IN FACT AND IN LAW

Taxation

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The Taxation of Venture Capital Financing

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*The issue of shares by a company to an existing or new shareholder can have significant tax consequences for a company, the subscriber and sometimes even the company's other shareholders. This is particularly true in the case of a new shareholder whose purpose is to invest in private companies (commonly known as a "venture capital company" and referred to in this newsletter as an "**investor**") since, in Quebec at least, it is frequently an institution with special tax status and this type of investor has interests in many other companies.*

The tax consequences resulting from an issue of shares to an investor may sometimes be subject to planning in order to minimize the negative aspects. Otherwise, the affected parties should be informed so that they may vote on the proposed share issuance knowingly.

*This newsletter, the third in a series of newsletters on venture capital financing, will give a brief overview of the most important federal and provincial tax consequences which normally result from a share issue for a company residing and operating in Quebec (referred to in this newsletter as a "**company**").*

CCPC Status

General

Status as a "Canadian controlled private corporation" ("**CCPC**") is important and favourable in many respects from a tax point of view and most small and medium-sized Quebec businesses benefit from it. This status is essential to fully benefit from the following tax measures:

- small business deduction ("**SBD**") which currently can represent significant annual tax savings;
- research and development ("**R&D**") tax credits;
- $500,000 capital gain tax exemption for shareholders of certain CCPCs when they sell their shares, which can represent a maximum tax saving of approximately $120,000 per shareholder;
- 5-year provincial tax holiday which can represent a maximum total saving of tax on capital and contribution to the health and social services fund of over $90,000 for the company.

Definition of CCPC

In general, for tax law purposes a CCPC is 1) a private company 2) which is a Canadian resident and 3) which is not controlled directly or indirectly by one or more entities which are not Canadian residents, which are public companies or by a combination thereof.

Control of a company is established at first by determining which shareholders hold shares allowing them to elect the majority of directors of the company. This analysis must take into account the number of voting shares of the company held by each of the shareholders as well as the specific

rights given to them in any agreement such as, for example, a shareholders agreement. Note also that any current or future right granted to one or more shareholders of a company respecting the voting shares or control of voting rights should generally be analyzed by assuming that it is already exercised.

Thus, for example, to the extent that a clause found in a shareholders agreement gives shareholders the right to purchase the shares of the company held by a shareholder withdrawing from the company, it could be argued that every shareholder has a potential right to the shares held by all the other shareholders. This provision could also apply to any right granted to a lender, shareholder or any other person to obtain the issue of shares of the company (warrants, options, etc.). Finally, an analysis of the CCPC status should take into account *de facto* control of the company. This concept may be difficult to determine.

Status of Venture Capital Companies

Investors can be classified into three broad categories:

- public or parapublic Quebec institutions (T^2C^2, SGF, CDPQ, Innovatech, etc.);
- private Canadian institutions ultimately controlled by resident Canadian private entities (FSTQ, entities of the Desjardins group, etc.); and
- foreign investors or those ultimately controlled by non-residents of Canada for tax purposes.

From a tax point of view, the third category seems at first glance to give rise to more difficulties since, to the extent that entities belonging to this category directly or indirectly control the company, it will lose its status as a CCPC and, naturally, the related tax benefits.

With respect to entities falling into the two other categories of investors, their tax status and its impact on the status of the issuing company as a CCPC should be analyzed based on the identity of each of them. Note, however, that investment in these entities generally does not make the issuing company lose its status as a CCPC either because they are not directly or indirectly controlled by public companies, non-residents of Canada or a combination thereof or because they are specifically excluded by tax laws from the category of shareholders which could make it lose its status as a CCPC. There are, however, several exceptions to this general rule, hence the need to analyze each specific case. Such analysis could, for example, warrant the amendment of certain provisions of the shareholders agreement in order to retain status as a CCPC.

Related Companies

General Comments and Tax Consequences

The concept of related companies is important with respect to many advantages given to companies in federal and provincial income tax statutes. Related companies must generally share many of these advantages. Such a measure is considered necessary by the tax authorities to avoid a proliferation of companies ultimately controlled by the same persons for the sole purpose of obtaining more overall tax advantages. The following tax advantages will therefore be reduced based on certain information concerning companies related to them:

- the $200,000 and $300,000 ceilings which can take advantage of the SBD must be shared among related companies;
- certain R&D tax credits will only be fully refundable if the total taxable income of related companies for the taxation year preceding the year in which the credits are claimed does not exceed $200,000;
- certain exemptions regarding special tax payable upon the payment of dividends must be shared between related companies;
- the 5-year provincial tax holiday will only be fully allowed if the company is not related to any other company during such 5-year period.

