



Cassels Brock & Blackwell LLP

## Presentation to Jones Day Cleveland

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Private Equity Investment in  
Canadian Corporations

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## Canadian Tax Considerations



- Canadian tax considerations generally applicable to non-residents (“NR”) of Canada investing in Canada applicable to private equity (“PE”)
- There are additional tax considerations applicable to PE

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## General Tax Considerations



- Canadian federal/provincial corporate tax rates are very competitive and decreasing (i.e. based on proposals the combined federal/Ontario general corporate tax rates are as follows: 2009: 33%; 2010: 30%; 2011: 28%; 2012: 26%; 2013 and beyond: 25%)
- Comparative Canada/US corporate tax rates do not generally favor shifting income to the US

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## General Tax Considerations



- Purchase of shares versus assets is a threshold decision
- Generally a Canadian acquisition corporation (“Buyco”) is used to buy shares of Canadian target (except for portfolio investments) (“Target”)
- If Buyco borrows funds to make the purchase, Buyco and Target amalgamate so that the interest expense offsets the operating income
- No increase in the tax basis of assets to fair market value of a Target on a share purchase (except under very limited circumstances)
- No consolidation in Canada

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## General Tax Considerations



- If there is “internal leverage,” to obtain increased interest deductions in the Target, debt/equity ratio of Target must comply with the “thin-capitalization” rules or otherwise excess interest is not deductible
- Interest, dividends and royalties payable by a resident of Canada to a NR subject to a statutory rate of 25% unless exempt under *Income Tax Act* (Canada) (“ITA”) or under a tax treaty

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## General Tax Considerations



- Under the ITA, there is no withholding tax on interest paid by a person resident to a NR with whom it deals at arm’s length, provided interest is not “participating” (this replaces the old 5/25 exemption)
- The Canada-US Tax Convention (the “US Treaty”) also provides an exemption for related party interest to be phased in

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## General Tax Considerations



- NR subject to tax on a disposition of “taxable Canadian property” (“TCP”) subject to relief under a tax treaty
- TCP includes shares of a private Canadian corporation, and shares that are publicly listed, if at any time during the 60-month period prior to sale the NR and/or non-arm’s length persons owned 25% or more of the issued shares of any class of the corporation
- A NR vendor will always want to sell shares of a top tier Cdn. holding company if treaty benefits are to be claimed rather than have a Cdn. holding company sell the shares of a Cdn. operating company

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## General Tax Considerations



- NR will be subject to certain tax compliance obligations discussed below
- Canada extends tax treaty benefits (e.g. reduced withholding rates, and exemptions) to partners of a partnership based on the tax treaty between Canada and home jurisdiction of each partner

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## Section 116 Clearance Certificate Procedure



- A NR must notify the Canada Revenue Agency (“CRA”) of any disposition of TCP and obtain a certificate of compliance (“Clearance Certificate”) under section 116 of the ITA, unless the new rules which provide relief from the filing obligations apply
- Quebec has its own clearance certificate regime
- The NR vendor is required to apply for a Clearance Certificate no later than 10 days after the disposition
- There is a potential purchaser liability of 25% of the amount by which the cost of shares (there are higher withholding rates for other types of property - e.g. inventory) exceeds the Clearance Certificate limit, if any

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## Section 116 Clearance Certificate Procedure



- If there is no Clearance Certificate produced by the NR vendor, the purchaser’s liability is 25% of purchase price regardless of the amount of the gain (or loss)
- The purchaser’s remittance deadline is 30 days after end of month of disposition. In view of insufficient time, CRA may issue “comfort letters” deferring the remittance date to allow time for processing to verify treaty relief
- Absent a Clearance Certificate or a CRA “comfort letter”, the purchaser will withhold on closing 25% of the purchase price (funds are placed with a third party such as a law firm) to avoid this liability

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## Section 116 Clearance Certificate Procedure



- Amendments were made to section 116 effective for dispositions after 2008 (“New Rules”) to provide some relief to NRs such that the NRs will not be required to obtain Clearance Certificates, and there will be no liability of the purchaser, in certain circumstances
- A Clearance Certificate is not required in respect of dispositions of TCP that qualify as “excluded property” (which includes a property, that is, at that time of its disposition, a “treaty-exempt property” of the person)

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## Section 116 Clearance Certificate Procedure



- The purchaser should have no liability and therefore should not withhold if:
  - The purchaser concludes, after reasonably inquiry, that the vendor is, under a tax treaty between Canada and another country, resident in that other country;
  - The property would be “treaty-protected property” if the vendor were resident of that country; and
  - The purchaser complies with new notice requirements
- The New Rules will only be of practical benefit in related party transactions
- In practice, we expect that the purchaser will require the vendor to file for a Clearance Certificate and will withhold consistent with past practice.

