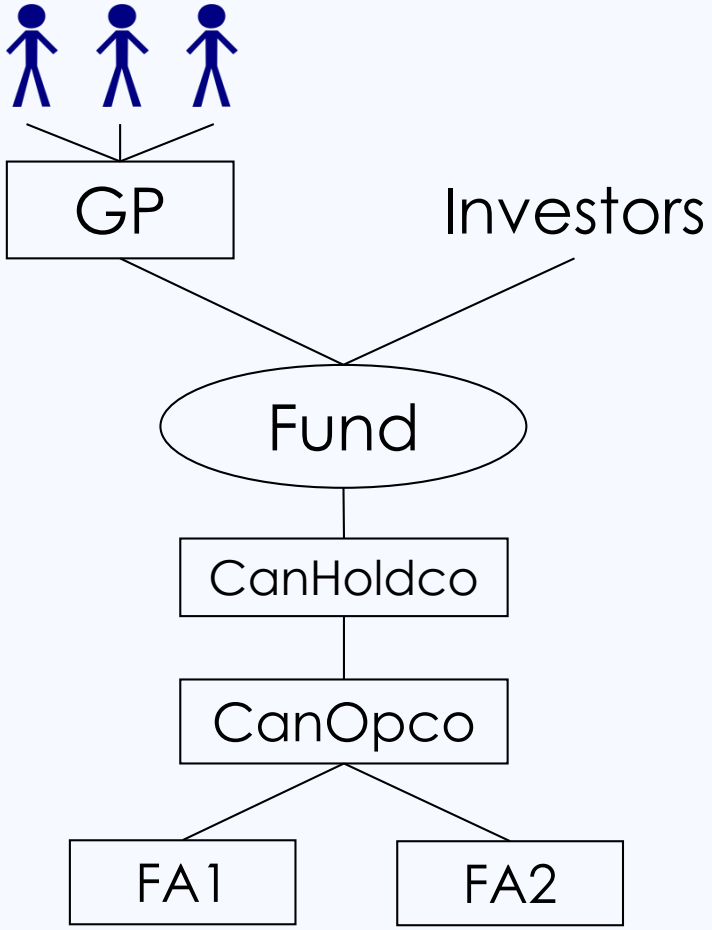
Tax Considerations for Private Equity Investment

- FAD – The Continuing Canadian Challenge
- U.S./Canada FTE Structures
- PE Funds and the MLI
- Investments in Mexico through a "CAN LP"

FAD

- When first introduced in 2012, foreign affiliate dumping (FAD) rules applied to a corporation resident in Canada (CRIC) controlled by a non-resident corporation in respect of investments made by the CRIC in foreign affiliates (FAs)
  - Amount of investment grinds cross-border paid-up capital (PUC), and results in a deemed dividend subject to Canadian withholding tax to the extent amount of investment exceeds PUC
  - PUC reinstatement possible when CRIC repatriates investment (including returns)
  - Exceptions for ordinary-course short-term receivables, intercompany debt for which a "PLOI" election is made, certain reorganization transactions, "more-closely connected business" test (MCCB)
  - Government's view is that the FAD rules apply where general partner of limited partnership is a company in legal form (e.g. LLC, Cayman company – U.S. tax treatment is irrelevant)
- Proposed amendment introduced March 2019 expands scope to control of CRIC by non-resident persons; not yet enacted, but retroactive effect to 3/19/19

