

2010 Canadian Federal Budget Removes Obstacle to Investments by U.S. Equity Investors

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The minority Harper government released its fifth Budget on March 4, 2010 ("Budget 2010"). The Budget 2010 provides that effective immediately, non-resident investors in Canadian corporations no longer need to obtain a clearance certificate under Section 116 of the Income Tax Act ("ITA") for equity disposition of non real property interests. The budget narrows the taxable Canadian property definition by excluding shares of corporations that do not derive their value principally from real or immovable property situated in Canada. Consequently, non-resident investors will no longer be subject to the existing tax withholding and compliance burdens, except where the equity disposition constitute real property interest.

Currently, subject to applicable treaties, non-residents are taxed on their gains from disposition of "taxable Canadian property." Most of Canada's tax treaties exempt non-resident investors from tax on gains except where the shares derive their value principally from real property interest. Despite this fact, a purchaser is generally required to withhold tax from the amount paid unless the non-resident entity obtained a clearance certificate. To obtain such a certificate, a non-resident must pay to Revenue Canada an amount equal to the non-resident's potential Canadian tax liability, post security or satisfy the authorities that no tax will be owed.

The process of obtaining a clearance certificate has been very burdensome especially for private equity and venture capital funds since most are structured as limited partnerships. These funds needed to disclose the identity and treaty status of their limited partners. The process took at

least six months or more to complete. This required non-resident sellers, typically to have 25% of their proceeds in escrow while they waited for Revenue Canada to issue the clearance certificate. This has proven to be a major challenge in Canadian companies finding investors outside of Canada.

Most investors were required to establish offshore "blocker entities." A widely used structure by U.S. investors involved the use of Exchangeable Shares. This structure involves setting up a U.S. corporation typically a Delaware corporation, into which the U.S. investor would make their investment. U.S. investors by utilizing this structure were not subject to the requirement of applying for a tax certificate at the time of exit because there was no taxing event in Canada. The use of exchangeable shares and other mechanisms to avoid the need for a "section 116" compliance was very expensive. The 2010 Budget specifically states that in no longer requiring section 116 clearance certificate it "...is intended to enhance the ability of Canadian businesses to attract foreign venture capital."

The 2010 Budget is not yet law but it is expected that it will be enacted shortly. Failure of parliament to approve the Budget would cause the government to fall. There is currently no expectation that this will happen. Similar changes are expected to be made by the government of Quebec.

The implications of this change go beyond future capital investment by venture capital investors and operating companies. Many of the exchangeable share transactions and third country blockers carry high maintenance costs. Consideration should be given to

collapsing these arrangements. The decision to keep the structure in place or collapse it is not obvious. One factor to consider is possible loss of Canadian research credits, another is U.S. and third-country exit costs which would be absorbed in a taxable exit transaction such as the exercise of exchange rights and the liquidation of a third country entity. These structures should also be reviewed in cases where a Canadian ULC is involved because of the changes in the U.S.–Canada tax treaty brought about by the 2007 Protocol. These costs may be a small factor in the case of portfolio companies with little built-in gain. Nevertheless, each case must be dealt with on its own, and there is no general rule as to the wisest course of action.

This significant modification to the tax treatment of cross border investment was a long time in the making. In January, Burns & Levinson was pleased to have co-hosted a meeting with U.S. investors and the Minister of Industry, Tony Clement. At that meeting, the Minister was informed of the obstacles that the current tax regime presented to U.S. investors. The Minister took to Cabinet the importance of removing the requirement of section 116 certificate, which was reflected in the 2010 Budget.

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