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Foreign Investment In Private Corporations: Canada Opens For Business

By Sharon A. Bennett

The soaring Canadian dollar is a testament to the attractiveness of Canada as a place to invest. Now Canada's tax legislators are harnessing that momentum. In the recent 2010 federal budget, Canada introduced a sweeping change to eliminate a long-standing barrier to foreign investment in private Canadian corporations.

Background

Until now, shares of private Canadian corporations, as well as certain partnership and trust interests, were considered "taxable Canadian property" and, as such, foreign investors were taxable in Canada on any gain from the sale of those interests, unless a treaty exemption was available. Furthermore, even where treaty relief was evident, Canada maintained a burdensome withholding tax mechanism that caused many foreign investors to retreat from Canadian investment opportunities.

The withholding tax mechanism was a particular irritant to venture capital that typically aggregates dozens, hundreds or even thousands of individual limited partners into a single VC fund. Under the previous rules, when selling shares of a private Canadian corporation, each limited partner was required to apply for a tax clearance certificate and, in so doing, to obtain a Canadian taxpayer number for reporting purposes. If claiming a tax treaty exemption, the foreign investor was required to prove eligibility for treaty relief. Canada Revenue Agency typically required four months, often more, to process these applications. Pending receipt of the tax clearance certificate, the buyer was required to withhold 25% of the gross sale price, and complex trust or escrow arrangements were necessary to administer the withheld amount pending receipt of the certificate. Complexity and inconvenience for foreign investors was further exacerbated in the case of transactions involving proceeds paid in shares or earn-outs. After a 2008 amendment to the rules, buyers were often asked to pay without receiving a clearance certificate, but that put buyers at risk.

Even after receipt of the tax clearance certificate and release of sale proceeds, Canadian tax rules generally required foreign investors to file a Canadian tax return for the year of sale. For non-treaty investors, payment of a 25% withholding tax was a pre-requisite to obtaining a Canadian tax clearance certificate. Transaction costs and other deductions could not be claimed in obtaining a clearance certificate so tax was invariably over-paid at the time of sale. The investor was required to file a Canadian tax return for the year of sale to claim those deductions and obtain a refund of any overpayment.

This compliance burden was often cited by VC funds as sufficient reason to look elsewhere for investment opportunities. The problem was not limited to Canadian technology and life science sectors,

but efforts to raise funding in these sectors were especially hampered by the withholding tax requirements.

Various transaction structures, including exchangeable shares and offshore holding structures, were developed to avoid or reduce Canadian tax and compliance requirements for foreign investors. However, the cost and complexity of these arrangements themselves discouraged investment in private Canadian corporations, especially for earlier stage investments.

2008 Attempt to Fix the Problem

In its 2008 federal budget, Canada recognized that the onerous compliance burden imposed on treaty-based investors was having a detrimental effect on the ability of private Canadian corporations to raise foreign capital. In an attempt to make the rules more workable, the requirements were eased for certain "treaty-exempt property".

However, the 2008 amendments essentially shifted the sellers' Canadian tax risk onto the buyer by imposing on buyers the burden of ascertaining whether the seller was entitled to a tax treaty exemption. The factual basis for making such a determination is often elusive to an arm's length buyer, particularly in light of extensive limitation of benefits provisions in the Canada-US tax treaty and the likelihood that Canada will continue to seek similar restrictions in future treaty negotiations. As a result, although the 2008 amendments were designed to respond to legitimate concerns of treaty-based foreign investors and to simplify the sale of their Canadian investments, the changes did not go far enough and the traditional compliance burden for these investors remained a practical reality.

The New Regime

Canada's further response, as announced in the 2010 federal budget, involves a simple and sweeping solution. Shares of private Canadian corporations and certain interests in partnerships and trusts – subject to exceptions noted below - will no longer constitute "taxable Canadian property". Therefore, in the hands of a foreign investor, such interests will no longer be subject to Canadian tax liability on gains and will no longer be subject to onerous compliance rules described above. The new rules will effectively provide compliance relief that was long-awaited by treaty-based foreign investors. In addition, the new rules eliminate Canadian tax altogether on gains realized on sales of such interests by all foreign investors, including those who are not eligible for a treaty exemption.

Tax liability and compliance requirements (including clearance certificates and withholding tax) remain in effect for interests that, at any time in the 60 months prior to sale, derived more than 50% of their value from real property in Canada, Canadian resource property or timber resource property. In many cases, sufficient information should be available to buyers to ascertain whether the rules apply. However, buyers will remain at risk where there is uncertainty regarding this valuation issue. Buyers should ensure that their due diligence captures the entire 60-month period and, in appropriate circumstances, may seek protection by way of indemnities or otherwise concerning the asset mix of the target during the period.

Where the new rules apply, they will be effective commencing March 5, 2010, assuming they are ultimately passed into law. It is widely expected that the new rules will be enacted, and in some cases Canada Revenue Agency has started to administer the new regime as if already enacted. Nevertheless, caution should be exercised until final enactment.

Where the new rules apply, sale transactions should be simplified by eliminating the need for detailed Canadian tax compliance mechanisms that were formerly required. As well, the new rules will eliminate the need for costly and complex investment arrangements, such as exchangeable share and offshore holding structures. Where such structures are already in place, it may be desirable to consider whether they may be unwound or simplified.

In summary, this bold move by Canada significantly improves the landscape for foreign investment in private Canadian corporations. Strengths in technology and life sciences, generous R&D and other tax incentives, and a stable financial sector are some of the reasons why foreign investors have been attracted to Canada as a good place to invest. These new rules will remove a long-standing tax impediment to foreign investment and will make Canada an even better place to invest.

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