

## 6. FINANCING THE INVESTMENT

### 6.1 Foreign Loans

Generally, there are no restrictions on the importation of capital to Canada or the exportation of capital from Canada thereby enabling the non-resident investor to finance a Canadian investment through funding from non-Canadian sources by way of, for example, loans or equity participation. However, capital employed in Canada is subject to Canadian taxation including the payment of Canadian capital gains tax upon the happening of certain events such as the death of an individual owning property in Canada, the permanent departure of a Canadian resident from Canada or the disposition of property by a non-resident individual or entity. So long as any such tax liabilities have been provided for, the non-resident investor is entitled to deal with his or her funds as he or she sees fit. If the acquisition is reviewable under the *Investment Canada Act* and the financier will in fact control the Canadian business, foreign financing may be subjected to Investment Canada considerations. In addition, there is a special withholding tax exemption for long term arm's length loans by non-residents to Canadian corporations (see Section 5.2 for details).

Most of the major international banks now have branches in Canada. It is often possible for a non-resident investor to negotiate a loan with the Canadian branch of his or her bank at home and to repay the loan provided by the Canadian branch with his or her revenue earned abroad. Banking has become competitive in Canada and the foreign-controlled "Schedule 'II'" banks are sometimes prepared to grant loans on favourable terms to persons who are known to them abroad. Although some foreign banks cannot carry on business in Canada without complying with our banking laws, isolated financings arranged and processed abroad are not subject to Canadian banking regulations. Many foreign banks have now established branches or affiliates which engage in restricted areas of business and may be able to grant loans, provide chequing privileges or supply other banking services customarily available from Canadian chartered banks.

Foreign lending institutions sometimes prefer security in the investor's country of origin. This, in turn, may impinge upon the investor's available credit for other purposes. It is advisable in these situations to persuade the foreign lender to accept Canadian assets as security. Loans from non-institutional overseas sources are not subject to any special restrictions but the lender will undoubtedly wish to have his or her security documents drawn in a form which is enforceable in Canada and which does not contravene the provisions of the *Interest Act (Canada)* or other Canadian laws. A Canadian bank will often advance funds on the security of the investor's Canadian assets supported only by the unsecured personal or corporate guarantee of the investor.

Funds can be advanced and repaid in any currency. If the loan is to be repaid in a currency other than Canadian dollars, the documentation must be carefully drawn to ensure that the appropriate conversion rate will be applied at the date of actual repayment. While foreign currency loans are subject to currency fluctuations, under certain circumstances this risk is offset by a reduction in the interest rate charged.

Most lenders are quite cautious when making loans which are to be secured primarily by commercial real estate. Accordingly, both Canadian and foreign lenders are reluctant to grant mortgage loans of more than 65% to 75% of the lender's project valuation.

There are also other long term loans aside from mortgage loans which are provided by banks, trust companies, insurance companies, and independent sales finance companies. Long term loans generally can be secured by the asset being purchased, the unencumbered physical assets of the business as well as from additional funds procured from the shareholders or the principals. Term loan evaluation tends to be more rigorous than mortgage loan evaluation. In order to enable a financial institution to evaluate the commercial viability of the business or the abilities of the management team, they will generally require a detailed business plan and extensive financial information and projections.

The current credit crunch has undoubtedly restricted many financial institutions from lending money. However, Canada is currently the only country in the industrialized world not to have experienced a bank failure and all the factors suggest that Canadian banks will not only survive the financial crisis but will also take advantage of opportunities that other banks are not in a position to exploit.

## 6.2 Domestic Loans

A complete range of financial institutions and services exists in most major Canadian centres. All of the major chartered banks have affiliates or correspondents in most main centres abroad and most major overseas banks have established branches or representative offices in Montreal, Toronto, Calgary and Vancouver but all of them have representation in Toronto as it is the commercial centre of Canada.

Investments may be funded through these financial institutions so long as the Canadian lending criteria are satisfied and the security requested is given. Non-resident investors are sometimes astonished to discover that Canadian chartered banks almost invariably insist on a first mortgage or equivalent security, as well as on personal guarantees of the principals based on their net worth. In addition, Canadian banks tend to expect their customers to deal exclusively with one bank, although the European multiple bank approach is rapidly gaining acceptance in Canada and, for large loans at least, the Canadian banks themselves often seek participation by several banks.

## 6.3 Public Financing

As indicated earlier, corporations which issue their securities to the public are subject to extensive government regulations designed to protect the public. Considerable delay and expense will therefore be incurred by the issuer in discharging those obligations. In addition, unless the corporation proposing to issue securities to the public is well known in this jurisdiction, it may encounter difficulties finding an underwriter prepared to underwrite the issue or an investment dealer prepared to market the securities. Recent amendments to the *Securities Act* (Ontario) make private placements somewhat easier but the preparation of an offering memorandum will usually still be necessary.

