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Should Canadian entrepreneurs incorporate in the United States?

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Canadian entrepreneurs often look to the United States for the future financial prospects of their startups, primarily through development funding from angel investors and venture capitalists or a transformative exit deal with a larger acquirer. This reality raises the stakes on a key initial corporate decision of where to start their company, and can cause Canadian entrepreneurs to wonder, "am I better off incorporating in the United States?"

On one hand, nine of the 10 largest Canadian venture capital financings in 2018 included direct investments from one or more U.S. venture capitalists, indicating that jurisdiction of incorporation does not impede the northbound flow of capital. Canada also offers attractive personal and corporate tax benefits to Canadian technology startups and their resident shareholders, the most notable of which are refundable tax credits for research and development activities that can be critical to a company in its initial development stages.

On the other hand, founders and early stage investors are sometimes concerned that incorporating in Canada carries a negative perception bias in the U.S. market and that tax issues may limit opportunities for future cross-border financings or exits. Even if a founder is comfortable that a certain structure works in a tax-efficient way today, the rules could (and often do) change, rendering an established structure ineffective or inefficient.

While any potential deal drag from an initial Canadian incorporation can generally be overcome – for example, by setting up a U.S. subsidiary, establishing sister companies on both sides of the border, or implementing an exchangeable share structure – the available solutions may be viewed by Canadian founders and shareholders, as well as U.S. investors and acquirers, as too complex and costly to implement, or too likely to cause unwanted distraction or diversion of focus. The ultimate question here is: will the generous but likely short-term tax benefits available from the Canadian government frustrate a subsequently successful startup's ability to fund its longer-term future growth?

We discuss the potential upside and downside of these choices. Is it ever in a founder's interest to forgo "free money" in the form of refundable tax credits in Canada in the hope of facilitating smoother access to the U.S. capital and exit markets? Or is the Canadian tax regime for technology startups just too tempting to pass up?

Upside benefits

CCPCs

The principal advantage of incorporating in Canada are the incentives offered by the Canadian government to Canadian-controlled private corporations (CCPCs) for scientific research and experimental development (SR&ED) activities. Under the Canadian federal

SR&ED program, CCPCs are eligible to receive refundable income tax credits at a 35% rate on qualified SR&ED expenditures, up to a maximum expenditure limit of C$3 million. In certain circumstances, qualifying SR&ED expenditures could be higher than the amount actually incurred for the purposes of the income tax credit. For example, a C$100 qualifying expenditure could be considered a qualifying expenditure of C$155 for the purposes of the federal tax credit, which would allow the corporation to benefit from a credit of approximately C$55 (or 35% of C$155). Where the refundable income tax credits exceed the taxes payable for the year, a qualifying CCPC is entitled to receive a cash refund from the Canadian government. As such, the cost of carrying on SR&ED activity in Canada could be significantly reduced by the SR&ED income tax credit incentives.

Key threshold questions for any founder, then, would be "is my company a CCPC and does it qualify for the SR&ED credit?" A CCPC is a corporation incorporated provincially or federally in Canada that is not "controlled" (in law or in fact) by one or more non-residents of Canada or public companies. Practically speaking, and absent extenuating circumstances, startup technology companies with a majority of Canadian resident founders will have CCPC status.

Qualifying SR&ED expenditures include basic and applied research and experimental development costs for technological advancement for the purpose of creating new, or improving existing materials, devices, products or processes. For qualifying companies with a low amount of revenue and research and development expenses, these benefits can significantly aid in the viability of a company, particularly in its initial stages.

In considering the value of this benefit, founders and investors should be mindful that company growth can impair the availability of the SR&ED credit. Generally, taxable income above C$500,000 and taxable capital above C$10 million in a prior year can start to reduce the availability of enhanced and refundable SR&ED credits available to a company.

Other benefits to qualifying as a CCPC include:

- Lower corporate tax rates on the first C$500,000 of active business income.
- Beneficial tax treatment for Canadian resident shareholders on the sale of shares of certain CCPCs, including (i) a one-time capital gains exemption (C$883,384 for 2020), and (ii) deferral of capital gains realized if the proceeds from the sale are reinvested in another CCPC, in each case, provided certain conditions are met.
- Beneficial tax treatment for certain Canadian resident arm's length employees on the exercise of options, including (i) a tax deferral until the employee disposes of the underlying shares (in contrast to non-CCPC options where the taxable benefit is realized at the time of exercise), and (ii) a deduction representing 50% of the benefit derived from the options on the sale of the underlying shares (even if the options were not granted at fair market value), provided the employee has held the shares for at least two years from the date of exercise (in contract to non-CCPC options which would only be eligible for the 50% deduction where the options were awarded with a fair market value exercise price).

