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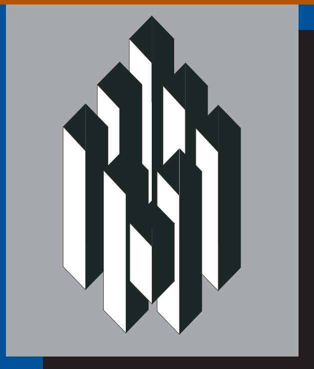

C.D. Howe Institute

Commentary

www.cdhowe.org   No. 244, February 2007   ISSN 0824-8001

Financing Canadian Innovation:

Why Canada Should End Roadblocks to Foreign Private Equity

Stephen A. Hurwitz
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In this issue...

Canada's cross-border tax laws raise barriers that needlessly discourage investment in Canadian private equity firms. We examine the harm these barriers cause, and propose ways of reducing them.

The Study in Brief

Why do promising Canadian ventures attract only one-third the capital of their US competitors in the North American marketplace? Why are many companies sold early in their life cycles, before they achieve market leadership, and at low prices? Why is the 10-year, net horizon return of Canadian venture capital firms a mere 2.5 percent, as opposed to 20.7 percent for US venture capital firms?

This *Commentary* argues that important causes are Canadian tax rules which needlessly, and unprofitably for Canada, block the inflow of hundreds of millions of dollars of needed foreign (mostly US) capital from institutional investors and private equity firms. Canada's cross-border tax scheme is particularly hard on gains realized by nonresidents on the sale of shares of private corporations, in sharp contrast to the treatment accorded under the tax schemes of other countries such as the United Kingdom and the United States.

This paper discusses the Canadian tax barriers to the entry of this needed foreign capital, the harm those barriers cause, and ways to change those laws to unblock that critical capital flow. Among the key recommendations:

First, the federal government should end the tax-clearance process that foreign private equity investors must follow when selling shares of a private Canadian company.

Second, to prevent double taxation, the Canada-US tax treaty ought to be amended to provide US limited liability companies the same tax treatment that ordinary US corporations receive when selling shares of a private Canadian company.

Third, the federal government should permit tax-free rollover of shares of a Canadian company into shares of a foreign company.

Without change, capital-starved Canadian companies will fail to commercialize much of the nation's R&D investment, raising the risk of Canada squandering a significant share of its intellectual capital, and needlessly imperiling its future economic growth.

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C.D. Howe Institute Commentary© is a periodic analysis of, and commentary on, current public policy issues. Barry Norris edited the manuscript; Diane King prepared it for publication. As with all Institute publications, the views expressed here are those of the authors and do not necessarily reflect the opinions of the Institute's members or Board of Directors. Quotation with appropriate credit is permissible.

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$12.00; ISBN 0-88806-704-6
ISSN 0824-8001 (print); ISSN 1703-0765 (online)

Canada's private equity sector — in which individuals and institutions fund private equity firms that invest, in turn, in Canadian operating companies — is needlessly hampered by Canada's cross-border tax laws. Those laws discourage investment by US institutional investors in Canadian private equity firms and by US private equity firms in Canadian operating companies. In this respect, the Canadian tax scheme stands in sharp contrast to that of other countries, such as the United Kingdom and the United States, where no similar cross-border tax barriers exist to this kind of foreign capital.

In this *Commentary*, we identify and discuss existing Canadian tax barriers to the entry of foreign (mostly US) private equity from both buy-out and venture capital firms[1] and of foreign (again, mostly US) institutional capital, primarily in the form of pensions and university endowments. We examine the harm these barriers cause, and we propose ways of reducing them.

In addition to the economic benefits that typically travel with cross-border capital, investment in Canadian operating companies by US private equity firms is usually accompanied by human capital. This human capital involves deep knowledge of the US market and extensive networks of executive, sales and marketing personnel, and familiarity with potential customers, distribution channels, suppliers, and strategic partners in that market. In addition, Canadian private equity firms that invest alongside their US counterparts have the opportunity to develop relationships that enhance their investing skills, leading to further co-investment opportunities in both countries.

