Cross Border Tax Issues

By

Reinhold G. Krahn

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I. INTRODUCTION

The purpose of this paper is to give readers an overview of the Canadian taxation issues that can arise in the context of a US investor making a venture capital investment in Canada. This paper also makes brief comment on some of the Canadian taxation consequences of a Canadian investor making an investment in securities of a US resident entity.

The Canadian federal government has often recognized the need for attracting venture capital to Canada and the role that the relatively high tax rates applicable in Canada have played in the venture capital market. A recent response of the federal government to this concern is the reduction in the effective rate of tax applicable to capital gains. With regards to the US, the benefits afforded to US residents under Canada-US Income Tax Convention (the "tax treaty") make venture capital investment in Canada relatively tax neutral when compared to investments made in the US by a US resident. This is because, generally, gains realized on the sale of Canadian securities realized by a US resident where the value of the corporation is not derived primarily from real property will not be subject to tax in Canada.

By way of background, the taxation system in Canada differs from the US in that Canada exercises its jurisdiction to tax on the basis of residency and not citizenship. Each Province of Canada also imposes its own income taxation. The income tax imposed by many Provinces is simply a percentage of the tax imposed by the federal government but some Provinces impose an independent income tax. Individuals pay tax on a graduated rate with the highest marginal rate beginning at an income level of approximately $60,000. The highest marginal rate for individuals resident in Canada is between 44% to 51% depending on the Province in which the individual is resident.

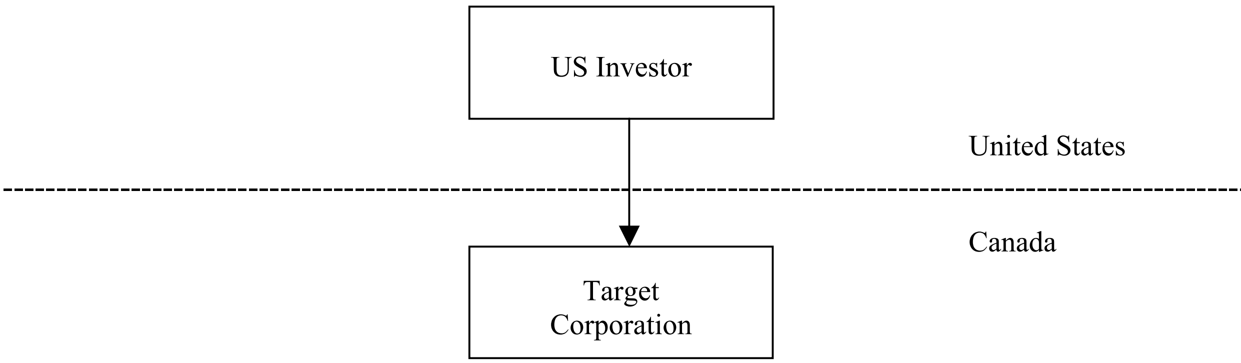
Canadian resident corporations pay tax at a rate of approximately 38% to 46% on taxable income with different rates being applicable depending on in which Province the income is earned. Foreign corporations that are subject to Canadian income tax are subject to a tax rate of approximately 39% on income earned in Canada. As a result of a recent mini budget introduced by our current government, 50% of capital gains are included in income. As a result the tax rate applicable to capital gains is approximately one-half of that applicable to income. For resident individuals this results in tax on capital gains of approximately 22% to 25% and for non-resident corporations this results in tax of approximately 20% on capital gains.

II. VENTURE CAPITAL INVESTMENT BY US INVESTORS IN CANADA

This section of the paper sets out a number of examples of types of investment structures that are utilized by US investors making venture capital investments in Canada and discusses the Canadian taxation implications of these structures to the US investors.

A. Share Investment in Canadian Corporation

The most typical model for a Canadian venture capital investment by US investors is ownership of shares in a Canadian corporation.



Under this structure assume that the Target Corporation is incorporated and has its offices in the Province of British Columbia. Target Corporation operates a business in British Columbia. Target Corporation is currently a private corporation seeking equity investment to expand and develop its business. The business plan of the Target Corporation includes the public listing of its shares on a major US or Canadian stock exchange within a few years after the equity investments are made by the US Investor. Assume that the US investor is resident in the United States for tax purposes and is also not resident in Canada for taxation purposes.

The types of income that will typically be realized from a venture capital investment are gains, dividends and interest. Occasionally investors will provide services relating to management or director roles and will realize income from the provisions of such services in the form of fees. The purpose of a venture capital investment is, however, primarily one of seeking returns on the basis of a gain on the investment resulting from a resale of the investment.

1. Taxation of Gains

In our typical model assume that the US Investor made an investment in stock of the Target Corporation and wishes to liquidate its investment in the Target Corporation. Some of the options available for liquidation to the US Investor include:

- sale of shares to a purchaser for cash;
- sale of shares to a purchaser in consideration for shares of the purchaser; or
- repurchase of shares by the Target Corporation.

<u>(a) Sale of Shares to a Purchaser for Cash</u>

The sale of shares to a purchaser could be either a private sale or a sale occurring after the shares have been listed on a stock exchange.

For Canadian tax purposes the US investor is subject to taxation on the gain realized if the shares of the Target Corporation are "taxable Canadian property". Taxable Canadian property includes shares in the capital stock of a Canadian resident corporation that is not listed on a prescribed stock exchange. If the shares are listed on a stock exchange that is "prescribed" for these purposes the shares will not be taxable Canadian property unless the US Investor, either alone or together with persons not dealing at arm's length with this investor, held at any time within the 5-year period ending at the time of sale, 25% or more of the issued shares of any class of the Target Corporation.

The tax treaty will override the domestic taxation of taxable Canadian property. Under the tax treaty, the gain realized on the sale of the shares of the Target Corporation by the US Investor will generally be exempt from Canadian taxation. This exemption does not apply if the value of the Target Corporation is derived principally from real property situated in Canada. For these purposes "principally" means more than 50%. This exemption will also not apply if the shares held by the US Investor are held as inventory in the course of a business carried on by the US Investor at a permanent establishment located in Canada. This latter claw back of the tax treaty exemption will be discussed further below in reference to the example of a partnership investment in the Target Corporation.

For purposes of determining whether the value of the Target Corporation is derived principally from real property, real property includes interests in natural resources, royalties from natural resources, options to acquire real property, shares of subsidiary companies whose value also is principally derived from real property and interests in a partnership, trust or estate, the value of which is derived principally from real property situated in Canada.

