



Wealth
Management

the Navigator



INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Foreign spin-offs

As a Canadian resident investor, you might own shares of a foreign corporation. Sometimes, foreign corporations undergo reorganizations where they spin off a subsidiary corporation by distributing shares of the subsidiary to its shareholders. This reorganization is often referred to as a foreign spin-off. For Canadian tax purposes, you'll generally have to include the fair market value (FMV) of the spin-off shares received in your income as a foreign dividend. However, under certain conditions, you can make a tax election to not include this amount in income. This article focuses on the tax implications of a foreign spin-off and what can be done to mitigate the tax impact.

Description of a foreign spin-off

A foreign spin-off is a form of divisive reorganization where a foreign corporation (the "original corporation") distributes shares ("spin-off shares") of another foreign corporation (the "spin-off corporation") to its shareholders. Foreign spin-offs are typically implemented by the original corporation to unlock market value, separate businesses to focus on core competencies or exit non-core business segments.

Tax implications of a foreign spin-off

Spin-off transactions are often completed on a tax-deferred basis under the tax laws in the jurisdiction where the spin-off occurs. However, as a Canadian resident, you must

apply Canadian tax laws to these spin-off transactions to determine how they should be treated for Canadian tax purposes.

The following tax implications are only of concern if you hold the foreign corporation shares in your non-registered account. The possible impact of a foreign spin-off in a registered account is discussed later in the section, "Registered accounts and non-qualified investments."

The default tax implications

The default Canadian tax implications of a foreign spin-off are typically not favourable and could increase the total tax on your investment.

The FMV of the spin-off shares you receive must be reported in your income as a foreign dividend in the year you receive them. Foreign



dividends are fully taxed at your marginal tax rate. They aren't afforded the same preferential tax treatment as dividends from Canadian companies. The FMV of the spin-off shares you receive also becomes the adjusted cost base (ACB) of these spin-off shares going forward.

Typically, a spin-off transaction results in a shift of value from the original corporation to the spin-off corporation. This is often reflected, after the spin-off transaction, as a decrease in the market price of the original corporation shares. However, even though there's a reallocation of the original corporation's value in a spin-off transaction, the ACB of the original corporation shares remains the same. This has the potential to result in a smaller capital gain, or even a capital loss on your eventual disposition of the original corporation shares, where previously there may have been a capital gain. If disposing of the original corporation shares post-spin-off results in a capital loss, the capital loss is deductible against any taxable capital gains you may have realized.

As such, the unfavourable default tax implications of a foreign spin-off are a combination of a fully taxed foreign dividend, as well as a potential capital loss upon selling the original corporation shares, which is only partially deductible and only against taxable capital gains.

One point to note is that after the spin-off, although it may appear on your statements that you have an accrued loss on your original corporation shares, you may not have a true economic loss. To determine your true economic gain or loss, you would need to compare the FMV of the original corporation shares, plus the FMV of the spin-off shares, less your old ACB of the original corporation shares.

Mitigating the tax impact

If the default tax implications of the foreign spin-off will have a significant negative impact, you may want to explore ways of mitigating the tax impact. The remainder of this article explores mitigation strategies that are possible before or after the foreign spin-off. In determining your course of action, tax should be only one of the factors you consider.

Mitigation strategies before the spin-off

When a company declares a spin-off distribution, it sets a record date when you must be on the company's books as a shareholder to receive the distribution. It also sets the distribution date. The ex-dividend date is generally one business day after the distribution date. If you sell your shares before the ex-dividend date, you're giving up the right to the distribution.

When a company declares a spin-off distribution, it sets a record date when you must be on the company's books as a shareholder to receive the distribution.

Beginning on or shortly before the record date and continuing through the last trading day before the distribution date, the original corporation shares may begin trading in two markets: a "regular-way" market and an "ex-distribution" market. Shares that trade in the "regular-way" market will trade with an entitlement to receive the spin-off shares up to the distribution date. Shares that trade in the "ex-distribution" market will trade without an entitlement to receive the spin-off shares. Therefore, if you sell (trade date) your original corporation shares in the "regular-way" market on or prior to the distribution date, you'll be selling your right to receive the spin-off shares. If you own the original corporation shares at the close of business on the record date and sell those shares in the "ex-distribution" market on or prior to the last trading day before the distribution date, you'll receive the spin-off shares because of your ownership of the original corporation shares as of the record date.

