RECENT TRANSACTIONS

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Introduction

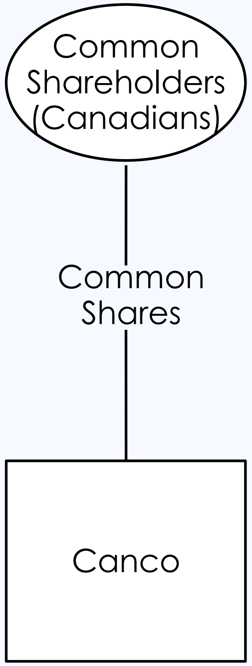
- Certain cross border issues arising on financing and eventual exit of early stage company
- Starting point: Canadian-controlled private corporation who has raised capital through issuance of common shares

OUTLINE

Stage 1: Early funding: Convertible notes vs. convertible shares

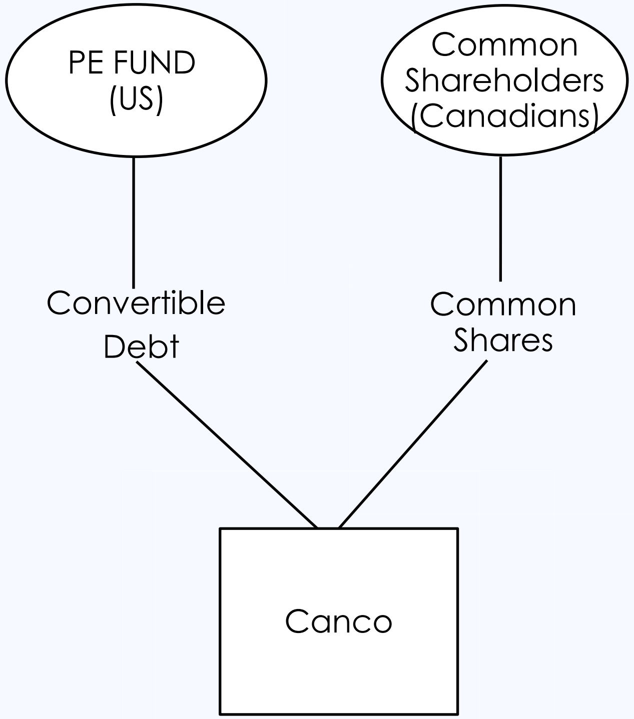
Stage 2: Exit Transaction

Non-resident and convertible note/share financing



- Canco is a CCPC
- Investor: US-based PE Fund structured as limited partnership
- Investment terms
  - $10M on closing; additional $15M over next 3 years
  - Priority on liquidation over common shares
  - Preferred return of 10% per annum; added to principal
  - Investor gets board seats as per unanimous shareholders' agreement
  - Initial security is convertible to common shares at Fund's option
- Form of Investment: Convertible debt or preferred shares?

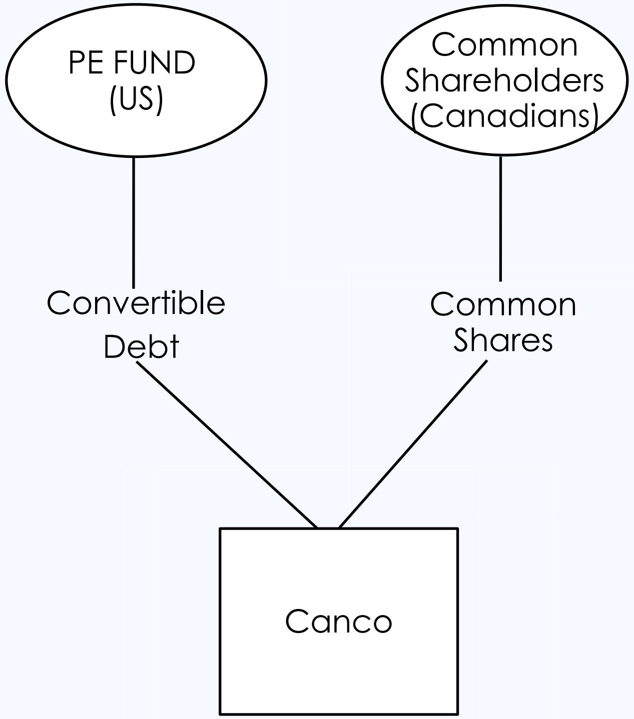
Non-resident and convertible note/share financing



