

Reforming Section 116
Key to Opening Canadian Borders to Foreign Venture Capital
By: Stephen A. Hurwitz

Canada's venture capital industry is in trouble. That industry is seriously underfunded, while Canada's emerging technology and life sciences companies are so capital-starved they risk being uncompetitive in the North American market. At the same time, much needed and sought after US capital that could richly fund that industry and those companies is being blocked by Canada's cross-border tax laws.

In just how much trouble is Canada's venture world? Given the size of Canada's GDP and population relative to those of the US, Canadian venture capital firms and Canadian venture-backed companies should be receiving approximately 10% of the total funds invested in those entities in the U.S. In fact, in 2008 Canada's venture capital firms received only approximately 4% of all funds invested in US venture capital firms, and Canada's venture-backed companies received only approximately 4.5% of all funds invested in US venture-backed companies. These are devastating shortfalls.

In 2008, venture capital investment in Canadian companies was at its lowest level in twelve years. In the same year, Canadian venture-backed companies raised, on average, \$3.6 million, as compared to \$9.5 million for US venture-backed companies. Yet these undercapitalized Canadian companies must directly compete in the same North American market with these far-better financed US companies. Hobbled by having a fraction of the capital of their direct competitors, many Canadian companies are forced to be sold early in their life cycles long before they obtain industry leadership. These sales are frequently to large US companies, and often at low prices.

The result – Canada is losing much of the benefit of its outlay each year of approximately \$9 billion in direct funding to universities and hospitals for R&D and in indirect funding of Canadian businesses through R&D tax credits. Rather than ultimately benefitting Canada, this extensive R&D funding has become, in effect, a subsidy to US businesses that acquire these promising Canadian companies cheaply, then reap the financial rewards when those companies achieve industry leadership. Worse still from a Canadian perspective, these companies are often then moved in their entirety to the US, resulting in loss of Canadian jobs and Canadian tax revenues. While public concern is sometimes expressed as to the perceived “hollowing out” of Canada with respect to its large resource/infrastructure industries, a very real and persistent “hollowing out” of Canada is occurring through early acquisitions of its most highly promising technology companies representing the future of Canadian innovation.

In addition, fundraising by Canadian venture capital firms in 2008 was at its lowest level in thirteen years. Because Canadian venture capital firms lack funds to finance Canada's emerging technology and life sciences companies in amounts needed for them to become industry leaders in North America and beyond, the investment performance of Canadian venture firms – ten-year horizon returns of 1.7 percent – dramatically lags their US venture capital counterparts' 18.1 percent returns. Because investing in venture firms involves greater risk than investing in the

public stock markets, a country's venture industry must achieve returns exceeding those of such markets to compensate for that risk if it is to be sustainable. Canada is failing that test.

This pervasive underfunding at every level is a cause of a dangerous downward-cycle in Canada's venture capital and emerging company worlds. The less funding Canadian venture capital firms receive, the less they have to invest in Canadian emerging companies. The more these emerging companies are underfunded, the less competitive they are. The less they succeed in their marketplace, the worse the resulting performance of the venture capital firms that fund them. The worse the performance of those venture firms, the greater their difficulty in securing their own funding from institutional and other investors. And so this toxic downward cycle goes, continuously reinforcing underperformance for Canadian entrepreneurs and venture capitalists alike.

But, Canada has a giant US neighbor with billions of dollars of institutional money that can contribute to the funding of its venture industry and billions of dollars in venture capital that can help fund its emerging technology companies, not to mention the accompanying human capital in the form of extensive knowledge of the vast US market and broad network of significant US customers, distributors, suppliers and executives. Rather than capitalize on this opportunity and welcome this money, Canada's cross-border laws thwart them at every turn.

How are Canada's cross-border laws thwarting entry of this much needed foreign capital?

The Canada – US tax treaty provides that investors of each country, when investing in the other, will be taxed on investment gain only once – in the investor's home country. For example, a Canadian venture capitalist investing in a private US company will be taxed only in Canada on its gain upon sale, and not in the US. The US strongly encourages Canadian investment in the US by automatically recognizing a Canadian investor's treaty exemption from double taxation – no paperwork – no delay – no withholding – and the Canadian VC is immediately free to take its sale proceeds back to Canada.