When making an investment in a Canadian Target Corporation it will be important for the US Investor to examine the balance sheet of the Target Corporation to determine whether the real estate owned, if any, by the Target Corporation comprises 50% or more of the value of the corporation. It will also be important to monitor the real estate holdings of the Target Corporation on an ongoing basis to determine the status of shares of the Target Corporation under the tax treaty .

If the tax treaty does not operate to exempt from taxation in Canada the gain realized by the US Investor, the applicable rate of tax to a corporate US Investor on a capital gain would be approximately 20%.

A significant reporting requirement arises upon the sale of any shares of a Canadian corporation by a non-resident person where such shares are taxable Canadian property. This reporting requirement arises notwithstanding that no taxes may be owing as a result of the application of the tax treaty.

In our example, the reporting requirements would require that the US Investor apply to the Canada Customs and Revenue Agency (the "CCRA") for a clearance certificate prior to the sale of the shares of the Target Corporation. The CCRA would issue a clearance certificate if the agency is satisfied either that no taxes are payable as a result of tax treaty exemption or, if taxes are payable on the disposition, that such taxes have been paid or adequate security for such taxes has been provided. If the vendor does not obtain this clearance certificate, the purchaser is required to withhold and remit to the CCRA one-third of the gross purchase price for the shares assuming such shares are held as capital property. If the shares are held as inventory, the purchaser is required to withhold and remit one-half of the gross purchase price. The obligation of the purchaser to withhold and remit a portion of the gross purchase price if a clearance certificate is not obtained applies regardless of whether the purchaser is resident in the US or anywhere outside of Canada, regardless of the location of the purchase and sale transaction and regardless of the tax status of the vendor. If the purchaser fails to withhold and remit the appropriate percentage of the gross purchase price, the purchaser is liable itself for the amounts it failed to withhold and remit.

The purpose of the reporting requirements is to ensure that when a non-resident of Canada disposes of taxable Canadian property appropriate measures are taken to protect the right of Canada to tax the gain realized on the sale. It is important to realize that the obligation of the purchaser to withhold and remit a portion of the gross purchase price arises even if the gain is not subject to taxation in Canada as a result of the tax treaty.

If the shares of the Target Corporation are listed on a "prescribed stock exchange" (which includes all of the major North American stock exchanges), the clearance certificate procedures described above are not applicable. However, if the US Investor held more than 25% of the shares of any class of the Target Corporation in the five year period prior to a sale, regardless of whether the shares of the Target Corporation are listed, the shares held by the US Investor may still be subject to tax in Canada as taxable Canadian property. Unless the tax treaty operates to exempt the gain on the sale of such shares, the US Investor would be obliged to file a tax return in Canada on the sale of such shares.

(b) Sale of Shares to a Purchaser in Consideration for Shares of the Purchaser

Venture transactions can involve sales of securities in consideration for other securities. Often publicly traded corporations will acquire the shares of private corporations on a share for share exchange basis. In our example, assume that the Target Corporation remains a private corporation and that the proposed purchaser is a US publicly traded corporation. The US Investor wishes to sell its shares of the Target Corporation in consideration for listed shares in the capital of the purchaser corporation.

For Canadian tax purposes, the US Investor will be considered to have disposed of its shares in the Target Corporation for consideration in an amount equal to the value of the shares in the purchaser corporation received by the US Investor. If the shares of the Target Corporation are held by the US Investor as capital property and if not more than 50% of the value of the Target Corporation is derived from real property situate in Canada, the provisions of the tax treaty should generally exempt from taxation any gain realized on such a share for share exchange transaction. If, however, the shares are not protected from taxation as a result of the tax treaty and are taxable Canadian property, the US Investor will be subject to Canadian taxation on the share for share exchange transaction notwithstanding that the transaction may be tax neutral for US taxation purposes.

If the share for share transaction is taxable to the US Investor, it is usually possible to reorganize the acquisition structure to allow a tax deferral. Such a reorganization would involve the use of a Canadian subsidiary company by the purchaser as the vehicle for the acquisition. The US Investor would then transfer its shares of the Target Corporation to the acquisition subsidiary company in consideration for "exchangeable" shares of that subsidiary company. The exchangeable shares would allow the US Investor to exchange the shares of the subsidiary company for shares in the capital of the publicly traded purchaser at any time. The benefit of this structure is that the US Investor is not subject to Canadian taxation until such time as the exchange of shares is exercised. There are numerous technical considerations regarding the implementation of this structure. A complete discussion of this structure is beyond the scope of this presentation.

(c) Repurchase of Shares by the Target Corporation

Another potential exit strategy for the US Investor is for the Target Corporation to repurchase the shares held by the US Investor.

A repurchase of the shares of the Target Corporation by the Target Corporation will trigger a deemed dividend for Canadian tax purposes to the extent that the proceeds of the repurchase exceed the paid up capital of such shares for taxation purposes. The paid up capital will generally represent the amount paid to the Target Corporation by the US Investor averaged with all of the capital contributed to the Target Corporation in respect of the class of shares held by the US Investor. The US Investor will also realize a gain on the repurchase for Canadian tax purposes to the extent that the paid up capital in its shares exceeds its adjusted cost base on such shares. Adjusted cost base is unique to each shareholder and represents, generally, the amount paid by the investor for the shares acquired.

The deemed dividend triggered on a repurchase of shares of the Target Corporation will be subject to Canadian level withholding tax at a rate of 25% under domestic Part XIII taxation. This tax is reduced, however, by operation of the tax treaty. The tax treaty will reduce the required withholding tax to 5% if the US Investor is a company and owns at least 10% of the voting stock of the Target Corporation. Otherwise the tax treaty will reduce the withholding tax to 15%. The correct amount of withholding tax is required to be withheld by the Target Corporation and remitted directly to the CCRA. The withholding tax is then credited to the tax account of the Target Corporation as payment of its tax liability in respect of the dividends received from the Target Corporation.

If the US Investor, in our example, acquires its shares in the Target Corporation for a subscription price that is less than the capital contributed by other shareholders holding the same class of shares, the US Investor will have a dilution of its paid up capital. If the

US Investor is issued a separate class of shares this dilution will not occur since the paid up capital of shares is not averaged across different classes of shares. As a result, it may be advisable, if a potential exit strategy is the repurchase of shares by the Target Corporation, to issue separate classes of shares to investors contributing different amounts of capital to the corporation.

