U.S. Federal Income Tax Issues in Acquisitions and Amalgamations of Mining and Exploration Companies

Special U.S. federal income tax rules may raise significant issues in acquisition and amalgamation transactions involving mining companies, especially mining companies that are still in the exploration stage and have not yet realized mining revenue ("exploration companies"). These special rules include the rules applicable to passive foreign investment companies ("PFICs"), the rules adopted under the United States Foreign Investment in Real Property Tax Act ("FIRPTA") and the rules applicable to outbound tax-free reorganization transactions under Section 367 of the U.S. Internal Revenue Code of 1986, as amended (the "Code"). Although it generally is possible to structure acquisition transactions as tax-free exchanges for U.S. federal income tax purposes, these special tax rules may cause an acquisition that otherwise qualifies as a tax-free exchange to be taxable to U.S. shareholders of non-U.S. or U.S. target companies, Canadian target companies that own U.S. mining properties and/or non-U.S. shareholders of U.S. mining companies. These rules also may have adverse impacts on taxable acquisitions. Successfully structuring an acquisition often will require balancing competing U.S. tax considerations, as well as Canadian tax and other business and legal considerations.

Overview of U.S. Tax Rules

Qualification As a Tax-Free Reorganization

An acquisition of a corporation by another corporation may be structured to qualify for tax-free treatment for U.S. federal income tax purposes, in whole or in part, provided that sufficient stock consideration is issued in the transaction and other technical requirements are satisfied. Under the U.S. tax rules, such a transaction must definitionally satisfy the requirements of a "reorganization" under Section 368 of the Code. There are several types of reorganizations, and the applicable type of reorganization depends on the form of the transaction. The benefit of a transaction qualifying as a reorganization is that U.S. shareholders of the target
corporation will not recognize gain on the exchange of target stock for acquiror stock except to the extent they receive consideration other than acquiror stock (or stock of its parent). Instead, the U.S. shareholders' built-in gain may be preserved in the acquiror stock through a carryover tax basis in the acquiror stock. U.S. shareholders that exchange target stock in a reorganization will recognize all or a portion of the gain in their target stock to the extent of any cash or other non-stock consideration they receive in the transaction (and any recognized gain would increase the tax basis in the acquiror (or parent) stock received in the transaction).

In general, if a Canadian corporation acquires the stock of a U.S. corporation, reorganization qualification is only important at the shareholder level because the U.S. corporation will not be considered to have transferred its assets. As discussed in more detail below, when a Canadian corporation acquires a U.S. corporation, the outbound stock transfer rules of Section 367 of the Code also must be satisfied.

The rules for determining whether a transaction qualifies as reorganization vary depending on the form of the transaction. If the target shareholders exchange their stock for stock of the acquiror, and there is no amalgamation of the target corporation, the transaction must be tested for qualification as a “B reorganization,” which generally has the most stringent requirements. A stock purchase qualifies as a B reorganization only if the consideration is solely voting stock of the acquiror (or its parent). Even a small amount of cash or other non-stock consideration, including nominal cash used to create a taxable “bump” for Canadian tax purposes (but typically excluding cash paid in lieu of fractional shares and cash paid to dissenters), will cause a stock acquisition to fail to qualify as a B reorganization. The payment of certain transaction expenses also may be treated as impermissible non-stock consideration.

At the other end of the reorganization spectrum is a “forward” amalgamation transaction in which the target amalgamates with either the acquiror or a wholly-owned subsidiary of the acquiror. A “forward” amalgamation transaction may qualify as an “A reorganization” or an “(a)(2)(D) reorganization” if at least 40 percent of the aggregate consideration given to target shareholders is acquiror stock (voting or non-voting) and certain other conditions are satisfied. A stock purchase transaction followed by a pre-arranged “forward” amalgamation of the target into the acquiror or a wholly-owned subsidiary of the acquiror also may be treated as an A reorganization or an (a)(2)(D) reorganization.

The requirements of the various reorganization forms are not always intuitive, and U.S. tax counsel should be consulted early in the structuring process.