FAD

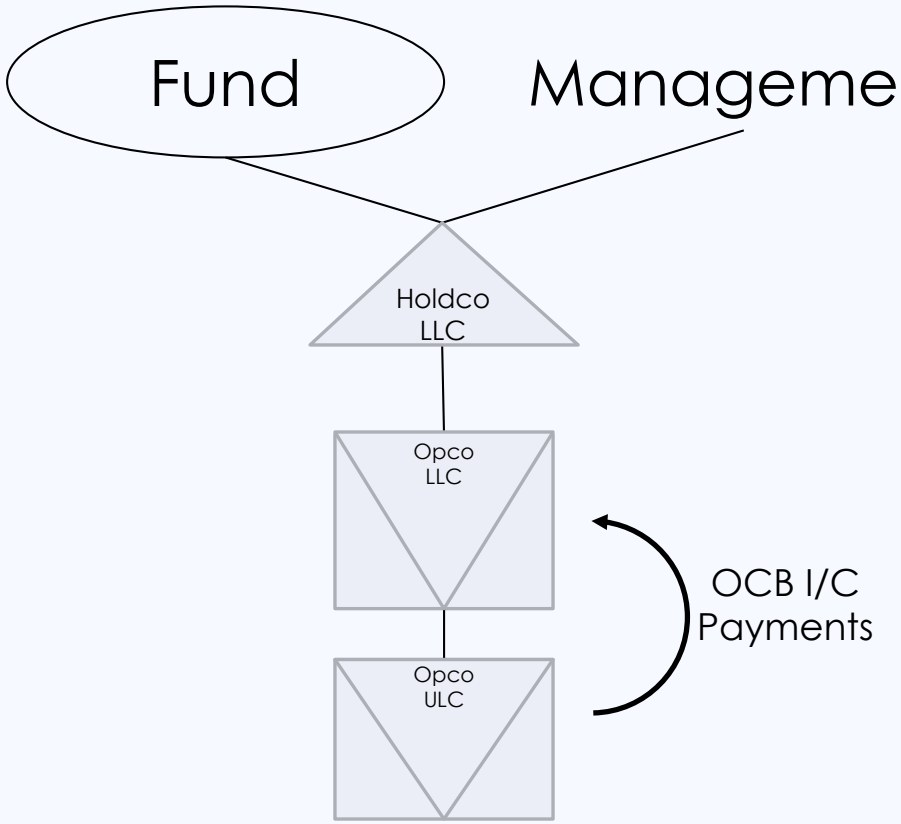


- FAD rules can create significant challenges for PE fund-controlled Canadian portfolio companies
  - Can adversely impact ability to inject commercially justifiable cash flow into existing non-Canadian subsidiaries
  - Can adversely impact ability to pursue non-Canadian M&A add-ons
  - Rules can create significant uncertainty, leading to possible insurance/indemnification issues on exit
  - Consequence mismatch - risk to sponsor, reward to economic owners

FAD

- Can the MCCB exception be relied upon?
  - 2012 Finance Explanatory Notes suggest yes, given the specific PE example
  - Rules must be analyzed very carefully
  - Does it matter whether the "investment" is ordinary course, or an add-on, refinancing or other capital transaction?
  - Second and third prongs of test focusing on decision-makers and their relative compensation (rather than first prong business case for FA investment below Canada instead of elsewhere in foreign parent group) do not align with commercial reality of how PE funds operate and the value sponsors bring to their portfolio companies
- Overarching challenge is that FAD rules do not clearly recognize that, generally, PE funds are already disincentivized from engaging in FA dumping where the foreign subs otherwise do not align with the Canadian parent's business

U.S./Canada FTE Structures



- Existing PE portfolio company structure is fiscally transparent for U.S. tax purposes
- Portfolio company desires to acquire a Canadian target, which will convert to a ULC in order to maintain FTE structure