Definition of Related Companies

The rules defining under what circumstances companies are related are very complex. Once again, we will simply give an overview of them bearing in mind the subject of this newsletter—the subscription of shares by an investor.

In general, companies are related in the following situations:

- one of the companies controls the other;
- two or more companies are controlled by the same person or the same group of persons. In this respect, note that the concept of group of persons is much broader for purposes of the definition of related companies than the common meaning of the expression.

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The concept of control of a corporation for the purpose of determining whether two or more companies are related is substantially the same as for determining whether a company is a CCPC. However, this concept is the subject of specific presumptions for determining the relationship. For example, a person or group of persons holding shares having a fair market value greater than 50% of the fair market value of all the issued and outstanding shares of the company is deemed to control it. Finally, the future rights and obligations have the same impact on the definition of related companies as in the case of determining CCPC status; it is therefore important to pay particular attention to agreements giving this type of rights in determining the status of related companies.

Problem Specifically Related to Investors

The concept of control group is very broad for purposes of the definition of related companies and the number of investors involved in Quebec is relatively low. Therefore, it often happens that a group of institutional investors is in a position where it controls several companies. An issue of shares or the granting of certain rights in a shareholders agreement can thus give control of a company to a group of shareholders which controls or is deemed to control a number of other companies. As previously mentioned, such a situation may have adverse tax consequences for the company.

Provincial Measures to Ease the Burden

Aware of the problem, the Quebec tax authorities have set up measures to ease the burden, ensuring that certain institutional investors are in theory excluded from the entities which may be considered to form part of a control group for purposes of determining whether two or more companies are related. The entities thereby excluded include the Caisse de dépôt et placement du Québec, the Quebec Solidarity Fund (F.T.Q.), the Société générale de financement du Québec, Investissement Québec and Société Innovatech du Grand Montréal.

Thus, although some of these entities control different companies, those companies are not considered to be related and will continue to benefit from the tax advantages listed on page 2 under the heading *General comments and tax consequences*. This measure has obviously improved the situation of companies using venture capital. Several major investors are not, however, on the list of excluded investors. Our firm has been consulted in certain situations where private investors constituted a major group involved in several companies. The easing of the provincial burden does not have any consequence at the federal level, where the problem still exists. It appears, however, that the federal tax authorities are well aware of the problem. Contrary to the Quebec authorities, they have decided not to legislate. They instead do not apply the concept of control by the same group of institutional investors in cases where there is no abuse of the tax advantages prescribed by law.

Other Possible Tax Consequences

Excluded Corporation for R&D Tax Credits

The full refund of federal R&D tax credits depends on several factors, some of which were previously mentioned. It also depends on the company not being considered an "excluded corporation" within the meaning of the relevant provisions of federal tax law.

An "excluded corporation" is generally a company which is controlled by or related to:

- a person exempt from paying income tax;
- Her Majesty in right of a province;
- a Canadian municipality;
- a public authority;
- any combination of the persons referred to above.

The fact that the definition of excluded corporation refers to a company related to one of the persons referred to above considerably broadens the possibility that a company may be covered by it. We must therefore take into account the future rights discussed above.

An example of the application of the concept of excluded corporation is, if the SGF, which is controlled by the Province, were to subscribe for shares in the capital stock of a private company giving it 40% of its issued and outstanding voting shares. To the extent that the SGF, or any other entity included in the above list, has options for the issue of shares, and that it could thus be issued over 10% of the issued and outstanding voting shares of the company, SGF is an excluded corporation.

Part VI.1 Tax

As a general rule, Part VI.1 of the federal *Income Tax Act* requires the payment of tax varying between 25% and 50% of the amount of dividends paid on certain types of shares. This tax is payable by the company which pays the dividend. Institutional investors require rights which often mean that their shares constitute shares on which the dividends are subject to Part VI.1 tax. Thus, it is important to be especially careful in this respect.

Conclusion

Although they do not dictate the conditions on which a round of financing by investors will be concluded, the tax implications are significant and should be subject to in-depth analysis. This analysis will often bring out potential or actual adverse tax consequences. Proper planning will not always make those consequences disappear, but it could reduce them significantly.

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