As a result of these benefits, CCPC eligibility may well be the determining factor on where to establish the company. In fact, U.S. investors that are aware of these benefits may expect that any Canadian tech startup in which they are investing take advantage of, and maintain, CCPC eligibility as long as possible. Further, where Canadian resident founders have made the initial decision to incorporate their company in the U.S. but come to realize that many of their R&D activities would be "SR&ED eligible," it is not uncommon for such companies to look at options for reorganizing into a Canadian-based structure; however, these cross-border reorganizations involve additional cost and complexity, as explored further below.

Foreign investment

The tax efficiency of investing in Canada has been made all the more important since tax barriers formerly placed on non-resident investors were removed. Previously, U.S. investors were subject to significant impediments to disposing of a cross-border investment by the Canadian tax regime, primarily in the form of requirements to apply for and obtain clearance certificates from the Canadian tax authorities, failing which large withholding requirements would be imposed on buyers. These barriers meant that most foreign investment (i) was done either through tax-favourable jurisdictions or countries that had entered into tax treaties with Canada to facilitate obtaining tax clearance certificates, or (ii) required the Canadian target to implement a share exchange structure (discussed below) or reorganize as a U.S. corporation. The removal of these barriers, which was brought about largely through advocacy efforts by U.S. investors, has made it much easier for Canadian startups to attract U.S. capital. This has permitted founders to focus on CCPC eligibility as being the key determining factor on where to incorporate.

NVCA documents

Practice has evolved over the past 10 years such that emerging companies in Canada are now commonly implementing National Venture Capital Association (NVCA)-style documents that U.S. investors are familiar with, but which have been modified to work in Canadian jurisdictions. This change has effectively eliminated a legal distinction that had given some U.S. investors pause when they considered investing in Canadian startups.

As a baseline, the corporate statutes in most Canadian jurisdictions, and certainly federally and in Ontario, are "modern" corporate statutes that reflect Delaware corporate law principles. Nevertheless, there are certain differences, such as the scope of fiduciary duties of the board, changes triggering class votes, shareholder consent requirements and the availability of the oppression remedy that continue to distinguish the jurisdictions. The Canadian NVCA-styled documents are designed to harmonize the differences between Canadian corporate law and Delaware corporate law through contractual agreement. For example, many Canadian technology companies will provide for unanimous shareholder consent on written instruments and enumerate certain changes triggering class votes. They also address U.S. tax considerations that arise in connection with the ownership of a foreign corporation (e.g., PFIC and CFC rules). U.S. investors are familiar with and understand these documents, which leads to increased confidence and streamlined processes when looking for potential investments in Canada.

Downside risks

Given the compelling CCPC benefits, what might make a forward-thinking or risk-averse founder consider incorporating in the United States?

Uncertain withholding regime?

First and foremost, any cross-border investment is inherently complex and comes with certain risks. This is because any investor or acquirer of a foreign business must first ask, "can I get my investment back in a way that is tax efficient?" For example, will that investor be able to receive dividends or distributions from its investment without large withholding requirements? Will a non-U.S. acquirer be able to successfully integrate cash flows and efficiently manage the target in its existing structure? Are the entities able to share intellectual property and other facilities across the border? If the value created from the

investment or acquisition cannot be taken out of the target company's home jurisdiction in a meaningful way, the transaction may not be worth doing. This risk is amplified by the fact that most potential tax impediments apply when the foreign party is exiting from the investment (e.g., on sale of the shares), rather than at the time that the investment is made. This means that both the company and the investors must have confidence in the future tax regime between the applicable jurisdictions.