As such, perhaps the simplest way to avoid the negative tax consequences of receiving spin-off shares is to not have a right to the distribution.

To add to the complexity, advance tax planning is challenging, as there's generally little time to properly analyze whether the foreign spin-off will have a significant negative tax impact. While companies may announce their intention to spin off in an early press release, it's often difficult to obtain the necessary detailed information to determine if the foreign spin-off will be eligible for favourable tax treatment in Canada.

If you're unable to properly analyze the situation in time, it's determined that the tax implications will be negative, or you just don't want to complete the tax election (discussed later), you might consider the following strategies to avoid the default tax consequences of an impending foreign spin-off.

Sell the shares

If you'd like to dispose of your investment or the original corporation shares are in a loss position, consider selling your position. You'd need to sell (trade date) the original corporation shares on or before the distribution date on the "regular-way" market. In other words, the last day to trade your original corporation shares and not receive the spin-off distribution is the distribution date. Although it may be best to sell it at least the day before.

If the shares are in a gain position, you will have to pay tax on the resulting capital gain. If the shares are in a loss position, selling them will allow you to realize a capital loss that may be used to reduce capital gains realized in the current year. Any unused net capital losses can be carried back three years and carried forward indefinitely to be used against future capital gains.

Contribute the shares in-kind to your registered account

If you'd like to retain the original corporation shares and they're in a gain position (or flat), consider contributing the shares in-kind to a registered account like your TFSA or RRSP. You will be deemed to have disposed of the shares for FMV and will have to pay tax on any resulting capital gain in the year you contribute them. If the shares are in a loss position, this strategy would likely not be beneficial for you. This is because the capital loss is deemed to be nil, and you can't claim this loss.

Your contribution to the registered account will be equal to the FMV of the investment on the date of transfer, so ensure you have the necessary contribution room before contributing the shares in-kind. Also ensure that both the original corporation shares as well as the spin-off shares will be considered a "qualified investment" for your registered account. Otherwise, you may face negative tax implications. For a brief discussion on these tax implications, please refer to the section on registered accounts and non-qualified investments later in this article.

Although both of these strategies may trigger a capital gain, realizing a capital gain, which is only partially taxable, may be preferable to receiving the fully taxed foreign dividend associated with a foreign spin-off.

Mitigation strategy after the spin-off

Under very specific conditions and only if certain steps are taken, section 86.1 of the Income Tax Act (the Act) provides a tax deferral in respect of eligible foreign spin-offs. The details of these necessary conditions and steps are explained in the following sections. As an overview, if the foreign spin-off meets certain criteria, the original corporation may apply to the Canada Revenue Agency (CRA) and provide the necessary information to have the spin-off approved as eligible. Once approved by the CRA as eligible, you may file a section 86.1 election with your tax return to treat the foreign spin-off as a tax-deferred transaction.

If you make the election, you wouldn't have to include a taxable foreign dividend in your income. In addition, the ACB of the spin-off shares will not be their FMV on the date of distribution, as would otherwise be the case. Instead, the ACB of the original corporation shares will be allocated proportionately between the original

If you'd like to retain the original corporation shares and they're in a gain position (or flat), consider contributing the shares in-kind to a registered account like your TFSA or RRSP.

corporation shares and the spin-off shares, based on their relative FMV immediately after the spin-off transaction. For an explanation and an example of how the ACB is reallocated, refer to the section, "Calculating the ACB when an election is made."

Making a section 86.1 election

Eligible foreign spin-off conditions

In order for a foreign spin-off to be eligible, it must first meet certain conditions. One of the main conditions is that the spin-off must not be taxable under the tax laws of the foreign country for shareholders resident in that country. Other conditions include:

- The spin-off is with respect to all of your original corporation common shares
- The distribution consists solely of common shares of the spin-off corporation which were owned by the original corporation immediately before the distribution
- Both the original corporation and spin-off corporation were never resident in Canada, and, at the time of the spin-off, both were resident in the same foreign country
- The foreign country where the corporations are resident has a tax treaty with Canada
- At the time of the spin-off, the original corporation shares are widely held and actively traded on a designated stock exchange

Information provided to the CRA by the original corporation

If the foreign spin-off meets the conditions to be considered eligible as outlined previously, the original corporation will then need to apply to the CRA and provide them with specific information within six months following the day on which the spin-off occurred. The CRA will evaluate whether the spin-off qualifies as eligible for Canadian tax purposes and if found to be eligible, posts their results on their website. The specific information required to be submitted by the corporation is beyond the scope of this article.

