

Pre-Budget Submission to the House of Commons Standing Committee on Finance

The Canadian Venture Capital Association (CVCA) was founded in July 1974 and is the trade association that represents the venture capital industry. Its membership comprises virtually all major Canadian venture capital investors, including banks, labour-sponsored funds, corporate investors and fund managers who manage pools of risk capital targeted at the small business sector. In total the CVCA represents about 170 entities who manage or invest most of the capital committed to early and developmental stage entities in Canada.

Canadians today enjoy high living standards – among the highest in the world. This success reflects the development of a dynamic, responsive economy which has fully exploited our human and natural resources. However our ability to maintain an innovative fast growing economy depends on the maintenance of a vibrant, competitive, venture capital sector. It is this sector which finances the small emerging businesses which are the engines of growth in an increasingly technological world.

In today's global economy, countries with underdeveloped venture capital sectors often experience a "drain" of business ideas and entrepreneurs to more accommodating locations offering better access to start-up capital. In Canada, this problem is particularly acute, located as we are next door to the United States, a country offering the deepest, most liquid capital pools in the world and a generally accommodating tax regime. When Canadian companies move south of the border, they take some of Canada's brightest minds, most highly skilled workers and best paying jobs with them. They also take away the potential for spin-off enterprises to develop in Canada as these often feed off the ideas and support of the original innovators.

Clearly venture capital is the lifeblood of an innovative economy. In this light, governments have a key role to play in creating the framework which will enhance the human and financial resources needed for a dynamic venture capital sector.

In this context, drawing on the views of its membership, the CVCA has developed several proposals which would help to strengthen this sector. In summary, these proposals would:

- Improve the potential to raise venture capital funding from Canadian Institutions;
- Eliminate barriers which discourage foreign investors from funding Canadian ideas;
- Remove practical impediments to Canadian venture capital investment; and
- Encourage the development of entrepreneurship in Canada.

1. Inadequacies of Existing Vehicles for Venture Capital Investment

If the flow of capital into the small business sector is to be increased, it is obviously important that the fiscal and regulatory regime allow the creation of “user-friendly” investment vehicles for financial institutions such as pension funds and life insurance companies. These investors have certain basic requirements which include the protection of their limited liability status; the receipt of income on a pre-tax basis; the minimization of investment costs; flexibility with respect to the amount and type of investment; and the avoidance of treatment of an investment as Foreign Property (as defined in the Income Tax Act, Canada, “the Act”) since their capacity to invest in Foreign Property is limited.

The existing fiscal and regulatory framework allows for a multiplicity of investment vehicles for institutions. However the CVCA is concerned that all these have deficiencies which act as impediments to institutional investment.

For example, investments in certain types of investment vehicles are included in Foreign Property holdings, regardless of the nature of the property underlying the investment vehicle. Most notably, an interest in a partnership is regarded as Foreign Property unless the partnership is either a qualified limited partnership or a small business investment limited partnership. The definition of small business investment limited partnership in the Act is extremely restrictive and the definition of qualified limited partnership provides that no limited partner (together with related persons) can at any time hold more than 30% of the units of the partnership. This limitation is often problematic particularly in light of the relatively few institutions who invest regularly in venture capital opportunities.

Recommendation:

In the United States, the basic investment vehicle for venture capital investment is the Limited Partnership. The CVCA proposes that the Act be amended to allow the Limited Partnership vehicle to perform the same role in Canada.

In particular, we suggest that the Act be amended to add a special rule applicable to limited partnerships similar to the rule in section 259 of the Act that applies to trusts. This rule would ignore the interest in the partnership and would treat the partner as holding directly a proportionate interest in the assets of the partnership. If such assets were Canadian, they would be treated as Canadian in contrast to the present regime which deems them to be foreign. In addition, as a Limited Partnership does not restrict the percentage of its ownership which can be held by a single investor, the 30% restriction referred to above would be eliminated.

As an alternative approach, the Act could be amended so that for purposes of the foreign property rules an interest in a limited partnership would be treated in the same manner as an interest in a mutual fund trust or share in a mutual fund corporation. An interest in a mutual fund trust or share in a mutual fund corporation is not regarded as foreign property in a particular month provided that at no time in the relevant period for the

particular month did the cost amount to the trust or corporation, as the case may be, of foreign property exceed 30% of the cost amount to the trust or corporation, as the case may be, of all property held by such trust or corporation (Regulation 5000 (1)). We suggest that Regulation 5000 (1) be amended so that an interest in a limited partnership would be treated in the same fashion.