Canada and the United States are no exception to this. As mentioned above, prior to 2010, certain barriers were imposed on foreign investors of Canadian companies that resulted in many investors investing through other jurisdictions, or not at all. While these barriers have since been removed, there is no guarantee that the more tax efficient regime will be permanent or that similarly efficient rules will stay in place. For example, U.S. tax reform (which occurred in late 2017), injected a great deal of uncertainty into the market for U.S. venture capital and private equity investment in non-U.S. portfolio companies when, as part of that overhaul, the U.S. government introduced the novel global intangible low-taxed income (GILTI) tax regime. The GILTI rules, as enacted in the *Internal Revenue Code*, would have had a materially negative and disruptive impact on the U.S. taxation treatment of foreign investment by certain U.S. investors by effectively accelerating the taxation of foreign income and thereby creating a new and pervasive form of "phantom" income. Fortunately, the scope of the GILTI rules was substantially scaled back by Treasury Regulation issued in June 2019. But for this largely unanticipated and unexpected regulatory restraint imposed on the GILTI rules, however, the GILTI regime would have created significant issues for U.S. investors in foreign corporations, and Canadian startups would have certainly felt that effect. So, while current tax regimes support foreign investment in Canadian corporations, these recent tax considerations demonstrate that it is possible this may not be the case in the future.

Lack of rollover treatment

For forward-thinking founders, another consideration is the tax issues that can arise when a Canadian company is acquired by a foreign corporation. This is predominantly relevant where an acquirer wants to satisfy part (or in some cases, all) of the purchase price with its own shares – a common acquisition structure for technology companies. In Canada, shareholders of a target company are entitled to defer the taxes owing on consideration shares in a stock-for-stock deal until those shares are sold. This rollover treatment is not available, however, where the shares of a Canadian target are exchanged for shares of a foreign company.

This means that, in cross-border stock-for-stock deals, Canadian shareholders can be left with a tax bill without having received any cash to pay it. This can be particularly problematic for Canadian residents who have material accrued gains on their shares. Alternatively, in the face of objections from the Canadian shareholders to what is effectively a lower net per share price, the acquirer may not be able to use its equity for all or a portion of the purchase price, which could limit the universe of potential buyers to those who can pay with cash.

This risk to the buyer pool leads founders and investors to consider the longer-term impact on the location of incorporation of a company. To avoid the risk of impairing an exit deal with a U.S. buyer offering shares as consideration or having no deal at all due to a diminished buyer pool, a founder may consider starting as a U.S. entity.

Is an exchangeable share structure the solution (and, by the way, what is

that)?

One thing to bear in mind when considering the above-noted exit risk (i.e., the risk that a startup's Canadian shareholder base will object to a share-for-share exit deal involving a buyer's U.S. shares due to lack of rollover treatment), is the complexity of the common "fix" to this risk. In what is often referred to as an "exchangeable share" structure, the U.S. acquirer will set up a Canadian corporation and authorize a class of "exchangeable shares" to be issued as consideration to the Canadian holders of the target shares. The exchangeable shares are meant to replicate the rights of the shares of the U.S. acquirer as much as possible, including the right to receive dividend payments in the same amount declared on the acquirer shares, the rights to receive acquirer shares on certain liquidity events and the right to exchange the Canadian shares for acquirer shares on demand.

While this is an effective and somewhat-commonly used solution in a deal that would otherwise not result in rollover treatment for Canadian resident shareholders, it is complex and costly to implement. Furthermore, the lack of understanding of these structures by the companies involved, as well as by their shareholders and counsel, can lead to confusion during and after the acquisition. This typically arises when the shareholders attempt to sell or exercise other rights with respect to their exchangeable shares. Unfortunately, this means that the common fix is not always an effective solution.

Other issues

Finally, a company may want to consider other factors, such as government grants that are only available to companies incorporated in the United States (e.g., the Small Business Innovation Research and Small Business Technology Transfer programs offered by the United States federal government), the location of its employees, customers and suppliers and whether the company intends to eventually move operations to the United States. While each of these items may not carry sufficient weight to give up tax benefits offered to CCPCs, particularly at the incorporation stage, they are worthwhile considerations at the outset given the difficulty, or in certain cases impossibility, of changing the jurisdiction of a company down the line.

Alternative startup structure

An alternative, which may be more appropriate where the startup is likely to have SR&ED-qualifying expenses but may not be or remain controlled by Canadians, is to implement what is known as a "SR&ED structure."

