MERGERS AND AMALGAMATIONS

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Although the special tax treatment afforded by s. 85I of the Income Tax Act[1] applies only to an amalgamation or merger which is effected by the procedure now provided for in s. 140a of the Alberta Companies Act[2] and in similar sections of the Companies Acts of other provinces, there are actually four methods by which an amalgamation or merger of two or more Companies may be effected.

Mergers and amalgamations were effected, and still are effected, by other means in jurisdictions where there are no provisions for statutory amalgamations such as are found in s. 140a. For example, amalgamations were carried into effect in Alberta before s. 140a providing for amalgamation by agreement was inserted in the Act.

An amalgamation (apart from the definition in s. 85I of the Income Tax Act) has been defined as an arrangement whereby the assets of two or more Companies become vested in or under the control of the Company (which may or may not be one of the original Companies) which has as its shareholders all or substantially all of the shareholders of the amalgamating Companies.[3]

Prior to the enactment of s. 140a of the Alberta Companies Act amalgamations in which Alberta Companies were concerned were usually effected by resort to one of the three following procedures:

SALE OF ASSETS

First, by the sale of the assets of one Company to another or by the sale of the assets of both Companies to a newly incorporated Company (the Company surviving or resulting from the amalgamation will be, in either case, hereinafter referred to as "the successor Company") for shares or securities of the successor Company. The selling Company or Companies would then be liquidated with their shareholders receiving shares of the successor Company.

Section 19(1) para. 1 of the Alberta Companies Act[4] gives a Company incorporated under that Act the power (unless excluded by its Memorandum of Association) to sell or dispose of the undertaking of the Company or any part thereof for such consideration as the Company may think fit and in particular for shares, debentures or securities of another Company wheresoever incorporated having objects altogether or in part similar to those of the selling Company. It also gives the Company the power to distribute any of the property of the Company among its members in specie.

Section 231 of the Alberta Companies Act[5] relates specifically to a case where the sale of a Company's undertaking has been made for shares and securities of another Company. It provides that where a Company,

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1 R. S. C. 1952, c. 148; S. 85I was enacted by s. 35 S.C. 1958 c. 32.
2 R.S.A. 1955, c. 53.
3 M. A. Wineberg, *Take-overs and Amalgamations*, 3.
4 *Ibid* n. 2 *Supra*.
5 Ibid.

called the transferor Company, is proposed to be or is in the course of being wound up voluntarily and the whole or part of its business and property is proposed to be transferred or sold to another corporation wheresoever incorporated, called the transferee Company, the liquidator of the transferor Company may, with the sanction of a special resolution of that Company, receive in compensation or part compensation for the transfer or sale, shares, debentures or other like interests of the transferee Company for distribution among the members of the transferor Company. It also provides that any transfer, sale or arrangement effected pursuant to s. 231 is binding on the members of the transferor Company.

It is, however, provided by s. 231 that any member of the transferor Company who does not vote in favor of the special resolution and expresses dissent therefrom in writing addressed to the Liquidator and left at the registered office of the Company within seven days after passage of the resolution may require the Liquidator either to abstain from carrying the resolution into effect or to purchase the dissenting member's interest at a price to be determined by agreement or arbitration as provided for in the section.

It has been contended, and the procedure has probably been followed in some cases, that a Company with the specific power in its Memorandum of Association to sell its undertaking for shares or securities of another, or perhaps only with the implied power granted by s. 19 of the Alberta Companis Act, can effect a sale of its assets and undertakings to another Company without compliance with the provisions of s. 231 of the Alberta Companies Act. However, the more cautious opinion is that if any sale of an undertaking of the Company is proposed to be followed by the winding up of the Company and the distribution of the shares received as consideration for the sale among the members of the Company then the sale should be conducted under the provisions of s. 231.

Usually the form of agreement between the Companies that are proposing to amalgamate by this procedure provide that if there should be more than a specified amount of shares which have to be purchased from dissenting members the amalgamation can be annulled at the option of either the transferor or the transferee Company. Here it might be mentioned that in the fairly large number of cases in which the writer has been professionally involved over the past twenty years and in which s. 231 was applicable, no transaction was ever avoided or annulled because of this provision.

An amalgamation under this procedure seems to find some favour with the Courts because a dissenting shareholder can be satisfied in a simple and expeditious manner if he is dissatisfied with a sale which has been approved by the requisite majority of approving shareholders. Also this procedure eliminates the necessity for much of the scrutiny which the Courts now appear to be directing to amalgamations effected through other than the sale of assets route.[6]

As amalgamations by "statutory" agreement may only be effected between Companies incorporated in the same Province, and because under s. 83A (8) (a) of the Income Tax Act[7] drilling and exploration costs of a

[6] *See* the judgment of Porter, J.A. in *Fogler* v. *Norcan Oils and Gridoil Freehold Leases* (1964), 47 W.W.R. 257, reversed on appeal, 49 W.W.R. 321 (S.C.C.).
[7] R.S.C. 1952, c. 148; s. 83A was enacted by s. 22(1) S.C. 1955, c. 54.

predecessor Company pass to the benefit of the successor Company (insofar as production from the predecessor's property is concerned) when the predecessor sells all or substantially all of its assets to such successor Company, amalgamations by the sale of assets route might still find favor, if it were not for the effect of the 1962 amendments[8] to s. 83A of the Income Tax Act, insofar as they relate to dispositions of oil and natural gas properties. Section 83A (5) (b) causes particular concern.

