

Canadian Tax Structuring for Gaming Ventures

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INTRODUCTION

WITH THE ENACTMENT of certain small but significant changes to the Income Tax Act¹ (the Act), the Canadian government has made it much more attractive for Canadian gaming corporations to seek flotation on various non-Canadian stock exchanges without interfering with their shareholders' liquidity or ability to alienate shares of their capital stock. For those corporations not wishing to be quoted on recognized stock exchanges—or, indeed, on any exchange—the more compliance-dependent mutual fund corporation (MFC) structure continues to be available. If and as the gaming sector becomes more open and again turns to the public markets for capital and liquidity, this changing tax landscape in Canada may be of particular interest to all manner of players in the industry.

Generally, both residents of Canada and non-residents of Canada are taxed on dispositions of taxable Canadian property. Persons resident in Canada pay tax on their taxable income during each taxation year,² i.e., on their so-called worldwide income. Non-resident persons not taxable pursuant to subsection 2(1) of the Act are still taxable on their taxable income earned in Canada in any taxation year if they have, inter alia, disposed of a taxable Canadian property (TCP) in that year.³

When a non-resident person disposes of TCP, that person must submit to the clearance or disclosure process set out in part I of the Act. This process is often called the “section 116 clearance process,” after the relevant section of the Act, or the “clearance

certificate process.”⁴ Two exceptions are of note to a Canadian corporation that is a gaming business, viz.:

1. if the corporation is a corporation quoted on a “recognized stock exchange,” shares of the capital stock of that corporation are excluded property within the meaning of the Act and are not subject to the § 116 clearance process; or
2. if the corporation is a public corporation and not quoted on a recognized stock exchange, but is an MFC within the meaning of the Act, shares of its capital stock will generally not be considered to be TCP in the first place, and therefore also not subject to the § 116 clearance process.

This article will briefly set out the meaning of TCP within the Act. It will proceed to outline the § 116 clearance process in more detail and highlight relevant changes to § 116 of the Act in recent years. The article will then look at MFCs and how those structures may still be used to good effect by entities involved in gaming. The article concludes with some comments on how gaming sector corporations in Canada may exploit these tax developments to attract more international investment.

¹ Income Tax Act, R.S.C., ch. 1 (2009) (Can.).

² See *id.* § 2(1).

³ See *id.* § 2(3)(c).

⁴ This latter term must not be confused with the clearance certificate provided for in § 159(2) of the Act. § 159(2) sets out a process for a legal representative of a taxpayer obtaining a clearance certificate from the Minister of National Revenue certifying, inter alia, that all amounts for which the taxpayer can be liable under the Act have been paid or that sufficient security has been posted therefor. The legal representative is to obtain such clearance before distributing any of the taxpayer's property to any other person.

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TAXABLE CANADIAN PROPERTY

TCP of a taxpayer at any time in a taxation year means, among other things, real property situated in Canada,⁵ property used or held by the taxpayer in a business carried on in Canada,⁶ and an insurer's designated insurance property for the year.⁷ TCP also includes a share of the capital stock of a corporation resident in Canada (except for an MFC) that is not listed on a designated stock exchange.⁸ Two definitions should be clarified here. First, a corporation is deemed to be resident in Canada if, in the case of a corporation incorporated after April 26, 1965, it was incorporated in Canada.⁹ Accordingly, any corporation incorporated pursuant to a Canadian federal or provincial statute after that date is deemed to be resident in Canada.

Second, a designated stock exchange means a stock exchange or a part of a stock exchange that the federal Minister of Finance has designated pursuant to § 262 of the Act.¹⁰ Section 262 allows the Minister of Finance to designate an exchange,¹¹ revoke a designation,¹² and provide for the time at and after which such designation or revocation is in effect.¹³ A background document issued by the federal Department of Finance¹⁴ outlines the criteria that the Minister of Finance will consider in designating an exchange, including whether the exchange's host country: has commercial, legal, and tax relations with Canada (for example, through a comprehensive tax information exchange agreement or a comprehensive tax treaty); is in good standing with the international financial community; and has a low risk of imposing capital restrictions or other impediments on the liquidation of investments and the repatriation of funds by foreign investors. The annex to the backgrounder provides a list of currently-designated exchanges including, for example, the London Stock Exchange (the LSE) (but excluding the Alternative Investment Market (the AIM) of that exchange).¹⁵

Therefore, generally the shares of a Canadian corporation not traded on a designated stock exchange will be considered to be TCP.¹⁶

SECTION 116 CLEARANCE PROCESS

Section 116 of the Act safeguards the Canadian government's ability to levy and collect tax on capital gains from dispositions of, for example, real

property and shares of certain corporations, even where the government has no direct jurisdiction over the non-resident vendor. The provision accomplishes this by allowing for a process of applying to the Canada Revenue Agency (CRA) for clearance before a transaction or notifying the CRA of the transaction *ex post* and, crucially, by making the purchaser of the TCP liable for the tax exigible on the transaction.