**PFIC Rules**

A non-U.S. corporation is a PFIC in a taxable year if (i) 75 percent or more of its gross income is “passive income” or (ii) 50 percent or more of its assets produce passive income. The rule and its focus on gross income is particularly problematic for exploration companies. This is because if an exploration company has no active mining income, even a single dollar of passive income, such as interest on cash equivalents, will cause the company to be a PFIC. In contrast to the FIRPTA rules discussed below, the tax consequences of the PFIC rules apply solely at the U.S. shareholder level and do not specifically affect the non-U.S. corporation. Although the PFIC rules traditionally have been an area in which there are varying levels of compliance, particularly among exploration companies with few U.S. shareholders, new U.S. tax rules enacted in March 2010 now require a U.S. shareholder of a PFIC annually to file a (yet unspecified) form with its U.S. federal income tax return. Exploration companies should expect an increasing number of inquiries from U.S. shareholders regarding their PFIC status and a heightened focus on PFIC status when an acquisition is contemplated.

A Canadian corporation structuring an acquisition may discover for the first time that it is, or has been, a PFIC. The PFIC rules were enacted to prevent U.S. persons from using offshore mutual funds or non-U.S. corporations to accumulate passive income offshore without current taxation to U.S. shareholders. The PFIC rules avoid this
result by subjecting U.S. shareholders to punitive taxation on the disposition of the stock of the non-U.S. corporation (or receipt of certain “excess” distributions). More specifically, on such a disposition (or distribution), the PFIC rules generally require each U.S. shareholder to allocate its gain (or distribution) over its entire holding period, treat the gain (or distribution) as ordinary income and then pay interest on the deferred tax liability over the tax that would have been imposed if such gain had been incurred ratably over the U.S. shareholder’s holding period. Further, shares in a PFIC generally may not be rolled over tax-free in a reorganization, unless the acquiror is a PFIC, and do not obtain a stepped-up tax basis on death of the U.S. shareholder.

As an alternative to this “interest charge” regime, a U.S. shareholder may make one of two elections, generally in the first taxable year in which it owns stock in the PFIC. The first election is a “QEF election” that requires the U.S. shareholder to be taxed in any year that the corporation is a PFIC on the shareholder’s share of the undistributed ordinary income and net capital gain of the corporation. If the non-U.S. corporation is a PFIC because it is an exploration company with no operating income, the QEF election may result in little or no current income to the electing U.S. shareholder. However, as a precondition for a U.S. shareholder to make a QEF election, the non-U.S. corporation must agree to provide its U.S. shareholders with the amount of their share of ordinary income and net capital gain, determined under U.S. tax principles, in each year that the corporation is a PFIC, and to make its books available for IRS inspection to confirm the calculations on audit. Alternatively, if the stock of the PFIC is traded on a stock exchange, a U.S. shareholder may make a “mark-to-market” election to be taxed (at ordinary income rates) on the appreciation in the value of the stock in any year that the corporation is a PFIC.

FIRPTA Rules

Depending on the circumstances, the FIRPTA rules may trigger U.S. tax consequences at either the shareholder or corporate level. The FIRPTA rules subject non-U.S. shareholders to U.S. income tax on the disposition of a “United States real property interest” (a “USRPI”). A USRPI includes stock of a U.S. corporation that is or has been a U.S. real property holding corporation (a “USRPHC”) at any time during the shorter of five years or the non-U.S. shareholder’s holding period for the stock. A U.S. corporation generally is a USRPHC if more than 50 percent of its business assets are USRPIs, which generally include land and certain mine structures and equipment. Thus, the FIRPTA rules clearly are relevant in the acquisition of a U.S. mining company. Taxation of non-U.S. shareholders under the FIRPTA rules is in contrast to the general rule that non-U.S. shareholders are not subject to U.S. tax on the sale of stock of a U.S. corporation, and it may come as a surprise to non-U.S. shareholders.

There is an exception from tax under FIRPTA for most non-U.S. shareholders if the U.S. corporation’s stock is considered “regularly traded” on an “established securities market” in the calendar year of the disposition. Stock traded on a U.S. exchange generally qualifies for this exception. However, stock traded on a non-U.S. exchange, such as the Toronto Stock Exchange, only qualifies for this exception if the corporation’s stock is not considered “closely held” and certain trading volume requirements are satisfied on a quarterly basis. A corporation’s stock is considered closely held during any calendar quarter if 100 or fewer persons own 50 percent or more of the outstanding stock at any time during the quarter. A closely-held corporation that is listed on a non-U.S. exchange, such as the Toronto Stock Exchange, may still qualify for this exception if its stock is traded on an over-the-counter market in the United States or is regularly quoted by U.S. brokers or dealers making a market in the stock.