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## Section 116 Clearance Certificate Procedure



- A NR vendor is required to file an income tax return under the ITA disclosing the disposition of TCP, unless there is no tax payable in respect of the year or a previous year, and property is “excluded property” (e.g., property that is, at the time of its disposition, a treaty-exempt property of the person) or property in respect of the disposition of which the Minister has issued to the NR a Clearance Certificate

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## Section 116 Clearance Certificate Procedure



- The Clearance Certificate procedure has been an annoyance to NR partners of a partnership, their legal advisors and in particular PE funds
- This is because all the tax compliance obligations apply to each partner and each partner must apply for treaty benefits if available under the applicable tax treaty
- These rules have led many PE funds to invest in Canada through a “blocker” (as discussed below) - the section 116 requirement will only apply to the NR “blocker” that will presumably be entitled to treaty protection

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## Section 116 Clearance Certificate Procedure - LLCs



- The question has arisen as to the effect of changes to the administration of section 116 to LLCs and its members
- The recent Fifth Protocol to the US Treaty (“Protocol”) extends treaty benefits to US resident members of a LLC (subject to the Limitation of Benefits Provision – “LOB”)
- The LLC remains the taxpayer from a Canadian tax compliance perspective

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## Section 116 Clearance Certificate Procedure - LLCs



- The Technical Notes to the Protocol states that the LLC must file under section 116 and that the LLC must document eligibility for treaty benefits based on the member’s eligibility
- This filing requirement will be manageable if there are just a few members, or all the members of the LLC are entitled to treaty benefits
- It is doubtful that this approach will be acceptable in other situations
- Consequently, it may remain advantageous for PE funds that are LLCs to still use “blockers”

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## Use of “Blockers”



- Onerous Canadian tax compliance led many PE funds to use “blockers” in low tax jurisdictions which have a favourable tax treaty with Canada
- Also, some tax treaties (e.g. Luxembourg) have gain protection provisions that provide more protection in respect of securities deriving their value from certain real property than provided by the gain protection provisions in the US Treaty
- There must be suitable “substance” in the “blocker” country from a Cdn. perspective

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## “BLOCKERS” - Dutch Co-op



- Examples of “blockers” are Dutch Co-ops (“Co-op”) and Luxembourg SARLs (“SARL”)
- Note that the Protocol has the only comprehensive LOB provision in any of Canada’s tax treaties
- CRA attempted unsuccessfully to apply the general anti-avoidance rule (“GAAR”) to treaty shopping in *The Queen v. MIL (Investments) S.A.* 2007 DTC 5437 (FCA)

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## “BLOCKERS” - Dutch Co-op



- The Co-op must have two members (e.g. 2nd person such as a LLC has a nominal interest)
- Funding will depend on whether the Co-op will earn investment income (if so, it should be funded with debt)
- No capital tax on contributions to equity
- The Co-op will be subject to Dutch corporate tax, but there is a “participation exemption” to exempt certain dividends and gains

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## “BLOCKERS” - Dutch Co-op



- If there is interest income, the Co-op can be leveraged (but there must be a margin)
- Subject to a tax ruling, members of a Co-op should not be subject to Dutch corporate tax for income and gains derived from a membership interest
- Distribution of profits and interest payments should not be subject to Dutch withholding tax
- A Co-op may be entitled to benefits under the Canada-Netherlands Income Tax Convention

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## **“BLOCKERS” - Luxembourg SARL**



- No capital tax for a SARL
- Sarls are very often funded with “preferred equity certificates” (“PEC”)
- A SARL will be subject to Luxembourg tax, but “participation exemption” may apply to gains and dividends
- Interest income subject to tax but can be leveraged with loans from PECs held by the PE fund

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## **BLOCKERS – Luxembourg SARL**



- US PE fund not liable for Luxembourg corporation tax (unless disposal of shares within six months)
- Dividends from SARL are in principle subject to a withholding tax, unless it is a liquidation distribution
- No withholding tax on return paid on PECs/Convertible PECs
- Interest payments made by SARL not subject to withholding tax

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## Hybrid Entities



- Unlimited liability companies (“ULCs”) very widely used by US investors in investing in Canadian businesses because of the US “check-the-box” rules
- The Protocol can deny treaty benefits for income derived from a ULC commencing in 2010 if the ULC is fiscally-transparent (consider dual member ULC)