These amendments require that the part of the consideration for the sale of assets allocable to oil and natural gas proprties and interests be brought into the income of the selling Company in the year of receipt. In many (if not most) cases this would produce disastrous results to the shareholders of the selling Company unless it had sufficient unused and available drilling and exploration costs to offset the income deemed to result from the sale. The transferee Company would not be adversely affected because, while it would lose the benefit of the drilling and exploration costs of the transferor Company (which would be applied against the proceeds of sale to offset the income deemed to be received by the transferor Company therefrom), it could write off the cost of the acquisition of the property against its income in the taxation year of the acquisition and thereafter as a drilling and exploration expense. This privilege would not appear to be confined to income derived from the purchased properties.[9]

One other consideration sometimes prevented amalgamations by the sale of assets route, for example, the case where the selling Company had undistributed income on hand and as a result, on the distribution of the consideration for the sale of its assets among its shareholders a proportion thereof equivalent to the undistributed income would be subject to income tax in the hands of the shareholders[10] (s.s. (1) Sec. 81). There were, of course, other features such as recapture of depreciation which also had to be considered in transactions of this sort.

While the sections of the Alberta Companies Act have been specifically referred to, the Companies Act of all of the Western Provinces have provisions similar or somewhat similar to s. 231 of the Alberta Act. However, no such provision is found in the Dominion Companies Act.[11]

TAKE-OVER BID

The second procedure by which amalgamations or mergers could be effected under either the Provincial Acts or the Dominion Companies Act is through a "take-over bid". By this method all of the shares of one Company (the "transferor Company") would be acquired by another Company (the "transferee Company") in exchange for shares of its capital stock following which the transferor Company would be liquidated or wound up and its assets distributed to its sole shareholder, the transferee Company.

While there are variations between the provisions of s. 138 of the Alberta Companies Act and s. 128 of the Dominion Companies Act, and some minor distinctions in other provincial Acts relating to take-over

8 S.C. 1962-63, c. 8.
9 S. 83A (5a).
10 S. 81 (1).
11 R.S.C. 1952, c. 53.

bids, the general nature of the procedure is practically the same as that used in Alberta.

Generally, the effect is that if the offer of the transferor Company is, within four months after the making thereof, approved by the holders of 90% (in Manitoba 75%) in value of the shares affected, the transferee Company may at any time within two months after the expiration of the said four month period give notice in *prescribed manner*[12] to a dissenting shareholder that it desires to acquire his shares. When such notice has been given the transferee Company becomes entitled and bound to acquire such shares for the same consideration offered to the other shareholders of the transferor Company at the expiration of one month from the date on which such notice is given unless, on an application made by a dissenting shareholder within the same period, the Court thinks fit to order otherwise.

It has been held in a number of English cases and most recently in Canada in *Esso Standard (Inter-America)* v. *J. W. Enterprises and Morrisroe,*[13] that shares in the transferor Company already held by the transferee Company or its creatures or subsidiaries may not be taken into account in determining the percentage of shares of the transferor Company required to be held by the transferee Company as a condition precedent to invoking the compulsory acquisition provisions. Furthermore, there are some cases which seem to go so far as to suggest that where the transferee Company and/or its subsidiaries already hold 90% of the outstanding shares of the transferor Company, the procedure may not be resorted to at all. More reasonable opinion seems to be that "shares affected by the offer" within the meaning of section 138, are those which are held by outside shareholders and if the required percentage of these are picked up within the prescribed period the compulsory procedure may be resorted to.

There are, however, some pitfalls to be avoided in connection with this procedure. The offer must be initially made open for acceptance for a period of four months from the date when it is made. It is not sufficient to extend it from time to time and the procedure of compulsory acquisition may not be adopted until the expiration of the four month period, regardless of the number of shares acquired prior thereto.[14]

The question as to when the offer is to be deemed to have been made is not altogether clear, although it seems to be the date on which it is despatched to the shareholders of the Company to whom the offer is made.[15]

Also, it is not clear what constitutes a "contract or scheme" within the meaning of Alberta s. 138 or "a contract" under s. 128 of the Dominion Companies Act, which is a condition precedent to resort to this procedure. It should be noted that s. 128 of the Dominion Companies Act does not use the word "scheme" but refers to a "contract" involving the transfer of any shares. However in s. 128 (4) a contract is defined to include "an offer of exchange and any plan or arrangement, whether contained in or evidenced by one or more documents, whereby or pursuant to which

12 Alta. 1961, Reg. 31.
13 37 D.L.R. (2d.) 598.
14 Rathie v. Montreal Trust Co. [1953] 4 D.L.R. 289.
15 See the judgment of Laidlaw, J.A. in the *Esso Case* [1962] O.R. 705.

the transferee has become or may become entitled or bound absolutely or conditionally to acquire all the shares in the transferee of any one or more classes of shareholders who accept or have accepted the offer . . ."

Notwithstanding this definition, Mr. Justice Kelly and Mr. Justice Laidlaw of the Ontario Court of Appeal in the *Esso Case*[11] and Mr. Justice Rand in the *Rathie Case*[16] had difficulty in applying the section to a simple offer made by one Company to the shareholders of another. It seems essential to precede the offer by a "contract", even if only the transferee Company is bound thereby, between the transferor and transferee Companies.