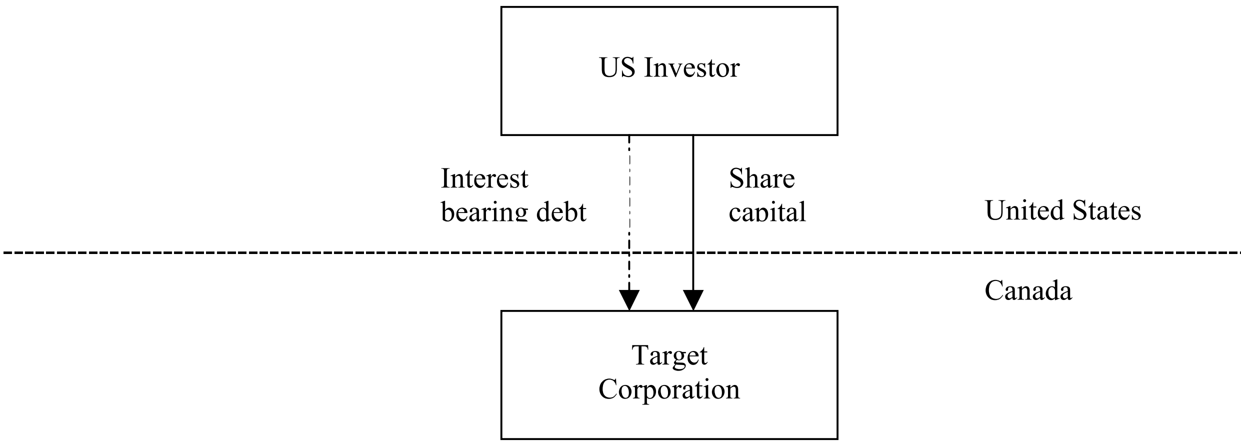
2. *Taxation of Dividends*

Dividends paid by the Target Corporation on its share capital will be subject to Canadian domestic withholding tax. As with the deemed dividend described above, the domestic rate of withholding tax is 25% which may be reduced to either 5% or 15% depending on the status of the shareholder receiving the dividend. The tax treaty will reduce the required withholding tax to 5% if the US Investor is a company and owns at least 10% of the voting stock of the Target Corporation. Otherwise the tax treaty will reduce the withholding tax to 15%.

B. Debt Investment in Canadian Corporation

Venture investment may also take the form of debt investment either together with share capital investment or as an alternative to share capital investment. In a venture business, the cash flow requirements needed to service interest on a debt may not be attractive. However, often if the target corporation is in a taxable position and the investor is either not taxable or has the benefit of tax shelter, debt investment may be an attractive consideration for taxation purposes. In addition, since the income tax rate is generally higher in Canada than in the US, interest expense at the Target Corporation level will result in a shift of taxable income from Canada into the US, thereby potentially reducing overall tax liability .

The following discussion is based on a structure whereby the US Investor holds both share capital investment and debt investment in the Canadian Target Corporation.



1. Canadian Taxation of Interest Income

Interest paid by the Target Corporation from Canada will be subject to Canadian withholding tax at a rate of 25%. That rate is, however, reduced under the tax treaty to 10% provided that the beneficial owner of the interest is resident in the US.

2. Five Year Debt

Under the five year debt exemption, interest paid by a Canadian corporation to a lender dealing at arm's length with the borrower is exempt from all Canadian withholding tax. In order for this exemption to apply the loan must meet the conditions set out below.

- The loan must be made by a non-resident person; in the example above, the US Investor.

- The borrower must be a corporation resident in Canada.

- The lender, that is the US Investor, must deal at "arm's length" with the borrower, Target Corporation. The arm's length concept is defined by legislation and jurisprudence and is dependent upon a factual determination. The concept generally requires, at a minimum, that the lender not control the borrower either directly or indirectly or either alone or together with other persons not dealing at arm's length with the lender.

- Under the terms of the loan or any agreement relating to the loan the borrower may not under any circumstances be obliged to pay more than 25% of the principal amount of the loan within five years from the date of issue of the loan obligation. This does not, however, preclude the borrower from voluntarily repaying the principal amount of the loan within this five year period or the loan becoming due as a result of a default.

The terms of a five year debt may allow either the borrower or lender to convert the debt obligation into common shares of the borrower without jeopardizing the five year repayment restriction on 25% of the principal amount of the loan.

The five year loan exemption from withholding tax will not apply where the US Investor holds 50% or more of the shares of the Target Corporation because in such circumstances the borrower will not be dealing at arm’s length with the lender. It may, however, apply where the US Investor is one of a number of other investors, all of whom deal at arm’s length with each other, provided that the US Investor does not control the Target Corporation nor exercise significant control or influence over the Target Corporation so as to cause the US Investor not to deal at arm's length with the borrower.

3. Thin Capitalization Restrictions

The borrower, Target Corporation, will usually be concerned about maintaining deductibility of the interest payments it makes on the loan made by the us Investor. Deductibility of interest is dependent upon, among other things, the proceeds from the loan being applied for the purpose of gaining or producing income from a business or property, the interest rate being reasonable and the thin capitalization rules not being applicable.

The thin capitalization rules will restrict the deductibility of interest payable by a lender on outstanding debts to specified non-residents. Specified non-residents are generally persons holding shares representing 25% or more of either the votes or value of the borrower corporation. In determining ownership of such shares, the lender is deemed to own all of the shares held by persons not dealing at arm’s length with the lender.

If the thin capitalization rules apply the ratio of debt to equity cannot be greater than 3:1 (or 75% debt) for taxation years that begin prior to or in 2000 and cannot be greater than 2:1 (or 66% debt) for taxation years that begin after 2000.

In our example, the thin capitalization rules would apply if the US Investor held shares of the Target Corporation representing 25% or more of the value of the Target Corporation or 25% or more of the voting rights attached to shares of the Target Corporation.

C. Hybrid Instruments

The above analysis relating to investment by a US Investor either by way of share subscription or loan assumes that the investment can be easily characterized as either debt or equity. The increasing utilization of complex hybrid financial instruments sometimes blurs the distinction between different instruments. Hybrid instruments can be used to obtain the benefit of both debt and equity investment. In Canada the tax system has struggled and continues to struggle with the bifurcation of financial instruments. It is not always easy to cubby-hole all or parts of financial instruments into debt or equity categories. As a result, the tax treatment of hybrid instruments is not always entirely clear.