## 6.4 Government Funding

Although there are several federal and provincial government agencies which encourage industries to locate in particular areas or engage in particular types of activity, these sources of funds are subject to specific lending criteria and are only available under certain circumstances. Some assistance, for example, is available only to Canadian-controlled enterprises. In addition, government programs offering incentives to designated industries change from time to time for policy or political reasons. If government assistance is required, the investor should therefore carefully explore the types of assistance available at the time the investment is to be made as programs are withdrawn and new programs are introduced regularly.

Assistance is often provided by way of loans with interest or principal payment concessions. Through the Business Development Bank of Canada (the "BDC"), the federal government provides financial assistance to persons establishing new businesses in Canada or attempting to take over existing businesses, with specific emphasis placed on export and technology sectors. The BDC offers financing solutions, such as long term financing, subordinate financing and venture capital, as well as consulting services. Financing of up to \$100,000 may be provided to an experienced entrepreneur in the start-up phase who can demonstrate that he or she has a competent management team, has invested reasonable financial resources in the business, and can show the business has realistic market potential. In the case of business acquisitions, companies with strong growth potential may qualify for quasi-equity financing between \$250,000 and \$10 million for market development or expansion projects.

By virtue of the *Small Business Financing Act* (Canada), which was enacted in April 1999 and which replaced the *Small Business Loans Act* (Canada), the federal government may guarantee loans of up to \$250,000 given to new and existing small businesses in order to finance the purchase of or improve fixed assets ("CSBF loan"). Since the government only guarantees the loan (up to 85% of the losses sustained by the lender), eligible businesses may apply at the financial institution of their choice. There is no direct government intervention and the final decision to grant the loan rests solely with the bank or other lender which would request adequate security for the loan. Eligible businesses are those operating for profit in Canada whose estimated gross revenue does not exceed \$5 million in the fiscal year of the business during which the loan is approved. Businesses operating outside Canada, farming enterprises, charitable organizations and religious organizations are not eligible. The amount of the loan may not exceed 90% of

the actual cost of the eligible assets, and interest rates on CSBF loans may be either floating or fixed. The floating rate cannot be more than 3 percent higher than a lender's prime lending rate. Fixed rates cannot be more than 3 percent higher than the lender's residential mortgage rate for the term of the loan. A registration fee of 2% of the total amount loaned under the program must also be paid by the borrower to the lender and this registration fee may be financed as part of the loan. Lenders are required to take security in the assets financed and they also have the option to take an additional unsecured personal guarantee, which cannot exceed 25% of the total amount loaned.

## 6.5 Money Laundering

Like all other OECD members Canada has enacted the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (Canada) (the "Act") requiring detailed reporting of currency or monetary instruments crossing the border, those circulating under suspicious circumstances, and large cash transactions. For legitimate business activity this legislation has little impact although the regulatory compliance burden has been increased by its enactment and its existence must always be borne in mind whenever funds are being transferred to or from Canada.

"Monetary instruments" is defined in the *Cross-Border Currency and Monetary Instruments Regulations* (Canada) and includes:

- (a) securities - including stocks, bonds, debentures and treasury bills; and
- (b) negotiable instruments - including cheques, promissory notes, bank drafts, travellers' cheques and money orders, other than warehouse receipts or bills of lading and negotiable instruments that bear restrictive endorsements or a stamp for the purposes of clearing or are made payable to a named person and are not endorsed.

Because only those monetary instruments whose title passes upon delivery are required to be reported, the following are exempt from the general reporting rule regardless of their value:

- (a) bank drafts, cheques or other negotiable instruments made payable to a named person or enterprise that have not been endorsed; and
- (b) share certificates that are not endorsed or that bear a restrictive endorsement (i.e. certificates that are endorsed to a named person or a corporate entity).

### (1) Cross-Border Transactions

Under the Act, anyone entering or exiting Canada with currency or monetary instruments of \$10,000 or more must file a report with Customs officials providing information on the reporting entity, the individual conducting the transaction, and the nature of the transaction itself. All persons making the cross-border transaction as well as those transporting on behalf of another entity are required to complete *Form E677, Cross-Border Currency or Monetary Instruments Report - Individual*, which can be filled online from the Canada Border Services Agency (CBSA) website at [www.cbsa-asfc.gc.ca/](http://www.cbsa-asfc.gc.ca/) and then printed, or if transporting on behalf of an entity or other person, that party must complete a *Form E667, Cross-Border Currency or Monetary Instruments Report - General*, which can also be filled online at the CBSA website. These reports must be given to a border services officer at a CBSA office upon entering or exiting Canada. The report is then forwarded to the Financial Transactions and Reports Analysis Centre of Canada ("FINTRAC"), a government agency that collects and analyses information in order to assist in the detection of money laundering and the financing of terrorists.