2. Barriers to Foreign Investment Capital

The CVCA takes the view that it is in Canada's interest to encourage the inflow of foreign capital for venture investment. In this respect, our existing tax regime contrasts negatively with those of other countries, most notably the United States.

A) Eliminating tax on capital gains realized by foreign investors

The U.S. has for many years pursued a policy of not taxing any foreign investors on capital gains generated in the U.S. so long as the foreign investors did not incorporate in the U.S. This is commonly known as the "10 Commandment Rule". This policy, together with the favourable capital gains tax treatment available to individuals, are widely believed to be the two most important factors behind the formation of the world's largest pool of risk capital and dynamic growth of entrepreneurial companies in the U.S.

This view is also supported by the Israeli experience. For many years, Israel received limited foreign investment due to its restrictive tax policies, which taxed foreign investors on capital gains. The Israeli Monetary Authority addressed this issue by granting special rulings to foreign investors and investment fund managers directly for specific investors stating that any capital gains generated by foreign investors in Israel would be tax-free. This very simple approach provided for enormous growth in the amount of foreign capital flowing into Israel. Today, Israel receives far more venture capital from foreign investors and annually lists more publicly traded companies on NASDAQ than Canada. Foreign investors clearly view Israel as a more favourable country in which to invest.

Until recently, venture capital fund managers in Canada were completely precluded from raising money offshore and in particular, from U.S. investors, as such investment either through a Canadian limited partnership ("LP") or through direct management would have treated such foreign investors as having a permanent establishment in Canada and, therefore, subject to tax in Canada.

Even if there was treaty protection, these foreign investors were typically viewed as carrying on business in Canada despite the fact that the investment was made through an LP structure managed by a Canadian fund manager. In the past, foreign investors were taxed in Canada via this deemed permanent establishment. The recent enactment of section 115.2 of the Act has attempted to address this problem. It is now possible to set up a U.S. LP with a U.S. based General Partner to facilitate U.S. investment in Canada. Thus, a U.S. LP with a U.S. General Partner and a Canadian service provider can now invest in Canada without the U.S. limited partners being deemed to carry on business in Canada. A Canadian services company manages the U.S. LP through a service agreement

on behalf of the Canadian fund manager. However, this structure poses serious shortcomings, which continue to hamper foreign investment.

Specifically, the structure does not address the following.

- **Significant marketing issues remain:** Institutional investors are conservative fiduciaries that require an extremely high degree of comfort regarding potential foreign tax liabilities. This was partially addressed by opinions being provided by tax accounting and legal firms. Unfortunately, this is still insufficient for many foreign fund managers who would prefer to have no residual tax risk or administrative burden.
- **Structure is overly complex, expensive and difficult to administer:** The U.S. LP needs to be managed as a side-by-side fund with the Canadian LP, which poses considerable administration and accounting cost. All cheques and required documentation are required to be physically signed in the U.S. by officers of the General Partner based in the U.S. Further, to ensure that the two partnerships cannot be viewed as a single partnership, separate decision making structures are required for the U.S. LP.
- **Limited to Treaty Countries:** The structure is applicable only to those countries that have signed a tax treaty with Canada. For example, an investor in Hong Kong is ineligible to invest through the above structure without a Canadian tax obligation because it is not a treaty country. There is a much bigger source of capital that Canadian venture capital firms want to approach than just the capital from treaty countries.

Recommendation:

We recommend the adoption of a policy similar to that available in the U.S. for foreign investors which would allow a non-resident investor to invest in a Canadian Limited Partnership on the same terms as Canadian investors and not be deemed to have a permanent establishment in Canada or be deemed to be carrying on business in Canada. Provided the investor is not operating directly through a Canadian entity, there would be no Canadian tax paid. This recommendation is restricted to Limited Partnerships which are investment vehicles as opposed to Limited Partnerships which carry on an active business.

Alternatively, we recommend a solution similar to the Israeli model, which would allow a Canadian Venture Capitalist (as defined in the Associated Corporation Rules section) to approach the Department of Finance and receive a formal ruling stating that any foreign investor investing in a Canadian Limited Partnership for venture capital purposes would be granted tax-exempt status.

It should be noted that this would not be lost revenue to Canadian tax authorities since these are new investors bringing new capital. In fact, it will lead to the growth of additional tax paying corporations and corresponding growth in aggregate tax revenues.

