Stikeman Elliott

Private Equity Investment in Canada

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Regulatory and tax considerations private equity firms should focus on when investing in Canada

The first nine months of 2022 have seen global M&A activity levels fall substantially from the records reached in 2021. However, with a continuing abundance of dry powder, private equity investors have remained relatively busy: data firm Refinitiv reports that, despite being down 25% compared to a year ago, private equity M&A activity accounted for a record 23% of global M&A activity in the first three quarters of 2022.

Canada has also experienced a decline in deal activity. Based on a report from Refinitiv, some C$12.2 billion worth of private equity buyout and related investments have been announced in the first three quarters of 2022, down 65% from the same period in 2021.

With increasing talk of an economic slowdown, we expect that private equity funds will continue to seek to profit from market timing opportunities in Canada, including through buyouts of public companies whose trading price may not be representative of their underlying value and through later stage private company growth equity investments.

Factors Relevant to Foreign Investors

Non-Canadian investors must be aware of a number of potential regulatory and tax issues that arise in the context of their investments in Canadian businesses. Regulatory issues may be triggered pursuant to the *Investment Canada Act* (*ICA*), Canada's foreign investment regulation, which applies to any acquisition of control of a Canadian business by a non-Canadian investor. Where they meet certain financial thresholds, acquisitions may be subject to economic review (and, extremely rarely, prohibited) if, based on factors such as the nature of the acquired business and the identity of the investor, the government determines that the transaction is not of "net benefit to Canada." In recent years, the number of acquisitions subject to economic review under the *ICA* has declined, owing to welcome increases in the financial thresholds triggering a review (particularly for investors from jurisdictions with trade agreements in place with Canada, such as the United States and the EU). Most investments instead proceed by way of an administrative notification to the government, with no review under the *ICA* required.

In addition, even where they do not meet the financial thresholds triggering an economic review, or do not constitute an acquisition of control (such as minority investments), investments by non-Canadians are also subject to potential national security review under the *ICA*. Under this process, investments may be reviewed and prohibited where they are deemed injurious to Canadian national security. In this respect, the *ICA* is similar to CFIUS in the United States. Investors must also be aware of applicable requirements of Canada's antitrust statute, the *Competition Act*.

Tax issues that non-Canadian investors often face include the potential loss of a corporation's tax-advantaged status as a Canadian-controlled private corporation (CCPC). Structuring routes that foreign investors should explore for their Canadian acquisitions include the so-called "leveraged equity" structure discussed below.

I. Regulatory Matters

Investment Canada Act

The *ICA* allows the Canadian federal government to screen certain proposed foreign investments to ensure that they are likely to produce a "net benefit to Canada." Direct acquisitions of Canadian businesses by non-Canadians are subject to automatic economic review if the enterprise value of the Canadian business exceeds a specified threshold. For 2022, the threshold for a "WTO investor" (i.e., an investor ultimately controlled by nationals of a WTO–member country) is C$1.141 billion in enterprise value, a figure which is indexed annually to Canadian GDP growth. For investors from countries party to certain trade agreements with Canada (which include, notably, the United States, the EU, and parties to the Trans-Pacific Partnership), this threshold is even higher, at C$1.711 billion (also subject to annual indexing). Lower thresholds apply in the case of other types of investors, such as non-WTO investors, or state-owned enterprises. Lower thresholds also apply in the case of acquisitions of control of cultural businesses—generally, businesses involved in activities such as the production, sale, publication, or distribution of film, audio, books, newspapers, or magazines. If a transaction does not meet the applicable monetary threshold, no pre-closing review is required from the investor to the government; however, a notification is required to be filed by the investor within 30 days after closing. In most cases, this notification is an administrative formality.

A transaction that is reviewable under the economic review sections of the *ICA* will be approved only if the Canadian government determines that the transaction is likely to produce a "net benefit to Canada." In making this determination, the government will take into account the following:

- the effect of the investment on the level and nature of economic activity in Canada;
- the degree and significance of participation by Canadians in the Canadian business and the relevant Canadian industry;
- the effect of the investment on productivity, industrial efficiency, technological development, product innovation, and product variety in Canada;
- the effect of the investment on competition within any industry in Canada;
- the compatibility of the investment with national industrial, economic, and cultural policies; and

- the effect of the investment on Canada's ability to compete in world markets.