Subsection 116(1) of the Act allows for a non-resident person proposing to dispose of TCP to notify the CRA in writing of the impending transaction. The notice is made through a prescribed form of election¹⁷ and any necessary addenda thereto. The notice must be given in advance of the proposed transaction and must set out certain prescribed particulars, including a description of the property to be disposed of,¹⁸ its adjusted cost base (ACB),¹⁹ and the proceeds of disposition (POD) from the transaction.²⁰ Where the applicant provides notice pursuant to subsection 116(1) and payment to the Re-

⁵ Income Tax Act, R.S.C., ch. 1 § 248(1), definition of "taxable Canadian property" (a) (2009)(Can.).

⁶ *See id.* § 248(1), definition of "taxable Canadian property" (b).

⁷ *See id.* § 248(1), definition of "taxable Canadian property" (c).

⁸ *See id.* § 248(1), definition of "taxable Canadian property" (d).

⁹ *See id.* § 250(4)(a).

¹⁰ *See id.* § 248(1), definition of "designated stock exchange" (c).

¹¹ *See id.* § 262(1).

¹² *See id.* § 262(2).

¹³ *See id.* § 262(3).

¹⁴ Department of Finance Canada, News Release 2008-049, "Backgrounder—Process for Designating Stock Exchanges" (2008), available at <http://www.fin.gc.ca/n08/data/08-049_1-eng.asp> (last visited June 30, 2009).

¹⁵ *See* Letter from Christian Leduc, Acting Head, Departmental Correspondence Unit, Department of Finance Canada to author (July 22, 2009) (on file with author); Canada Revenue Agency, Income Tax Ruling Document No. 2007-0253561E5(F) (2008); and Department of Finance Canada, "Designated Stock Exchanges" (2009), available at <www.fin.gc.ca/act/fim-imf/dse-byd-eng.asp> (last visited July 26, 2009).

¹⁶ Note, however, § 248(1) definition of "taxable Canadian property" (f). A taxpayer's share listed on a designated stock exchange or a taxpayer's share of an MFC will be considered to be TCP if the taxpayer and/or persons with whom the taxpayer is not at arm's length own 25% or more of the issued shares of any class of the capital stock of the corporation that issued the shares.

¹⁷ Canada Revenue Agency, Form T2062 (Request by a Non-Resident of Canada for a Certificate of Compliance Related to the Disposition of Taxable Canadian Property).

¹⁸ Income Tax Act, R.S.C., ch. 1, § 116(1)(b) (2009) (Can.).

¹⁹ *See id.* § 116(1)(d).

²⁰ *See id.* § 116(1)(c).

ceiver General of Canada (Receiver General) of 25% of the difference between the POD and the ACB (or security acceptable to the Minister of National Revenue), the clearance certificate will be granted in prescribed form.²¹ If and when the certificate is issued by the Minister of National Revenue, the POD set out in the subsection 116(1) notice becomes the “certificate limit” associated with the transaction.

Where the certificate has not been applied for in advance of the transaction, a substantially similar process exists to apply for clearance within 10 days following the disposition of the TCP by the non-resident person.²² Note, however, that under subsection 116(3), if an application is not made in prescribed form pursuant to subsection 116(1), the non-resident disposing of TCP must notify the Minister of National Revenue about the transaction in prescribed form; unlike subsection 116(1), subsection 116(3) is not an optional process.

While subsection 116(1) is elective to the extent that a non-resident person is not required to apply for clearance, a non-resident will rarely (if ever) be well-advised to ignore this process. If a certificate is not obtained pursuant to subsections 116(2) or 116(4) of the Act, the purchaser is liable to pay to the Receiver General 25% of the amount by which the purchaser’s cost exceeds the certificate limit (if any) on the certificate issued pursuant to subsection 116(2).²³ Where there is no clearance certificate, there is no certificate limit and the purchaser is responsible for remitting 25% of the proceeds (not the gain) to the government.²⁴ Penalties are levied in respect of late payments of these taxes pursuant to subsection 227(9) of the Act.

