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TAX COUNSEL

Insights Series: Tech Sector Income Tax Issues

This Felesky Flynn Insights Series focuses on tax issues relevant and specific to start-up businesses operating in the technology sector in Canada.

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TAX CONSIDERATIONS WHEN RAISING CAPITAL

Commercial considerations will often determine the means of raising capital. The income tax consequences can vary as between alternatives, so much so that in some cases income tax consequences may change the economics of financing alternatives, especially where there are foreign investors or government incentives and tax credits.

This article briefly describes certain tax considerations when raising capital by various means, such as: debt, equity, government programs, reward-based crowdfunding, and non-traditional contracts like Simple Agreement for Future Equity ("**SAFE**") agreements. The article is intended to describe some alternatives only and is not intended to be comprehensive.

1. Debt

Interest-free loans are simple and cost-effective, which is why they are often the first means of financing a company. New investors generally expect interest-free loans from founders or their family members ultimately to be converted into common shares. When this happens, the company should consider whether the debt forgiveness rules, which can be complex and cause adverse tax consequences, will apply. If a company's liabilities do not exceed the value of its assets, the debt forgiveness rules generally do not apply on such a conversion.

Of course, if investors are not all contributing proportionately, interest-free loans are not feasible. In that case, interest may be charged, but interest-bearing loans from founders can often be tax inefficient for early-stage start-ups. The company can generally deduct the interest payable on the loan, but the company's interest deduction may not be useable until the company is profitable. The interest payable to lenders is generally taxable income to the lender, even if the company cannot currently afford to make the interest payments due to cash flow concerns.

2. Equity

Share issuances to certain types of investors can affect a company's status as a Canadian-controlled private corporation ("**CCPC**"). CCPC status is necessary to receive the small business deduction (*i.e.*, low combined income tax rate of 11% versus 23% at the general corporate rate in Alberta) and other government incentives, such as enhanced and

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refundable investment tax credits, beneficial stock option rules, and access to the lifetime capital gains exemption. CCPC status may be lost where non-residents or public corporations together have greater than 50% of the voting rights of a company. This applies even where non-residents or public corporations have a contingent right, such as with an option or convertible debt, to purchase shares with greater than 50% of the voting rights. If a founder or investor with substantial shareholdings moves to another country, there is a similar risk to CCPC status.

It also is important to consider the price at which shares are issued. Generally, investors (including founders) should pay fair market value consideration for their shares. Sometimes, start-ups do not issue enough shares to founders or key people at the early stages. If a company is not very valuable yet, it may issue low-cost shares without problems. If a company becomes more valuable, there may be adverse tax consequences (along with other corporate law concerns) to the founder if he or she pays less for any additional shares than they are worth. In such cases, a capital reorganization may be required. There are additional tax considerations with respect to options, warrants, restricted share units, and other instruments involving equity.

Start-ups generally issue common shares to the founders and early-stage investors. Sometimes, however, investors want to purchase preferred shares, which often provide preferred entitlement to dividends, priority over assets in the event the company is dissolved, and anti-dilution clauses. Preferred shares can be an effective tool to raise capital, but can raise additional tax considerations if the company plans to pay dividends on the preferred shares. In particular, companies that issue preferred shares should turn their minds to the "taxable preferred share" rules and Part IV.1 and Part VI.1 tax.

Start-ups also should consider whether to issue new classes of shares to later investors. Founders often receive common shares with low paid-up capital ("**PUC**"). The issuance of new classes of shares to later investors may protect them from certain PUC averaging rules, which can limit their ability to extract funds from the company on a tax-free basis.

Businesses involved in the renewable energy sector also should consider issuing flow-through shares. These may be applicable where equipment is used to generate or conserve energy by means of a renewable source (*e.g.*, wind, solar), use fuel from waste (*e.g.*, manure), or efficiently use fossil fuels (*e.g.*, certain efficient cogeneration systems). Flow-through shares are attractive to investors in that they enable the "flow-through" of the corporation's "Canadian renewable and conservation expense" deduction for qualified expenses directly to investors. Investors are able to deduct these amounts against their incomes in circumstances where the company cannot make immediate use of those deductions.

3. Government Programs

There are a number of government programs which can provide capital to assist start-ups. At a high-level, these can have tax consequences of which the company should be mindful. For example, interest-free loans from a government can reduce the value of certain government tax incentives, such as SR&ED deductions and investment tax credits. Government grants also can often be fully taxable to a company.

4. Reward-Based Crowdfunding

Some start-ups turn to crowdfunding as a means of raising both their brand awareness and capital. Under reward-based crowdfunding, members of the public who wish to support a company's product or venture can provide funds in exchange for a reward. Sometimes the reward is simply being the first to receive a product, but there are many creative ways in which companies have enticed supporters to make a donation or otherwise provide funding.

While some crowdfunding options include "donations" or "gifts", which are not ordinarily taxable to individuals, these "gifts" will generally be taxable to for-profit companies. The expenses related to issuing rewards will also generally be deductible or added to depreciable cost. Where the reward or other promotional expense incurred to raise brand awareness involves some form of personal benefit to a founder or investor, additional tax issues may arise.

5. Simple Agreement for Future Equity ("SAFE") Agreements

A SAFE agreement is a contract where the investor provides funds to a company in exchange for an equity stake at a later date. There is generally no interest payable, no maturity date, and the company is often under no obligation to repay investors unless certain triggering events occur. Despite comments that these agreements are neither debt nor equity, the language of each particular SAFE agreement should be reviewed to determine its proper characterization for tax purposes. To our knowledge, no Canadian court has ruled on whether these agreements are debt or equity and there may be more uncertainty in the income tax context than many commentators suggest. In particular, a SAFE agreement could be considered a contingent right to equity, which could impact CCPC status depending on the types of investors. Also, the tax consequences on conversion into equity, or extinguishment of the SAFE agreement, may involve complexities similar to those relating to convertible debt, especially if the start-up involves a partnership structure rather than a corporation.

In summary, there are different tax consequences of which start-ups should be aware when considering various means of raising capital. Start-ups should be mindful of how they have raised capital in the past because certain events beyond their control, like key investors moving abroad, can have significant adverse tax consequences. We recommend that start-ups engage tax counsel early on to determine how their commercial interests align with their income tax planning to best support cash flow and encourage tax-efficient investment.