Information provided in the reports may be disclosed to such bodies as the Canadian Security Intelligence Service or the governments of foreign states. These reports can be made known to tax authorities in Canada and those in any nation with which Canada has entered into a tax treaty. Such a disclosure would effectively neutralize any advantage of transporting currency and monetary instruments outside of the formal international banking system, since the reporting requirements include the disclosure of the identity of both

the sender and the recipient.

Any individual not reporting a reportable cross-border transaction faces substantial financial/criminal penalties in addition to the potential loss of the funds where criminal activity is alleged and the legitimacy of the funds is not proved. Though the avoidance of tax does not fall strictly within the enumerated list of prohibited activities, any unreported cross-border transaction would likely be treated as though the funds were proceeds of crime and would therefore be subject to the same scrutiny. Absent a finding of reasonable grounds for suspecting that the funds are the proceeds of crime, the unreported transportation of a reportable transaction, if discovered, is still subject to a penalty of between \$250.00 and \$5,000.00 depending on whether there was an attempt to physically conceal the funds and, if so, the extent of the attempt to conceal them.

## **(2) Suspicious Transactions**

A report must be filed with FINTRAC, Canada's financial intelligence unit, of any "suspicious transaction" which is a transaction, or a series of transactions, in respect of which there is reason to believe it/they may be connected to terrorist or money laundering activities. Effective June 23, 2008, this applies whether the transaction in question was carried out or simply attempted. Entities that are required to report such transactions include financial organizations (including banks, credit unions, and trust and loan companies), life insurance companies, brokers or agents, securities dealers, portfolio managers and investment counsellors who are provincially authorized, foreign exchange dealers, money services businesses, agents of the Crown selling money orders, accountants and accounting firms or real estate brokers and sales representatives carrying out activities on behalf of their clients, and casinos. Effective December 30, 2008, dealers in precious metals and stones must report suspicious transactions and effective February 20, 2009, real estate developers have also been subject to this duty. Lawyers are currently not required to report suspicious transactions, however, new client identification and verification requirements implemented in Ontario, referred to in Section 1.5 of this Manual, are designed to curtail terrorist and money laundering activities.

Again, details regarding the reporting entity, the person involved in the transaction, and the transaction itself must be included in the report. Where suspicions have been raised by a series of transactions, information on each must be disclosed. Failure to report suspicious transactions could result in a fine of up to \$2 million and/or imprisonment for up to 5 years.

## **(3) Large Cash Transactions**

Under the Act, persons who receive \$10,000 or more in a single transaction, or over the course of several transactions which occurred within 24 consecutive hours by or on behalf of the same entity, are required to file a Large Cash Transaction Report with FINTRAC. Such reports must be sent within 15 days of the transaction and must include the same information as that mentioned above for suspicious transactions.

There are several exceptions to the general reporting rule. No report is needed if the cash has been sent by financial institutions, such as banks, credit unions, or trust and loan companies. Similarly, no report is required if the cash has been sent by provincial/federal departments or Crown agencies, incorporated municipal bodies, or hospital authorities, unless the reporting entity is a casino. However, some entities, such as financial institutions, money services businesses or a casinos are required to report certain electronic funds transfers (EFTs) to FINTRAC.

## **6.6 General Monetary Considerations**

Although Canada does not have any foreign exchange controls in effect, various other countries do have them and the non-resident investor should always keep them in mind when planning the financing of an investment as this can affect the funding of the business enterprise. For example, if the proposed financing package consists of a loan to the Canadian subsidiary of a non-resident corporation which is secured by a guarantee of the non-resident parent corporation, the entire transaction may be delayed or

jeopardized if the lender is unwilling to accept a guarantee unless the foreign exchange control laws of the parent corporation's home jurisdiction are complied with or an exemption is obtained.

In addition, three different, yet related, tax considerations must be borne in mind. Firstly, the "thin capitalization" rule referred to in Section 5.1(3)(f) may result in restricting an interest expense deduction for the Canadian business enterprise if the debt to equity ratio of the shareholder(s) exceeds two to one (2:1) by disallowing as a deductible expense the interest payable on the excess indebtedness. Secondly, if capital is obtained by borrowing funds from a non-resident source, withholding tax will be exigible unless the loan is exempt as a result of satisfying the requirements set out in Section 5.2. Thirdly, if capital is obtained through equity financing, the Canadian business enterprise will not receive any deduction for tax purposes upon payment of dividends to the equity participants and withholding tax will be exigible upon dividends paid to non-resident shareholders.

In summary, it is very important for the prospective non-resident investor to carefully plan the financing of the Canadian investment before making any commitments in connection with the investment. Careful structuring of the investment can avoid many pitfalls and can facilitate the successful completion of the investment. Therefore, the assistance of Canadian accounting, financial, legal and tax advisers should be sought at the outset in order to avoid costly errors and preventable delays.

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