Convertible Notes

- **Interest deductibility**
  - Deductibility subject to thin cap, EIFEL, transfer pricing, and HMA rules (discussed below)
  - Money is borrowed for the purpose of earning income from a business or property
  - If interest is not "paid" (but simply accrues), could have issues under ITA 78 and/or ITA 20(1)(d)

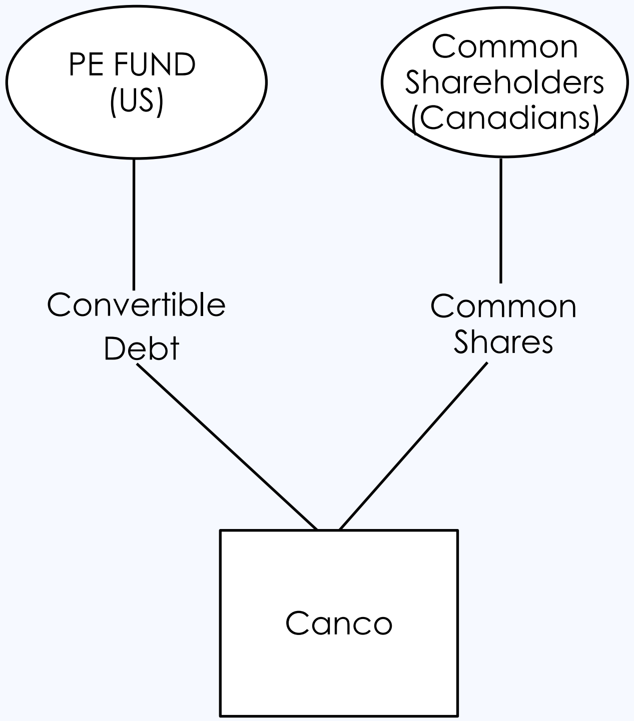
Non-resident and convertible note/share financing



Convertible Notes

- **Thin cap**
  - Convertible debt is deemed to have been exercised for "specified shareholder" test, but such deemed shareholdings do not count towards "equity amount"
  - CRA position is to look through partnership for "specified shareholder" test. Question is whether there are any 25% shareholders on a look through basis.
  - Watch out for corporate entities in the PE Fund's structure that may cause the "specified shareholder" test to be satisfied (e.g., LLCs).
  - May be minimal "equity amount" for thin cap calculation given that the PE Fund owns no shares

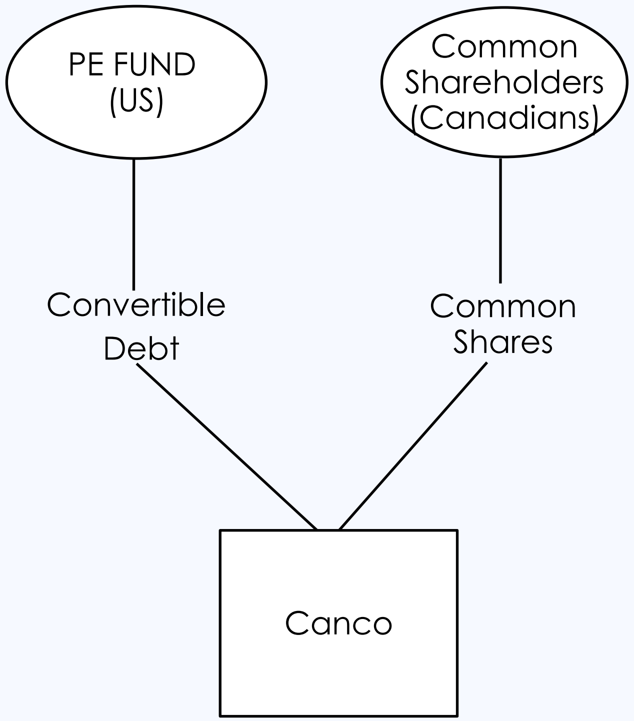
Non-resident and convertible note/share financing



Convertible Notes (cont'd)

- **EIFEL**
  - Will generally restrict interest deductibility to 30% of "adjusted taxable income", unless one of the exceptions apply
  - Para (a) of "excluded entity" – This exception may apply providing Canco retains its CCPC status and its taxable capital is less than $50M