Only some of the most basic forms of hybrid instruments such as convertible debt, participating debt and linked debt, are discussed below.

1. Convertible Debt

Under a convertible debt, the holder of the debt instrument may be entitled to convert the outstanding debt into share capital of the borrower. Two common methods of arranging a convertible debt instrument are providing a right within the debt instrument for conversion of the debt into share capital or providing an option or warrant together with the debt instrument.

A convertible debt or warrant or option to acquire shares of a corporation is taxable Canadian property if the shares that are the subject of the option to convert would be taxable Canadian property if issued. This arises from the fact that taxable Canadian property includes any interest in or option to acquire a share of the capital stock of a corporation resident in Canada. Accordingly, upon a sale or disposition of convertible debt or an option or warrant to acquire shares of the borrower, the taxation treatment afforded to taxable Canadian property described above would apply. In addition, the tax treaty should generally be applicable.

The exercise of the conversion feature of convertible debt will generally not trigger Canadian tax liability. If the debt instrument itself contains a right to convert the debt into share capital, the exercise of the conversion will not be considered to be a disposition for Canadian tax purposes provided that the only consideration receivable upon the exchange are shares of the corporation that issued the debt. The exercise of a warrant or option by surrendering debt issued together with such warrant or option should also generally not result in Canadian tax liability provided that the exercise price is equal to the principal of the debt being surrendered.

2. Participating Debt

Participating debt typically provides that the interest rate payable upon the debt is dependent, in some fashion, on revenues, profits or distributions of the borrower. Issues arising from such an instrument in a cross border venture transaction scenario include ensuring deductibility of interest at the borrower level, withholding tax treatment and application of the five-year loan exemption in respect of withholding tax.

The law in Canada regarding deductibility of participating interest is not entirely clear. The *Income Tax Act* does not specifically allow for the deductibility of participating interest. However, Canadian jurisprudence as well as CCRA technical interpretations suggest that participating interest will be deductible by the borrower provided that certain conditions are met in respect of the structuring of the borrowing. In particular, interest must be calculated by reference to a principal sum (e.g. as a percentage of the principal); interest can only be payable while principal is outstanding; the amount of interest must be determinable prior to the period in which it is payable (e.g. by reference to formulas based on prior period performances) and the interest must be capped at a reasonable rate of interest applied to the principal sum. A common method of satisfying these criteria is to provide that interest in a particular period is calculated as a percentage determined by a formula which has as its inputs cash flow performance of a prior period.

These conditions for deductibility of participating interest have been developed in the context of Canadian jurisprudence which provides that in order for a payment to be considered “interest” it must be considered compensation for the use of money, it must reference a principal amount and must accrue on a day-to-day basis.

If the conditions for deductibility are met as described above, the participating interest will be classified as interest for all purposes of the *Income Tax Act.* The result is that withholding tax would then be payable on any payments of such participating interest. The relevant rate is 25% but reduced under the tax treaty to 10% as long as the beneficial owner of the interest is resident in the US.

The 5-year loan exemption from withholding tax does not apply if the interest payable on an obligation is computed by reference to revenue, profits, cash flow, commodity prices or any other similar criterion or by reference to dividend payments. As a result, participating interest will generally not be eligible for the 5-year loan exemption from withholding tax. However, if interest is not calculated by reference to cash flow or similar criteria but as a simple percentage with the condition that it is only payable when certain cash flow criteria are met, the 5-year loan exemption should be available. In such circumstances, however, it will be important to ensure that the interest remains deductible by the borrower as the issue will be whether or not the interest is actually "payable" in such circumstances which is a prerequisite to deductibility .

3. *Linked Debt*

Linked debt can take on different forms. One form of linked debt provides an investment return based on a formula linked to, for example, commodity prices or financial indexes such as the S & P 500. Another form of linked debt provides a fixed rate of interest but a redemption feature that is based on the principal amount multiplied by a ratio of, for example, a commodity price at the time of redemption to a reference commodity price. An example is as follows:

Issue Price: US$1,000

Redemption Price: US$1,000 x $\frac{\text{price of gold at redemption date}}{\text{price of gold at issue date}}$

Such linked debt can also be combined with option features for conversions into stock.

As with participating debt, the issues arising from such an instrument in a cross border venture transaction scenario include deductibility of interest at the borrower level, withholding tax treatment and application of the five-year loan exemption in respect of withholding tax.

Deductibility of interest on linked debt where the interest is linked to a commodity is dependent on the technical structuring of the calculation of the interest. It is usually possible to structure the calculation of the interest to meet the technical criteria of interest to support deductibility. This may take the form, as with participating interest, of determining the applicable percentage rate for a period by reference to a commodity price or financial index of a prior period.

The application of withholding tax to payments on linked debt will depend on whether the investment return can be characterized as interest. If the payment of interest is structured so as to be deductible by the borrower as "interest" it is likely that withholding tax would be payable on payments of interest made to non-residents.