The section 116 clearance process varies somewhat where, for example, the vendor is resident in a country with a tax treaty with Canada²⁵ and the TCP is treaty-protected property,²⁶ as well as in the case of gifts.²⁷ Certain property is also excluded from the ambit of section 116 so that capital markets can function efficiently; if non-resident shareholders of widely-held Canadian public companies, for example, were compelled to participate in this process, the tax rules would effectively dissuade investment in many Canadian enterprises. Small but important changes enacted by the federal Parliament in late 2007 are at the root of making investment in Canadian gaming enterprises traded on certain exchanges more attractive to international investors.

The old rules: Prescribed stock exchanges

Prior to amendments in December 2007, excluded property within the meaning of subsection 116(6)(b)—i.e., property in respect of which the section 116 clearance process was not applicable—included a share of the capital stock of a corporation listed on a prescribed stock exchange. Prescribed stock exchanges included stock exchanges inside Canada and outside Canada as set out in the Income Tax Regulations.²⁸ Old Regulation 3201(n) included the LSE but not the AIM on the LSE.²⁹

Several gaming corporations have chosen to list on the AIM. For example, Playtech Ltd. (AIM:PTEC) and AsianLogic Limited (AIM:ALOG) are AIM-quoted companies, and Excapsa Software Inc. (AIM:XCP) (Excapsa) was AIM-listed until it entered liquidation in late 2006. An overview of the reasons for seeking admission to AIM and comparing it with other exchanges is beyond the scope of this article,³⁰ but its flexibility and its shorter financial history requirements are draws for many businesses seeking flotation.

Under the old § 116 rules, there was no exclusion from the clearance process for corporations listed solely on AIM that were not MFCs. A corporation generally became an MFC in order to be excluded from the definition of TCP in subsection 248(1) of the Act, failing which the corporation’s non-resident shareholders had to submit to the clearance process when seeking to dispose of any share of the capital stock of the corporation. AIM-listed Canadian corporations unwilling to adopt the MFC structure, with all of its intricacies and ongoing compliance oblig-

²¹ See *id.* § 116(2).

²² See *id.* § 116(3) and § 116(4).

²³ See *id.* § 116(5)(c) and § 116(5)(d).

²⁴ In the case of depreciable property and certain other types of property, the amount to be remitted can be 50% of the difference between the cost to the purchaser and the amount fixed in the certificate, if any; see *id.* § 116(5.3).

²⁵ See *id.* § 116(5.01)(a).

²⁶ See *id.* § 116(5.01)(b).

²⁷ See *id.* § 116(5.1).

²⁸ Income Tax Regulations, C.R.C. § 3200, 3201 (2007) (Can.) (pre-Dec. 14, 2007 amendments to the Income Tax Act and the Income Tax Regulations).

²⁹ Canada Revenue Agency, Income Tax Ruling Document No. 2001-0096635 (2002).

³⁰ See generally AIM-London Stock Exchange, <<http://www.londonstockexchange.com/companies-and-advisors/aim/aim/aim.htm>> (last visited on June 14, 2009) (background information on AIM), and Sinclair Stewart, *Taking AIM at the world’s small caps*, GLOBE MAIL, Apr. 18, 2006, at B10.

ations (more will be said about this below) almost certainly gave up some international investor interest because of the cumbersome and delayed section 116 process.

The new rules: recognized stock exchanges

Pursuant to amendments introduced by the 2007 Federal Budget second bill and effective December 14, 2007, the concept of prescribed stock exchanges was removed from the definition of excluded property in paragraph 116(6)(b) of the Act.³¹ (Indeed, Regulations 3200 and 3201 were repealed at the same time as these legislative changes were introduced.) The notion of a recognized stock exchange was substituted for prescribed stock exchange. A share of a class of shares of the capital stock of a corporation listed on a recognized stock exchange is now exempt from the § 116 clearance process.³²

A recognized stock exchange means a designated stock exchange³³ and any other stock exchange if that exchange is located in Canada or in a country that: (i) is a member of the Organization for Economic Co-operation and Development (OECD); and (ii) has a tax treaty with Canada.³⁴ The AIM is clearly a recognized stock exchange; the United Kingdom is a member of the OECD³⁵ and has a tax convention with Canada.³⁶ More generally, this opens up more exchanges to exemption from the § 116 process than under the old rules. By this small but significant change, Parliament has cut back restrictions on capital flows and markets and allowed Canadian gaming corporations considering flotation on recognized exchanges (that may not be designated exchanges—the AIM, for example) to pursue international investors more aggressively than before, and without the necessity of those corporations tying themselves up in the MFC capital and corporate structure.