In sharp contrast, US venture capital firms investing in Canada face nightmarish red-tape and delays to achieve the same reciprocal treaty benefit in Canada. When selling shares in a private Canadian corporation, they must apply for a "Section 116" clearance certificate to one of 45 Canadian government offices that grant it. An application is required for every investor in a US venture fund, and many funds have dozens or even hundreds of investors. A single stock deal can literally require hundreds of applications and hundreds of signatures. One US venture capital firm in a single transaction had to obtain almost 900 signatures in connection with a Section 116 processing.

Inconsistent practices and procedures in these 45 Canadian offices, wholly unpredictable in their timing and requirements, often lead to protracted waits of up to four or eight months (waits of one to two years are not unheard of) for US venture investors. Further, 25% of the gross sale proceeds must be withheld by the buyer from the outset until the Section 116 clearance certificate is granted and the proceeds then released to the US venture firm. When those withheld proceeds are in stock of a listed public company buyer, the stock value can plummet if during the long wait there is a decline in the public market, which can cost US investors thousands, if not millions, of dollars. To add insult to injury, usually more than 25% of the gross

sales proceeds are withheld when in the form of shares to compensate for any potential downturn in the stock price while withheld.

These same US venture investors may also have to deliver copies of their prior US tax returns and must obtain Canadian taxpayer ID numbers and file Canadian income tax returns – even though in virtually every case no Canadian tax is ultimately due as most foreign parties are exempt under the treaty. Worse still, the charters of many US venture firms prohibit them from investing in countries where foreign or past private tax returns must be filed by their investors.

Because of these administrative burdens and economic risks of delay, many US venture investors just say no to investing in Canada. Those that do invest must engage in complex, expensive and time-consuming legal acrobatics to escape the administrative hurdles, such as forming a Luxembourg or Barbados subsidiary (but only after an assessment of its legality under Canada's anti-avoidance tax laws), or doing a convoluted reorganization of the Canadian investee company into a wholly-owned Canadian subsidiary of a newly-formed Delaware holding corporation. If these reorganizations are not done with the greatest of care, serious consequences can ensue, including the Canadian subsidiaries losing huge amounts in Canadian tax benefits (scientific research and experimental development refundable tax credits) and existing Canadian shareholders losing significant personal tax benefits, as well as labor sponsored and other government subsidized Canadian venture capital firms becoming ineligible investors in these subsidiaries. Further, the legal costs of such a reorganization are high, sometimes exceeding \$400,000, which amount could go a long way to assist in completing a new technology product or a new clinical trial or funding a much needed marketing campaign for a promising Canadian company.

Because most US venture investors choose the Delaware corporation alternative as the lesser of the two evils, a growing number of Canadian technology companies are becoming Delaware corporations. It is ironic that existing Canadian public policy is forcing many of Canada's most promising venture-backed technology and life sciences companies to become Delaware corporations.

The tax clearance process generates virtually no tax revenue for Canada, because almost all US venture firms and their investors are exempt under applicable treaties with Canada from paying Canadian tax. This process intended to assure treaty compliance instead frustrates an important goal the treaty should achieve: furthering cross-border investment.

It should be remembered that these worrisome Canadian cross-border rules apply not only to US VCs investing in Canadian emerging companies, but also to other US private equity groups, as well as to US institutional investors when investing in Canadian venture capital and other private equity firms. Thus, these Canadian cross-border rules starve the entire Canadian venture capital ecosystem of much needed funding.

In short, Canada's cross-border laws needlessly thwart hundreds of millions of dollars in much needed and sought after foreign venture capital from entering Canada. The cost to Canada is the potential loss of untold jobs and millions of dollars in tax revenues that successful investments can create. Canada's predicament will only worsen as other countries – from emerging giant players such as China and India to smaller, competitive jurisdictions such as Ireland and Israel – take increasingly vigorous stands to attract foreign capital.