It is very common for the government to require investors to provide legally binding undertakings as a condition to receiving a net-benefit-to-Canada ruling. These undertakings, which will vary from transaction to transaction in light of the particular facts, may include commitments to maintain employment levels in Canada, to appoint and maintain a certain number of Canadians to board or senior management positions, and to make minimum capital expenditures in Canada. The government will generally monitor the investor's compliance with the undertakings during the period in which they are in place (typically three to five years following closing) with periodic progress reports.

Transactions in which the applicable monetary threshold is not met may nevertheless be reviewed by the government where it has "reasonable grounds to believe" that the investment "could be injurious to national security." This concept is not defined in the *ICA* or its regulations, though the government has released guidelines as to the factors it will consider. The government has 45 days from the date it receives notice of a transaction that must be notified to advise the investor that it may undertake such a review. For certain minority investments that do not otherwise trigger a notification obligation, the government has either five years or 45 days from the date the investment is voluntarily notified to advise the investor that it may undertake a national security review.

Our experience since the national security review rules were implemented in 2009 is that very few transactions attract the scrutiny of the Canadian government on national security grounds, but any investment in Canada by a non-Canadian investor can trigger this process regardless of:

- whether it is reviewable or notifiable according to the rules above;
- whether by a US investor or other;
- whether it is for the establishment of a new Canadian business, the acquisition of control of a Canadian business, or the acquisition of a minority interest in a Canadian business; and
- the dollar value of the transaction.

That said, investors from certain countries and into sensitive industries may attract the most scrutiny under the national security provisions of the *ICA*. Notably, national security review applies not only to the acquisition of control of a Canadian business but also to minority investments in Canadian businesses. Furthermore, there is no minimum dollar threshold for national security review (i.e., investments in targets with low enterprise values are nonetheless potentially reviewable). Since the beginning of the COVID-19 pandemic, we have observed that the government has applied a heightened degree of national security scrutiny to transactions that might not have raised any national security concerns prior to the pandemic.

In April 2020, the Canadian government issued guidance indicating that certain types of transactions (namely, transactions impacting the healthcare industry, transactions involving the supply of critical goods and services to Canadians or to the Canadian government, and transactions involving state-owned or state-influenced investors) would be subject to greater scrutiny under the *ICA*.

In March 2022, the Canadian government issued guidance indicating that investments that have ties, directly or indirectly, to individuals or entities associated with, controlled by or subject to influence by Russia will likely be subject to national security review.

In October 2022, the Canadian government issued a policy statement noting that investments from state-owned enterprises involving Canadian businesses or entities operating in a critical mineral sector in Canada will likely be subject to national security review. Shortly afterwards, the Canadian government announced that three foreign investors were ordered to divest their interests in Canadian critical mineral companies.

The timeline for a national security review is prescribed by regulation and can add significant delays to the process of obtaining required regulatory approvals. If the maximum periods under the regulations are fully utilized, a national security review could take 155 days or longer (upon the consent of the investor). As there is no formal pre-closing notification requirement in relation to a national security review if government approval is not otherwise required prior to closing (i.e., the mandatory threshold for economic review is not met), it is possible that an investor may learn that the transaction is subject to national security review only following closing upon receipt of a notice from the government. However, even if a pre-closing *ICA* review is not required, an investor may choose to file a notification in advance of closing in order to trigger the 45-day period in which the government must give notice of a review or possible review under the regulations.

Competition Act

Canada's federal antitrust statute, the *Competition Act*, applies equally to Canadian and non-Canadian investors. The *Competition Act* requires mandatory pre-merger notification if certain monetary thresholds are met. This is determined based on a complex formula that considers the revenues and assets of the target and its affiliates and, potentially, the investor and its affiliates. In the case of acquisitions of interests in partnerships or corporations, certain voting interest or shareholding thresholds must also be met before a notification is triggered. We have developed a Merger Notification Assessment Tool to guide companies through the process. It can be found on our website and in our report *Canadian Competition and Foreign Investment Outlook 2020*. For 2022, the Size of Transaction threshold is C$93 million, while the Size of Parties threshold is C$400 million.