These are important issues, because there is a shortage of capital flowing to Canada's private equity firms. Given the size of Canada's gross domestic product (GDP) and population relative to those of the United States, Canadian venture capital firms should be receiving about 10 percent of the total funds invested in the two countries' venture capital firms. Their share, however, is far short of that amount and falling, as Table 1 shows. It is not surprising, then, that the share of investments in Canada *by* venture capital firms also falls far short of the amount one would expect (see Table 2).

In 2005, emerging Canadian venture-funded companies raised an average of C$3.1 million, while their US counterparts raised an average of C$10.4 million (Thomson Financial 2006). Yet these companies compete directly in the same North American market and ostensibly have the same need to be well capitalized. An especially serious shortage exists in Canada of so-called later-stage B, C, and D

Stephen A. Hurwitz is a member of the Tax Policy Committee of the Canadian Venture Capital & Private Equity Association. Choate Hall & Stewart LLP, the law firm in which the authors are partners, represents private equity firms in the course of its practice. The authors wish to thank Bill Robson and Finn Poschmann of the C.D. Howe Institute, as well as its talented editors and reviewers, for their encouragement, support, and excellent contributions.

1 Buy-out firms and venture capital firms are almost invariably formed as limited partnerships, with 20 to 100 or more limited partner investors. Buy-out firms invest primarily in control positions in established private companies with positive cash flow sufficient to support acquisition debt. In contrast, venture capital firms invest primarily in minority positions in private companies at the seed, early-stage, and later-stage levels, often without positive cash flow and, in some cases, without revenues or even a product. A private equity firm may invest in dozens of operating companies during its life, which is usually about 10 years.

Table 1: *Venture Capital Fundraising, 2003–06*

Amount Raised	2003	2004	2005	2006 (Jan-Sept.)
		Canadian dollars, millions		
United States	14,212	23,359	33,274	28,936
Canada	1,973	1,779	2,220	1,286
Total	*16,185*	*25,138*	*35,494*	*30,222*
Canadian share of North American total	12%	7%	6%	4%
		Canadian dollars		
Per capita, United States	49	80	112	n/a
Per capita, Canada	62	56	69	n/a
Per $1,000 of US GDP	0.92	1.52	2.27	n/a
Per $1,000 of Canadian GDP	1.63	1.38	1.62	n/a

Sources: Bureau of Economic Analysis (2006) and Thomson Financial.

Table 2: *Venture-Capital-Related Investments, 2003–06*

Amount Invested from any Source in North America	2003	2004	2005	2006 (Jan.-Sept.)
		Canadian dollars, millions		
United States	35,985	37,495	35,276	29,670
Canada	1,695	1,843	1,820	1,190
Total	*37,680*	*39,338*	*37,096*	*30,860*
Canadian share of North American total	4%	5%	5%	4%
		Canadian dollars		
Per capita, United States	124	128	119	n/a
Per capita, Canada	54	58	56	n/a
Per $1,000 of US GDP	2.34	2.45	2.41	n/a
Per $1,000 of Canadian GDP	1.40	1.43	1.33	n/a

Sources: Bureau of Economic Analysis (2006) and Thomson Financial.

venture financing, relative to the abundance of such funds in the United States, which is critical to funding the market expansion of emerging companies.[2]

The investment performance of Canadian venture capital firms also significantly lags that of US firms. Over the 10-year period prior to the end of June 2006, Canadian venture firms had net horizon returns of 2.5 percent, while their US counterparts achieved 20.7 percent (Thomson Financial and CVCA 2006). We hypothesize that the underfunding of Canadian venture capital firms, demonstrated in Table 1, is a significant contributing cause to their underperformance. The less funding Canadian venture capital firms receive, the less they have to invest in emerging Canadian companies.