The federal Canadian government has removed restrictions on investments by a Canadian pension plan in “foreign property” **outside of** Canada that exceeds 30 percent of all its property. To an outside observer, it seems extremely odd that, despite such a move, major tax impediments to the flow of a much larger pool of US institutional and private equity capital **into** Canada remain unaddressed. So there is an anomaly – while there are neither Canadian nor US restrictions on millions of dollars of scarce Canadian institutional and venture money leaving Canada (potentially in vastly growing amounts) and being invested into the US, Canada makes it extremely difficult for much needed US capital to be invested into Canada. In short, Canada has a “post-NAFTA” position as to the unrestricted cross-border flow **out of** Canada of capital vitally needed by its own venture capital industry, while maintaining a “pre-NAFTA” position severely restricting the cross-border flow **into** Canada of capital for its venture capital industry.

Unlike Canada, neither the US nor the UK discourages cross-border investments into their respective countries through any similar tax clearance certificate process. There is, however, a silver lining in this problem – it can be easily fixed. The following solution was presented to the Canadian government for consideration in its 2009 Budget by John Ruffolo, Chair of the Tax Policy Committee of the Canadian Venture Capital & Private Equity Association. I believe his proposal has full support of the venture capital industries in both Canada and the US and would solve the Section 116 problem once and for all:

Canada currently defines taxable Canadian property (TCP) to include shares of a private corporation resident in Canada. At the same time, Canada’s tax treaties cede taxes jurisdiction to the country where the non-resident vendor is resident, provided the shares do not derive their value principally from real property (including resource property and timber property). Based on the large number of tax treaties Canada has concluded, it appears that Canada is prepared to exempt from taxation all gains realized by non-residents, other than gains from the disposition of real property. In light of this treaty policy, we believe that Canada should adopt a broader exemption in its domestic law to exempt gains realized by non-residents other than those arising from the disposition of real property. We see little benefit in providing the exemption only on a bilateral basis. The benefit of a broader exemption is that it would make Canada a more attractive destination for equity investment by non-residents, and in particular, venture capital and private equity funds. A broader exemption would also reduce a significant compliance burden that acts as an impediment to foreign direct investment in Canada. Recently enacted changes regarding the Section 116 clearance certificate process did not address the issue and are unlikely to reduce the number of situations involving arm’s length transactions in which clearance certificate are obtained.

We would propose to amend the definition of TCP in subsection 248(1) to exclude the shares of private corporations, except for shares of private corporations whose value is specifically derived from real property, resource property, or timber property situated in Canada.

This proposal would be consistent with how Canada currently taxes most gains realized by non-residents. As stated in 2008 Federal Budget Commentary, “most tax treaties allow Canada to tax capital gains only on Canadian real and

resource properties and on shares of companies that derive most of their value from such properties.” Under this proposal, non-residents of Canada would not be subject to withholding under Section 116, nor be required to file Canadian tax returns in respect to dispositions of Canadian private corporations, except to the extent the value of the shares was principally derived from Canadian real and resource properties. This alternative would significantly streamline the administrative process for non-resident vendors and lessen the tax barriers to foreign investment in Canada.

This proposal is the only one presented from any source to date that, if adopted, would truly solve the Section 116 problem and over time result in a significant increase in much needed US (and other foreign) capital for Canadian innovation without adverse fiscal effect on Canada. Mr. Ruffolo’s proposal was ignored in the federal Canadian 2009 Budget.

The benefits of a healthy venture capital industry for a nation’s economy and society that reforming Section 116 would advance are best illustrated by an example. In a recent year, venture capital investment in the US equaled 2/10 of 1% of US GDP, while in the same year revenues from venture capital-backed US companies equaled almost 18% of US GDP. That is a multiple of almost 90.

A recent prominent study further highlights the continuing harm to Canada from failing to reform Section 116. In 2007, the accounting firm of Deloitte did a major international venture study revealing that 40% of US venture capital respondents and 28% of global venture capital respondents cited Canada’s unfavorable tax environment as a key reason for not investing in Canadian companies. This concern as to investing in Canada was at a level **five times higher** than for any other country in the survey. This Deloitte report is in the hands of major venture capital firms all over the world, and this adverse finding is likely to further worsen Canada’s venture financing predicament.

If Canada’s venture capital and emerging company industries remain chronically underfunded, much of Canada’s billions of dollars of investment in R&D could be lost and its intellectual capital squandered and future growth imperiled.

Investment money has no nationality and should be borderless. Canada should change its cross-border laws to enable its venture firms and emerging companies to freely access much needed international capital.

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