B) Eliminating withholding tax on interest

Subject to certain exceptions, the Act currently imposes a withholding tax of 25% on interest payments made to foreign creditors. The rate of withholding tax is reduced to 10% if the recipient of the interest is a resident of the United States who is entitled to the protection of the Canada-U.S. Income Tax Convention. Treaties with other countries provide similar relief. We are concerned that the withholding tax imposed on interest payments made to non-residents discourages U.S. and other foreign lending institutions from making loans to Canadian companies thereby increasing the cost of borrowing in Canada and reducing the pool of affordable capital available to Canadian companies. The United States provides an exemption from withholding tax in respect of interest payments to a non-resident on interest paid on "portfolio investments". This permits U.S. borrowers to access capital on a cost-effective basis, from either domestic or foreign sources.

Recommendation:

We propose that the withholding tax provisions be revised to make it cheaper and easier for Canadian companies to access U.S. and other foreign capital. We propose that the Act be amended to provide an exemption from withholding tax on interest paid on portfolio investments regardless of whether the investor resides in a treaty country or not.

We further propose that the Act be amended to provide an exemption from withholding tax for interest paid to a non-resident in any jurisdiction by a Canadian corporation that has income which qualifies for the small business deduction. This will provide small Canadian controlled private corporations with the widest access to loan capital which is often difficult for such corporations to obtain in the domestic market.

C) Extending Treaty Protection to Limited Liability Companies

The Canada-U.S. Income Tax Convention (the "Treaty") provides a reduction of the rate of withholding tax on dividends and interest payable by a resident of Canada to a resident of the United States. It also provides protection from Canadian tax on capital gains realized by U.S. residents on most Canadian source capital gains, other than capital gains derived from Canadian real property. In order to benefit from the Treaty, the taxpayer must be a "resident" of the United States. The definition of resident in Article IV, section 1 of the Treaty, is a person who, under the laws of that person's state is liable to tax therein. U.S. law currently allows for limited liability companies ("LLC") which, provided an election is made, are treated as a flow-through vehicle for tax purposes. Income of the LLC is taxed in the hands of its shareholders. The Canada Customs and Revenue Agency has consistently taken the position that LLCs are not entitled to treaty protection.

A significant amount of U.S. capital is invested by LLCs. The refusal to extend treaty protection to LLCs reduces the ability of Canadians to access U.S. capital.

Recommendation:

As a result, we propose that the Treaty be amended to extend protection to LLCs to the extent that the investors in the LLC would be entitled to protection under the Treaty. Similar amendments should be made to the bilateral treaties Canada has with any other countries which have LLCs or similar look-through vehicles.

3. Negative Tax Implications from the Associated Corporation Rules

The Act contains the concept of "associated corporations". Associated corporations must share a single \$200,000 small business deduction. More importantly, association can increase a corporation's liability to pay large corporations capital tax and reduce its ability to access SR&ED tax credits. These provisions have been burdensome for both corporations and venture capital investors because they have caused corporations to be regarded as associated only because they have accessed capital from the same venture capital sources. Moreover, investee corporations are faced with a difficult compliance problem. They often do not know whether an investment by one or more venture capitalists will result in the investee corporation being associated with one or more other corporations.

The rules for determining whether corporations are associated are set out in subsection 256(1) of the Act. In very general terms, two corporations are associated if, inter alia, they are controlled by the same person or group of persons, or they have common direct or indirect control. In general terms, where a person has a right to acquire shares or to cause a corporation to redeem acquired or cancel shares, the test is to be applied as if such person owns such shares, or such shares were redeemed, acquired or cancelled, as the case may be. Certain venture capital investors make investments in numerous Canadian corporations. These corporations do not otherwise share common ownership or control. Their link is that they have accessed capital from the same venture capitalist.

The problem is exacerbated by the fact that many venture capital investments in niche technology companies are in fact co-investments by 2 or 3 different (arm's length) venture capitalists. This allows for more cost-effective investment, and for risk sharing, since it allows one lead investor to do the due diligence for the group. It is very difficult to determine all of the possible groups of investors that may control more than one investee. In addition, due to the high risk of these investments, venture capital investors typically impose terms under which, in certain circumstances, they can take control of the investee. These conditions often cause the provisions of subsection 256(1.2) to apply, which again can cause a number of investees to be associated.

We are of the view that such corporations should not be associated.