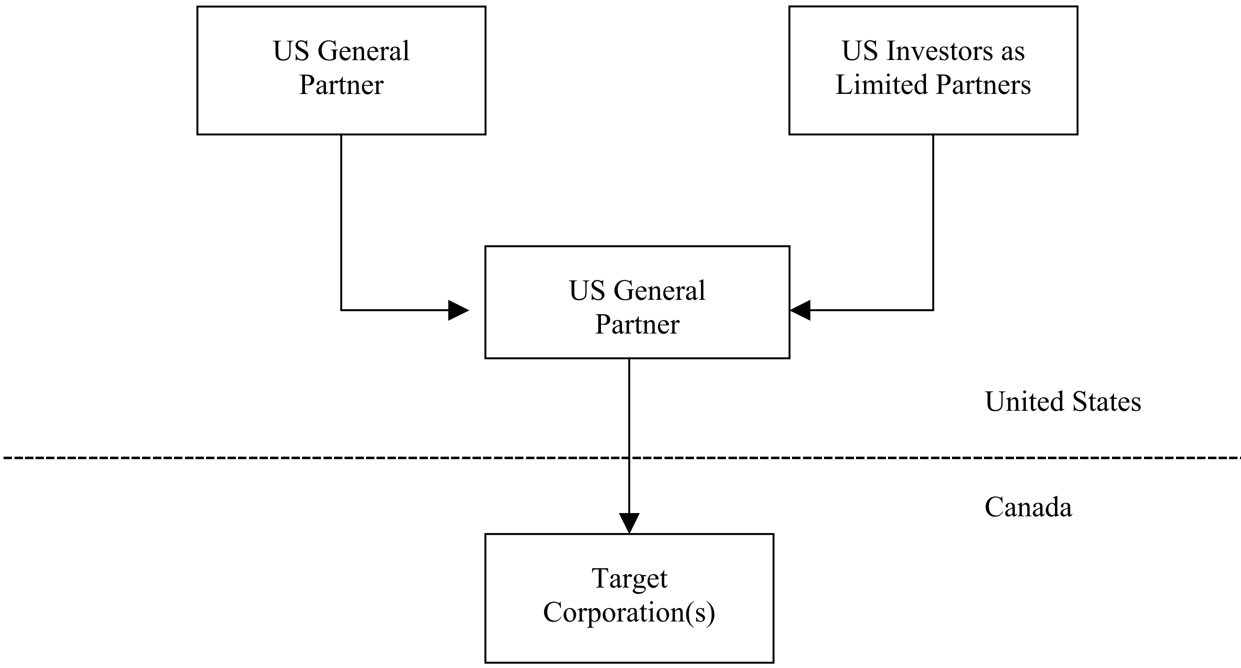
The 5-year loan exemption from withholding tax does not apply if the interest payable on an obligation is computed by reference to commodity prices or any other similar criterion. As a result, interest that is linked to a commodity price will not be eligible for the 5-year loan exemption from withholding tax. It is unclear whether the 5-year exemption from withholding tax would be applicable to linked debt where the interest is calculated by reference to a financial index. The position of the CCRA is that where a linkage exists between the particular index and profitability of the borrower, that the financial index is “similar criterion” and, thus, not eligible for the 5-year loan exemption from withholding tax. It is questionable whether this position is supportable at law.

Where linked debt is of the form where the principal amount payable upon maturity is determined by a reference to a commodity price, the excess payable on maturity is usually considered to be a payment of “principal”. As a result, the US holder of such a debt instrument would realize a gain and not interest income (which would be subject to withholding tax) on the redemption of the debt obligation. From the perspective of the borrower, the excess amount payable upon maturity may be deductible under the discount rules applicable to debt issued at a discount. The excess may be deductible, in full, if the discount is considered to be a “shallow discount” or 75% of the amount would be deductible if the discount is considered to be a “deep discount”.

D. Investment by US Partnership

Often investors will pool capital for purposes of making venture capital investments. Limited partnerships are the most common form of pooling utilized for this purpose. The taxation implications of making investments by way of a limited partnership will depend on the tax status of the partners making the investment and the location of the partnership. For purposes of this discussion the two structures considered are: a US partnership where the partnership is formed in the US and each member of the partnership is resident in the us and a Canadian partnership with a mix of US investors and Canadian investors each holding limited partnership interests.

1. US Partnership Structure



Under the US partnership structure the general partner is a corporation located and incorporated in the US as well as resident in the US for taxation purposes. Each of the limited partners is also resident in the US. The limited partners contribute capital to the US Limited Partnership in consideration for the issuance of units in the partnership. The US Limited Partnership utilizes the capital to make investments in target corporations located in Canada. Typically such an investment partnership will be established as a vehicle for making a number of investments.

For purposes of this example it is assumed that all of the activities of the general partner are conducted from the US at the offices of the general partner in the US. The activities of the general partner will be limited to the review of potential investments and the making of such investments in Canadian resident corporations. It is also assumed that the US Limited Partnership will not be subject to taxation in the US but will be treated as a flow through vehicle for US taxation purposes.

For purposes of the tax treaty the US Limited Partnership would generally not be considered to exist as a separate legal entity. The gains and income realized by the partnership would be allocated, for Canadian tax purposes, to each of the partners who are each responsible for any Canadian tax payable on gains or income realized by the partnership. In the computation of income of a partnership under Canadian tax law the partnership is treated as though it were a separate person resident in Canada. The partnership will initially compute its income or loss at the partnership level and the member's share of the income or loss of the partnership from each source will flow through to the individual member. Therefore, except for the computation of income, a partnership is treated as a conduit with all income being taxed in the hands of its partners while retaining its characteristics in respect to source and its nature.

(a) Capital Gains on Disposition of Shares of Target Corporation

From the discussion above regarding the taxation of gains realized on the sale of shares of a Canadian Target Corporation, it will be desirable to ensure that the tax treaty will apply to allocations of gains and income made by the partnership to its limited partners. The limited partnership is not considered to be a separate person for purposes of the tax treaty. In the normal course the limited partnership would acquire and dispose of share investments made Target Corporations. The gains from these investments and dispositions would be allocated to the limited partners and the general partner in accordance with the governing partnership agreement. For purposes of determining liability for tax on the gain, the CCRA will generally accept the status of the limited partners on a look through basis. This position is not codified but is an administrative position of the CCRA. As a result, gains from the dispositions of shares of a Target Corporation realized by the partnership would be flowed through to the US Investors as limited partners. For purposes of the tax treaty , the US Investors would be considered to have disposed of the shares in the Target Corporation. If the shares are not considered to be held on the account of inventory as part of a business conducted by the partnership in Canada through a permanent establishment and provided that the value of the Target Corporation is not derived principally from real property situate in Canada, the gains allocated to the US Investors, as limited partners, should not be subject to taxation in Canada by virtue of the tax treaty.

If the value of the Target Corporation is derived principally from real property situate in Canada then each partner of the limited partnership will be subject to and liable for taxation on the gain allocated to the partner.

The requisite clearance certificate would be required to be obtained in connection with any sale by the limited partnership of shares of the Target Corporation that are taxable Canadian property. This clearance certificate would generally be sought by the general partner on behalf of the limited partners.

(b) Dividends

As discussed above, dividends paid by a Canadian resident corporation to non-residents are subject to domestic withholding tax. When the Canadian Target Corporation pays a dividend to the US Limited Partnership each of the individual US Investors holding a partnership interest would be allocated, for tax purposes, their respective proportionate share of the dividend. The US Investors resident in the US would be entitled to the benefit of the reduced rate of 15% on the withholding tax applicable under the tax treaty.