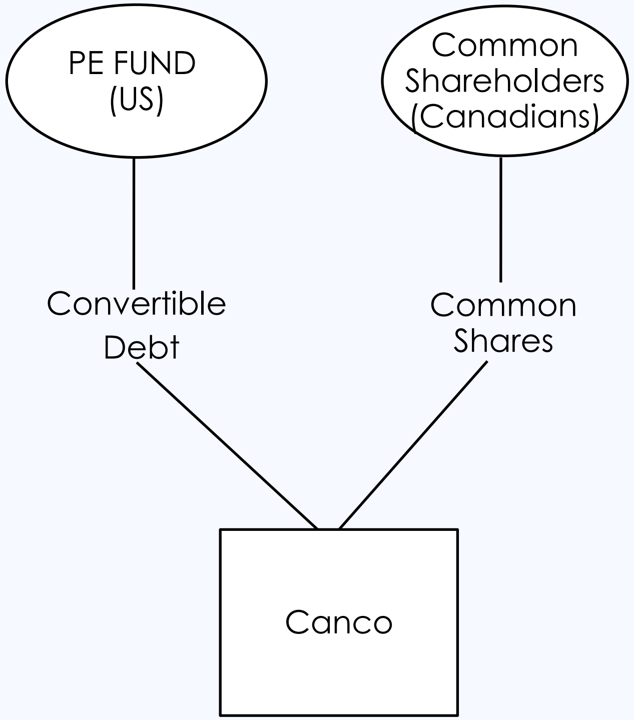
Non-resident and convertible note/share financing



Convertible Notes (cont'd)

- **Transfer pricing**
  - Should not be an issue providing Canco and PE Fund deal at arm's length
  - Even if they cease to deal at arm's length, interest rate should presumably meet "arm's length" test since it was negotiated between arm's length parties
- **Hybrid Mismatch Arrangement**
  - If there is a HMA that gives rise to a D/NI mismatch, all or part of the interest deduction could be denied

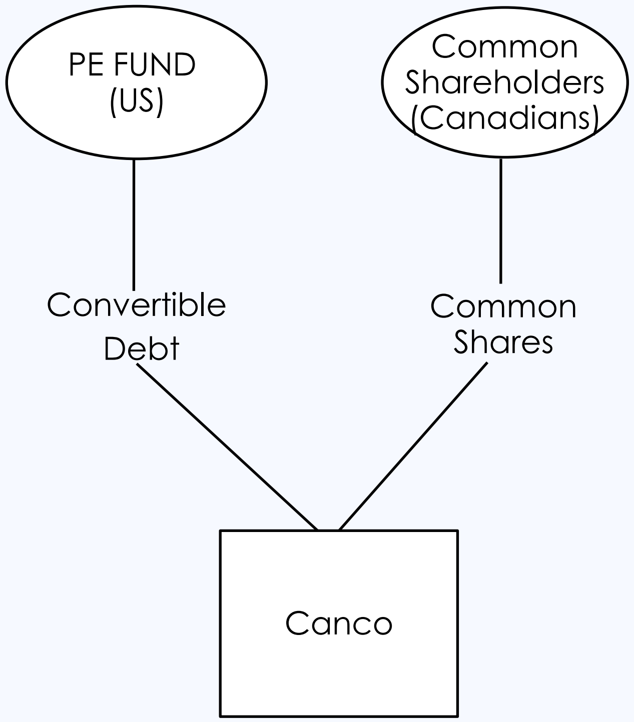
Non-resident and convertible note/share financing



Convertible Notes (Cont'd)

- **Part XIII withholding tax**
  - **ITA 212(1)(b)** - Payment of periodic interest
    - No withholding tax providing PE Fund deals at arm's length with Canco and interest is not "participating debt interest" ("**PDI**")
    - Periodic interest should generally not constitute PDI
    - Potential treaty relief for investors in a treaty jurisdiction (e.g., Art XI:1 of Canada-US Treaty)

