LAWSON LUNDELL LLP

March 17, 2010

Federal Budget 2010
Taxation Measures of Interest to Technology Companies, Private Equity and Venture Capital

The March 4, 2010 Federal Budget introduced some targeted measures of interest to companies in the technology industry, as well as private equity and venture capital funds investing in technology companies.

Definition of 'Taxable Canadian Property'

For years, both foreign and domestic venture capital and private equity funds have complained about the onerous requirements under the *Income Tax Act* (Canada) ("*Tax Act*") on a sale of shares in a Canadian entity. Currently, all non-resident investors in Canadian entities are taxed on gains realized from dispositions of 'taxable Canadian property', subject to treaty protection. Prior to the changes set out in the 2010 budget, the definition includes the shares of any corporation incorporated in Canada unless the shares are listed on a public stock exchange (i.e. private corporations).

Most treaties (such as the Canada-US Tax Treaty) exempt such gains from tax, unless the shares are a real property interest. Under the current provisions, in order to establish that an investor has access to the exemption, the investor is required to obtain from the Canada Revenue Agency a 'compliance certificate' under section 116 of the *Tax Act* (known as a "section 116 certificate'). If the investor/seller cannot produce a section 116 certificate, the buyer is required to withhold and remit 25% of the purchase price to the CRA.

Obtaining a section 116 certificate is not a perfunctory exercise and the administrative burden on private equity and venture capital funds is even more burdensome as it requires obtaining the relevant information to complete the certificate from each and every one of limited partner investors in the fund. Every limited partnership is deemed to be non-resident if it has even one non-resident limited partner. As a result, this requirement poses a significant barrier to foreign investment in Canada.

The March 2010 Federal Budget has changed the definition of 'taxable Canadian property' so that private corporations are included in the definition <u>only</u> if more than 50% of the value of the private corporation is attributable to real property situate in Canada or Canadian resource property, timber resource properties or a combination of the two. As a result, non-residents will no longer be subject to tax in Canada in respect of gains derived from the sale of most private Canadian corporations, including in respect of investments in companies engaged in the technology industry.

This change in the definition of 'taxable Canadian property' also means that non-residents will no longer have to notify the Canada Revenue Agency when they sell shares of private Canadian corporations and transactions will be far less cumbersome to complete where foreign investors are involved.

Stock Options

The March, 2010 Federal Budget also significantly affects the way employees and employers are taxed in Canada on stock options. In general terms, the granting of an option to an employee is not a taxable event but if the option is granted in respect of shares of a publicly traded corporation, then the employee has a taxable event at the time that the option is exercised. The employee effectively has taxable employment income from the exercise of the option equal to the difference between the value of the shares on the date of exercise and the amount paid for the shares. If the option exercise price equals the value of the shares on the date that the option was granted then the employee includes in income only 50% of the stock option benefit. By contrast, if the option is granted in respect of shares of a private Canadian corporation, then the income inclusion is deferred until the employee sells the shares received by exercising the option.

As a result of changes introduced in the 2000 federal budget, employees with options to acquire shares in public corporations were entitled to elect to defer the inclusion of income associated with a stock option exercise until the year that the employee actually disposed of the shares. The deferral was capped based on the value of the shares subject to the option grant in each year. The deferral maintained the value to an employer of granting stock options where the options had an expiry date. Without the deferral, the employee might have let the option expire rather than being faced with a tax bill on the exercise.

The 2010 Federal Budget eliminates the ability of an employee to defer the recognition of stock option benefits in respect of shares of public corporations past the date on which the employee exercises the option. Employees who have relied on the deferral and are holding shares that have declined in value following the date of exercise of their options will be able to make a special tax election that will lessen the tax burden arising from having securities worth less than the deferred tax liability. If the employee disposes of the shares issued on exercise of the stock option, the taxpayer will be able to elect to pay a special tax in an amount equal to the proceeds from the sale of the shares.

The March 2010 Federal Budget also restricts the ability of a corporation to deduct stock option cash out payments. A 'cash out payment' occurs when an employee sells his or her stock option rights back to the corporation in consideration of a cash payment. Typically, the employee receives cash equal to the "in the money" value of the stock options on such sale. The Canada Revenue Agency permits the employee to include in income 50% of the stock option benefit as if the employee had exercised the options and

sold the shares. The Federal Budget provides that the employee can only have this favourable treatment if the employer agrees not to take a deduction for the amount of the cash out payment.

Additional Miscellaneous Changes

Accelerated CCA for Clean Energy Assets

In 2005, the government introduced accelerated depreciation for clean energy generation. Before the March 2010 Federal Budget, clean energy generation equipment included high efficiency cogeneration equipment, wind turbines, small hydroelectric facilities, fuel cells, photovoltaic equipment, wave and tidal power equipment and equipment that generates electricity using geothermal energy or eligible waste fuel. The budget expands this list to include most heat recovery equipment and distribution equipment in district energy systems that rely primarily on ground source heat pumps, active solar systems or heat recovery equipment. In addition, corporations that carry on a business of producing fuel, generating energy or distributing energy (or a combination of these businesses) using clean energy equipment may now renounce their expenses in favour of their shareholders effectively permitting their shareholders to deduct expenses incurred by the corporation.

SR & ED Credits

The government also made continuing statements concerning its intention and commitment to improving the administration of the SR&ED program. The government's efforts to date include additional technical reviewers, self-assessment tools and claim form guides.

For more information on the taxation of private equity and venture capital funds as well as technology companies, please contact **Leonard Glass** at 604.631.9140 (lglass@lawsonlundell.com) and for information on the formation of private equity and venture capital funds, portfolio investments, technology company financing and mergers and acquisitions, please contact **Valerie Mann** at 604.631.9173 (vcmann@lawsonlundell.com).

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