To continue this argument, the more poorly capitalized emerging Canadian companies are, the less competitive they will be in the North American marketplace against their better capitalized US counterparts. The more poorly these emerging Canadian companies perform, the worse is the resulting performance of the Canadian venture capital firms that fund them. The worse the performance of these Canadian venture capital firms, the greater their difficulty in securing funds from institutional and other investors. And so this debilitating cycle goes, reinforcing and causing underachievement for Canadian entrepreneurs and venture capitalists alike.[3] Thus, at each level of the Canadian venture capital sector, a significant shortage of capital exists relative to that available in the US counterpart, and the data reported in Tables 1 and 2 suggest that fundraising and investments by Canadian venture capital firms in 2006 will be at their lowest levels in four years.

Because Canadian and US private companies compete directly with each other in the same North American market, the lack of capital of Canadian venture-backed companies — on average, less than one-third of that of their US competitors — is a significant handicap. Further, the inability of Canadian operating companies to obtain sufficient capital to expand successfully in the North American market also contributes to their having to be sold early in their life cycles and long before they attain market leadership, frequently to large US companies and often at low prices.[4]

The result is that Canada is not deriving the full benefit of the billions of dollars of direct funding the federal government delivers for university and hospital research and development (R&D) or the indirect funding it affords Canadian businesses through Scientific Research and Experimental Development (SR&ED) tax credits (see Canada 2006).[5] Rather, this extensive federal government

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2 Venture investments are almost universally made in stages referred to as "rounds," denominated by letters starting with A, and often consisting of larger rounds as the investee firm grows and has greater financial needs relating to product production and broader market penetration. In the first three quarters of 2006, for example, follow-on venture financing in the United States totalled C$21.75 billion, but in Canada only C$0.98 billion, or about 4 percent of the Canadian-US total (Thomson Financial 2006).

3 Dr. Robin Louis, Chairman of Canada's Venture Capital & Private Equity Association, has reported on this cycle in various public addresses; see, for example, Louis (2004).

4 For a private equity firm to achieve a respectable performance, its portfolio companies must be financed at sufficient levels so that at least a small number of them achieve market leadership.

5 Suspicion that Canada is failing to reap the full benefits of R&D investment is an emerging theme in works such as MacKenzie (2006).

funding has become, in effect, a subsidy to US businesses that acquire Canadian companies cheaply, then reap the financial rewards when these companies achieve market leadership. Worse, Canadian companies that are sold early to US companies are often moved in their entirety to the United States.

Vast pools of private equity and institutional capital exist in the United States that are seeking the highest return on their investments, with no governmental restrictions on how much of that capital is invested outside the United States. But surveys of US venture capitalists investing in Ontario and Quebec indicate that, although Canadian talent and technology are major attractants, Canada's cross-border tax laws are seen as impediments to the flow of this much-needed private equity capital (see Thomson Financial 2005a,b).

Impediments to US Private Equity and Institutional Investment in Canada

What are the Canadian tax impediments to US investment? How do they discourage such investment? What are the solutions?

Venture investments most often are made in *private* corporations, as are many buy-out investments. However, Canada's cross-border tax scheme is particularly hard on gains realized by nonresidents on the sale of shares of private corporations when compared with such tax treatment in the tax schemes of other countries. For example, if a Canadian private equity firm were to invest in a US private company, gain on the sale of shares of the US company would not be subject to any US tax — the Canadian private equity firm and its investors would pay only the taxes imposed by Canada.[6] By contrast, a US private equity firm or institutional investor that invested in a Canadian private corporation would be potentially subject to *both* US tax (at up to 15 percent of the gain) and an additional Canadian tax (at 25 percent of the gross proceeds) unless it were to comply with the onerous Canadian tax procedures described below.

The 116 Clearance Certificate

Following the worldwide pattern, Canada has entered into income tax treaties with a number of countries in order to provide relief from double taxation. The Canada-US treaty is typical in generally exempting US residents who dispose of shares in private Canadian corporations from paying any Canadian tax on the sale of those shares — the treaty exemption similarly applies to Canadians investing in the United States. The United States automatically recognizes the treaty exemption applying to Canadian firms so investing in the United States. However, and in sharp contrast, a US resident who is fully exempt from Canadian tax must still comply with an onerous administrative procedure prescribed under section 116 of Canada's *Income Tax Act*.