MUTUAL FUND CORPORATIONS

Some Canadian gaming businesses may wish to solicit more non-resident investors by carving themselves out of the § 116 clearance process while not floating on any stock exchange or while being listed on a stock exchange that is not a recognized stock exchange (i.e., in the case of an exchange in a country that is not an OECD member or that has no tax

convention with Canada). For those corporations, an MFC structure may still be an attractive, if involved, vehicle for providing its non-resident shareholders with added liquidity.

At its most basic level, an MFC mimics some of the characteristics of publicly-traded corporations through limitations on participation in its shareholdings by insiders, filing requirements with Canadian securities regulators, and with respect to how widely held its securities are. For a corporation to become and then remain an MFC, the following requirements under the Act must be met.

Canadian corporation

In order to be an MFC at any particular time in a taxation year, a corporation must be a Canadian corporation within the meaning of the Act at that time.³⁷ Canadian corporation is defined in subsection 89(1)³⁸ and includes a corporation resident in Canada and that was incorporated in Canada.³⁹

Public corporation

In order to be within the ambit of MFC provided by the Act at any particular time in a taxation year, a corporation must also be a public corporation at that time.⁴⁰ Where a class of the corporation's shares is not listed on a designated stock exchange in Canada,⁴¹ there are, generally, several tests that a corporation must satisfy in order to be characterized

³¹ Income Tax Act, R.S.C., ch. 1, § 116(6)(b) (2009) (Can.), amended by 2007 Federal Budget second bill (effective Dec. 14, 2007 to change “prescribed stock exchange” to “recognized stock exchange”).

³² *Id.*

³³ Income Tax Act, R.S.C., ch. 1, § 248(1), definition of “recognized stock exchange” (a) (2009) (Can.).

³⁴ *See id.* § 248(1), definition of “recognized stock exchange” (b).

³⁵ *See, e.g.*, Organization for Economic Co-Operation and Development: Member Countries, <http://www.oecd.org/document/58/0,3343,en_2649_201185_1889402_1_1_1_1,00.html> (last visited June 14, 2009).

³⁶ Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains, CAN.-N.Ir.-U.K., Apr. 15, 1980, S.C., Part 10, ch. 44 (Can.).

³⁷ Income Tax Act, R.S.C., ch. 1, § 131(8)(a) (2009) (Can.).

³⁸ *See id.* § 248(1), definition of “Canadian corporation.”

³⁹ *See supra* text accompanying note 9.

⁴⁰ Income Tax Act, R.S.C., ch. 1, § 131(8)(a) (2009) (Can.).

⁴¹ *See id.* § 89(1), definition of “public corporation” (a); *see also id.* § 248(1), definition of “designated stock exchange”; *see also id.* § 262.

as a public corporation within the meaning of the Act at any particular time, viz., the corporation: must be resident in Canada at the particular time;⁴² must have filed an election in prescribed form and manner before the particular time;⁴³ must have complied with the prescribed conditions in Regulation 4800(1) at the time of its prescribed election;⁴⁴ between the time at which it became a public corporation and before the day that is thirty days before the particular time, must not have been designated by the Minister of National Revenue not to be a public corporation;⁴⁵ and, at the time of any such designation by the Minister of National Revenue (the Designation Time), must not have complied with the prescribed conditions in Regulation 4800(2).⁴⁶

Prescribed form and manner of election

Before the particular time at which a corporation's status as a public corporation under the Act is being determined, the corporation must have filed an election to be a public corporation in prescribed form and manner.⁴⁷ That is, a properly completed Form T2073—Election to be a Public Corporation, with the required executed statutory declaration and, generally, a directors' resolution, must be executed and filed with the CRA on or before the date that the corporation elects to be a public corporation for purposes of the Act.⁴⁸

Compliance with prescribed conditions— Regulation 4800(1)

A public corporation must also, at the time of its prescribed election, comply “with prescribed conditions relating to the number of its shareholders, the dispersal of ownership of its shares and the public trading of its shares.”⁴⁹ The prescribed conditions that are to be met pursuant to this provision are in Regulations 4800 and 4803.