The Alberta Companies Act does not define "contract" but it should be noted that it also refers to a "scheme" and therefore possibly its application may be wider than that of the Dominion Companies Act. The usual procedure is that if the scheme is successful and it is possible to do so without dire tax consequences, the transferor Company will be put into liquidation after control of all of its shares has been acquired by the transferee Company and its assets transferred to the transferee Company.

Here, however, trouble can again be encountered because of the combined effect of the 1962 amendments[17] to the Income Tax Act and s. 17 (6) of the same Act.[18] Section 17 (6) provides that if the assets of a Corporation are transferred to a shareholder on its winding-up and the sale of the assets at fair market value immediately prior to the winding-up would have increased the Corporation's income for a taxation year then for the purpose of determining the Corporation's income for the year it shall be deemed to have sold the property during the taxation year and to have received for it the market value.

As s. 83A (5b) of the Income Tax Act would require the Company to bring into its income for the taxation year the proceeds of sale of petroleum and natural gas rights if sold prior to liquidation, the combined effect of this section and s. 17 (6) could obviously, in many cases, result in serious tax consequences to the transferor Company and its shareholders.

It may therefore be truthfullly said that this procedure of a "take-over bid" is beset by procedural difficulties, tax problems and possible defeat of the objectives of the transaction by dissenting shareholders. Before leaving the subject of "take-over bids" as a form of amalgamation, it should be mentioned that in Fraser & Stewart[19] it is indicated that the acquisition by a Company of all the shares or of one or more classes of shares of another Company is not really an amalgamation. It is submitted, however, that when this acquisition is coupled with the winding-up of the transferor Company and the distribution of the shares of the transferee Company to the shareholders of the transferor Company it can properly be said that an amalgamation or merger has taken place.

Perhaps it should also be emphasized that when the "take-over bid" procedure is followed the offer may be expressed in cash or shares or securities of the transferee Company or partly in one and partly in another, but where the offer is expressed in cash it would not result in an "amalgamation".

16 Ibid n. 14 at 296.
17 *Supra* n. 8.
18 *Supra* n. 1.
19 *Company Law of Canada*, 706.

ARRANGEMENT

A third method of amalgamation which was sometimes employed, possibly most often in cases involving Dominion Companies, was through an arrangement made with shareholders under s. 126 of the Dominion Companies Act.[20] Similar arrangements were sometimes worked out pursuant to ss. 139 and 140 of the Alberta Companies Act[21] which are similar to s. 126 of the Dominion Companies Act and the "arrangement" sections of other Western Provinces. The Arrangement sections are particularly appropriate to an amalgamation because they actually use the words "amalgamation" as being one of the objectives sought to be achieved by an Arrangement.

The expression "Arrangement" as used in s. 126 of the Dominion Companies Act (and in most of the Provincial Acts) is defined as including an "amalgamation or reconstruction". An amalgamation or reconstruction is defined as an arrangement pursuant to which a Company (the transferor Company) transfers or sells or proposes to transfer or sell to any other Company (the transferee Company) the whole or a substantial part of the business and assets of the transferor Company for a consideration consisting in whole or in part of the shares, debentures or other securities of the transferee Company and, either any part of the consideration is proposed to be distributed among shareholders of the transferor Company, or the transferee Company proposes to cease carrying on business.

When this procedure is adopted, a plan or scheme (the "Arrangement") is worked out whereby the assets of the transferor Company will be transferred to another Company in consideration of shares or securities of that Company. The rights of the shareholders of the transferor Company are thereafter confined to their right to receive a proportionate part of the shares or securities received in such exchange. It should be noted that s. 126 does not apply to a cash transaction.

While there are some precedural differences between the Dominion Companies Act and Provincial Companies Act, generally speaking when the arrangement is reduced to writing application is made to the court of the province in which the head office of the transferor Company is situated for an order directing the convening of a meeting of its shareholders to be summoned in such manner as the Judge may direct. Where the shareholders present in person or by proxy at the meeting agree to the arrangement by a majority of three-fourths of the shares represented and voted, then the arrangement may be sanctioned by the Judge, and if so sanctioned, such an arrangement may be confirmed by supplementary letters patent which are binding on the Company and its shareholders.

Where at such a meeting dissenting votes are cast by shareholders but notwithstanding, the arrangement is agreed to by the requisite majority, it is necessary, unless the Judge otherwise orders, that the Company give notice to each dissenting shareholder in a manner prescribed by the Judge of the time and place at which application is to be made to the Judge for sanction of the arrangement. On the hearing of the application the Judge may sanction the arrangement, refuse such sanction or sanction it with modifications.

[20] *Supra*, n. 11.
[21] *Supra*, n. 2.

Amalgamations between Companies incorporated in different jurisdictions can be effected by "arrangements". It is only necessary that the "transferor" Company should have been incorporated in the jurisdiction of the Court where the required applications are made.

A transfer of property effected under such an arrangement carried with it the drilling and exploration costs of the transferor Company and made them deductible from the income attributable to production from the property of the transferor Company acquired by the transferee Company. It was quite a satisfactory way of handling things until the 1962 amendments to the Income Tax Act came along and made it necessary to bring the proceeds of sale of petroleum and natural gas rights into income of the transferor Company on the transfer following the confirmation of the arrangement. Consequently the "Arrangement" type operation was "fouled up."