6 An exception would apply in the case of investments in US companies where more than half the value of their assets consists of real property.

When applied to US private equity firms, most of which are structured as partnerships, the procedure is time consuming, expensive, complex, and uncertain. Briefly, an application must be made on a prescribed form (Form T2062) for a certificate commonly referred to as a "116 clearance certificate." The application may be made in advance of the sale of Canadian private stock — although full information, such as the foreign exchange rate, is not normally available in advance of closing and often the Canada Revenue Agency (CRA) will not begin its analysis until all information is complete — but in any event within 10 days after the date of the sale, otherwise penalties may apply. Moreover, many US private equity firms have 20 to 100 or more limited partner investors, each of whom must submit a separate application because Canada "looks through" (or essentially disregards) a partnership for tax purposes. If an investor in a private equity firm is itself a partnership, then each of *its* partners in turn is also required to submit an application, and so on. In some cases, thus, literally hundreds of signatures may be required on hundreds of application forms.

Accompanying the application form is a long list of required supporting material, which can vary depending on whether the investor is an individual, trust, corporation, or other entity. For example, partners in a US private equity firm who are individuals or corporations may be required to submit copies of their most recent income tax returns filed in their countries of residence together with a letter from the tax authorities in those countries confirming their residency status. Moreover, all applicants must obtain a Canadian tax identification number in addition to the number issued by their country of residence. For the individual applicant, that means submitting a second prescribed form (Form T1261), together with original or certified identification documents (such as birth certificate and passport). In short, applications for 116 clearance certificates will not be accepted until the applicant has been assigned a Canadian tax identification number.

Having cleared all bureaucratic hurdles thus far, the 116 clearance certificate application Form T2062 is then processed by one of 45 CRA tax services offices, with differing and often inconsistent practices and procedures. The time it takes a US private equity firm to obtain approval can be unpredictable and varies widely, ranging from several weeks to, more often, four to eight months. The risk, when the sale of stock in a private Canadian company by a US private equity firm is in exchange for marketable securities of the purchaser, is that a market decline may occur when there is a delay in obtaining a 116 clearance certificate. This risk is well known to US private equity firms that might otherwise consider investing in Canada.

The CRA rarely issues a section 116 clearance certificate to a US private equity firm before the closing of sales of private company stock. Yet, on closing, the purchaser that does not have a certificate is required to withhold 25 percent of the gross sale proceeds (including any noncash consideration), an amount that might well exceed 25 percent of the gain. The purchaser must then remit these funds to the CRA within 30 days of the end of the month in which the closing occurred, or such later date as the CRA expressly allows in writing. The purchaser who does not make the required withholding and remittances can be held personally liable for Canadian taxes.

In practice, the CRA rarely issues 116 clearance certificates to US private equity firm investors before the remitting deadline; instead, it often provides a “comfort letter” that allows the purchaser to retain the funds for a longer period of time. But only much later, when the CRA actually completes its review of the application and issues the certificate is the purchaser able to transfer the funds withheld to the nonresident private equity firm. If the purchaser does not receive a comfort letter and actually remits funds to the CRA, the nonresident then must undergo a further delay while it claims a refund.

If the applicant successfully navigates the application process, the CRA will issue a 116 clearance certificate, which the applicant must then furnish to the purchaser of the shares in order to release the 25 percent share of the purchase price that was withheld. But the process is not yet complete. Even with a tax clearance certificate in hand, the applicant must still file a Canadian income tax return for the year to report the sale of the stock, even though no tax is due or payable. The problem for US private equity firms is that many operate under agreements prohibiting general partners from entering into arrangements that require limited partners to file tax returns in foreign jurisdictions or to disclose certain private information such as tax returns, thus precluding them from investing.