Qualified for public distribution. Pursuant to Regulation 4800(1)(a) of the Regulations, a class of the corporation's capital stock designated by the corporation in its prescribed form of election must be qualified for distribution to the public at the time of the election. The term “qualified for distribution to the public” for purposes of Regulation 4800(1)(a) is defined in Regulation 4803(2). A class of shares of a corporation's capital stock is qualified for distribution to the public if:

[A] prospectus, registration statement or similar document has been filed with, and, where required by law, accepted for filing by, a public authority in Canada pursuant to and in accordance with the law of Canada or of any province and there has been a lawful distribution to the public of shares or units of that class in accordance with that document.⁵⁰

In the case of a corporation in Ontario not listed on any stock exchange, for example, this can be done by the corporation distributing its shares to the public by way of a private placement of its shares in reliance on certain prospectus exemptions and dealer registration exemptions. This would allow the corporation to distribute the shares without delivering a prospectus and floating on any stock exchange.

No fewer than 150 shareholders. Regulation 4800(1)(b)(i) of the Regulations provides that, where the class of shares referred to in Regulation 4800(1)(a) is equity shares, there shall be no fewer than 150 shareholders of that class of shares (none of whom are insiders) at the time at which the election was made.

Equity shares are defined in Regulation 4803(1) of the Regulations by reference to section 204 of the Act.⁵¹ Generally, an equity share is a share of the capital stock of the corporation entitling the owner thereof to a dividend and surplus⁵² at least as great, in any event, as the right of the owner of any other share of the corporation.

⁴² Income Tax Act, R.S.C., ch.1, § 89(1), definition of “public corporation” (b), (c). (this requirement has already been addressed in the context of the MFC definition in § 131(8)).

⁴³ See *id.* § 89(1), definition of “public corporation”; Income Tax Reg. § 4800(4) (2009) (Can.).

⁴⁴ Income Tax Act, R.S.C., ch. 1, §89(1), definition of “public corporation” (b)(i) (2009) (Can.).

⁴⁵ See *id.* § 89(1), definition of “public corporation” (c)(ii).

⁴⁶ *Id.*

⁴⁷ Income Tax Act, R.S.C., ch. 1, §89(1), definition of “public corporation” (b)(i) (2009) (Can.).

⁴⁸ Income Tax Regulations, C.R.C., § 4800(4) (2009) (Can.).

⁴⁹ Income Tax Act, R.S.C., ch. 1, §89(1), definition of “public corporation” (b)(i) (2009) (Can.).

⁵⁰ Income Tax Reg. § 4803(2)(a) (2009) (Can.).

⁵¹ Income Tax Act, R.S.C., ch. 1, § 204, definition of “equity share” (2009) (Can.).

⁵² The surplus of the corporation is computed after: repayment of any capital and payment of dividend arrears on the redemption of the share; a reduction of the capital of the corporation; or the winding-up of the corporation.

Insiders of a corporation are defined in Regulation 4803(1) of the Regulations by reference, *mutatis mutandis*, to section 100 of the Canada Corporations Act (CCA).⁵³ Pursuant to the CCA as modified by the definition in Regulation 4803(1) of the Regulations, insiders of a corporation include directors, officers, and any person beneficially owning, directly or indirectly, or exercising control over, more than 10% of the voting rights attached to all equity shares of the corporation. Certain employees of a corporation and those not at arm's length from the corporation are also deemed to be insiders of the corporation pursuant to Regulation 4803(1).

Regulations 4803(3) and (4) of the Regulations provide rules for consolidating shareholdings of the capital stock of the corporation based on the concept of a group of persons for purposes, *inter alia*, of Regulation 4800(1)(b) of the Regulations. Essentially, where a group of persons holds certain shares of a corporation's capital stock, that group will generally "count" as only one person towards the aggregate number of (i.e., 150) required shareholders of the class of shares.

Block of shares; FMV of shares held; insiders not to hold more than 80% of shares. Under Regulation 4800(1)(b)(iii) of the Regulations, each shareholder (i.e., of the at least 150 shareholders specified in Regulation 4800(1) (b)(i) of the Regulations) must hold not less than one block of shares. Regulation 4803(1)(a) states that a block of shares, with respect to any class of the capital stock of the corporation, means 100 shares if the fair market value (FMV) of one share of the class is (for example) less than C\$25.

Pursuant to Regulation 4800(1)(b)(iv) of the Regulations, each shareholder of a minimum 150 shareholders owning at least one block of shares must own shares of that class of capital stock having an aggregate FMV of not less than C\$500.