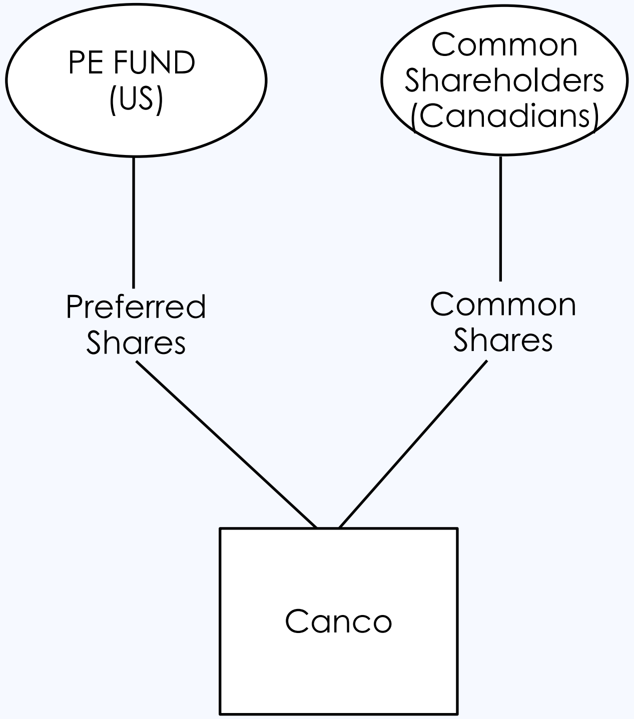
Non-resident and convertible note/share financing



Convertible Notes (Cont'd)

- **Part XIII withholding tax**
  - **ITA 212(1)(b)** - Conversion into shares
    - ITA 214(7) can deem conversion premium to be "interest"
    - Is the convertible debt an "excluded obligation" under ITA 214(8)?
      - 5/25 exception (ITA 214(8)(a))
      - Shallow discount exception (ITA 214(8)(c))
    - Would the conversion premium constitute PDI?
    - Conversion premium on conversion of "standard" convertible debenture does not constitute PDI according to CRA
  - **ITA 212(2)** - Applicable if denied interest deduction deemed to be a dividend under thin cap or HMA rules (25% statutory rate or reduced by treaty)

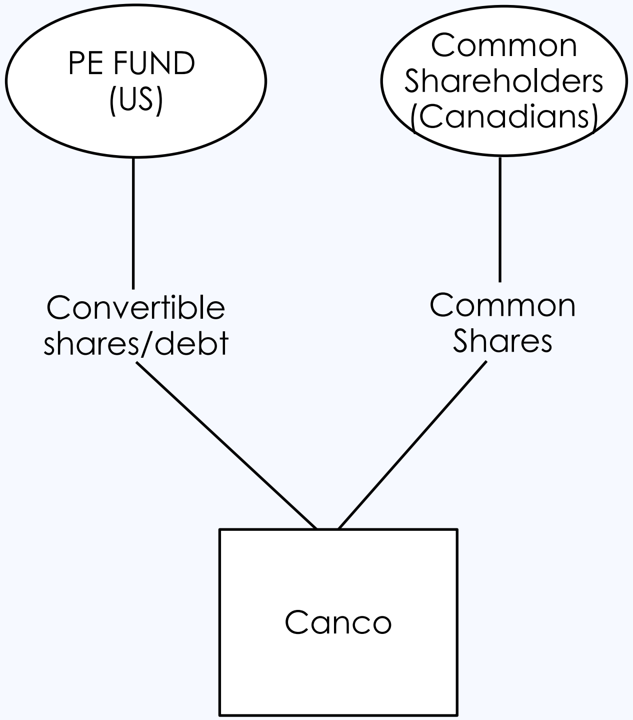
Non-resident and convertible note/share financing



Convertible Preferred Shares

- No deduction for Canco on dividend payments, but avoids complications of convertible debt structure
- Part IV.1 and VI.1 tax issues if dividends are paid
- Distributions can be made as tax-free returns of capital up to invested amount
- Part XIII withholding tax on any dividends (25% subject to reduction under applicable tax treaties)
- Conversion into common shares tax-deferred under ITA 51

Non-resident and convertible note/share financing



Impact on CCPC Status

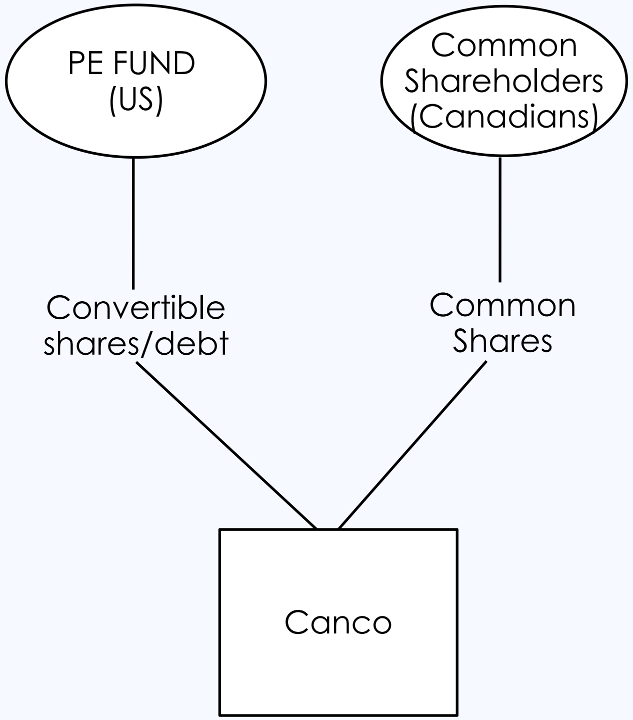
- Why is CCPC status important?
  - Stock options rules
  - Small business deduction
  - SR&ED refundable credits
  - EIFEL excluded entity