US private equity firms and institutional investors do have some ways around the 116 clearance certificate process. They can form an intervening subsidiary corporation in a country, such as Barbados or Luxembourg, that has a tax treaty with Canada for the avoidance of double taxation. The subsidiary can then submit a *single* application for a 116 clearance certificate. They can also enter into an exchangeable share program, where the Canadian operating company is reorganized as a Delaware parent with a Canadian subsidiary.[7] The US private equity firm then invests in the Delaware parent.

These ways around the 116 clearance certificate process are complex, time consuming and expensive, especially the exchangeable share program, and represent serious impediments to investment. The exchangeable share program in particular, if not planned with the greatest of care, can result in the loss of SR&ED credits. It can also cause difficulties for continuing investment by government-subsidized private equity firms, such as the Business Development Bank of Canada, and by Canadian labour-sponsored funds. Canadian entrepreneurs also risk losing their ability to use the $500,000 small business capital gains exemption.

A further and relatively new problem arises for a Canadian company that goes public only on the London Alternative Investment Market — the “AIM” stock exchange — rather than having a dual listing on both AIM and the Toronto Stock Exchange. Under Canadian tax law, because AIM is not a “prescribed stock

7 In an exchangeable share program, a US private equity investor invests in a new US company that acquires a few shares of a Canadian operating company. Simultaneously, the shares of the Canadian company held by its founders and others are converted into exchangeable shares — exchangeable for stock of the new US company, often with a mandatory exchange in case of a liquidity event or after the passage of a fixed period, such as seven years. Such an arrangement permits the US private equity investor to invest directly in a US company, while postponing the time of recognition of income by the Canadian founders and other shareholders, which occurs when they exchange shares of the Canadian company for shares of the new US company.

exchange," shareholders not resident in Canada must still obtain a 116 clearance certificate before shares can be sold on the exchange.

To avoid the impediment to attracting US private equity that the 116 clearance certificate process represents, some Canadian venture capital firms, in what could be a growing trend, now require their portfolio companies to become Delaware corporations at the outset. Yet, Canadian government-funded and tax-subsidized private equity firms are often prohibited from investing in companies, however promising, that are incorporated outside the country, which can preclude them from significant investment opportunities.

Further, if a Canadian venture capital firm accepts a US investor in its fund, the Canadian firm itself becomes subject to the 116 clearance certificate process with respect to its investments in Canadian operating companies. To avoid this result, Canadian venture firms often sponsor separate US funds for US investors, which is time consuming and costly.

Anecdotal evidence suggests that many US investors simply are unwilling to go through the complex, time-consuming, and costly acrobatics necessary to invest in Canada, and choose instead to invest elsewhere.

As a matter of policy, Canada does not tax most nonresidents on capital gains from the sale of stock of private Canadian companies. This policy — embodied in tax treaties with countries from which most foreign private equity investors in Canadian private companies come — effectively reduces the Canadian capital gains tax to zero. To the extent that the current section 116 clearance process prevents any tax "leakage," it likely affects only a small group of investors. Since Canada probably would agree to enter into a treaty reducing the capital gains tax to zero for any country with which it had commercial relations of significance, there is little to be gained by sticking to the 116 certificate process. In fact, a process meant to assure treaty compliance might itself be sabotaging the policy of furthering foreign investment in Canada that the treaty implements.

Our Solution

The most effective solution would be for Canada to give foreign investors the same tax treatment as exists in the United States and United Kingdom: no tax generally exists on gain when a Canadian investor sells shares in a private US or UK company.

If that solution is not acceptable, certain limited exceptions could be created - such as a legislated definition of a "private equity firm" — so that sale of stock in a private Canadian operating company by a US private equity investor would not be subject to withholding tax. Alternatively, the tax clearance certificate process could be streamlined so that, to avoid Canadian tax withholding, the selling foreign investor is required merely to file a claim for treaty benefits with the purchaser, rather than obtain a 116 clearance certificate from the CRA. In either case, the solution should be self executing, and should avoid any governmental approval or certification process that replicates the kinds of administrative burdens inherent in the current approval process. Compliance with these proposed solutions could also be monitored if, shortly before or after the sale,

either the seller or the purchaser were required to give the Canadian government formal written notice confirming all the factual requirements for legal compliance.