If a transaction exceeds the applicable thresholds, it will require a pre-closing notification to the Commissioner of Competition. Even if the transaction does not meet the threshold, the Commissioner can investigate any transaction (within a year after closing) if he believes that the transaction "would or would be likely to prevent or lessen competition substantially" in a relevant market. This is the same test that the Commissioner uses when deciding whether to initiate an application to the Competition Tribunal, and it is also the test that the Tribunal uses in its adjudication of an application. In applying the test, the Commissioner and the Tribunal may consider a number of antitrust factors and arguments, depending on the facts of the case. These may include the extent and availability of acceptable substitutes for any overlapping products or services supplied by the parties, potential barriers to entry in the relevant market(s), whether the transaction would result in the removal of a vigorous and effective competitor, the extent to which there would be effective remaining competition following the transaction (including considering in some cases competition from foreign competitors), the nature and extent of change and innovation in the relevant market, and whether the business of a party to the transaction has failed or is likely to fail in the absence of the transaction. In an analysis unique to Canada, the Bureau and Tribunal may also consider an efficiencies defense if raised by the parties—that is, where the efficiency gains likely to result from the transaction are large enough to offset any likely anti-competitive effects, the Tribunal may not make an order in respect of the transaction. The merger review filing fee in Canada in 2022 is C$77,452.36.

The Competition Bureau maintains a steady flow of cases. In 2021–2022, it concluded 256 merger reviews. While the Bureau's initial statutory waiting period following receipt of a notification is 30 days, the majority of mergers are cleared prior to this period. In 2021–2022, for instance, most mergers fell into the non-complex category and were cleared within the 14-day non-binding service standard. About 25% of mergers were classified by the Bureau as complex and took on average 38 days to review, below the Bureau's non-binding 45-day service standard.

The Bureau also has the ability to issue a supplemental information request (SIR) in complex cases, similar to the US second-request system under the US *Hart-Scott-Rodino Act*, which can require significant documentary productions. Where the Bureau issues an SIR, it triggers an additional 30-day waiting period following both parties' filing of certified responses to the SIR, during which the transaction cannot be closed. However, SIRs have been used sparingly and were invoked in only 9 complex merger transactions concluded in 2021–2022.

We continue to see transactions proceed to close despite not receiving positive clearance (once the applicable statutory waiting periods had run out)—this remains an ongoing trend in Canadian antitrust practice. The Bureau retains the ability to challenge a transaction in such a case within one year following closing.

II. Tax Matters

Canadian-Controlled Private Corporations

Non-Canadian investors in Canadian businesses need to be aware of the tax advantages afforded to CCPCs. The Canadian federal *Income Tax Act* (*Tax Act*) provides CCPCs with a range of preferential tax treatment not available to public or non-Canadian private corporations, including:

- a lower effective tax rate on its first C$500,000 of net active business income;
- the potential for individual shareholders to each claim a lifetime capital gains exemption on the sale of the shares of the corporation (C$913,630 for dispositions in 2022);
- preferential tax treatment for employees holding stock options; and
- enhanced and refundable investment tax credits on all or a portion of the corporation's SR&ED qualified expenditure pool. A SR&ED credit is an important federal tax credit that applies to expenditures related to basic and applied research undertaken for the advancement of scientific knowledge and experimental development carried out for the purpose of achieving technological advancement. These credits are often significant (and sometimes the only source of income) for technology and science-based companies. Equivalent credits may be available under provincial legislation.

