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Canadian Government Changes Tax Regime to Encourage US Venture Investment

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On March 4, 2010, the Canadian Government announced a long-awaited change to the tax regime governing foreign investments in Canadian businesses. The change, if passed into law, would make it much simpler for U.S. venture capital funds to invest in Canadian companies by relieving an administrative burden and eliminating any Canadian tax on the disposition of investments in most Canadian operating companies.

Under existing Canadian law, non-residents of Canada are subject to Canadian tax on sales of "taxable Canadian property", which includes shares of private Canadian companies. In addition, purchasers of taxable Canadian property from non-residents are required to withhold and remit part of the purchase price to the Canadian government.

Canadian tax treaties often provide an exemption from the tax on taxable Canadian property. If a tax treaty applies, a seller can obtain a "clearance certificate" that eliminates the purchaser's withholding obligation. In the case of U.S. venture capital funds, which are typically formed as partnerships, establishing the exemption and obtaining a clearance certificate requires disclosure of the identity and treaty status of all of the fund's partners. These disclosure requirements are sufficiently burdensome that most venture capital funds cannot, as a practical matter, establish the exemption. In addition, venture capital funds may have partners that cannot claim treaty benefits with respect to Canadian investments. Accordingly, it has been typical for venture capital funds to make investments in Canada through "exchangeable share" or "blocker" structures, both of which significantly increase the cost of investing in Canadian companies.

Under the new Canadian budget, the definition of taxable Canadian property would be amended to exclude equity interests in Canadian corporations, partnerships and trusts, unless more than 50 percent of the value of such equity is (or was during the 5-year period preceding a sale) derived from Canadian real property. Accordingly, dispositions of investments in Canadian companies that do not hold Canadian real property would no longer be subject to Canadian tax. In addition, the withholding tax and clearance certificate regime would no longer be applicable.

If passed into law, the new rules would apply to dispositions made after March 4, 2010. Accordingly, we anticipate that, once passed, U.S. venture capital funds should immediately be able to invest directly in Canadian target companies without establishing alternative investment structures. It may also be possible to unwind existing structures thereby reducing the ongoing costs associated with maintaining current Canadian investments.

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