Regulation 4800(1)(c) of the Regulations states that insiders of a corporation may not hold more than 80% of the issued and outstanding shares of the capital stock of the corporation specified in the corporation's prescribed election. An insider of the corporation has the same meaning as that discussed above.

Not designated to not to be a public corporation

In order to be a public corporation at a particular time, a corporation must not, between the time at

which the corporation last became a public corporation and before the day that is thirty days before the particular time (i.e., the particular time at which the corporation may be a public corporation pursuant to the preamble of subsection 89(1)⁵⁴, be designated by the Minister of National Revenue not to be a public corporation.⁵⁵

This condition is conjunctive with the other terms of subparagraph 89(1)(c)(ii) such that no change in a corporation's status from a public corporation to a corporation that is not a public corporation can occur on the basis of the Minister of National Revenue's designation alone. Accordingly, this part of the article focuses on the substantive requirements of Regulation 4800(2) and not on the ministerial designation.

Non-compliance with prescribed conditions— Regulation 4800(2)

A corporation wishing to be a public corporation at a particular time must also not comply with or meet "prescribed conditions relating to the number of its shareholders, the dispersal of ownership of its shares and the public trading of its shares"⁵⁶ at the Designation Time. Because the 30 days and the Designation Time referred to in subparagraph 89(1)(c)(ii) is always moving forward (along with the particular time), these prescribed conditions must not be met on a continuing basis from the time at which a corporation last became a public corporation.

It should be noted that meeting these prescribed conditions is a cumulative matter, i.e., all of the tests of Regulation 4800(2) must be met as of the Designation Time in order for a corporation to cease to be a public corporation at the particular time. While the provisions of Regulation 4800(2)(c) might appear to mandate that the prescribed conditions in Regulation 4800(1) must apply on a going forward basis, the prohibition on there being a class of shares of the capital stock that meets the requirements of Regulation 4800(1) is only one of several in Regulation 4800(2).

⁵³ Canada Corporations Act, R.S.C., ch. C-46 § 100, definition of "insider" or "insider company" (1970) (Can.).

⁵⁴ Income Tax Act, R.S.C., ch. 1, §89(1), definition of "public corporation" (b)(i) (2009) (Can.).

⁵⁵ See *id.* § 89(1), definition of "public corporation" (c)(ii).

⁵⁶ *Id.*

For example, consider a corporation that was required to have at least 150 shareholders when it became a public corporation pursuant to Regulation 4800(1)(b)(i), but is only required to have 50 or more shareholders at the Designation Time in order to remain a public corporation. If, at the Designation Time, the corporation had only 100 shareholders, it would still meet the test in Regulation 4800(2)(b)(i). Assuming there was only one class of shares of the capital stock of this hypothetical corporation, there would no longer be a class of shares that complied with Regulation 4800(1) at the Designation Time. Assuming that all of the other prescribed conditions in Regulation 4800(2) were not met, in the convoluted language of the Regulations, the corporation would not be a non-public corporation at the Designation Time (i.e., it would continue to be a public corporation) because not all of the prescribed conditions in Regulation 4800(2) were met.

Insiders not to hold more than 90% of shares. Pursuant to Regulation 4800(2)(a)(ii), the first prescribed condition is that insiders of the corporation (as defined in Regulation 4803(1) of the Regulations by reference to the CCA) hold more than 90% of the issued and outstanding shares of the capital stock of the corporation designated in its prescribed election to become a public corporation. Compliance with this requirement may cause a corporation to not be a public corporation for purposes of the Act. Accordingly, a corporation wishing to retain its status should fail this condition, i.e., 90% or less of its capital stock should be held by insiders of the corporation.

Fifty or more shareholders. Regulation 4800(2)(b)(i) requires that, with respect to the shares described in Regulation 4800(2)(a)(ii) and at the Designation Time, there be fewer than fifty shareholders of the corporation, none of whom are insiders of the corporation. Therefore, at the Designation Time, the corporation is effectively required to have fifty shareholders or more in order to continue to be a public corporation.

Block of shares. Pursuant to Regulation 4800(2)(b)(iii), each of the fewer than fifty shareholders must hold not less than one block of shares of the capital stock referred to in Regulation 4800(2)(a)(ii). A block of shares has the same

meaning as the reference to block of shares in Regulation 4800(1)(a)(iii); accordingly, block of shares means 100 shares if the FMV of one share of the class is less than C\$25. That is, in order to cease to be a public corporation, each of less than fifty shareholders in aggregate must hold at least 100 shares of the capital stock (having an FMV of less than C\$25 per share) being tested in Regulation 4800(2).