As the name suggests, an important factor in being a CCPC is that the corporation be controlled by Canadians. If a CCPC is controlled by someone other than a Canadian at any point in a year, it is deemed to have not been a CCPC for such entire year and will lose all the tax benefits relating to CCPC status for that year (and all subsequent tax periods during which it is not Canadian-controlled). Where a non-Canadian acquires voting control of a CCPC, CCPC status will be lost at the time of signing of the purchase agreement, whether or not the closing date of the transaction is delayed. Non-Canadian investors should understand the impact that the loss of CCPC status will have on the target's balance sheet, such as a substantial loss in the value of SR&ED tax credits available to the company. Where a non-Canadian acquires a minority interest in a CCPC (i.e., less than 50% of the voting shares, even if a greater percentage of the economic interests is acquired), there are ways to structure the acquisition and the post-closing arrangements between the shareholders to try to ensure that the corporation maintains its CCPC status despite the foreign ownership. In general, a CCPC is a Canadian private corporation that is not controlled, directly or indirectly in any manner whatsoever, by one or more non-resident persons

or public corporations. By referring to "control," the definition of CCPC captures *de jure* control (i.e., legal control), and by referring to "directly or indirectly in manner whatsoever," it also captures *de facto* control (i.e., control in fact). The *Tax Act* also contains various provisions that, for the purposes of determining control, deem persons who have certain rights with respect to the shares of a corporation to be in the same position in relation to the control of the corporation as if they had already exercised those rights.

Two things that should be borne in mind are, first, that it is possible for one person to have *de jure* control while another person simultaneously has *de facto* control, and secondly that if one or more non-residents have either *de jure* or *de facto* control, CPCC status will be lost.

The concept of *de jure* control looks at who has effective control over the affairs of the corporation. Effective control is established by looking *exclusively* at the corporation's governing statute, its share register and its constating documents, and by determining who has the ability to elect the majority of the board of directors and the extent to which there are restrictions on the powers of the board of directors to manage the corporation. The reason for this is that, generally, under corporate law, the directors of a corporation have the right to control the affairs of the corporation, but since the shareholders elect the board of directors, in reality a shareholder who holds more than 50% of the voting shares typically will have effective control of the corporation, except where the powers of the directors are sufficiently restricted by the constating documents. For the purposes of determining CCPC status, the *Tax Act* considers whether *de jure* control is held by non-resident persons individually, but it also considers them together. More specifically, the *Tax Act* looks at whether a single hypothetical person would have *de jure* control if all the shares held by all non-resident persons and all public corporations were held by that hypothetical person and whether the non-residents and public corporations are related or are acting in concert.

The *Tax Act* provides that a person has *de facto* control where that person has "any direct or indirect influence that, if exercised, would result in control in fact of the corporation." Note that a person does not need to own a single share in the corporation to have *de facto* control of the corporation.

A question that has often been debated is what type of influence matters for the purposes of *de facto* control. Over the years, two types of influence have been considered: (i) influence over the composition or the powers of the board of directors of the corporation, and (ii) operational influence over the corporation.

Influence over the composition or the powers of the board of directors is the narrower test. Essentially, it is established by asking whether anyone has the "ability to effect a significant change in the board of directors or the powers of the board of directors or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors."

Operational influence is the broader test and looks at economic dependence and the ability to influence day-to-day operations. To determine whether a person has operational control of a corporation, one must consider "all factors that are relevant in the circumstances" and not merely whether a person has a legally enforceable right or ability to effect a change in the board of directors of the corporation. Courts have not clarified the breadth of the expression "all factors that are relevant in the circumstances." Therefore, there is some uncertainty regarding what factors are relevant and how they should be weighed relative to each other. It is clear, however, that agreements between shareholders will be considered.