U.S./Canada FTE Structures

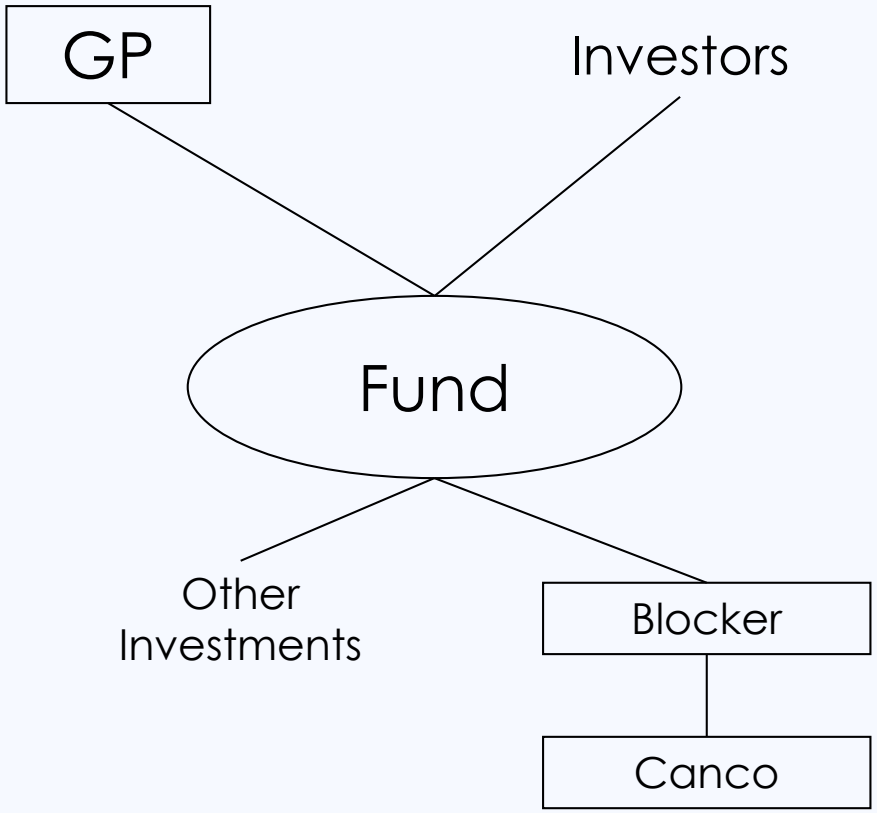
- Need to convert pre-closing? Possibly, because of U.S. tax reform
- Commercial impact of pre-closing ULC conversion to sellers
  - Solve by inserting limited partnership above target?
- Anti-hybrid rule in Canada-U.S. Treaty (Art. IV(7)) denies benefits:
  - Management & administrative fee payments (ITA s. 212(1)(a))
  - Intercompany debt (ITA s. 212(1)(b))
  - Royalties (ITA s. 212(1)(d))
- Also consider impact of FTE structure on cross-border payments by Canadian customers (e.g. royalties)

PE Funds & The MLI

The Principal Purpose Test (PPT)

Notwithstanding the other provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.

PE Funds & The MLI



- How to Interpret the PPT?
  - The "$64K Question"

  - Too early to tell how PPT interpretation in Canada will shake out, but parties are taking the MLI into account in structuring considerations
  - Interaction with modified preamble
  - Differences between the PPT and GAAR?

PE Funds & The MLI

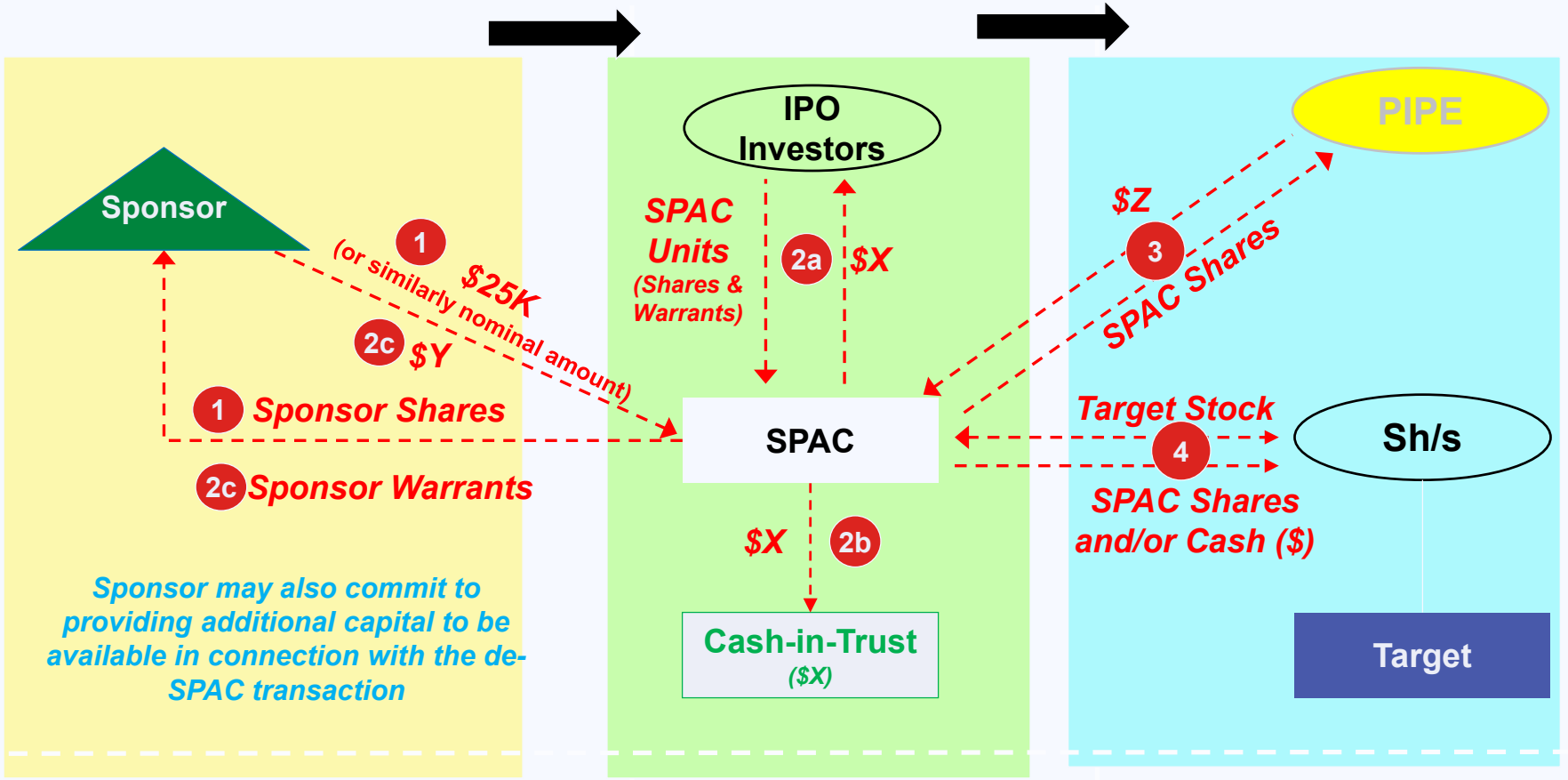
- Canada establishing "Treaty Abuse Prevention Committee" (TAP Committee)
  - Chaired by the Director of the International Division of CRA Rulings Directorate
  - Members include representatives of CRA Rulings, Legislative Policy, Tax Avoidance and International Tax Divisions, as well as Department of Finance and Department of Justice
  - Operates similar to GAAR Committee
  - TAP Committee will now consider application of GAAR to a provision of a tax treaty