However, even if a U.S. exploration company’s stock qualifies for the publicly-traded exception, non-U.S. shareholders who actually or constructively hold five percent or more of the U.S. corporation’s stock generally are subject to tax under FIRPTA. Since five-percent shareholders may include founders or officers with substantial built-in gain in their stock, it is important to
be aware of potential FIRPTA issues early in the structuring process.

As discussed in more detail below, the FIRPTA rules also may be relevant if a Canadian corporation that owns U.S. mining assets, either directly or through a U.S. subsidiary, is acquired in an amalgamation transaction.

**Acquisitions of Canadian Mining Companies**

**Tax-Free Reorganizations**

As previously discussed, an acquisition of a Canadian mining corporation by another Canadian corporation may be structured to qualify as a reorganization in which gain may be deferred depending on the form of transaction and the level of stock consideration.

Qualification as a reorganization can be beneficial to U.S. shareholders of the target Canadian corporation that have significant built-in gains in their shares, as it will allow them to defer their gains to the extent they receive acquiror stock. If the U.S. shareholders receive cash or other non-stock consideration, they will recognize gain to that extent.

However, if the target Canadian corporation is a PFIC for which a U.S. shareholder has not made a QEF election or a mark-to-market election, a transaction otherwise qualifying as a reorganization nevertheless will be taxable to such U.S. shareholder, and the recognized gain will be subject to the punitive interest charge regime under the PFIC rules. The only exception to such treatment would be if the acquiror also is a PFIC in the year of the acquisition. Accordingly, if the target corporation is a PFIC and the acquiror is not a PFIC, qualification of the acquisition as a reorganization generally is irrelevant. In such case, it may be possible to avoid the PFIC rules by having the target corporation acquire the acquiror (but in certain cases that might be disadvantageous to shareholders going forward).

If the target Canadian corporation owns USRPIs, including a U.S. subsidiary that is a USRPHC, a “forward” amalgamation transaction likely will be treated as disposition of the USRPIs or USRPHC, the gain on which would be subject to U.S. tax at the corporate, rather than shareholder, level. Such result can be avoided by structuring the transaction as a stock purchase (non-amalgamation) transaction. However, as previously discussed, a stock purchase transaction only may qualify as a B reorganization if the consideration is solely voting stock of the acquiror (or its parent). This will prevent the use of nominal cash to create a “bump” for Canadian tax purposes. Alternatively, many recent transactions have been structured as amalgamation transactions in which the target corporation is designated as the surviving entity in the amalgamation (a “reverse amalgamation” structure). If the reverse amalgamation structure is used, the target corporation would not be considered to dispose of its USRPIs and USRPHCs for U.S. tax purposes, and no corporate-level tax under FIRPTA would be triggered. A reverse amalgamation transaction may qualify as a “(a)(2)(E) reorganization” if at least 80 percent of the consideration paid from the acquiror to target shareholders is acquiror voting stock and the target corporation retains “substantially all” of its assets in the overall transaction.

**Taxable Acquisitions**

A taxable acquisition of a Canadian target corporation raises PFIC and FIRPTA considerations similar to those discussed above.

**Acquisitions of U.S. Mining Companies**

**Tax-Free Reorganizations**

An acquisition by a Canadian corporation of a U.S. corporation may be structured so as to qualify as a reorganization. The relevant rules are the same as the rules previously discussed, except that in the United States the amalgamation transaction typically would be undertaken as a statutory merger involving a first-tier, wholly-owned U.S. subsidiary of the Canadian acquiror. In the statutory merger, the target corporation may be
designated as the surviving entity, in which case the transaction will be tested as either an (a)(2)(E) reorganization or a B reorganization. Alternatively, the merger subsidiary may be designated as the surviving entity, in which case the transaction will be tested as an (a)(2)(D) reorganization. If the transaction does not involve a merger, and rather is undertaken as a direct exchange of stock of the U.S. target for stock of the Canadian acquiror, the transaction will be tested as a B reorganization.