FMV of shares held. Regulation 4800(2)(b)(iv) provides that the shares held by fewer than fifty shareholders must have an aggregate FMV of C\$500 or greater. For a corporation to lose its status as a public corporation, each of less than 50 shareholders in total must hold a block of shares having an aggregate FMV of \$500 or greater.

If a corporation being tested has at least 50 shareholders each holding at least one block of shares and each shareholder having an aggregate FMV of his shares of the capital stock of that corporation equal to at least C\$500, that corporation will not meet the conditions of Regulation 4800(2)(b) and should continue to be a public corporation within the meaning of the Act.

No class of shares meeting the tests in Regulation 4800(1). The various tests in Regulation 4800(1) have been summarized, above. If a class of the shares of the capital stock of a corporation satisfies the prescribed conditions set out in Regulation 4800(1), then that corporation cannot cease to be a public corporation pursuant to subparagraph 89(1)(c)(ii). It is worth noting that ongoing compliance with the terms of Regulation 4800(1) will assure success in retaining a corporation's status as a public corporation insofar as the provisions in Regulation 4800(2) are concerned.

Confinement of undertakings

In order to be an MFC at any time in a taxation year, generally, a corporation's only undertaking at that time may be "the investing of its funds in property (other than real property or an interest in real property)."⁵⁷ All of the corporation's property is in-

⁵⁷ Income Tax Act, R.S.C., ch. 1, § 131(8)(b)(i) (2009) (Can.).

cluded in the definition of property in subsection 248(1) of the Act; the definition is broad and would include, for example, the corporation's shares of the capital stock of subsidiary corporations and the corporation's trade receivables.

Retractability of shares and FMV of retractable shares

In order to be an MFC at any time in a taxation year, generally, the issued shares of the capital stock of the corporation must include shares that are retractable in accordance with the share conditions attached thereto, and the FMV of those retractable shares may not be less than 95% of the FMV of all of the issued shares of the capital stock of the corporation.

Ninety Percent of property is non-taxable Canadian property

Paragraph 131(8.1)(a) of the Act states:

Where, at any time, it can reasonably be considered that a corporation, having regard to all the circumstances, including the terms and conditions of the shares of its capital stock, was established or is maintained primarily for the benefit of non-resident persons, the corporation shall be deemed not to be a mutual fund corporation after that time unless throughout the period that begins on . . . the day of its incorporation and ends at that time, all or substantially all of its property consisted of property other than property that would be taxable Canadian property if the definition "taxable Canadian property" in subsection 248(1) were read without reference to paragraph (b) of that definition.

Subsection 131(8.1) is an anti-avoidance provision that says that corporations that were established or are maintained primarily for non-residents cannot be MFCs unless certain conditions are met. One exception is with respect to the nature of the property owned by the corporation. If all or substantially all (i.e., 90% or more) of the corporation's property is not TCP, then the corporation may be an MFC, notwithstanding that it was established or is maintained primarily for the benefit of non-resident persons. An exception is made to excluding TCP from the assets of the corporation in respect of property

used or held by the corporation in a business carried on in Canada. For example, a corporation established or maintained for non-residents that only owns TCP that was property used in a business carried on in Canada may still be an MFC within the meaning of the Act.

Sale of an MFC's underlying assets and shareholder distributions

Where an MFC has recognized capital gains (and those gains are in excess of the MFC's capital losses), the MFC may distribute those amounts to its shareholders such that the capital gains treatment (generally, only one-half of the capital gain is taxable in Canada) may "flow through" the MFC and be recognized in the hands of its shareholders. This flow-through treatment is similar to certain partnership and LLC structures common in North America and can be of immense benefit to the MFC and its shareholders; if done properly, the MFC may pay no federal tax on dispositions giving rise to capital gains and the MFC's shareholders may take advantage of the lower capital gains inclusion rate on distributions that can be characterized as capital gains dividends and not as taxable dividends under the Act.