- CCPC Definition in ITA 125(7)
  - Paragraph (a): Not controlled by one or more non-residents or public corporations or a combo; control means de jure or de facto
  - Paragraph (b): "particular person" would have de jure control if owned all Canco shares held by non-residents and public corporations

- Consider ITA 251(5)(b) rights and CRA positions on "selective dilution" (2007-0253591I7)

- Convertible rights are ITA 251(5)(b) rights

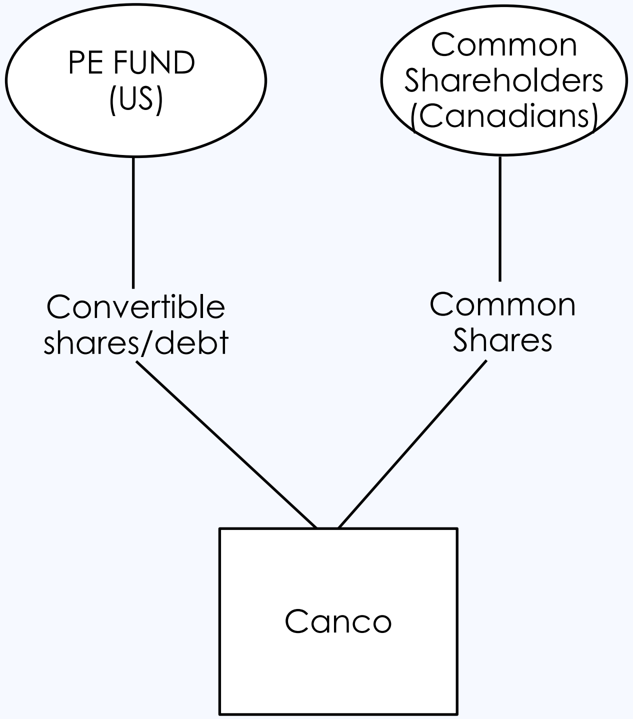
Non-resident and convertible note/share financing



Impact on CCPC Status (Cont'd)

- Staged financing
  - Initial financing: PE Fund's actual or ITA 251(5)(b) rights less than 50%
  - Final tranche: PE Fund's actual or ITA 251(5)(b) rights more than 50%
- General partner holds property for PE Fund
- Do parties want to maintain CCPC status?

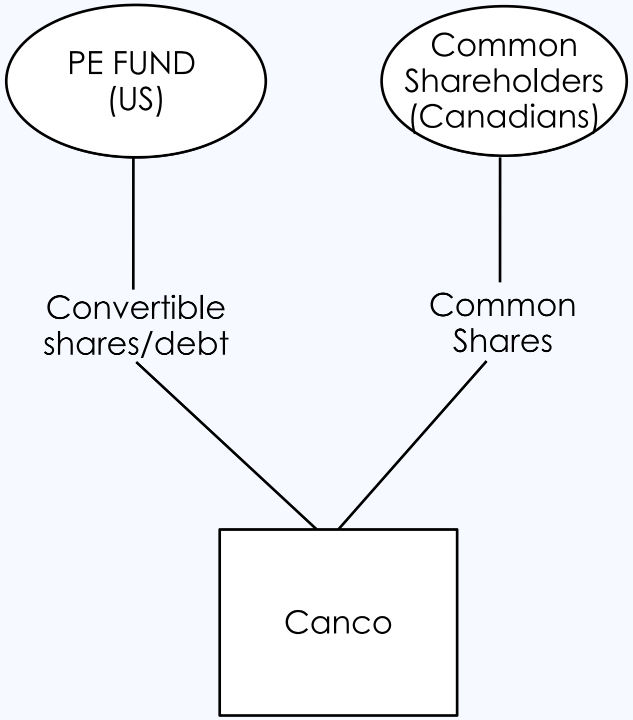
Non-resident and convertible note/share financing



