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Exchangeable share structures – an overview

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Exchangeable share structures have been a fixture in structuring cross-border share exchange mergers and acquisitions involving Canadian corporations for decades. These structures are driven by the fact that, under Canadian tax rules, Canadian shareholders cannot exchange shares of a Canadian corporation for shares of a foreign corporation on a tax-deferred basis. Nevertheless, exchangeable share structures may be used to effectively achieve such a result.

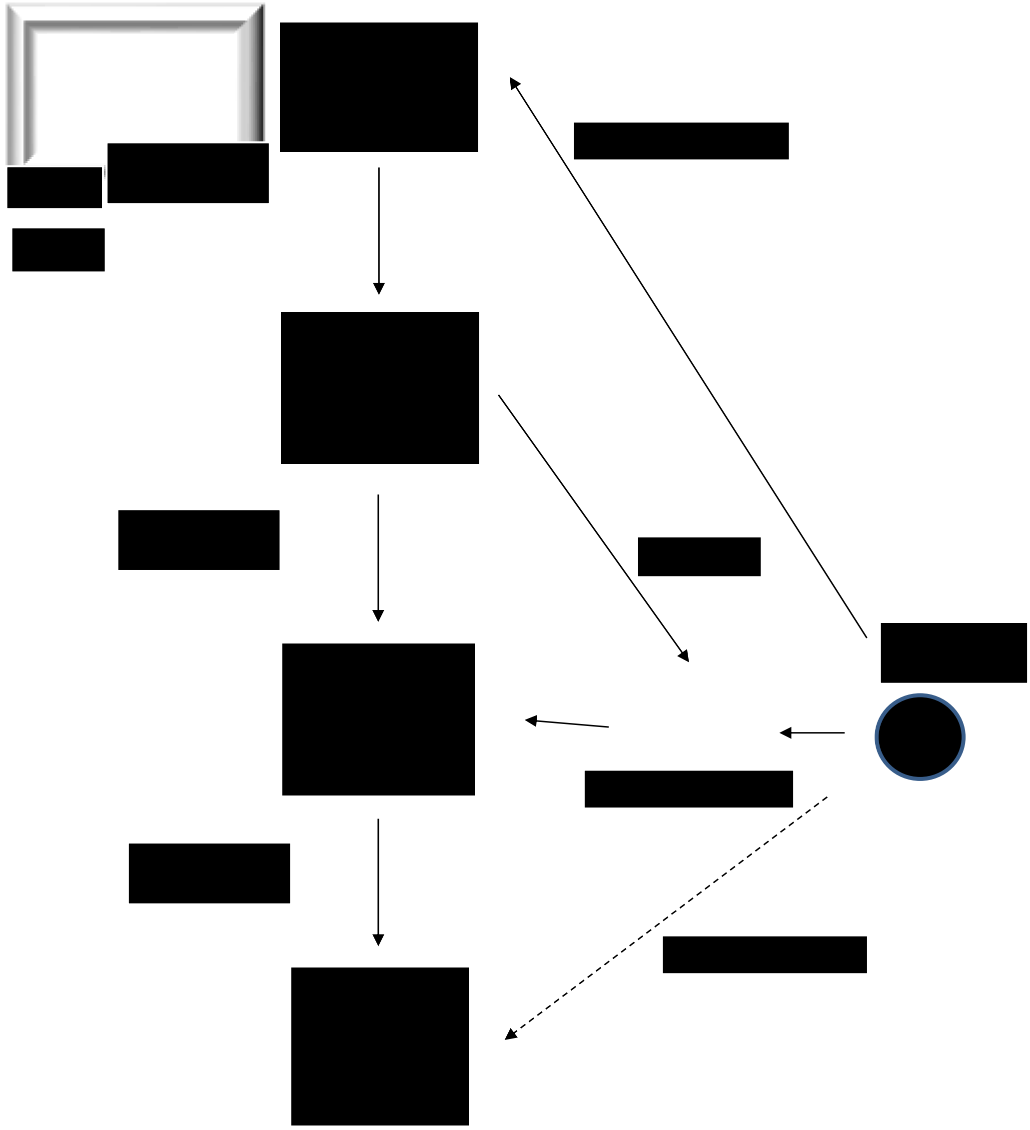
The primary benefit of exchangeable share structures is they allow Canadian shareholders to achieve full or partial deferral of Canadian taxes on capital gains, which otherwise would be payable when a non-Canadian corporation acquires the shares of a Canadian corporation where the consideration consists, in whole or in part, of the acquirer's own shares.