The issue of the Alternative Investment Market should be easy to resolve. Already, Canadian tax law recognizes as "prescribed stock exchanges" several that are smaller than AIM, and it should not be difficult to extend the same exempt status to AIM.[8]

The Problem of Limited Liability Companies

US limited liability companies (LLCs) face special cross-border issues. Because of their corporate features, Canada considers LLCs to be corporations, not partnerships. The CRA has indicated that it does not consider LLCs that have elected to be treated as partnerships under US tax law to be either US "residents" for purposes of the Canada-US income tax treaty or eligible for tax relief from double taxation under the treaty. This CRA interpretation is based, in part, on a Supreme Court of Canada decision that, for an entity to be entitled to treaty tax relief, it must be "liable to tax" in the country of the treaty partner. Because LLCs are considered separate legal entities by Canada, but are treated in the United States as "flow-through" partnerships,[9] the CRA views them as not being "liable to tax" in the United States and, therefore, not entitled to the benefits of the tax treaty.

Because many US private equity firms have LLCs among their partners, this Supreme Court interpretation has created a serious potential problem of double taxation for those that seek to invest in Canada. Yet, Canada gains no discernable benefit from this failure to extend treaty benefits to LLCs, and continuing negotiations with the United States have so far failed to resolve the issue.

Our Solution

The LLC problem could be solved if the two countries were to amend the Canada-US tax treaty or enter into a protocol clarifying that the treaty relief applies to LLCs, or if the Canadian government were to create a legislated definition of the term US "resident" expressly to grant treaty tax relief to LLCs. In the alternative, the CRA could adopt an administrative position providing for LLCs to be covered by the treaty, or a narrower definition could be created under the treaty to provide tax relief solely to LLCs that are private equity firms. In either case, as with reforms to the 116 clearance certificate process, the solution should be self-executing and aim to reduce bureaucratic barriers as much as possible. Again, formal written notice by the parties to the Canadian government would enable the monitoring of legal compliance.

8 In value and volume of securities traded, AIM is much larger than, for example, the New Zealand Stock Exchange. For the current list of prescribed exchanges, see website: http://lois.justice.gc.ca/en/I-3.3/C.R.C.-c.945/136862.html#section-3201.

9 In the United States, the income of LLCs flows directly to their members, who bear any resulting tax liability.

Limitations on Tax-Free Rollovers

Canadian investors in a Canadian company are permitted a tax-free rollover when the company's shares are exchanged for shares of another Canadian company, but not when they are exchanged for shares of a non-Canadian company. This is a serious impediment to cross border investment because it can create a conflict of interest between the founders and foreign private equity investors in what is called a "liquidity event."

One kind of liquidity event is an initial public offering. In this case, the most favorable terms might be available if the Canadian company's shares were sold on a foreign market, with the company first being redomiciled to the country in which the market is located. Another kind of liquidity event would occur if the company were acquired in exchange for equity of the acquirer. In both cases, US private equity investors in a Canadian company would enjoy tax-free rollover treatment under US law, but no such treatment would be available to the Canadian founders and investors in the company. The resulting conflict between the interests of the Canadian shareholders and those of the foreign private equity investors could result in the company's being sold in a market or in a manner that brings a lower price than might otherwise have been obtained.

Our Solution

Proposals to extend tax-free rollovers to all Canadian investors have appeared in federal budgets for four years, but none has been acted upon. We believe it is time that Canada enact such a law. A more limited but still effective approach would be to limit the tax-free rollover benefit solely to Canadian companies that have foreign private equity investment. With appropriate safeguards, the CRA could collect tax at the time the Canadian resident ultimately disposed of the rollover stock of the foreign acquirer.