Recommendation:

As a result, we recommend that investments made by a "Canadian Venture Capitalist" in corporations should be ignored for purposes of the association rules. The Act does not contain such a definition; however, we propose the following definition:

"Canadian Venture Capitalist" means:

- (a) an enterprise or related group of enterprises whose principal business is investing in the securities of small and mid-sized Canadian entities;
- (b) has funds in excess of \$10 million under management or committed for investment;
- (c) is managed by full-time employees whose activities, powers and compensation are governed by contract;
- (d) has specific investment objectives, restrictions and strategies set out in its constating documents;
- (e) acts as a fiduciary in terms of predominantly managing funds owned by parties other than its managers; or, alternatively;
- (f) has been designated a Venture Capital Corporation by a Canadian Securities Commission or is a Labour Sponsored Venture Capital Corporation under the Income Tax Act.

This change will ensure that corporations which are associated only because they have accessed capital from the same venture capital source will not be disadvantaged for tax purposes. It is our understanding that Revenue Québec has recently announced changes which will ensure that common investments in corporations by certain providers of venture capital (including, Hydro-Québec, Société général de financement du Québec, the Business Development Bank of Canada and Innovatech) will not result in the investee corporations being associated.

4. More Equitable Tax Treatment for Cross Border Mergers

It is very common for growing technology companies to enter new markets and acquire new customers, employees, technologies and strategies through a merger with a complimentary business or even a competitor. Many early-stage technology companies routinely complete several mergers and/or acquisitions prior to achieving maturity as a successful business and generating any returns for their investors. Since the U.S. market is so large, and has such a dominant global presence in the technology industry, Canadian companies frequently seek to complete cross-border mergers with U.S. companies as part of their normal pattern of growth and development.

For a variety of business reasons, including the fact that early stage companies simply do not have excess cash for acquisitions, the overwhelming majority of these mergers are completed through a share exchange structure and not as a cash purchase. The company's shareholders receive shares in the combined company and no investor receives cash

proceeds in these transactions, since the risk-taking business venture has not yet achieved success, but is continuing.

When Canadian investors hold shares in Canadian companies which merge with other Canadian companies in this way, the investor receives a rollover such that no cash tax is payable until the investor actually receives cash proceeds for his investment. Similarly, when Canadian investors hold shares in non-Canadian companies, which merge with other non-Canadian companies, rollover treatment is also available. However, when a Canadian company completes a merger with a non-Canadian company –typical cross-border transaction– no such rollover is currently available. Canadian tax laws impose a cash tax obligation on Canadian investors who receive no cash, only high-risk illiquid shares in private companies, in these transactions. In these situations Canadian investors in early-stage technology companies are frequently put in a position where they are required to make substantial cash tax payments to Canadian tax authorities in respect of unrealized capital gains, long before they achieve liquidity and any opportunity to actually receive cash proceeds from their investment. This is clearly an untenable situation, particularly for founder shareholders who have significant shareholdings at a nominal cost base –therefore a substantial unrealized capital gain– and no cash proceeds from the transaction with which to pay the tax.

Since successful mergers and acquisitions are a key element of the success of many growing technology companies, this gap in Canadian tax law creates significant problems for many of them. Professional tax and legal advisors in Canada have created complex transaction structures designed to address this problem through the creation of so-called Canadian exchangeable shares. While these structures avoid the immediate tax problem, they create consequential problems under U.S. securities and tax laws, and they are needlessly time-consuming and expensive. In many cases, the original Canadian investors in the merged company end up with reduced liquidity for their investment relative to their U.S. counterparts and thereby become "second class citizens" in the company. By holding the exchangeable shares, these Canadian investors become ineligible to sell their shares under Rule 144, the standard mechanism for early stage investors to achieve liquidity under U.S. securities laws. It is common for these Canadian shareholders to be forced to delay a share sale by several weeks (or even months) after their U.S. counterparts are permitted to sell their shares – a severe disadvantage in highly volatile markets. The issue has become so severe that many Canadian entrepreneurs establish their new businesses as U.S. incorporated companies when they begin, driving capital market activity to U.S. lawyers, accountants and investment bankers and weakening Canada's financial industry.

Even where the U.S. merger partner is already publicly traded, it is frequently not possible for shareholders in the Canadian merged company to sell as a result of negotiated contractual commitments in merger agreements which restrict the ability of merging company shareholders to sell all of their stock immediately following completion of the transaction. The exchangeable share transaction also becomes much more expensive and complex in the public company environment, where the

exchangeable shares must be publicly listed on a Canadian stock exchange in order to avoid reclassification of the investment as foreign property.