Exchangeable share structures are often used in acquisitions which involve private equity buyers, where there is a commercial desire to provide rollover equity in a non-Canadian entity to former Canadian shareholders of the Canadian target who continue to be involved in the management and operations of the target. They may also be used where it is desirable to effect a tax-deferred "inversion" transaction − one in which a stand-alone Canadian company, or the Canadian parent company of a corporate group, has a non-Canadian parent going forward.

This article provides an overview of the legal and Canadian tax basics of exchangeable share structures, and of some of the ways in which the basic structure can be modified to achieve particular commercial goals.

The basic structure of an exchangeable share transaction

A common structure for an exchangeable share transaction involving a foreign (e.g., U.S.) acquiring corporation (Acquiror) is outlined in the chart below.



Incorporation of Callco and Acquisitionco

Acquiror will incorporate two Canadian corporations: a direct subsidiary of Acquiror (Callco) and a direct subsidiary of Callco (Acquisitionco). Callco is incorporated to exercise the "call rights" described below, while Acquisitionco is incorporated to acquire the shares of the target Canadian corporation (Target) from its Canadian shareholders for exchangeable shares issued – on a tax-deferred basis – by Acquisitionco to the Canadian shareholders.[1] (Non-Canadian or tax-exempt shareholders of Canadian target may prefer to receive Acquiror shares in exchange for their Canadian target shares.) Future exchanges of exchangeable shares for shares of Acquiror will be a taxable event for Canadian tax purposes to the holders of exchangeable shares.

For Canadian tax purposes, the use of a separate Callco is generally preferable to maximize cross border paid-up capital (PUC), which represents the amount that can generally be distributed free of Canadian withholding tax. Specifically, use of a Callco generally allows PUC to be determined based on the value of exchangeable shares at the time of exchange, rather than based on the historic PUC in the exchangeable shares (which generally will not exceed the historic tax cost of the Canadian Target shares to the Canadian Shareholders).

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Creation of exchangeable shares

The exchangeable share structure is designed to provide the Canadian shareholders with the same economic rights and benefits as holders of the Acquiror shares into which the exchangeable shares are exchangeable, while allowing the Canadian shareholders to benefit from the tax-deferred rollover available on the issuance of the exchangeable shares. The share terms of exchangeable shares generally have the following attributes:

1. Retraction: Canadian shareholders have a “retraction right”, which means that Canadian shareholders can require that Acquisitionco redeem exchangeable shares held by a Canadian shareholder. The consideration on a retraction would be the same as in the event of redemption, described below.
2. Redemption: Acquisitionco has a “redemption right”, which means that it can redeem all of the exchangeable shares for Acquiror shares on a one-for-one basis (plus any declared but unpaid dividends), in certain limited circumstances.
3. Dividends/Distributions: To maintain economic equivalence, if a dividend is declared on Acquiror shares, an equivalent dividend must be declared on the exchangeable shares, and vice versa.
4. Voting: The exchangeable shares are typically non-voting and, being shares of a subsidiary of Acquiror, do not in any event confer on the Canadian shareholders any entitlement to vote at meetings of Acquiror shareholders. To place the Canadian shareholders on the same footing as the direct holders of Acquiror, the Canadian shareholders may be granted special voting rights in Acquiror, either through the issuance by Acquiror of special voting stock to the Canadian shareholders, or to a voting trustee if permitted under its applicable law. However, it is not always necessary and is often commercially impracticable to provide voting rights to the Canadian shareholders. If voting rights are provided, the intent is to provide Canadian shareholders with the same amount of votes that they would have had if they held ordinary Acquiror shares.
5. Shareholders Agreements: Consideration should be given to having the Canadian shareholders be party to any shareholders agreement (or limited liability company agreement, limited partnership agreement, or other governance agreement) of Acquiror, even where the Canadian shareholders do not hold special voting stock. This may allow the Canadian shareholders to benefit from any equity holder rights available under such an agreement, including pre-emptive rights, rights of first offer, or refusal and liquidity rights. The shareholders agreement can be structured so as to take into account the Canadian shareholders’ economic rights in Acquiror on an “as exchanged” basis.
6. Liquidation/Dissolution: On a liquidation or dissolution (and subject to the overriding call right), exchangeable shares entitle the holder the right to receive shares of Acquiror on a one- for- one basis, plus an additional amount for declared but unpaid dividends.
7. Term: If desired, the exchangeable shares could have a sunset clause triggering an automatic exchange after a period of time (such as 10 years). The exchangeable share terms may also provide for an automatic exchange in various circumstances, such as where only a nominal number of exchangeable shares remain outstanding, on a

liquidation event, because of adverse change in tax laws, or prior to an initial public offering.