An MFC's capital gains dividend account at any time generally means the amount, if any, by which the MFC's capital gains for all taxation years that began more than 60 days before that time from dispositions of property after 1971 and before that time while it was an MFC⁵⁸ exceeds the total of its capital losses calculated over the same period⁵⁹ and previously-distributed capital gains dividends.⁶⁰ If a dividend becomes payable by the MFC, if the MFC elects in prescribed manner,⁶¹ and if there is a positive balance in its capital gains dividend account:

1. the dividend is deemed to be a capital gains dividend payable out of the corporation's capital gains dividend account to the extent that it does

⁵⁸ See *id.* § 131(6), definition of "capital gains dividend account" (a).

⁵⁹ See *id.* § 131(6), definition of "capital gains dividend account" (b)(i).

⁶⁰ See *id.* § 131(6), definition of "capital gains dividend account" (b)(ii).

⁶¹ Income Tax Reg. § 4800(4) (2009) (Can.); Canada Revenue Agency, Form T2055 (Election in Respect of a Capital Gains Dividend Under § 131(1)).

- not exceed the account balance at the time it becomes payable;⁶²
2. any amount received by the shareholder qua dividend is not included in computing the taxpayer's income for the year as income from a share of the capital stock of the corporation;⁶³ and
 3. if the disposition of the capital property by the MFC took place after Oct. 17, 2000, the dividend is deemed to be a capital gain of the shareholder.⁶⁴

If the dispositions giving rise to the capital gains in the MFC are of TCP, a so-called TCP gains balance will arise in the corporation.⁶⁵ Any capital gains dividend election will be deemed to include a pro rata portion of the existing TCP gains balance, called a TCP gains distribution.⁶⁶ This will not affect the nature of the distribution to residents of Canada. However, note that subparagraph 131(1)(b)(vii) of the Act (i.e., the provision deeming the capital gains dividend to be a capital gain of the recipient taxpayer) will not apply to non-residents of Canada.⁶⁷ For non-residents, the amount of the TCP gains distribution will be deemed to be a taxable dividend paid by the MFC.⁶⁸

The refund mechanism to the MFC on payment of the capital gains dividend is contained in subsection 131(2) of the Act.

Becoming an MFC in Canada is an involved, expensive, and time-consuming process. As the tests for remaining an MFC are point-in-time assessments going forward from the initial time that the corporation became a public corporation, the structure requires a great deal of ongoing tax monitoring to ensure that the entity is continually in compliance with its corporate and tax obligations. However, for the Canadian gaming corporation that does not wish to list on a recognized stock exchange within the meaning of the Regulations, or that does not want to float on any exchange, the MFC may remain a viable and useful structure. As outlined in this article, the MFC can use the structure to dispense with the § 116 clearance process on dispositions of shares of its capital stock (increasing its attractiveness to non-residents of Canada) and can flow through cap-

ital gains treatment on dispositions of property by the MFC to other parties.

CONCLUSION

Gaming businesses in Canada may leverage these tax developments to grow through new capital and investors. Prior to the amendments in late 2007, there were growing calls to broaden the list of stock exchanges prescribed by the Regulations. Parliament has addressed this concern by introducing the concept of recognized stock exchanges, thereby effectively exempting AIM-listed corporations (and other small cap exchange-listed entities meeting the recognized exchange criteria) from the § 116 clearance process on disposition of shares of their capital stock by shareholders. For those gaming businesses not ready to list on a recognized stock exchange, the MFC structure is still available and can be of assistance. It is not a compliance burden to be taken on lightly, but it has definite advantages for certain corporations seeking expansion and more international investment.

Canada has contributed greatly to the gaming sector—notably to Internet gaming. Canadian corporations continue to be heavily involved in many different aspects of gaming, including software development and client management operations. As the sector becomes more open and seeks to tap public and other international markets for capital, these tax structures may be of interest to existing Canadian corporations and to domestic and international ventures seeking to set up operations for exploitation from Canada.

⁶² Income Tax Act, R.S.C., ch. 1, § 131(1)(a) (2009) (Can.).

⁶³ See *id.* § 131(1)(b).

⁶⁴ See *id.* § 131(1)(b)(vii). This provision does not apply in respect of TCP gains distributions to non-resident persons or partnerships that are shareholders. See below.

⁶⁵ See *id.* § 131(6), definition of “TCP gains balance”; *id.* § 131(5.1).

⁶⁶ Income Tax Act, R.S.C., ch. 1, § 131(6) definition of “TCP gains distribution”; *id.* § 131(5.1).

⁶⁷ Income Tax Act R.S.C., ch. 1, § 131(5.1)(b)(i) (2009) (Can.).

⁶⁸ See *id.* § 131(5.1)(b)(ii).