Where a transaction has been structured such that the non-Canadian investor does not hold voting control of the corporation (or the power to elect a majority of the board of directors), the non-Canadian investor may seek to exercise control over the corporation through a shareholders' agreement. If, pursuant to the corporation's shareholders' agreement, the non-Canadian shareholder has the right to require the corporation to take specified actions, there is a heightened risk that the corporation will be held not to be Canadian-controlled. This is not to say that non-Canadian shareholders can never hold any approval rights under a shareholders' agreement without jeopardizing a corporation's CCPC status, but care must be taken when drafting any such agreement to ensure that any such rights are not so broad as to run afoul of the *de jure* and/or *de facto* control restrictions placed on CCPC ownership. For example, a corporation likely would not lose CCPC status if the non-Canadian shareholder's approval rights relate to matters that are particularly material to the value of the non-Canadian's investment, and therefore are considered acceptable governance clauses designed to protect and enhance the rights of the investor. Acceptable approval rights would typically include the right to veto decisions involving the winding up and dissolution of the corporation, the payment of dividends, acquisitions or sales of businesses, the incurring of debt above a specified threshold that is relatively material given the size of the business, salary setting for and retention of key employees, and the approval of budgets.

It should be noted that any rights of non-Canadian investors to acquire additional shares of the corporation that would give them voting control, or to require the corporation to redeem shares held by Canadians that, if exercised, would give the non-Canadian voting control, will be deemed to be exercised for the purposes of determining control. Moreover, those rights are taken into account even if they are remote: more specifically, they do not need to be immediate, absolute, or under contract.

From a practical perspective, for the purposes of CCPC status, various

instruments that may be used as part of an investment, such as options to acquire shares, redeemable shares, convertible shares, convertible debt, put and call rights, or even binding letters of intent to acquire shares from another shareholder, will be considered and can result in a finding of control by non-Canadians even though the underlying right is not actually exercised. This same deeming rule will also cause control to be acquired for purposes of CCPC status in the context of an M&A transaction at the time of signing of a share purchase agreement, whether or not the closing date of the transaction is delayed. There are some exceptions—in terms of administrative practice, rights of first refusal and shotgun provisions are normally not considered for the purpose of the deeming provisions.

Leveraged Equity Structures

Private equity investors strive to finance their acquisition with third-party debt in the most efficient and tax effective manner. In Canada, structures can be implemented that allow US private equity funds to convert up to 60% of their equity investment in a Canadian corporation into intercompany interest-bearing debt. Historically, it has been possible to do so without a corresponding interest income accrual being realized by the funds and their investors for US tax purposes.

These structures often relied on the different treatment afforded to such structures under Canadian and US domestic tax laws and pursuant to administrative pronouncements issued by the Canadian and US tax authorities. The Canadian tax system looks at the legal nature of arrangements and tends to defer to form in the absence of a "sham," and therefore views these arrangements as being debt giving rise to deductible interest expense. On the other hand, the US tax system favors economic substance over legal form and often views these arrangements as equity or as taking place between two non-US entities, thereby avoiding annual interest accrual for the private equity funds and their investors.

The tax benefit of these structures depends on (i) the ability of the related party extending the shareholder loan to secure an interest withholding tax rate that is significantly lower than the combined Canadian federal and provincial income tax rate applicable to the Canadian corporation, and (ii) the ability of the Canadian corporation to deduct interest paid to the related party extending the shareholder loan against income earned in Canada. The deductibility of such interest payments may be limited by recent interest limitation rules introduced in Canada to restrict the deductibility of net interest and finance expenses on all debts of Canadian corporations. Such limitation is similar to the EBITDA/EBIT-based limitation introduced by the US in 2017.

To secure reduced Canadian withholding tax on interest, an analysis of the treaty eligibility of the private equity funds' investors is mandated.

A recent Canadian federal budget proposal, in line with the OECD's BEPS initiatives against "hybrid mismatch arrangements", would propose to reduce the ability of non-Canadian investors to structure their investment in a Canadian entity by way of interest-bearing debt while avoiding interest accrual for the private equity funds and their investors.

Conclusion

Overall, Canada remains an enticing market for private equity investors, whether based in the US, Europe or elsewhere. A growing array of sophisticated and innovative technology companies, tackling everything from artificial intelligence to blockchain, complements the country's traditional strengths in the minerals, energy, manufacturing and industrial sectors. When investing in a Canadian business, there are a number of Canadian regulatory and tax issues of which non-Canadian investors must be aware. With the right advice, non-Canadian investors can create tax-efficient structures that meet their financial needs, address regulator concerns, and take advantage of unique opportunities. ■

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