As was described above, the tax treaty will reduce the required withholding tax to 5% if the beneficial owner of the interest is a company that owns at least 10% of the voting stock of the Canadian corporation paying the dividend. In the case of a US partnership, even if all of the partners of the partnership are corporations resident in the US and the partnership holds more than 10% of the voting stock of the Target Corporation, the CCRA takes the position that the reduced rate of 5% is not applicable. This is because the US Investor holding a partnership interest is considered not to have an ownership interest in the voting stock of the Target Corporation paying the dividends but rather to own a partnership interest.

Notwithstanding that the applicable rate of tax on the dividend received by the US Investors under the tax treaty is 15%, the Canadian Target Corporation is still required to withhold the domestic rate of 25%. However, it may be possible, on a case-by-case basis, to approach the applicable local district taxation office where the Target Corporation files its income tax return, to determine if the local office is prepared to reduce the withholding rate to that of the treaty rate on the amounts ultimately payable to residents of the us. If this is not possible, it will be necessary for the us Investors to file returns in Canada to obtain a refund of the excess tax withheld by the Target Corporation at source.

(c) Interest

If the investment by the US Limited Partnership in the Target Corporation includes a debt instrument bearing interest, the interest payable by the Target Corporation will be subject to Canadian domestic withholding tax. The applicable rate of tax is 25%.

Under the tax treaty, the partners of the US Limited Partnership that are residents of the US will be entitled to reduced Canadian tax at a rate of 10% on the interest allocated to them by the partnership. However, the Target Corporation is still required to withhold tax at the 25% rate. It will then be the responsibility of the partners to apply to the CCRA for appropriate refunds of the withholding tax withheld at source.

It will still be possible to structure a loan to the Target Corporation by the US Limited Partnership as a 5-year exempt loan provided that each of the members of the partnership deal at arm's length with the borrower, Target Corporation. If this is the case and all other conditions relating to the 5-year loan are met, interest paid on such a loan could be exempt from Canadian withholding tax.

(d) Management Fees

In venture investments of the form considered in our example, often management fees will be payable by the Target Corporation to the US Limited Partnership in respect of management services rendered by the general partner to the Target Corporation. Typically reasonable management fees which are paid in such circumstances to a resident of a country with which Canada has a tax treaty, such as the US, will be considered to be business profits for purposes of the tax treaty. Management fees will be allocated to the US Investors holding partnership interests in the US Limited Partnership. Under Article VII of the tax treaty, as long as the US Limited Partnership does not maintain a permanent establishment within Canada, such management fees will be exempt from tax in Canada. If, however, the US Limited Partnership does maintain a permanent establishment in Canada, such management fees would be taxable in Canada as business income at the applicable rate. This would then result in each of the US Investors holding partnership interests as well as the general partner being subject to Canadian taxation on business income. In addition to triggering tax liability, income tax returns and filings would be required to be made by each partner.

Even if the US Limited Partnership does not have a permanent establishment in Canada, the Target Corporation would be required to withhold and remit to the CCRA 15% from all management fees paid to the US Limited Partnership if the services in respect of which the management fees are paid are rendered in Canada. The US Limited Partnership would then be required to file appropriate tax returns in Canada seeking a refund of the withholding tax on the basis that the US Limited Partnership does not have a permanent establishment in Canada. It is possible, however, to obtain a clearance certificate from the CCRA prior to the payment of any management fees. The clearance certificate would allow the Target Corporation to pay management fees to the us Limited Partnerships free from withholding tax. Under the clearance certificate application, the US Limited Partnership will have to satisfy the CCRA that it does not have a permanent establishment in Canada.

(e) Concept of Permanent Establishment

The concept of a permanent establishment is important in the context of not only the earning of management fees from an investment in Canada but also in respect of shares held on account of income.

In respect of management fees and other types of business income, if the US Limited Partnership has a permanent establishment in Canada and such fees or business income can be allocated to that permanent establishment this will trigger Canadian tax liability and filing obligations. In addition, if the shares of the Target Corporation are held on account of income (i.e. inventory) and the partnership has a permanent establishment in Canada, a disposition of such shares, to the extent that the gain thereon can be attributable to the Canadian permanent establishment, will be subject to taxation in Canada.

Under Article V of the tax treaty a permanent establishment includes a place of management, a branch, an office, a factory and a workshop. This might include an office or designated space in the offices of the Target Corporation. It will be important in this regard to ensure that neither the general partner of the US Limited Partnership, nor any of its employees, directors or officer, acting in their capacity for the general partner, have such an office within Canada. Otherwise this may result in the US Limited Partnership being considered to have a permanent establishment in Canada. If the general partner has a permanent establishment in Canada, each of the partners of the partnership will also be deemed to have such a permanent establishment in Canada.

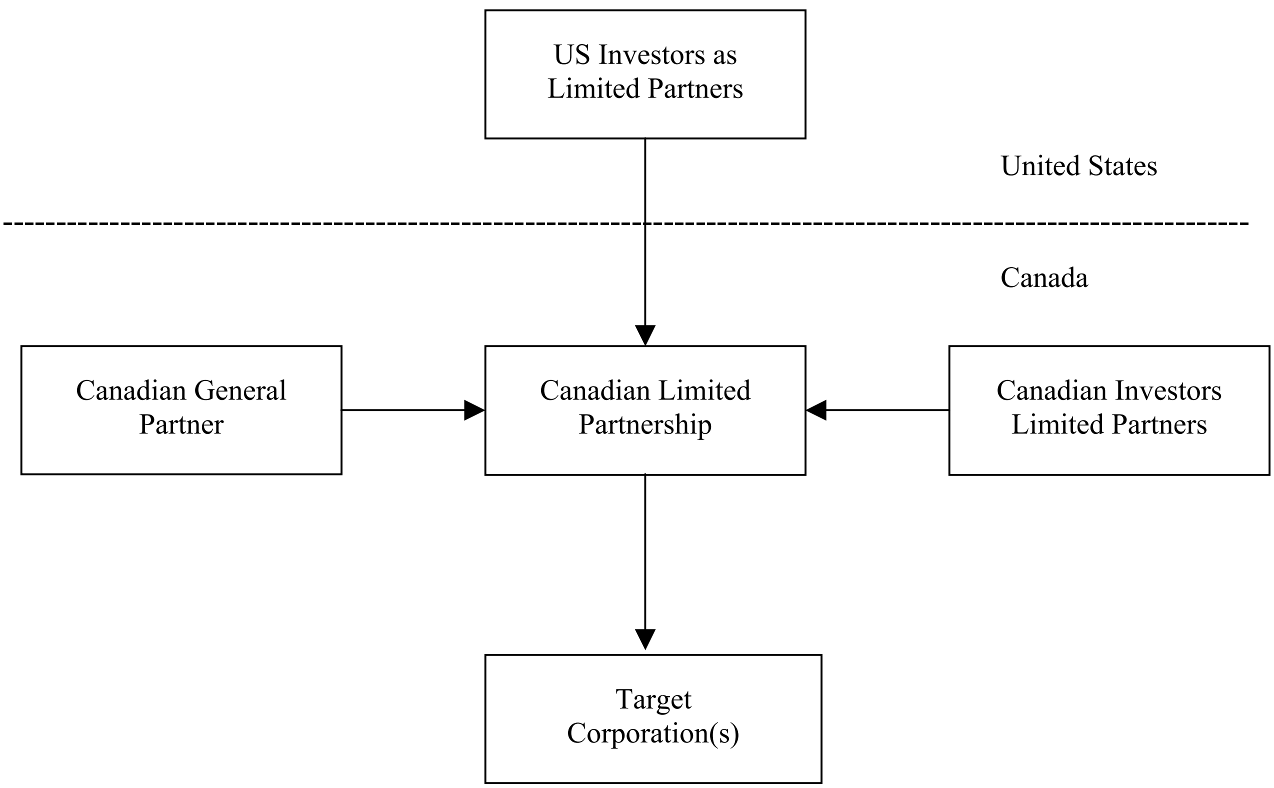
An agent acting on behalf of a US resident in Canada (other than an independent agent acting in the ordinary course of its business) is deemed to constitute a permanent establishment if such agent has, and habitually exercises in Canada, an authority to conclude contracts in the name of the US resident. In the context of the US Limited Partnership, in order to avoid having a permanent establishment in Canada, it will be important that the general partner generally conclude its contracts outside of the US to ensure that it does not have a permanent establishment in Canada since the general partner acts in an agency capacity for the partnership and the limited partners of the partnership.