If the original corporation does not apply to the CRA, it's not possible for the spin-off to be considered eligible and receive tax-deferred treatment for Canadian tax purposes.

Before filing the election

Before you make the election, you'll need to confirm whether the foreign spin-off is eligible. To assist in determining whether a foreign spin-off is eligible, the CRA has provided a list of approved eligible foreign spin-offs on their website.

Filing the election

Once the spin-off has been approved by the CRA, you can file the election with your income tax return for the year in which the spin-off occurred. There's no prescribed form for the election, so it's recommended that you work with a qualified tax advisor to complete the election.

The election must contain all the following information:

- That section 86.1 applies to the foreign spin-off
- A description of both the original corporation shares and spin-off shares
- The number, ACB and FMV of the original corporation shares immediately before the distribution
- The number and FMV of the original corporation shares and spin-off shares immediately after the distribution

For Canadian tax reporting purposes, all amounts must be converted into the equivalent Canadian-dollar amounts using a foreign exchange rate in effect on the day of the transaction.

Since this election must be filed with your income tax return for the year in which the distribution occurred, the deadline for filing this election is generally April 30 of the year following the spin-off, for an individual shareholder. The deadline can be June 15 of the year following the spin-off if you or your spouse earn self-employment income. In some circumstances, the election may be filed late under the taxpayer relief provisions. If you find yourself in a late-filing position, be sure to discuss the appropriate actions you should take with a qualified tax advisor.

If you're filing a section 86.1 election for a particular year, you will not be able to electronically file your tax return for that year.

Calculating the ACB when an election is made

If you file the election for an eligible foreign spin-off, the ACB of the original corporation shares will need to be allocated between the original corporation shares and the spin-off shares, based on their relative FMV immediately after the spin-off transaction. To accomplish this, you first need to calculate how much you need to reduce the ACB of an original corporation share by, based on the following formula:

The reallocation of the ACB between the original corporation shares and the spin-off shares is best explained through a numerical example.

$A \times [B \div (B + C)]$ where,

A = The ACB of the original corporation share immediately **before** the distribution.

B = The **FMV**, immediately **after** the distribution, of the spin-off share(s) or fraction of a spin-off share you received for each share of the original corporation.

C = The **FMV** of the original corporation share immediately **after** the distribution.

The revised ACB of the original corporation share, immediately after the spin-off, is the original ACB less the amount determined by the formula. The amount determined in the formula is also the ACB of the spin-off share(s) or fraction of a spin-off share received for each original corporation share owned.

A numerical example

The reallocation of the ACB between the original corporation shares and the spin-off shares is best explained through a numerical example. All amounts in this example are expressed in Canadian dollars, unless otherwise specified.

Assume you own 400 shares of a widely held and actively traded U.S. corporation, Aco, with a total ACB of \$10,000, or \$25 per share. You had originally purchased Aco at US\$20 per share when the USD/CAD exchange rate was 1.25.

Aco decides to spin off its interest in Bco, a subsidiary, and distributes to each of its shareholders 0.25 (one-quarter) of a Bco share for each Aco share held. As a result of the spin-off transaction, you received 100 shares of Bco as a foreign dividend.

The FMV of an Aco share after the distribution is US\$38 per share and the FMV of a Bco share after the distribution is US\$9.50 per share. The USD/CAD exchange rate on that day was 1.053, so the Canadian-dollar equivalent FMV of an Aco share and a Bco share is \$40 and \$10 per share, respectively.

Assume that the spin-off meets all the conditions for an eligible foreign spin-off, the CRA has approved it as an eligible foreign spin-off, and you continue to hold all your Aco and Bco shares. You elect under section 86.1 to not include the dividend in the amount of \$1,000 (100 Bco

shares x \$10 per share) in your income. Therefore, you need to calculate the new ACB for both your Aco and Bco shares, as follows:

The ACB of your Aco shares will be reduced by:

$A \times [B \div (B + C)]$ where,

A = \$25 (The ACB of an Aco share immediately **before** the distribution).