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## Hybrid Entities



- In acquisitions, consider whether ULCs should still be used
- A “blocker” can be interposed between a ULC and a US PE fund and benefits will be available under the treaty between Canada and the jurisdiction of the “blocker”

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## Canadian Tax Representations and Warranties



- Will differ from standard US tax reps in several respects
- Acquisition of control of the corporation triggers a taxation year-end
- There is no consolidation in Canada
- Specific rules in the ITA vs. the Code
- Need for a representation as to tax residency

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## Foreign Investment in Canada



- *Investment Canada Act* applies to
  - all acquisitions of “control”
  - of a “Canadian business”
  - by “non-Canadians”
- If applies, either pre-closing review or post-closing notification
- “Net benefit” test
- “National security” test

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## Foreign Investment in Canada (cont'd)



- Reviewable Investments
  - Direct investments
    - Canadian business worth \$600 million (WTO investors)
    - Canadian business worth \$5 million (non-WTO investors)
  - Indirect investments
    - Non-reviewable if WTO investor
    - Canadian business worth \$50 million (non-WTO investors)
  - Acquisition of cultural business

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## Foreign Investment in Canada (cont'd)



- Cultural Business (Reviewable by Canadian Heritage)
  - Publication, distribution or sale of books, magazines, periodicals or newspapers
  - Production, distribution, sale or exhibition of film or video recordings, audio or video music recordings
  - Publication, distribution or sale of music
  - Broadcasting

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## Foreign Investment in Canada (cont'd)



- 45-day review period with right to extend for additional 30 days
- Investors are generally required to give undertakings to satisfy “net benefit” test
  - Continued role for Canadians
  - Maintenance of Canadian operations
  - Continued investment in Canada

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## Foreign investment in Canada (cont'd)



- Notifiable investments
  - Pro-forma filing made within 30 days of closing
  - Minister may review, but very unlikely

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## Competition Act – Pre-Merger Notification



### Two primary thresholds

- “Size of Transaction”
  - Target must have assets in Canada or gross revenues in or from Canada over \$70 million

AND

- “Size of Parties”
  - Parties, together with their respective affiliates, must have assets in Canada or gross sales in, from or into Canada, with an enterprise value of over \$400 million

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## Competition Act – Pre-Merger Notification



- Definition of “affiliate”
  - Key issue is control
  - ownership of over 50% voting shares or partnership interest
  - Includes both upstream and downstream affiliates

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## Competition Act – Pre-Merger Notification



- Additional thresholds for share acquisitions
  - If acquire more than 20% of voting shares of public corporation or 35% of voting shares of private corporation
  - If already over 20/35%, notification required if increase shareholding to over 50% (acquisition of control)
  - Includes affiliates' shareholdings

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## Pre-Merger Notification (cont'd)



- US-style merger review process
  - Initial 30-day waiting period
  - Waiting period stayed if Commissioner requests additional information
  - Further 30-day waiting period runs from the time information is provided

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## Substantive Review



- Independent of notification requirement
- Statutory test
  - Does the merger result or is likely to result in a substantial prevention or lessening of competition

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## Canada Transportation Act



- Notification under *Canada Transportation Act*
  - Applies to acquisitions of a “transportation undertaking”
  - Triggered by *Competition Act* notification
  - Statutory test
    - Does transaction raise any “issues with respect to the public interest as it relates to national transportation.”

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## Form of Purchase Agreement



- Canadian share and asset purchase agreements are generally similar to American forms.
- Common changes:
  - Changing references to applicable federal and provincial legislation.
  - Changing tax references to reflect Canadian vs. US tax rules.
  - “Not a non-resident” – avoiding withholdings under s. 116 of the *Income Tax Act*.
  - Spelling and terminology differences.

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## Purchase Price Adjustments/Holdbacks



- Common practice to include a holdback from the purchase price:
  - Settle post-closing adjustments to the purchase price; and
  - Fund for indemnification claims.
- Escrow agents - common for counsel to one of the parties to act as escrow agent. It is less typical for the parties to use a third party commercial escrow agent.

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## Indemnities



- Caps/Ceilings: Customary for indemnification obligations to be capped at the total amount of the purchase price (vs. US practice of capping obligations at a portion of the purchase price).
- Exceptions – e.g. environmental.
- Baskets: Indemnification baskets common.
- Threshold baskets vs. deductibles basket.
- Basket amount of 1% of the total purchase price, depending on transaction size.

