

# Blakes Bulletin

## Private Equity

### 2010 Canadian Federal Budget Significantly Narrows Taxation of Non-Residents Investing in Canadian Equity

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In its Budget delivered on March 4, 2010, the Government of Canada announced a significant liberalization of Canadian tax laws applicable to foreign investors in Canadian businesses. Effective immediately, non-resident investors will no longer be subject to the existing tax, withholding and compliance burdens applicable to equity dispositions, except where the equity constitutes a real property interest. Equity will generally be a real property interest at a point in time only where the equity derives (or did, at any time in the preceding 60 months, derive) more than 50% of its value from Canadian real property, including resource property. This will eliminate the burdensome and invasive "section 116" compliance and withholding regime in most cases involving an exit from a Canadian business by way of share sale. These changes also call into question in many cases the continuing need for offshore "blocker" entities.

#### CURRENT TAXATION OF NON-RESIDENTS, SECTION 116 CERTIFICATES AND TAX RETURNS

Non-residents are taxable in Canada on gains realized from dispositions of "taxable Canadian property" (TCP), subject to tax treaty protection.

Unlike most developed countries, Canada's domestic tax statute taxes foreign investors on gains from sales of shares of any private Canadian corporation. Most of Canada's tax treaties exempt such gains from tax except where the shares are a real property interest. However, the process of establishing entitlement to the exemption has proved burdensome, especially in the private equity context where the identity and treaty status of all investors in a partnership would need to be disclosed in order to obtain a "section 116" compliance certificate, which is needed to avoid purchaser withholding.

Under existing rules, a non-resident disposing of TCP must generally provide a section 116 certificate issued by the Canada Revenue Agency (CRA) to the purchaser. If no certificate is provided, the purchaser will withhold and must remit 25% of the purchase price to CRA.

After reviewing a section 116 application, CRA will issue a certificate upon either (i) payment by the non-resident of a proxy for the capital gains tax owing, or (ii) being satisfied that the gain is treaty-exempt (in which case no payment is required). If a payment is remitted to CRA, the seller will have to file a Canadian tax return and claim a refund of all or part of the remitted amount (depending on whether a treaty exemption is available).

The section 116 withholding and compliance regime has been a major irritant in many cross-border transactions. It typically takes CRA six months or more to complete its review. In some cases, it can take over a year. Selling shareholders are usually entitled to treaty protection, but the process of proving that entitlement requires disclosure of significant information regarding the identity and treaty status of the seller (including, where applicable, each member of a selling partnership). In the meantime, non-resident sellers typically have 25% of their proceeds tied up in escrow while they wait for CRA to complete its review. New elective rules were introduced at the beginning of 2009 which were intended to streamline the process. However, those rules were widely believed to be defective and generally have not been embraced by the market.

Any non-resident person disposing of TCP, including all partners, must also file a Canadian tax return, unless a section 116 certificate is obtained and no tax is payable, or the disposition is treaty-exempt.

These tax considerations have meant that most private equity funds, which are often structured as limited partnerships, have not been able to invest directly in Canadian private company shares without subjecting each of their investors to Canadian section 116 and tax return compliance obligations. For most private equity

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funds, this prospect is a non-starter and so investments have been made through "blocker" entities in third countries.

### **WELCOME CHANGES TO THE DEFINITION OF TCP**

The Budget proposes to dramatically narrow the definition of TCP to exclude shares of corporations, and partnership and trust interests, that are not real property interests.

For this purpose, a real property interest is generally a share or other investment that derives more than 50% of its value, at the time of disposition, or at any time in the preceding 60 months, from real property situated in Canada (including resource property). As a result of these amendments, non-residents will no longer be taxable on dispositions of Canadian equity except where the equity is a real property interest. It is hoped that the detailed legislation implementing this change will provide some measure of protection to a purchaser who makes a reasonable inquiry as to the status of the investment as a real property interest. However, it is not clear at this time whether such a due diligence defence will be available. In any event, some degree of inquiry will likely be needed to confirm that a particular investment is not a real property interest.

Correspondingly, the amendments will generally eliminate section 116 compliance and tax return filing obligations in respect of such dispositions. The Budget materials state that this measure will bring Canada's domestic tax rules more in line with its tax treaties and the tax laws of its major trading partners, and improve the ability of Canadian businesses to attract foreign venture capital.

These changes will apply to dispositions made after March 4, 2010. While the Budget is not yet law, there is to date no indication that the government will fall over the Budget, and it is expected that these proposed amendments will be passed. Similar changes are expected to be made by the Government of Quebec to its TCP and section 116 regime equivalents.

### **ARE BLOCKERS STILL NECESSARY?**

Do these proposed changes also mean the end of offshore blockers? Not necessarily in all cases. Canada still imposes withholding tax at the statutory rate of 25% on the payment of dividends, royalties and, in the case of non-arm's-length recipients, interest. If such payments are made directly to a private equity fund, entitlement to reduced withholding tax under one or more tax treaties will depend on the Canadian payor being satisfied as to the entitlement of the recipients to treaty protection. If a blocker is used, the payor need only be satisfied that the blocker is entitled to treaty protection. Further, under many treaties, a corporate shareholder is subject to just 5% withholding tax on dividends if it owns a 10% or greater interest in the Canadian payor (as opposed to the standard treaty rate of 15%). There still may be a role for blockers, especially where an investment is internally financed or periodic distributions of dividends are expected. In many other cases, however, especially where the main focus is on a future exit, the need for offshore blockers will be eliminated.

These proposed changes are welcome news for non-resident private equity funds looking to invest in Canada and those with existing investments. With the exception of investments in real property interests, funds no longer have to worry that a large portion of their sale proceeds on exit will be tied up for months while waiting for the section 116 review to be completed. In some cases, they may also be able to avoid the use of more complex blocker structures that are costly and time-consuming to implement and maintain.

The Budget contains other proposals that may be of interest to private equity investors. Such proposals are discussed in our March 2010 [Blakes Bulletin on Tax: 2010 Federal Budget](#).

For further information, please contact a member of our [Tax Group](#) listed on the following page, or a member of our [Private Equity Group](#).

## Private Equity

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