A SR&ED structure is used where the operations of a business are run out of the United States, but the research and development activities are carried out in Canada by a corporation that qualifies as a CCPC. Various considerations between the relevant stakeholders need to be carefully considered in these arrangements, including putting in place the requisite corporate and commercial protections.

In the appropriate circumstances, this type of dual arrangement can allow investors in a U.S. startup to benefit from Canada's favourable SR&ED incentives. But these structures are complex and costly to implement (e.g., consultation with legal and tax advisors is essential) and administer, which in some cases, means these structures may not be a viable option for a startup without significant resources.

Corporate migration across the Canada-U.S. border by a continuance can be complicated (and costly)

An entity that wishes to migrate across the border any effect that change through a corporate restructuring or through the option of transferring its jurisdiction (known as a 'continuance' under Delaware law) from Canada to the United States (or vice versa). Founders should be mindful, however, that a continuance can result in significant tax consequences in both Canada and the United States. Specifically, for Canadian tax purposes, the company continuing from Canada to the United States will be deemed to have disposed of all of its property at fair market value and will be required to pay income tax on the portion of its income and capital gain that is deemed to have been realized thereunder. In addition, the company must pay branch taxes equal to 25% of the excess of the fair market value of its assets over the total of the paid-up capital of its shares and outstanding debts. In addition, U.S. shareholders of the migrating Canadian company may be subject to current U.S. taxation in connection with the continuance (which is particularly unattractive given that there is frequently no liquidity in connection with a continuance transaction).

In the other direction, when a U.S. corporation engages in a corporate law continuance out of the U.S. and into Canada, there is an important threshold question of whether that migration will accomplish any U.S. tax effect at all. More particularly, the U.S. anti-inversion rules are designed with the specific purpose of preventing corporate expatriation out of the United States. When applicable, these rules can apply to treat the continued corporation as if it remained a U.S. corporation for all U.S. federal income tax purposes (even though, as a corporate law matter, the redomiciled entity is a Canadian corporation). The anti-inversion rules are notoriously complex and, by way of summary, make it very difficult for a U.S. corporation to successfully expatriate to a non-U.S. jurisdiction unless the corporation has "substantial business activities" (i.e., substantial income, assets and employees) in the new foreign jurisdiction. If the U.S. corporation expatriating to Canada falls victim to the U.S. anti-inversion rules, it will be in the unenviable situation of concurrently being treated as a U.S. corporate taxpayer for U.S. tax purposes and a Canadian corporate taxpayer for Canadian tax purposes. For some corporations, this dual status can be managed, for many others it is unworkable.

Even if the expatriating U.S. corporation is able to avoid the application of the anti-inversion rules, the continuance itself may carry a hefty U.S. tax toll charge. In particular, the continuance (a) is likely to trigger corporate level tax for the U.S. corporation (i.e., the continued U.S. corporation would be subject to U.S. federal income tax, currently at a rate of 21%, on the built-in gain (if any) in its assets at the time of continuance), and (b) is generally taxable for U.S. shareholders of the continuing corporation if they have built-in gain in their shares of the U.S. corporation at the time of the continuance. In some cases, these issues can be managed through structuring or otherwise but the process of systematically identifying and addressing the relevant tax issues can make the migration a complicated (and costly) undertaking.

Conclusion

For Canadian startup companies with anticipated research and development expenses, particularly in its initial years, incorporating in Canada to take advantage of the tax advantages offered by the Canadian government makes a lot of sense.

Or, if an entrepreneur with sufficient resources for legal costs anticipates both operating in the United States and qualifying for CCPC status, it may be worth considering alternate arrangements that can still preserve certain benefits of Canada's SR&ED regime.

On the other hand, even though the tax regimes in Canada and the United States have been supportive of cross-border investment over the past decade, an entrepreneur who anticipates being acquired by a U.S. company, particularly in the near term, may choose a different path. She or he may choose to forego the potential upfront tax incentives offered by the Canadian government's SR&ED credits and proceed by incorporating in the United States in a bid to ensure the widest universe of potential buyers and eliminate the possible need to rely on complex exit mechanics, such as exchangeable share structures, which might impair an otherwise smooth exit transaction.

Incorporating in Canada is a viable, and often compelling option, but there is no "one size fits all" solution, and savvy founders are advised to consider the issues so that they can make an informed decision.