No amalgamation section similar to s. 140a of the Alberta Companies Act has as yet appeared in the Dominion Companies Act and very serious tax difficulties affect any attempt to merge oil companies incorporated under the Dominion Companies Act or to work out any Arrangement for their amalgamation with a company incorporated in one of the Provinces. In fact it seems impossible to do, unless there are sufficient unused drilling and exploration costs or businesses losses in the transferor Company to offset the income which will be deemed to have been received by the transferor Company from the transfer of its assets.

However, a Company not in the oil and gas business can still resort either to the "arrangement" procedure or the "sale of assets" route as a convenient method of effecting a merger or amalgamation.

Statutory Amalgamation

The fourth and, at the moment, the most important form of amalgamation is the "statutory amalgamation" which is provided for under s. 140a of the Alberta Companies Act. Provisions similar to s. 140a are found in all of the Companies Acts of the Western Provinces. Ontario has had a similar provision in its Companies Act for a good many years.

How an amalgamation is effected under the statutory amalgamation procedure will be outlined briefly. Under s. 140a, which was enacted in 1959, any two or more Companies, including holding and subsidiary Companies, may amalgamate and continue as one Company. The Companies proposing to amalgamate may enter into an amalgamation agreement, which prescribes the terms and conditions of the amalgamation and the mode of carrying it into effect.

An Amalgamation Agreement must set out the name of the amalgamated Company, the place where its Head Office is to be situated, its authorized capital, the objects for which it is to be established, the names, occupations and places of residence of its first directors, the date when subsequent directors are to be elected, the manner of converting the authorized and issued capital of each of the Companies into that of the amalgamated Company and "such other details as may be necessary to perfect the amalgamation and to provide for the subsequent management and working of the amalgamated Company. The amalgamation agreement may provide for the adoption of the articles of association of one of

the amalgamating Companies or for the adoption of new articles as the articles of association of the amalgamated Company.

The amalgamation agreement should be submitted to the Registrar of Companies and conditionally approved by him. Thereafter it is required to be submitted to the shareholders of each of the amalgamating Companies at general meetings called for the purpose of considering the agreement. If three-fourths of the votes cast at such meetings are in favor of the amalgamation agreement, the secretaries of the amalgamating Companies certify that fact and the Agreement is submitted to the Registrar and approved by him in writing. Then a petition is filed in the Trial Division of the Supreme Court requesting the court to approve the amalgamation.

Unless the Court otherwise directs, each amalgamating Company is required to notify its dissenting shareholders and, sometimes, its creditors, of the time and place when the application for the approving order is to be made. Upon the application for the approving order, the court will hear and determine the matter. The court, having regard to the rights and interests of all parties, including the dissenting shareholders and creditors, may approve the amalgamation agreement as presented or may approve it subject to compliance with such terms and conditions as it thinks fit to impose.

The amalgamation agreement and the approving order is then filed with the Registrar of Companies and he issues a certificate of amalgamation under his seal of office certifying that the amalgamating Companies have amalgamated. From that date they are amalgamated and are continued as one Company with the authorized capital, objects, etc. specified in the amalgamation agreement.

Now, of all the methods of amalgamation above outlined, it is only an amalgamation which is effected under these statutory provisions that will qualify for the special tax treatment provided by s. 85I of the Income Tax Act.

In that section an amalgamation is defined as a merger of two or more Corporations (each of which is referred to as a "predecessor corporation") to form one corporate entity (referred to as the "new corporation") in such manner that, by virtue of the merger:

(a) All of the property of the predecessor corporations immediately before the merger becomes the property of the new corporation; and
(b) All of the liabilities of the predecessor corporations immediately before the merger become liabilities of the new corporation; and
(c) All of the shareholders, except any predecessor corporation, of the predecessor corporations immediately before the merger become shareholders of the new Corporation;

but the foregoing is followed by these important words: "otherwise than as a result of the acquisition of property of one corporation by another corporation pursuant to the purchase of such property by the other corporation or as a result of a distribution of such property to the other corporation upon the winding up of the corporation".

These words arbitrarily exclude the application of section 85I to amalgamations by the first three procedures I have mentioned, and also

exclude Dominion Companies from the benefits of section 85I because there are no provisions in the Dominion Companies Act which will permit a merger or amalgamation to be effected otherwise than by arrangement, or sale of assets, or take-over and dissolution.

It will of course be obvious that the amalgamation agreement must be drawn in such a manner as to accomplish the results outlined in (a), (b) and (c) above, or it too will not qualify for the treatment provided for in s. 85I. However, there are a few other points to which attention should be directed.

You will note that under s. 85I all of the shareholders of the amalgamating Companies must become shareholders of the successor Company, but that the section does not provide that they have to become holders of the same type of shares as they held in the amalgamating Companies, or of the same number or in the same proportions. Consequently, it is quite possible to provide for an amalgamation under which the shareholders of one Company might receive redeemable preferred shares of the amalgamated venture. This might be done with the idea that these redeemable shares could be later redeemed and the amalgamated Company made a wholly owned subsidiary of another Company which had received the amalgamated Company's common shares under the amalgamation agreement.

You will also note that s. 85I does not preclude the shareholders of the predecessor Companies from receiving securities, as well as shares, of the amalgamated Company, so long as they do in fact become shareholders of that Company. You will have particularly noted that the amalgamation agreement must be approved by a Judge.