Impact on CCPC Status (Cont'd)

- Canadians have multi or variable voting shares?
- Board composition under unanimous shareholders agreement
  - *Duha Printers, Bagtech*
  - *Example:*
    - *Board of 5 directors*
    - *Canadian resident shareholders nominate and vote to elect 2 directors*
    - *US Fund nominates and votes to elect 2 directors*
    - *Independent director: Who nominates? Who approves?*

Exit Transaction



- Assume at this point
  - PE Fund (US) holds either convertible debt or common shares of Canco
  - the Common Shareholders (Canadians) continue to hold common shares of Canco
  - there are a significant number of Canadian employees holding stock options
- A Canadian purchaser is offering to purchase with cash on closing plus an earnout

Exit Transaction

Earnout Considerations

- Concern that earnout would be income for the Vendors: CRA position
  - ITA 12(1)(g) for Canadian vendors
  - Subject to withholding tax for the non-Canadian vendors under ITA 212(1)(d)(v)
    - Not a "royalty" within definition in most tax treaties
- CRA policy to allow cost recovery method of reporting a gain or loss on a share sale if (IT-246R):
  - the vendor and purchaser are dealing with each other at arm's length
  - the gain or loss is clearly of a capital nature
  - the earnout feature relates to underlying goodwill the value of which cannot reasonably be expected to be agreed upon
  - the earnout feature must end no later than 5 years after the end of the taxation year of the target corporation in which the shares are sold
  - the vendor submits a copy of the sale agreement with its tax return and requests the application of the cost recovery method
  - the vendor is resident in Canada

Exit Transaction

Earnout Considerations (Cont'd)

- Some CRA positions on the use of the cost recovery method:
  - 5-year rule following strictly (2022 CTF Roundtable, q. 11)
  - Cost recovery method not available to a limited partnership vendor (2021-0884651E5)
  - "Underlying goodwill" can relate to the goodwill of a lower tier company (2019 CTF Roundtable, q. 12)
  - CRA generally will not apply ITA 212(1)(d)(v) when shares (TCP or not TCP) are sold by a non-resident under and agreement that includes an earnout clause in respect of future earnings, provided the first 4 conditions in IT-246R are met (2019 CTF Roundtable, q. 10 and 2005 APFF Roundtable)

Exit Transaction

Earnout Considerations (Cont'd)

- How do the milestones relate to goodwill?
  - EBITDA or revenue targets generally OK
  - Continued employment of key employees?
  - External factors: commodity price; regulatory approval?
- ITA 116 compliance if shares are taxable Canadian property
  - Withhold 25% of max purchase price?; or
  - Apply for ITA 116 certificate on closing and each earnout payment?
- Earnout and option holders
  - Earnout rights affect the FMV of shares for determining ITA 7(1)(a) stock option benefit amount (2013-0502761E5)
  - Determining the value of the benefit: T4s, payroll withholding, holders' tax returns

Exit Transaction

Alternatives to Earn Out

- Reverse earnout
  - CRA view: ITA 12(1)(g) does not apply (IT-462, para. 9; 2009-0337651R3)
  - Typically structured as a promissory note
  - If milestone event is not met; portion of note is not paid
  - BUT consider…
    - If ITA 116 applies, need to withhold on closing and contingent amounts
    - Debt forgiveness for purchaser
    - Upfront income inclusion for vendors
    - No capital gains reserve because amount is contingent (2013-0505391E5)
    - Capital loss carry-back limited to 3 years

Exit Transaction

Earnout Considerations (Cont'd)

- Special earnout shares of target are issued to incorporate the earnout economics Vendors dispose of some Canco shares for cash on closing
  - Vendors exchange some Canco shares for "earn out" shares issued by Purchaser
    - Shares redeemable at earn out milestones
    - To maintain capital gain treatment and avoid Part IV and VI.1, upper tier purchaser entity (a Callco?) acquires the earn out shares
    - ITA 85 rollover; Vendors may need to claim QSBC exemption on closing transaction depending on status of Purchaser
  - BUT consider…
    - GAAR
    - Derivate forward agreement
    - Synthetic disposition
    - Mandatory disclosure?
      - No hallmark specific to earn out shares?
      - Pre-Royal Asset: What if tax indemnity in SPA and purchase of earn out shares in future part of same series?

Questions?