The exchange of stock of a U.S. target for stock of a Canadian acquiror (including in a merger transaction) also implicates the outbound stock transfer rules of Section 367 of the Code. If the transaction does not satisfy these rules, a U.S. shareholder will recognize gain, but not loss, in the transaction, even though the transaction otherwise qualifies as a reorganization. Although Section 367 of the Code has several requirements that must be met in order to avoid gain recognition, the requirements most likely to cause issues for exploration companies are the “active trade or business” test and the substantiality test.

Under the active trade or business test, the acquiring non-U.S. corporation or certain of its subsidiaries must have conducted an active trade or business outside of the United States for a 36-month period ending on the date of the acquisition. It is unclear whether an exploration company that is not yet generating revenue satisfies this test. The U.S. Internal Revenue Service (the “IRS”) has taken the position in a related context that exploration stage activities alone, in the absence of revenue, do not constitute the conduct of an active trade or business. Depending on the specific circumstances, it may be possible to obtain a private ruling from the IRS that a company is in substantial compliance with this and other requirements of Section 367 of the Code, but the ruling process can take several months.

Under the substantiality test, the fair market value of the acquiring non-U.S. corporation must exceed the fair market value of the target U.S. corporation on the date of the acquisition. For publicly-traded corporations, fair market value is generally measured by each corporation’s market capitalization. However, under the applicable regulations, the fair market value of the acquiror, as generally measured by its market capitalization, must be reduced by the amount of passive and certain other assets acquired outside of the ordinary course of business in the preceding 36-month period. Passive assets include cash raised in financings, as well as cash equivalents and short-term assets acquired with such cash. In addition, the substantiality test can pose particular challenges in transactions in which the two corporations are relatively close in value because their stock prices may fluctuate in the period leading up to an acquisition.

Even if an acquisition meets the requirements of Section 367 of the Code, former U.S. shareholders who will own five percent of the acquiror’s stock are subject to additional requirements and generally must enter into a special gain recognition agreement with the IRS. It is not uncommon for mining companies to have such five-percent shareholders.

If the acquisition of the U.S. target by the Canadian acquiror would not satisfy the active trade or business requirement or the substantiality test, it may be possible to reverse the order of the transaction and have the U.S. target acquire the Canadian acquiror. If this is desired, the structure of the reverse transaction would need to take into account whether the acquisition of the Canadian corporation will qualify as a reorganization for the benefit of U.S. shareholders of the Canadian corporation and whether the Canadian corporation is a PFIC. The structure also would need to take into account the Canadian tax treatment to Canadian shareholders of the Canadian corporation in light of the Canadian outbound stock transfer rules. It may be necessary to structure the acquisition of the Canadian corporation to use an “exchangeable share” structure to provide tax deferral to Canadian shareholders of the Canadian corporation.

The U.S. target mining corporation likely would be a USRPHC for purposes of the FIRPTA rules. This potentially could cause certain non-U.S. shareholders of the U.S. target corporation to be taxed on the gain in their
shares even though the transaction otherwise qualifies as a reorganization, although the publicly-traded exception discussed above would exempt less-than-five-percent shareholders of a publicly-traded target.

If the target corporation is a U.S. corporation, the PFIC rules would not be relevant to the treatment of the disposition of the stock of the U.S. target corporation. However, U.S. shareholders may not want to acquire stock of an acquiring non-U.S. corporation that is a PFIC.

Taxable Acquisitions

A taxable acquisition of a U.S. target corporation would not implicate the outbound stock transfer rules of Section 367 of the Code because the acquisition would be taxable to U.S. shareholders in any event. It still would be necessary to consider the possible application of the FIRPTA rules discussed in the previous section.

Circular 230 Disclosure

Any tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of avoiding tax penalties and is not intended to be used or referred to in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

Laurence E. Crouch
Menlo Park/Toronto Office
+1.650.838.3718
lcrouch@shearman.com

Laurence M. Bambino
New York Office
+1.212.848.4213
lbambino@shearman.com

Peter H. Blessing
New York Office
+1.212.848.4106
pblessing@shearman.com

Don J. Lonczak
Washington DC Office
+1.202.508.8080
dlonczak@shearman.com

Douglas R. McFayden
New York Office
+1.212.848.4326
dmcfayden@shearman.com