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Hidden Tax Savings in Foreign Spinoffs: Section 86.1 Tax Elections

When Good Companies Position Themselves for Greatness

Successful foreign companies occasionally chose to reorganize their corporate structures in a manner that allows their separate "like" businesses to operate more efficiently and profitably. These organizations often grow in multiple directions as profitable opportunities become available. Over time, they may grow so large that it makes economic and strategic sense to break the larger company into its smaller "like" components through a spin-off transaction. This allows management teams to focus on issues unique to their industry and more efficiently grow their smaller and now more 'nimble' piece of the original larger company. All of these are positive indicators of a good investment.

A classic example of such a foreign spin-off, where a company became so diversified in its products and businesses that it decided to re-structure to achieve some of these opportunities was in 2007 when Altria Group Inc. (the parent company) spun-off Kraft Foods Inc. Following their success in the initial spin-off, the following year Altria Group Inc. also spun-off Phillip Morris International Inc. Investors experienced a large successful and diversified parent-company (Altria Group Inc.), becoming three separate more focused successful companies by introducing two new spin-off companies: Kraft Foods Inc (specializing in food products) and Phillip Morris International (a leading player in the world-wide tobacco products industry).

A Neutral Economic Value Impact for Investors

At the time of the event, when companies are being "broken apart" there is no real economic benefit introduced from an investor and market place point of view. A parent company worth $100 million dollars would become two companies worth $40 million dollars and $60 million dollars each after a spin-off. The market price of the parent company is adjusted proportionately downwards to reflect the market price attributed to the spin-off company. The intention of this market price balance is to recognize no economic benefit as a result of the spin-off transaction. The marketplace of investors may perceive this event as a growth opportunity for the collection of resulting companies. Investors often believe the companies are better positioned to achieve their goals without the added weight of the larger initial organizational structure. Market prices tend to reflect this optimism shortly after the spin-off is completed. This market response is often recognized in the market price of the parent company in the lead up period to the spin-off transaction.

The Bad News: Taxable Dividends for Canadians

Canadian investors who invested in foreign companies that are engaging in these spin-offs are subject to taxation on the results of the event. Even though the ownership in the parent company is being transformed into a new format that does not introduce new economic value, the spin-off still introduces taxable consequences for Canadian investors as though it had.

For Canadian investors, the spin-off event is processed as a foreign-sourced dividend for Canadian tax purposes. The new spin-off company is valued at a price determined at the time of the spin-off. This per share value of the new spin-off company multiplied by the number of shares received in the restructuring has two key uses. It becomes the new cost base of the spin-off company shares that the investor receives. It also is the value of the foreign-sourced dividend that Canadian investors will be taxed on. This amount will be reported on the shareholder's T5 at the time tax filing slips are issued by investment dealers in Canada.

The Good News: Tax Relief Exists for Canadian Investors

Fortunately, the Canadian Income Tax Act ("The Act") and the Canada Revenue Agency (CRA), have made provisions to fairly recognize the economic substance of a foreign spin-off. For certain transactions, if the parent company has applied to the CRA and received approval to have their spin-off transaction be deemed eligible for Section 86.1 Election treatment, Canadian taxpayers can apply for relief. Although it is not a guaranteed practice, this provision is most likely to be made available by larger companies who have a Canadian market presence.

A Section 86.1 Election allows Canadian investors who were subject to a foreign spin-off, the ability to effectively reverse the taxable income effects of the original transaction. The foreign dividend income recognized on their T5 by their investment dealer can be reversed. The shareholder will also be able to instruct their investment advisor to restore and re-allocate the pre-event cost base of the parent company across the resulting collection of companies (parent and spin-off(s)). This process makes the outcome of the spin-off transaction effectively "**tax free**" for the investor.

Finding Foreign Spin-off Tax Savings Opportunities

The CRA maintains a list of all eligible foreign spin-off transactions that is posted on its website. Investors who have been subject to Section 86.1 Election eligible spin-offs may benefit from reversing the taxable affects of these events. Depending on the individual circumstances, this may result in sizeable tax savings opportunities.

Only spin-off company shares received in taxable investment accounts are subject to taxation as a result of a foreign spin-off transaction. Spin-off company shares received in registered accounts such as RRSPs, RRIFs, LIRAs, TFSAs and RESPs are not subject to tax on dividends resulting from foreign spin-off transactions.

Get it Right the First Time

Section 86.1 Elections are complex. Knowledge about these elections in the investment and tax marketplace is limited. These tax elections are one of the key areas of investment-related taxation that has caused the most difficulty for investors and their advisors. When it comes to saving money, sooner is always better than later. At Canadian Tax Elections we have the expertise and experience to make sure that your elections are accurately completed on a timely basis.

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