Support and exchange agreement

Acquiror will often enter into a support agreement with Callco, Acquisitionco, and the Canadian shareholders pursuant to which Acquiror agrees, if required, to (a) provide Acquisitionco with sufficient funds to pay dividends to Canadian shareholders in an amount equal to dividends (if any) paid on Acquiror shares, and (b) issue Acquiror shares to Acquisitionco or the Canadian shareholders to support Acquisitionco's redemption of the exchangeable shares (including on a retraction of such shares by a holder) or Callco's exercise of its call right, discussed below. In other words, a holder of exchangeable shares is typically assured of enjoying all of the economic rights and other benefits substantially equivalent to those enjoyed by the direct holders of Acquiror's shares through the combination of the exchangeable share terms, and the support and exchange agreement.

Call right

Callco is granted a call right whereby it may purchase the exchangeable shares from the Canadian shareholders in exchange for Acquiror shares (the call right). The purpose of the call right is to allow Callco to "purchase" the exchangeable shares rather than having Acquisitionco redeem such shares on a redemption or retraction, or in connection with a liquidation event, thus avoiding the adverse deemed dividend tax consequences to shareholders that may arise from a redemption/retraction of exchangeable shares.

Other tax issues

Canadian shareholders are generally taxed more advantageously on dividends received from Canadian corporations as compared to those received from foreign corporations. In particular, dividends received on shares of Acquiror will not be eligible for the "gross-up" and "dividend tax credit" regime applicable to certain dividends, or the reduced tax rate applicable to designated "eligible dividends" received by individuals from taxable Canadian corporations. However, dividends received on exchangeable shares will generally result in certain Canadian preferred share tax rules applying to the issuer – which may discourage paying dividends on the exchangeable shares. In addition, foreign tax considerations may also discourage paying dividends on the exchangeable shares (such as the potential risk of foreign withholding taxes). The impact of the Canadian preferred share tax rules may be mitigated where the issuer is otherwise taxable – but that may not always be sufficient, particularly in the exchangeable share context, since the quantum of dividends is in part dependent upon non-Canadian operations. Therefore, in some cases, dividends may be declared but not paid on exchangeable shares, with such unpaid dividends generally increasing the price for which exchangeable shares are purchased by Callco (or redeemed or retracted).

The *Income Tax Act* includes rules that require income inclusions (in place of capital gains) where capital property is purchased or sold pursuant to "derivative forward agreements". These rules were primarily introduced to address character conversion transactions, but there had been some concern that these rules could apply to a sale of exchangeable shares to Callco. However, both the Department of Finance and the CRA have indicated that typical exchangeable share arrangements should not give rise to derivative forward agreements provided that the ability to receive shares of Acquiror in exchange for the exchangeable shares is incorporated into the terms of the exchangeable shares themselves.

Variations on the theme

The basic structure outlined above may be modified or supplemented depending upon the specific needs of the parties.

If required for financing purposes, an additional Canadian entity can be inserted between Callco and Acquisitionco (Midco), and former Target shareholders who initially receive shares of Acquisitionco on the acquisition of Target can exchange their Acquisitionco shares for exchangeable shares of Midco. The use of Midco can facilitate a pledge of 100% of the shares of an operating entity (*e.g.*, a pledge by Midco of shares of the corporation resulting from an amalgamation of Acquisitionco and Target), if required by lenders.

In the private equity context, it is possible for exchangeable shares to be exchangeable into limited partnership interests, rather than shares of a corporate Acquiror, if preferred from a commercial perspective. A limited partnership may be useful as an "aggregator" entity in which the economics of the Canadian and non-Canadian operations can be rolled up in one entity, particularly if the acquiror group prefers to hold target businesses through tax transparent entities that can also accommodate flexible economics, including carried interest. Note that if there is a commercial desire to provide options to former target shareholders, in addition to rollover equity, any such options should generally be options to acquire shares of a corporation (*e.g.*, a wholly-owned subsidiary of the limited partnership), rather than options to acquire units of a partnership or shares exchangeable into such units, since options to acquire partnership units (or shares exchangeable into partnership units) are not eligible for the deduction under paragraph 110(1)(d) of the *Income Tax Act* (which can otherwise provide option holders with capital gains tax rates on employment benefits from stock options in certain circumstances).

For more information about exchangeable share structures, please contact any member of our National Business Law or National Tax Group.

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[1] Canadian shareholders may generally also take back cash or other consideration (such as debt) on the transaction on a tax-deferred basis, provided that such cash or other consideration does not exceed the Canadian shareholder's tax cost in the Target shares. In this scenario, it would be important to ensure that *each* Target share is exchanged for both cash or other consideration and exchangeable shares. Acquisitionco and each Canadian shareholder needs to file a joint tax election under section 85 of the *Income Tax Act* in order to obtain the tax deferral for the Canadian shareholder.