There is no reason for Canadian companies to remain at this significant disadvantage. Canadian tax authorities do not currently receive any tax revenue from these transactions since there are no cash proceeds paid to the Canadian shareholders as a result of the exchangeable share structure. The result is unnecessary complexity which:

- imposes substantial additional transaction costs and delays on Canadian companies;
- puts Canadian investors at a significant liquidity disadvantage relative to their U.S. counterparts who have invested in the same company; and
- has no impact on revenues collected by Canadian tax authorities.

Recommendation:

The key issue is that cash taxes should not be payable prior to the time when cash proceeds are received by the taxpayer. The Economic Statement released in October 2000 indicated that the Department of Finance intended to develop a share-for-share exchange rollover which would allow shareholders of Canadian corporations to transfer their shares solely in exchange for shares of a foreign corporation on a tax-deferred basis. The Economic Statement further indicated that the Department would work in consultation with the private sector to develop these rules. The CVCA would be pleased to work with the Department of Finance in this regard. We believe it is important that the rollover be available in all circumstances where shares of a Canadian corporation are exchanged solely for shares of a foreign corporation and not be restricted to situations where one or both corporations are listed on a prescribed stock exchange.

5. Employee Stock Options in Canadian Controlled Private Corporations ("CCPCs")

The CVCA recognizes and applauds the significant steps taken by the Federal and other governments to reduce the burden of taxation on capital gains. In the CVCA's view, however, there remain certain problems, mostly of a technical nature, which are practical impediments to the encouragement of Canadian entrepreneurship.

For example, the Act provides that, where an employee exercises options acquired in connection with his or her employment to acquire shares of a CCPC and the employee holds the shares for a period of at least two years, the amount of the employment benefit conferred and otherwise required to be included in income (which is equal to fair market value of the shares at the date of acquisition less the exercise price) is reduced by 1/4. The 2000 Federal Budget proposed to increase the amount of the deduction to 1/3 and the Economic Statement and Budget Update¹ (the "Economic Statement") proposes to further increase the amount of the deduction to 1/2 of the employment benefit (to parallel

¹ Proposals from the 2000 Budget and Economic Statement are included in the Notice of Ways and Means Motion dated March 16, 2001

the change to the capital gains inclusion rate). This reduction results in the benefit being taxed at capital gains rates. However, the benefit is not a capital gain. It cannot be offset using the capital gains exemption that is available in respect of capital gains on qualified small business corporation shares nor can it be reduced by allowable capital losses.

Recommendation:

We propose that the Act be amended to permit the employment benefit conferred on the exercise by an employee of options which options have been vested for a minimum of two years to acquire shares of a CCPC to be treated as a capital gain eligible for the \$500,000 capital gains exemption and against which capital losses are deductible.

Investors or founder employees must hold shares in an eligible CCPC for a period of two years before being able to take advantage of the lifetime \$500,000 capital gains exemption. However, employees of these same companies who buy shares, through the exercise of stock options, must hold the shares for at least two years before they are eligible for the lifetime capital gains exemption, regardless of how long they may have held the options as employees before exercising the options. Provided the options have been vested for at least two years, they are in fact proxies for share ownership, or, alternatively, represent the requisite economic commitment to equity in the company. This proposal would eliminate the significance of the form in which employee holds his or her interest in the company.

6. Broader Rollover Privileges for Reinvestment in CCPCs.

The cycle of venture capital investment by professional investors involves three basic phases; the investment phase, the holding phase; and the harvesting or realization phase. Funds realized from the harvesting phase are recycled into new investments and the cycle begins again. In this light, it would be beneficial if the funds targeted for productive reinvestment enjoyed deferral from capital gains taxation. This principle was recognized in the 1999 budget.

The 1999 Budget proposed to allow individuals (other than trusts) to defer the recognition of capital gains realized on dispositions of shares of certain small business corporations where the share proceeds are used to acquire the shares of other small business corporations. The proposal was modified in the 2000 Economic Statement. The deferral will be available on up to \$2,000,000 of eligible small business corporation shares (by reference to adjusted cost base) in any particular corporation (or related group). The deferred capital gain reduces the adjusted cost base to the individual of the new shares and will be realized again when those shares are disposed of.

Recommendation:

The CVCA recognizes the steps taken by the Department of Finance in the 1999 Budget and the 2000 Economic Statement (now included in section 44.1 of the Act) to provide rollover treatment in these circumstances. However, in order to ensure that the maximum

amount of capital is available to small Canadian corporations, we are of the view that the proposal should be extended to be applicable to disposition of shares by taxpayers other than individuals, including corporations, trusts and partnerships.