Up to the delivery in late February, 1964 of the decision of the Alberta Appellate Division in the *Fogler Case*[22] referred to above, the Judge, before whom the application was heard, was usually only, or perhaps, chiefly, concerned as to whether or not the formalities prescribed by the Alberta Companies Act had been followed. He would, however, listen to objections from dissenting shareholders and if he found any real validity or substance in them he could refuse to approve the amalgamation or could attach terms to it. The writer is not aware of any cases prior to the *Fogler Case* in which a Court of Alberta refused to approve an amalgamation provided the requisite formalities had been followed, and it was of the opinion that all the shareholders were being treated properly, particularly having regard to the apparent value of their respective interests. However, in the *Fogler Case,* which was an Appeal from an Order of Mr. Justice Cairns confirming the Gridoil-Norcan amalgamation, the Appellate Court took a much stricter view, and laid down some guide lines which must be observed in future cases.

The judgments in this case were delivered by Chief Justice Smith (with whom Mr. Justice Johnson concurred) and by Mr. Justice Porter. Mr. Justice Porter took the view that financial statements and other material furnished to the shareholders of the amalgamating Companies were misleading and confusing. After citing instances appearing to support this view, he concluded by saying:

> No court can determine whether this merging transaction is fair and no shareholder can make a decision without having knowledge of all the facts which a

22 *Supra*, n. 6.

prudent man disposing of one stock and acquiring another would require to weigh and consider before coming to a decision. The necessary facts will vary with the characteristics of the Companies involved, but in Companies of the kind being dealt with here they may well include, for example, the following; book value for historical purposes, demonstrated earning capacity, liabilities current and long term, cash flow, provisions for depreciation and depletion, market activities, the speculative potential of the acreage of an exploration company, proper estimates of reserves, and their marketability, as well as the benefits that might accrue to the shareholders in the future operations of the merged Company that would not be available if the Companies were not merged.

In my view the material before the learned Judge was so lacking in essential facts that it could not form the basis for the exercise of discretion. The Order approving the merger should therefore be set aside.

Chief Justice Smith based his judgment on somewhat narrower grounds. He said, in part:

My view is that the Proxy Statement sent to Shareholders of Gridoil was insufficient because of the omission (1) of the figure as to the revaluation of the oil and gas properties of that Company and (2) of a reference to the tax credits of $2,000,000 referred to by Porter, J.A. Under these circumstances my view is that the shareholders were not enabled to exercise an intelligent judgment upon the merits of the proposed amalgamation. I do not consider that the Directors in the Proxy Statement were 'honestly putting forward to the best of their skill and ability a fair picture of the Company's position'. (In *re Chemical Industries Ltd.* [1936] 1 Ch. 587 at p. 618) or that the Proxy Statement disclosed sufficient information to enable 'the shareholders 'to judge of the fairness and propriey of the scheme'. (Headnote in *Carruth* v. *Imperial Chemical Industries Ltd.* [1937] 2 All E.R. 422).

It might perhaps be mentioned that the material sent to shareholders was exactly what the Securities Exchange Commission required to be sent to American shareholders with the idea, presumably, that they might intelligently consider the propriety of the amalgamation proposals. Obviously what the Securities Exchange Commission considers the proper material to be sent to shareholders to enable them to form a proper judgment in such matters differs from the opinion of the Appellate Division of the Supreme Court of Alberta, and this should be borne in mind in future cases.

The judgments of Smith, C.J. and Porter, J.A. laid down principles and guide lines which should be read and followed in cases of this type if difficulties are to be avoided, because, as noted by Mr. Justice Porter, the statute itself gives no guidance and imposes no limits on thė grounds upon which the discretion of the Court is to be exercised.

The *Fogler Case* is now being appealed to the Supreme Court of Canada,[22a] and while the decision of the Appellate Division (which set aside the Order of Mr. Justice Cairns) may not be upheld, it is obvious that the utmost care will have to be followed in connection with material submitted to shareholders when asking them to approve an amalgamation agreement.

TAX IMPLICATIONS

Having gone through, perhaps at unnecessary length, the various methods by which mergers or amalgamations may be effected, some of the features of an amalgamation from a purely taxation standpoint will now be dealt with.

First, it should be emphasized that, in the main, the taxation features applicable to amalgamated ventures which will be discussed, are applicable only to amalgamations which qualify under s. 85I of the Income Tax Act; in other words, amalgamations which are commonly referred to as

22a See p. 479, *post*.

"Statutory Amalgamations" effected under the provisions of those Companies Acts which have special sections providing for amalgamation. Perhaps it should be repeated that (1) at the moment the Dominion Companies Act has no such provision and it is accordingly impossible to effect an amalgamation of Dominion Companies or of a Dominion Company with a provincial Company, which will entitle the amalgamated Company to the special tax treatment of section 85I, and (2) it is also impossible to effect Statutory amalgamations of companies incorporated under different Provincial Acts; for example, you cannot amalgamate a Saskatchewan Company with an Alberta Company and obtain the benefit of s. 85I.

This situation has received serious consideration by the Special Committees of The Law Societies of the various Provinces who are endeavouring to work out a scheme whereby the corporate existence of a Company created by the Statute of one Province can be extinguished in an amalgamation with a Corporation incorporated in another Province. It is submitted that no very serious constitutional problem would arise in the enactment of legislation which would permit such an amalgamation. Amalgamations of this nature are permitted in many of the states of the United States, where "domestic" Corporations and "foreign" Corporations can merge by a procedure similar to that provided by s. 140a of the Alberta Companies Act, and in such a way as to obtain the benefit of s. 85I of the Income Tax Act where Canadian operations are involved.