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## Survival Periods - *Limitations Act, 2002*



- Representations relating fundamental matters survive indefinitely, e.g. corporate existence, authority and qualification.
- For tax and other matters with statutory limitation period, survival will be tied to such limitation period.
- All other representations is generally from 12 months to 2 years.
- However, note the Ontario *Limitations Act, 2002* - limits the time period during which initiate court proceedings can be initiated.
- Basic limitation period vs. ultimate limitation period.

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## Survival Periods - *Limitations Act, 2002*



- “Business agreements” exception allows variance or exclusion of basic limitation period and variance of ultimate limitation period (can be suspended or extended only if the relevant claim has been discovered.)
- Indemnity provisions - not possible in the business agreement, as first entered into by the parties, to extend or suspend its running past the ultimate limitation period.
- Analogous legislation for other provinces (not all have the business agreement exemption).

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## Other Considerations



- Arbitration –Less common in Canadian agreements. There is less concern in Canada over juries awarding large and unpredictable settlements for damages.
- Opinions –Remains common practice in Canada for counsel to insist on the delivery of opinions from opposing counsel on most M&A deals, especially share purchase transactions.

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## Employment Law



- Unlike, the US Canadian employment and labour law is more employee and union friendly.
- No at will employment law concept.
- Less severe awards in disputes.
- Termination for cause very difficult to prove.

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## Employment Law



- Ontario – where employees are terminated without cause, entitled to notice of termination (or pay in lieu of notice);
- *Employment Standards Act* minimums; subject to common law increases.
- Sale of business – purchaser responsible severance costs for pre-closing service period.
- Due diligence must include assessment of potential severance costs.
- Allocate responsibility for post-closing severance.

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## Restrictive Covenants



- Non-competition covenants are very difficult to enforce in an employment context.
- Consider non-solicitation covenants.
- Non-competes are more enforceable on the sale of a business.
- Scope of covenant must be reasonable.
- Canadian courts will not “blue pencil” covenants.

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## Environmental Law



- Legislation is typically provincial; generally no more stringent than US laws.
- Clean up costs – “care, management and control” – in present and past.
- Extends to lessees as well as owners.
- Phase 1 and Phase 2 assessments usual practice for purchasers and lenders in due diligence.

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## Securities Laws



- Sale of securities in Canada is highly regulated, primarily through provincial and territorial legislation; no federal securities regulator.
- Private equity transactions rely on prospectus and registration exemptions.
- “Accredited investor” – includes Canadian financial institutions and entities with net assets over a certain amount (\$5,000,000 currently).
- “Private issuer” exemption.

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## Forming the Purchaser



- Companies can be incorporated provincially or federally.
- Ontario *Business Corporations Act* (“OBCA”); *Canada Business Corporations Act* (“CBCA”).
- Unlimited liability companies an option in certain provinces; US tax planning considerations.
- Requirements for resident Canadian directors.
- 25% of directors of an Ontario or federal corporation must be Canadian residents (or at least one if less than four directors).

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## Forming the Purchaser



- Which jurisdiction to choose?
- A CBCA company may, as of right, conduct business in any province.
- May be extra-provincial licensing requirements.
- “NUANS” name searches - for CBCA companies, search across Canada, less likely there will be a confusing name already registered in another province.
- Amalgamation –companies must be incorporated in same jurisdiction.

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## Canadian Acquisition - Financing Issues



- Introduction
- Legislation is similar to Articles 8 and 9 of the UCC
- Provincially governed
- PPSAs, *Bank Act*, IP legislation

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## Canadian Acquisition - Financing Issues



### Requirements for Perfection

- Rights in collateral
- Value must be given
- Written security agreement
- Registration

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## Canadian Acquisition - Financing Issues



### Registration Considerations

- Where to Register?
- Bank Accounts
- Secured Party Acknowledgements
- Motor Vehicles
- Quebec Issues
- Real Property

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## Canadian Acquisition - Financing Issues



### Issues in Pledging Securities

- *Securities Transfer Act* is similar to Article 8 of UCC
- Delivery of Certificates and Endorsements for “control”
- Resolution from the board of the issuer

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## Canadian Acquisition - Financing Issues



### Other Issues

- Guarantees
- Usury Laws and Penalties after Default
- Recognizing and Enforcing Foreign Laws in Canada
- Judgements in Canadian Currency
- Move to IFRS

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The image features a dark blue header at the top. Below it, on the left, is the Cassels Brock Lawyers logo, which consists of a stylized 'C' and 'B' in white and gold, with the text 'CASSELS BROCK' in white and 'LAWYERS' in gold below it. To the right of the logo is a photograph of a conference room with a long wooden table and several black chairs. The bottom section of the image is a light beige background with the website address 'www.casselsbrock.com' in dark blue text.

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