B = 0.25 multiplied by \$10, equaling \$2.50 (the **FMV**, immediately **after** the distribution, of the 0.25 of a Bco share you received for each Aco share held).

C = \$40 (the **FMV** of an Aco share immediately **after** the distribution).

$= \$25 \times [\$2.50 \div (\$2.50 + \$40)] = \$1.47 \text{ per share.}$

As a result, the revised ACB of your Aco shares is \$23.53 (\$25 – \$1.47) per share. Since you have 400 shares in total, the ACB of all your Aco shares is \$9,412 (400 × \$23.53).

Since you only received 0.25 (one-quarter) of a Bco share for each Aco share you held and each quarter share of Bco has a calculated ACB of \$1.47, the ACB of a full Bco share after the election is \$5.88 (\$1.47 × 4). Since you have 100 Bco shares in total, the ACB of all your Bco shares is \$588 (100 × \$5.88).

Notice how after the election, the total ACB of your Aco and Bco shares is \$10,000 (\$9,412 + \$588), which is the same as the ACB of the Aco shares that you owned before the spin-off distribution.

Cash in lieu of fractional spin-off shares

For a foreign spin-off to be eligible, the original corporation must distribute only common shares of the spin-off corporation, and the distribution must not include non-share consideration. That said, the CRA has indicated that a foreign spin-off may still be eligible where the payment of cash in lieu of fractional spin-off shares is not made by the original corporation but rather by a depository or broker who has received and sold the fractional shares on behalf of the shareholder.

If you receive cash for your fractional spin-off shares, it will be treated as proceeds of disposition that may give rise to a capital gain or capital loss. The total cost amount of the fractional shares would be equal to the number of fractional shares you would have received multiplied by the ACB per spin-off share immediately after the distribution. Therefore, the total ACB of the spin-off shares you receive should be reduced by the cash you received in lieu of fractional spin-off shares.

For a foreign spin-off to be eligible, the original corporation must distribute only common shares of the spin-off corporation, and the distribution must not include non-share consideration.

Registered accounts and non-qualified investments

If you hold the original corporation shares in a registered account — for example, your TFSA, RRSP or RRIF — you will need to ensure that both the original corporation shares as well as the spin-off shares will be considered a “qualified investment” for your registered account. Qualified investments include, among other securities, most shares listed on a designated stock exchange. However, in some instances, the spin-off shares may not be listed on a designated stock exchange and therefore may not be a qualified investment.

Tax implications of non-qualified investments

If you acquire a non-qualified investment in your registered account or an existing investment becomes non-qualified, significant adverse tax consequences apply. You will be subject to a 50% tax on the value of the investment, which will apply at the time you acquire the non-qualified investment or when the investment becomes non-qualified. In addition, the registered plan is taxable on any income earned on the non-qualified investment.

The 50% tax is generally refundable if you dispose of the non-qualified investment from your registered account before the end of the year following the year in which the tax applied (or by such later time as the CRA considers reasonable). However, if you knew, or ought to have known, that the investment was non-qualified or would become non-qualified, the 50% tax will not be refundable. In addition, if the non-qualified investment is not publicly traded, it may have no valuation and therefore be difficult to remove from your registered account or to sell.

These penalty taxes are quite complex and undesirable, so if you become aware of an impending foreign spin-off, you should consult with a qualified tax advisor as soon as possible to assist you in determining whether both the original corporation shares and the spin-off shares will be a qualified investment for your registered account.

If there's a chance the shares will be non-qualified, there may be some planning opportunities to consider, such as selling your shares within the registered account before the spin-off occurs.

Conclusion

The default Canadian tax implications of a foreign spin-off are unfavourable and could increase the total tax on your investment. However, if it's a CRA-approved eligible foreign spin-off, and you make an election in your tax return under section 86.1 of the Act, you can treat the transaction as a tax-deferred rollover. You should consult with a qualified tax advisor to determine if it makes sense, in your circumstances, to file the section 86.1 election. If you decide to file a tax election, remember to notify your RBC advisor of any necessary ACB adjustments so that the adjusted ACBs can be properly reflected in your account statements going forward.

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