For instance, the writer recently obtained an opinion from the Department of National Revenue that the amalgamation of a Pennsylvania oil Corporation and a Delaware oil Corporation which met the requirements prescribed in the definition of amalgamation in s. 85I of the Income Tax Act would qualify for the special tax treatment afforded by that section.

It is suggested that the present situation is somewhat ridiculous and the writer has urged The Honourable Mr. Walter Gordon, the Minister of Finance, to clear it up. The writer suggested that perhaps the most expeditious way of doing so would be the elimination of the concluding words of s. 85I (1), which reads as follows:

> Otherwise than as a result of the acquisition of the property of one Corporation by another Corporation, pursuant to the purchase of such property by the other Corporation or as the result of a distribution of such property to the other Corporation on the winding-up of the Corporation.

If these words were eliminated, an amalgamation, by whatever means it is effected, which satisfies the three conditions set out in (a), (b) and (c) of section 85I (1) of the Income Tax Act should qualify for the tax treatment provided for in s. 85I.

It appeared that some officials of the Finance Department were sympathetic to this suggestion but, if so, it would seem that the mills at Ottawa grind very slowly, and at the moment we are faced with the anomalous situation where two Companies incorporated in the same Province, which has an amalgamation section in its Companies Act, can get the benefit of s. 85I of the Income Tax Act, while others cannot.

Dealing specifically with some of the salient features of s. 85I, reference might first be made to s. 85I (2) (a) where it is provided that the corporate entity formed as the result of an amalgamation is to be deemed

a new Corporation, and the first taxation year of the new Corporation shall be deemed to have commenced at the time of the amalgamation. The taxation year of a predecessor Corporation, that would otherwise have ended after the amalgamation, shall be deemed to have ended immediately before the amalgamation.

When s. 85I was first enacted it was found that it offered a means of "dividend stripping" that was hailed with delight by those tax experts who appreciated its significance.

Mr. MacDonald (*Canadian Income Tax*)[23] gives an example of dividend stripping through "vertical" amalgamations (amalgamations where one Company already holds a substantial amount of the shares of the other) which involves the following:

1. Sale by A of his shares in surplus laden X Ltd. to Y Ltd., which is controlled by A;
2. Sale by A of his shares in Y Ltd. (which has no surplus) to Z Ltd.;
3. Amalgamation of X Ltd. and Y Ltd. to form XY Ltd. (no designated surplus arises);
4. Winding up of XY Ltd. into its parent Z Ltd. which assumes the liabilities of XY Ltd. including the indebtedness to A inherited by XY Ltd. from Y Ltd.; and
5. Payment to A by Z Ltd. of the purchase price of Y Ltd., which is a capital and therefore a tax free transaction.

However, s. 105C was added to the Income Tax Act in 1959 and is applicable to all amalgamations after May 13, 1959. It imposes a tax of 20% on the amount by which the undistributed income of all the predecessors exceeded the value of the assets of the new Corporation (other than good-will) less its liabilities, including preferred stock. Now that s. 138A of the Income Tax Act has been passed the low rate of tax on "dividend stripping" applied by s. 105C may not be the only consequenc of such a transaction, although the writer is not aware of any action which has yet been taken under s. 138A. However, this is a somewhat complicated matter and probably not particularly important to oil lawyers who will be more concerned with other features as follows:

1. *Inventory Treatment*

Subsection (2) (b) of s. 85I of the Income Tax Act provides in effect that the value of the inventory of the Corporation resulting from the amalgamation is deemed to be the value of the inventory of the predecessor Corporations at the end of their last taxation year. Here you will note that under subsection (2) (a) the taxation years of the predecessor Corporations shall be demed to have ended immediately before the amalgamation.

For the purpose of computing the income of the new Corporation for the first taxation year the property included in the inventory of the new Corporation at the commencement thereof shall be deemed to have been acquired by the new Corporation at its cost or fair market value, whichever is lower, except where there are special provisions by regulation.

Mr. Stikeman[24] points out that in cases where a predecessor Corporation computed its income by the cash method the value of its inventory

23 *Canadian Income Tax* (1955).
24 *Canadian Tax Service* 85-1013, 85-1014, (1951).

to be included in the inventory of the new Corporation would be nil. He also raises the question whether s. 85E of the Income Tax Act would apply to the predecessor Corporation. This section provides that when a taxpayer has sold all or any part of its inventory upon or after disposing of or ceasing to carry on business the property so sold shall be deemed sold during the last year in which he carried on business and in the course of carrying it on. A further question raised is whether the amalgamation deprives the Taxation Division or the taxpayer from the right to reopen years which might otherwise be within their reach but which are applicable only to the predecessor Corporation.

Mr. Stikeman comes to the conclusion, somewhat "hesitante and dubitante", perhaps, that s. 85E would not apply and that the legal disappearance of the predecessors terminates the right to reopen.

2. *Capital Cost of Depreciable Property*

This is taken care of in s. 85I (2) (d), and related sections, Paragraph (a) of s. 11 (1) and s. 20 of the Income Tax Act. Paragraph (a) of s. 11 (1) provides that there may be deducted in computing the income of a taxpayer for a taxation year, such part of the capital cost to the taxpayer of property or such amount in respect of the capital cost to the taxpayer of property, if any, as may be allowed by regulation, that is to say, depreciation at the rate fixed by regulation applicable to that property.