(f) Inventory vs. Capital Property

Whether a sale of shares in the Target Corporation held by the US Limited Partnership triggers an income gain or a capital gain is a factual determination. The determination of whether a gain or loss on the disposition of property is on income or capital account continues to be determined by an ever evolving body of case law. No other area of tax law has generated so much tax litigation in Canada, considering that prior to 1972 capital gains were not subject to taxation. In Canada there are a number of factors that are considered by our courts in determining whether a profit is business income or a capital gain. These include: (1) the intention of the taxpayer, (2) the number and frequency of transactions, (3) the relation of the transaction to the taxpayer's regular business, (4) the nature of the transaction, including the nature of the disposed asset and the method of disposition, (5) the declared objects of a corporation in the case of corporate transactions, and (6) the type of assets being disposed of. The primary consideration is intention, which may be primary intention or secondary intention. If the shares of the Target Corporation are purchased by the US Limited Partnership with a primary or secondary intention or motivation being to realize a profit on a quick re-sale of the investment, such shares would likely be considered to be held on income account. In such circumstances, it will be important to ensure that the US Limited Partnership not have a permanent establishment in Canada to avoid being liable for Canadian income tax on the sale of the shares of the Target Corporation.

2. Canadian Partnership Structure

The structure considered below is a Canadian Limited Partnership formed under the laws of a Province of Canada with the general partner being a resident of Canada. Under this structure there may be other limited partners that are resident in Canada. It is assumed that the Canadian Limited Partnership will hold shares in the capital of the Target Corporation as venture investments but will not actually carry on any business itself other than perhaps providing management services to the Target Corporation. US Investors would invest by way of limited partnership interests in the Canadian partnership.



Under this structure the Canadian Limited Partnership will be a treated as a conduit for Canadian taxation purposes. For Canadian taxation purposes, however, the Canadian Limited Partnership will be treated as a non-resident since it has at least one non-resident partner. This will generally require the Target Corporation to withhold tax on dividends and interest in the same manner as described above in relation to a US Limited Partnership. The partners would then be obliged to seek appropriate refunds based on either treaty status (for the US Investors) or Canadian residence status (for the Canadian Investors). In addition, the clearance certificate requirements applicable on the sale of taxable Canadian property (which the shares of the Target Corporation may be) will be applicable (see the discussion above).

The application of the withholding tax on interest and dividends received by the Canadian Limited Partnership and the application of the clearance certificate procedures on a potential sale of the stock of the Target Corporation(s) by the Canadian Limited Partnership, often lead managers to form separate partnerships: one for Canadian investors and another for US investors. This allows the particular non-resident issues arising in the context of US Investors holding interests in a Canadian partnership to be isolated away from the Canadian limited partners.

One of the more important issues that US Investors in a Canadian Limited Partnership will consider, is the fact that any activities of the general partner in Canada are imputed to be activities of the limited partners. As a result, in a scenario where a limited partnership is carrying on business in Canada through a Canadian permanent establishment, each of the partners, including any non-resident limited partners, are considered to be carrying on that same business in Canada through a Canadian permanent establishment. This will have significant implications if the activities of the partnership include the realization of management fee income or if the activities of the partnership amount to active trading of securities on income account. In such circumstances US Investors would be required to file income tax returns in respect of income allocated to them from the partnership.

E. Nova Scotia Unlimited Liability Company

In the case of a significant venture investment by a US resident in a Canadian Target Corporation it may be appropriate to consider structuring the Canadian Target Corporation as a Nova Scotia unlimited liability company (NSULC) to take advantage of the favourable US tax results that the NSULC has to offer. Note that Nova Scotia is a Canadian Province located on our east coast. An NSULC is a corporation for Canadian purposes but can elect to be treated as a partnership for US tax purposes under the "check the box" regulations. The key corporate difference between an NSULC and a normal Canadian corporation is that the shareholders of an NSULC have unlimited liability for the debts and obligations of the NSULC.

As an entity classified as a partnership for US tax purposes, the income or losses of the NSULC are directly attributed to the US shareholders. Thus losses incurred by the NSULC would be directly deductible by the US shareholders on the US income tax return. Conversely, income earned by the NSULC would be included in the US return and any Canadian income taxes incurred on such income would be creditable against US tax. Due to the fact that the NSULC is a corporation that is incorporated in Canada, it is a resident of Canada for Canadian tax purposes. As a resident of Canada, the income earned in respect of the Canadian operations is subject to Canadian tax.