Loss of CCPC Status

Canadian-controlled private corporations (CCPCs) are private corporations incorporated in Canada that are not controlled, directly or indirectly, by nonresidents or by public corporations (or any combination of the two). The importance of this status is that CCPCs are entitled under Canadian law to certain tax benefits, including higher refundable tax credits, certain federal tax reductions, favorable treatment on employee stock options, and a $500,000 capital gain exemption available to individual shareholders who are resident in Canada. The corporation's CCPC status might be jeopardized, however, if a foreign private equity firm's investment in it is significant enough to cause the loss of Canadian control of the company. Presented with potential US investment, therefore, the company's founders often must either accept the investment and lose the benefits of CCPC status, or decline it and preserve their status.

Our Solution

The tax benefits to which CCPCs are currently entitled should be based on their maintaining certain levels of business activity and/or employees in Canada, rather

than on Canadian control, ownership, or incorporation. This change would ensure that tax benefits are afforded to companies only when there is a significant continuing economic benefit to Canada. A more focused solution would be to permit a limited exception to the requirements of Canadian control, ownership, and incorporation, but only while a Canadian company (i) is at an early stage of development, (ii) has a domestic or foreign private equity investor that has invested at a certain level, and (iii) maintains a certain level of employees and/or business in Canada.

Conclusion

Canadian tax impediments to cross-border flows of private equity hinder Canadian companies in their competition in the global marketplace for access to much needed US investment capital and its associated human capital. These impediments prevent significant amounts of capital from coming into Canada for investment in the private equity sector, or at the very least increase the costs, complexity, and time required to invest in Canada. 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 government recently removed restrictions on investments by Canadian pension plans in "foreign property" outside of Canada that exceeds 30 percent of all its property. To an outside observer, it seems 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.

A more complete assessment of the proposals in this *Commentary* would require a comparison of the amount of revenue the 116 clearance certificate process raises from US private equity firms and institutional investors, the cost of its enforcement, and the cost to Canada's economy. Such an assessment, however, is not possible in the current state of our knowledge. Anecdotal evidence suggests that the overwhelming majority of applications for tax clearance certificates by US private equity firms are eventually granted with no tax owing. It would be informative to know how much of the tax revenues, if any, actually raised in that process come from US private equity firm investors who are entitled to treaty exemption from paying the tax but who are unable to comply with the certification process.[10] More difficult to determine would be the number of those investors who, based on either an unsatisfactory experience or their knowledge of the unsatisfactory experience of others, decline to make investments. Yet this — or, more precisely, the cost to Canada of the economic activity foregone — may be the biggest problem cross-border barriers create.

It is hard to imagine any benefit to Canada in not amending the Canada-US tax treaty to entitle LLCs to exemption from double taxation. Excluding US LLCs from the treaty results in the generation of little or no Canadian taxes; likewise, it results in little or no investment by US LLCs in Canada, because US investment

10 We understand that CRA data may be able to establish how much tax revenue, if any, has been collected in the past from US venture capitalists in the 116 certificate process.

entities with LLCs in their structures, owing to their being subject to double taxation, simply will not invest in this country. If and when Canada agrees under the treaty to exempt LLCs from double taxation, there should be no further need for the 116 clearance certificate process to apply to US private equity firms or institutional investors, since it is highly improbable that they would then have any investors in their structures that would not be treaty exempt.

Less detrimental are the roll-over and CCPC tax impediments. But they, too, act to hinder US investment in Canada and should be removed.

Canada spends billions of dollars to fund R&D, whether directly to universities and hospitals, or indirectly through SR&D tax credits. It is not surprising, then, that respected international agencies often rank Canada at or near the top in those things that matter most to an economy and a society — science, engineering, research — and sometimes ahead of countries, such as the United States, with far larger economies and populations.

The Canadian private equity industry is a principal vehicle for successfully commercializing Canadian technology in order to convert those billions of dollars of Canadian R&D investments into real economic gain and societal benefit. If the Canadian private equity industry and its technology and life sciences portfolio companies continue to remain underfunded, much of this investment in R&D could be lost.

A simple, uncontroversial logic underpins our recommendations. Economic transactions between knowledgeable, well advised parties presumably are beneficial to both sides. The onus is squarely on those who would impede them to show why the impediment is justified.

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