Investments in Mexico through a CAN LP

- Recent years have seen growth in the use of Ontario or other Canadian-law-governed limited partnerships used by PE Funds, other sponsors and family offices to make investments in Mexico and certain South American countries
- These limited partnerships are structured to have no nexus to Canada except governing law
- As of 2021 Can LPs are regarded as a "person" for Mexican tax purposes; thus, capital gains are now subject to a 25% tax on gross proceeds.
- Under the prior legislation, the treatment was based on the nature of the recipient
  - Exempt under a treaty
  - Reduced rate such as the 10% of different tax treaties; or
  - At least, apply the optional 35% net gain procedure under domestic law.

IV. SPACS

SPAC – Life Cycle – Typical Tax Issues



SPAC / "de-SPAC" – M&A Overview

Comparable to Typical M&A

- ✓ SPAC transactions may involve a U.S. or non-U.S. acquirer, i.e., the SPAC, trying to acquire / combine with a target
- ✓ Target may be a corporation, partnership (or other flow-through), division, basket of assets, etc. – and, if an entity, may be U.S. or non-U.S.
- ✓ Acquisition consideration commonly consists of shares and cash
- ✓ Sponsor typically has an economic stake that greatly exceeds its capital investment at the time of de-SPAC

Less Common vs. Typical M&A

- SPAC is merely a box of cash
- The existing shareholders of the box of cash – can "vote no" on a shareholder-by-shareholder basis and get redeemed at NAV once a deal is put to a vote
- Commonly, the SPAC acquires substantially less than 50% of the Target
- Warrants may represent a key part of the SPAC's capital structure
- New and committed equity capital – via the PIPE investors – frequently represent a key part of the deal financing
- SPACs are initially controlled by individuals who have a very low tax basis in their stock and warrants – and they often have an investment horizon that differs from the SPAC's other investors
- High percentage of deals have earn-outs in one form or another

Common Tax Issues with SPACs

- Taxation of SPAC shareholders and warrant holders
  - US tax free reorganization?
  - Holding company formation (but US taxation on the warrants)
- Taxation of de-SPACing partner and its shareholders
- Anti-Inversion rules
  - Corporate anti-inversion rules
  - Shareholder anti-inversion rules