In the context of a venture investment, it may be appropriate to consider an NSULC structure to allow US Investors the ability to set off start up losses from the venture against their US income without directly carrying on the business. An NSULC may also be beneficial for foreign tax credit purposes as well as for financing because borrowing by the NSULC may allow the US participant a deduction for interest in addition to the deduction available to the borrowing NSULC.

For US purposes, a NSULC is treated as a flow-through entity, just like a partnership or an LLC. A US person can address the lack of limited liability with a NSULC but preserve the US tax treatment by holding the NSULC shares through an S corporation or an LLC.

If a US Investor is considering making a significant investment in an already existing corporation in Canada, it is possible to migrate the Target Corporation into an NSULC. The typical structure requires the Target Corporation to continue into the jurisdiction of the Province of Nova Scotia. The US Investor would incorporate a NSULC and the existing shareholders of Target Corporation would transfer their respective shares to the NSULC on a rollover basis for new shares of the NSULC. The Target Corporation and the NSULC will then typically amalgamate and the US Investor would make their investment by way of share capital in the amalgamated entity which would qualify as an NSULC. As the amalgamated entity can be classified as an NSULC it would then afford the US Investors the beneficial treatment of a flow through entity for US taxation purposes.

Dividends and interest paid by the NSULC will still be subject to regular withholding taxes as described above in respect of an investment by a US resident in shares of a regular Canadian corporation.

F. LLC Investment

As LLCs are common investment vehicles in the US, some comment from a Canadian perspective is merited in respect of venture investments made by LLCs in Canada. The primary consideration when making an investment in Canada by way of a us LLC is that Canada does not respect the LLC as a resident of the US for purposes of the tax treaty. As a result, an LLC will not be entitled to rely on the benefits afforded to US residents available under the tax treaty. The benefits that are lost as a result include increased withholding tax of 25% applicable on dividends and interest (as opposed to 5% and 10%, respectively). In addition, an LLC will not be entitled to rely on the business profits article of the tax treaty which requires that before business profits can be taxable in Canada, the US resident realizing such business profits must have a permanent establishment located in Canada to which such profits are attributable. In the case of a trader in securities, this would have a significant consequence since an LLC holding and selling securities on account of income would not be required to carry on such activities through a permanent establishment located in Canada before Canada could exercise its jurisdiction to tax such activities.

Another consideration regarding the use of an LLC for an investment in Canada is that because the tax treaty does not apply to an LLC, the residency rules applicable under the tax treaty for corporations are also not applicable. As a result, if, under Canadian tax law, the “mind and management” of the LLC is exercised in Canada, notwithstanding that the LLC is formed and also operated in the US, the LLC would be subject to taxation in Canada as a Canadian resident and thereby taxable on its world wide income.

III. VENTURE CAPIT AL INVERTMENT BY CANADIAN INVESTORS INTO THE US

This section of the paper will discuss, in summary form, some of the Canadian tax consequences of a Canadian person making venture investments in the US. It is assumed that the type of investment made in the US will be securities of a US corporation. Some comments are also made regarding investments made by way of an interest in a US limited partnership or an interest in an LLC.

A. US Corporation

In the case of an investment by a Canadian person in a US corporation (the "US Investee Corporation") that is involved in an active venture business, Canada will generally not tax the Canadian person on the income realized by the US Investee Corporation unless that corporation realizes certain types of passive income. The Canadian investor will, however, be required to include into income dividends received from the US Investee corporation. If the US Investee corporation is a "foreign affiliate" of a Canadian corporate investor, dividends paid from the "exempt surplus" of the US Investee corporation would be deductible. The exempt surplus of the US Investee corporation would typically include capital gains that are not considered to be passive income as well as net earnings from an active business carried on in the US.

If the US Investee is a "controlled foreign affiliate" of the Canadian investor, Canada will tax the Canadian investor on the "passive income" (called foreign accrual property income or FAPI) that is earned by the US Investee corporation. The rules relating to passive income in Canada provide a mechanism whereby Canadian residents cannot defer taxation on passive income by earning such income through foreign entities. For these purposes, a "foreign affiliate" is a foreign corporation if the direct equity percentage in the corporation is at least 10% while a "controlled foreign affiliate" is a foreign affiliate that is controlled by Canadian taxpayers. Passive income for these purposes is essentially income from property and businesses other than an active business.

On a sale of the shares of the US Investee, the Canadian investor will be subject to tax in Canada on the gain realized. If the US imposes tax on the gain, it is likely that the Canadian investor should be entitled to the utilization of a foreign tax credit with respect to such taxation.

B. US Partnership

In respect of an investment by the Canadian investor in a US partnership, the Canadian investor will be taxed on the income allocated to it by the partnership. The income calculation for the partnership is required to be undertaken for Canadian tax purposes, applying Canadian tax laws (regardless of the calculation of taxable income already undertaken for US tax purposes) in order to determine the taxable income allocable to the Canadian investor.

C. LLC

Under Canadian tax law a US LLC is considered to be a corporation notwithstanding the fact that it may be treated as a partnership for US tax purposes. As a result, distributions made by the LLC are considered to be dividends for Canadian tax purposes. The Canadian investor will typically be entitled to some form of foreign tax credit in respect of the branch profits tax that the Canadian investor will be liable for on distributions from the LLC. However, if the Canadian investor is a corporation and the LLC is a "foreign affiliate" of the Canadian investor, no foreign tax credit will be available, rather the distribution received may be included in the exempt surplus of the LLC if earned from an active business and thereby exempt the entire distribution from Canadian income tax.

A more detailed discussion of the Canadian tax rules relating to the treatment of investments in LLCs is beyond the scope of this paper. The rules are complex and still evolving and great care must be undertaken when Canadian investors consider holding investments in the US through a LLC or when making direct investments in LLCs.

Vancouver
1600 Cathedral Place
925 West Georgia Street
Vancouver, British Columbia
Canada V6C 3L2
Telephone 604.685.3456
Facsimile 604.669.1620

Calgary
3700, 205-5th Avenue SW
Bow Valley Square 2
Calgary, Alberta
Canada T2P 2V7
Telephone 403.269.6900
Facsimile 403.269.9494

Yellowknife
P.O. Box 818
200, 4915 – 48 Street
YK Centre East
Yellowknife, Northwest Territories
Canada X1A 2N6
Telephone 867.669.5500
Toll Free 1.888.465.7608
Facsimile 867.920.2206

genmail@lawsonlundell.com
www.lawsonlundell.com

LAWSON
LUNDELL LLP