Section 20 provides in effect that where a depreciable property has been disposed of and the proceeds of disposition exceed the undepreciated capital cost, then the amount of the excess or the amount of the excess that would have been if the property had been disposed of for the capital cost thereof to the taxpayer, whichever is the lesser, shall be included in computing his income for the year. Section 85I (2) (d) operates so that where depreciable property of a prescribed class is acquired by the new Corporation from a predecessor Corporation, the capital cost of the property to the new Corporation is deemed to be the amount which was the capital cost thereof to the predecessor Corporation. In determining the undepreciated capital cost to the new Corporation of depreciable property of a prescribed class at any time, first, there is to be added to the capital cost to the new Corporation of depreciable property of that class acquired before that time, the undepreciated capital cost to each of the predecessor Corporations of property in that class immediately before the amalgamation. Secondly, there is to be subtracted from the capital cost to the new Corporation of depreciable property of that class acquired before that time, the capital cost to the new Corporation of property of that class acquired by virtue of the amalgamation. The foregoing is, perhaps, a rather general statement of the cumulative effect of the sections referred to and there are some refinements which do not seem to be necessary to deal with in this paper.

3. *Business Losses, Section* 85I (2) (1) *of the Income Tax Act.*

Mr. Stikeman says[25] "Subsection (2) (i) is the glaring exception to the otherwise simple provisions dealing with mergers. Business losses of a predecessor Corporation may not be carried forward to be deducted by the new Corporation. This hiatus is probablly explained by the fact

25 Ibid at 85-1016.

that the predecessor Corporations have already a large degree of latitude in carrying forward tax losses except where share control has changed since the loss was incurred. An amalgamation results in a partial alteration of equity ownership and to that extent the prohibition against the carrying forward of losses here is consistent."

You will appreciate that there is a vast difference between the treatment accorded to business losses and the treatment accorded to unused exploration and development expenses as will be hereinafter noted.

4. *Controlled Corporations.*

Section 28 (2) and (3) of the Income Tax Act eliminates the exemption from tax on dividends paid by one Canadian Company to another Canadian Company if the payee Corporation controls the payor and the payor Corporation had undistributed income on hand at the end of its last complete taxation year before the control was acquired (termed "designated surplus") and the dividend was paid out of "designated surplus". Now subparagraph (j) of s. 85I (2) provides that for the purpose of s. 28, (except paragraph 9 (a), which deals with subsidiary controlled Corporations and provides for special regulations with respect to dividends paid by them to each other), where a Corporation was controlled by a predecessor Corporation immediately before the amalgamation and has, by virtue of the amalgamation, become controlled by the new Corporation, the new Corporation shall be deemed to have acquired control of such Corporation, at the time control thereof was acquired by the predecessor Corporation. This provision, of course, means that dividends paid out of designated surplus of the controlled Corporation, existing at the time control was acquired by the predecessor Corporation, will not pass tax free into the hands of the amalgamated Corporation.

5. *Undistributed Income and Tax-Paid Undistributed Income.*

On this point the writer can do no better than to quote Mr. Stikeman[26] who says: "Paragraphs (k) and (1) of Subsection (2) provide in simple terms that the 'undistributed income on hand' and the 'tax-paid undistributed income' of a predecessor Corporation shall be carried forward into the new Corporation while s.s. (4) provides for a similar continuity with respect to the making of elections to pay tax under section 105 (1) and (2)."

Here it might be noted that where one of the amalgamated Companies has a surplus of undistributed income and another has a deficit, such deficit is not deductible in the computation of the undistributed income of the new Corporation.

It might also be noted that paragraph (a) of Subsection (4) of s. 85I gives the new Corporation the right to elect to pay the special 15% tax on undistributed income on hand at the end of the 1949 period of its predecessor Corporations that have not already done so.

6. *Exploration, Prospecting and Development Expenses*

We now come to the feature which is probably the most important to those connected with the oil industry.

Under subsection (3) of s. 85I of the Income Tax Act a new Corpora-

[26] Ibid at 85-1017.

tion which emerges from an amalgamation effected after 1957 and has as its principal business:

(a) Production, refining or marketing of petroleum, petroleum products or natural gas, or exploring or drilling for petroleum or natural gas;

(b) Mining or exploring for minerals;

(c) Processing mineral ores for the purpose of recovering metals therefrom;

(d) A combination of processing mineral ores for the purpose of recovering metals therefrom and processing minerals recovered from the ores so processed; or

(e) Fabricating metals;

may in computing its income deduct any drilling and exploration expenses incurred by the predecessor Corporation on or in respect of exploring or drilling for petroleum or natural gas in Canada. It may also deduct prospecting, exploration and development expenses incurred by the predecessor Corporation in searching for minerals in Canada, which were not deducted by such predecessor Corporation before the amalgamation. But it can deduct this expenses to the extent only of the income which may be reasonably regarded as attributable to the production of petroleum or natural gas, or the production of minerals, from the property of the predecessor Corporation.

Paragraph (a) of s. 85I(2) of the Income Tax Act (added in 1962) provides that for the purpose of s. 83A, where a predecessor had acquired a right, license or privilege to explore for, drill for or take in Canada petroleum, natural gas or other related hydrocarbons (except coal) under an agreement, contract or arrangement described in s. 83A(5) (a) and by virtue of the amalgamation such right, license or privilege or any interest therein or in production of wells situate on the lands to which it relates became the property of the new Corporation, ,such new Corporation shall be deemed to have acquired the right, license or privilege under an agreement contract or arrangement described in s. 83A(5) (a). It may thus treat the cost thereof as a drilling and exploration expense and (semble) this would be deductible from the income of all of its properties, not just the income from the property so acquired.

Subsection (3a) of s. 85I, also added in 1962, permits the deduction by the new Corporation of bonus payments made before April 11, 1962 by a predecessor Corporation for the right to explore for petroleum or natural gas or for a petroleum or natural gas lease if before the predecessor was entitled to any deduction from its income for the amount so paid the property of the predecessor Corporation was acquired by the new Corporation and the new Corporation surrendered the right or lease so acquired, without consideration therefore, before any well came into production in reasonable commercial quantities on the land comprised in such right or lease.

Some points should be noted here and perhaps the most important one is that the exploration and development costs which may be deducted from income of the new Corporation are limited to those which were *incurred by the predecessor corporation,* and the deduction does not ex-

tend to such costs incurred by a predecessor of the predecessor Corporation. In other words, where a predecessor had "inherited" exploration and development expenses from another in a transaction qualifying under s. 83A(8)(a), (i.e. a transaction under which all or substantially all of the first Corporation's property used in carrying on its business in Canada was acquired by the "predecessor Corporation"), the exploration and drilling costs so inherited go "out the window" and are no longer deductible even with respect to the income derived from the first Corporation's properties.

There is a marked difference here between the treatment afforded such costs under s. 85I and s. 83A respectively. Under s. 83A(8)(a) an acquisition after April 10, 1962 by a second *successor Corporation* of all or substantially all of the property in Canada of the first successor Corporation carries with it the benefit of unused development and exploration costs acquired by such first successor Corporation from its immediate predecessor.

Why this difference should appear to exist is not explained. It is suggested however that it is quite possible that subsection (8d) might be construed as applicable to an amalgamation after April 10, 1962. In this connection note the words of subsection (8d) as follows:

". . . where a Corporation (hereinafter in this subsection referred to as the "second successor Corporation") whose principal business is of the class described in subsection (3b) has at any time after April 10, 1962 acquired from a Corporation (hereinafter in this subsection referred to as the "first successor Corporation") that was a successor Corporation within the meaning of subsection (8a) all or substantially all of the property of the first successor Corporation used by it in carrying on in Canada its principal business, there may be deducted by the second successor Corporation in computing its income (etc.) . . .".

In an amalgamation the new Company usually acquires all the property of each predecessor, in fact it must to qualify under s. 85I. The new Corporation and its acquisition of property of a predecessor may also qualify under subsection (8a) of sec. 83A. If so, it would appear that s. 83A (8)(d) could be made to apply. Against this it would no doubt be argued that s. 85I(3) is expressly applicable to amalgamations and s. 83A only applies in such cases where it is expressly referred to or brought into application by s. 85I. Since subsection (8d) is not referred to in s. 85I or otherwise made applicable to a transaction intended to be covered by that section, it would be argued that it is not available in an amalgamation. It is the writer's understanding that this is the present view of the Department of National Revenue but it does not seem logical that there should be any difference in tax treatment of development and exploration costs in total sale of assets by a company or their acquisition by a new Company in an amalgamation. It is further suggested that the non-inclusion in s. 85I of a subsection similar to s. 83A(8)(a) may be a "casus omissus".

Another important point to remember is that the "compartmentization" of development and exploration provided for in s. 83A(8)(a) is carried forward in s. 85I so that the expenses carried forward are still

only deductible from income attributable to production from the properties of the predecessor Corporation.

The foregoing falls far short of exhausting the subject assigned to the writer; however, it attempts to deal with those aspects of the subject which may be of interest to lawyers who are chiefly concerned with its application to companies engaged in the oil and gas industry in Western Canada. If it succeeds in directing attention to some of the more important points for consideration in mergers or amalgamations in which such companies may be involved, it may have served some useful purpose.[27]

Since writing, the Supreme Court of Canada has allowed the appeal in the *Fogler Case*, see (1964), 49 W.W.R. 321. Mr. Justice Martland, Ritchie and Hall, JJ. concurring, held that in the circumstances the certificate of amalgamation could not be invalidated, but expressed no opinion as to the adequacy of the material sent to shareholders. Mr. Justice Spence, Judson, J. concurring, dissented for reasons similar to those expressed in the Alberta Appellate Division—namely, that the shareholders "... had far less accurate information or explanation than they were entitled to ..."

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[27] On May 7th, 1964 while the above paper was in the course of preparation, Bill S22 entitled An Act to Amend the Companies Act received first reading in the Senate. This Bill provides, among other things, for the addition after Section 128 of the present Act of a new Section 128A providing for the amaglamation of companies incorporated under the said Act by a procedure similar to that provided for in Section 140a of the Alberta Companies Act and the Statutory Amalgamation provisions contained in the Companies Acts of various provinces. If and when the section is enacted it will enable two or more companies incorporated under the Dominion Companies Act to amalgamate and continue as one company in accordance with the procedure set out therein.