The Canadian Opportunity

A Brief Overview of the Canadian Economy and Investment Opportunities

Canada: A World-Class Economy

Canada is the world's eleventh largest economy as measured by Gross Domestic Product (GDP) at market exchange rates in 2014. Its GDP of US $1.79 trillion ranks ahead of South Korea, Spain and Mexico, with annual growth remaining steady – in the 2-3% range – over the past five years. By way of comparison, if Canada were a U.S. state, it would place second in GDP, behind California but significantly ahead of Texas. Canada's largest province, Ontario, has an economy similar in size to Illinois and Pennsylvania.

Low Cost

Canada ranks as one of the most **cost-effective global investment destinations** due in part to relatively low corporate taxes and a duty-free manufacturing tariff regime. KPMG's 2014 Competitive Alternatives study found that Canada leads the G-7 with the lowest overall business costs – 7.2% lower than U.S. levels. At a sectoral level, KPMG found that Canada had the **lowest costs of any G-7 country** in 14 of 19 industries studied, including aerospace, automotive, biotechnology, digital entertainment, electronics, green energy, medical devices, metal components, pharmaceuticals, plastics, product testing, professional services, software design and telecommunications. According to Forbes' 2015 "Best Countries for Business" ranking, Canada is the sixth best country for business and the only G-7 or other large economy in the top ten. It ranks first for personal freedom and second for its absence of red tape.

Export Oriented

In addition, Canada is a significant part of the global supply chain in a wide range of sectors. Its membership in NAFTA guarantees access to a market of more than 450 million consumers in markets with a combined GDP of more than US $20 trillion. **On a typical day, over US $2 billion in trade traverses the U.S.-Canada border.** Nearly every large Canadian city is within a few hours, by road or rail, of major U.S. markets. Canada is by far the largest supplier of crude oil to the U.S., with exports to the U.S. rising from 678m to 918m barrels between 2009 and 2013.

It is worth noting that, while the U.S.-Canada relationship remains the largest bilateral trading relationship in the world, Canada's economic trade links are increasingly diversified. In fact, its NAFTA counterparties, the U.S. and Mexico, are merely two of **43 countries with which the Government of Canada has concluded or implemented trade agreements**. Collectively, these countries comprise more than 50% of the global economy, providing a large and dependable market for Canada's export-oriented businesses.

Canada is the top G-7 country in Forbes' 2015 Best Countries for Business

FORBES

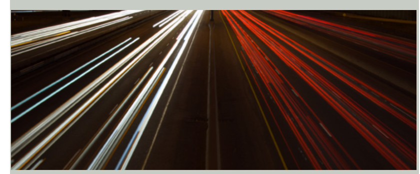
Canada ranks second out of 157 countries evaluated for business climate

BLOOMBERG 2014 BEST COUNTRIES FOR DOING BUSINESS

Canadian business costs are **7.2 percent below** comparable U.S. costs

KPMG 2014 COMPETITIVE ALTERNATIVES STUDY

ALSO INSIDE



6 KEY DIFFERENCES BETWEEN CANADA AND THE U.S.

What American Investors Need to Know

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For more information about doing business in Canada, please contact your Stikeman Elliott lawyer, or any lawyer listed at www.stikeman.com

> Canadian businesses will look most towards **foreign acquirers and private equity buyers** to help increase the region's deal activity
>
> RR DONNELLEY: CANADIAN DEAL MAKING OUTLOOK JUNE 2015

Canada on Sale: Exchange Rate Drives New Opportunities for U.S. Acquirors

After several years of parity or near parity with the U.S. dollar, the Canadian dollar began a slow but steady decline in 2013. By August 2015, it stood at approximately 76 cents (U.S.), a level that was typical of the 1990s and early 2000s. **This situation is highly favourable not only to U.S. investors but to those who are financed in Euros, Pounds or Yen**, which currencies (among several others) have strengthened vis-à-vis the Canadian dollar over the past two years. The Canadian dollar appears unlikely to recover substantially against the U.S. dollar unless and until oil prices increase significantly.

These facts and figures add up to an excellent investment opportunity for foreign acquirors – essentially a 25% discount in the case of U.S. buyers. In addition to favourable acquisition prices, Canadian businesses should generally be able to take advantage of low Canadian dollar input costs in a global export market, access to which is secured by NAFTA, a pending free trade agreement with the EU and an ever-growing number of other bilateral arrangements.

Another attractive aspect of investment in Canada – particularly in the mid-market – is that potential acquirors do not typically find themselves facing the amount of competition that they do in the U.S. as there are not as many private equity firms in Canada targeting businesses in the mid-market.

Sectoral Focus: High Tech / R&D

From next-generation cars to smartphone technology, Canadian innovations touch the lives of millions worldwide. In Canada, **scientific talent is available at competitive costs**. KPMG's Competitive Alternatives 2014 study ranks Canada the lowest-cost G-7 country in almost every high tech sector, from aerospace to biotech to game and software design. As reported by KPMG, Canada's cost advantage over the U.S. currently stands at 24% for digital entertainment products and 13% for software. In 2015, the Bloomberg Innovation Index ranked Canada as one of the five most innovative countries in the high tech space, ahead of significantly larger economies such as Germany and the U.K.

Favourable Tax Regime

Canada has a very favourable tax regime for foreign private equity investors. The following are some of the key considerations which may be relevant:

Low Corporate Tax Rates

Corporations that are resident in Canada are subject to federal and provincial income tax on their worldwide income. The combined (federal and provincial) tax rates for such corporations vary between 26% and 31%, depending on the province(s) of taxation, and are among the lowest rates of the G-7 countries and substantially lower than the average U.S. combined (federal and state) rate of 40%.

Withholding Tax

Under Canada's domestic rules, there is no Canadian non-resident withholding tax on interest paid (or deemed to be paid) by a Canadian resident corporation to a non-resident person with which the payor deals at arm's length and where the interest is not considered to be "participating debt interest". Consequently, cross-border acquisition financing by foreign lenders is generally common in Canada.

In addition, under the Canada-US Income Tax Convention ("US Treaty"), Canadian withholding tax on arm's length and non-arm's length payments of non-participating debt interest to U.S. persons is generally reduced to nil. As a result, U.S. originated internal financing structures are also quite efficient from a Canadian perspective.

> Canada is among the **top five countries for high technology**
>
> BLOOMBERG INNOVATION INDEX, 2015

Canadian resident corporations must withhold tax on certain amounts paid to non-residents in respect of certain passive amounts paid to non-residents such as, inter alia, dividends and royalties. The domestic rate of withholding is 25% but may be reduced by the applicable bilateral income tax treaties to which Canada is a party (more than 90). For example, under the US Treaty, the withholding rates are generally reduced to either 5% or 15% for dividends and 10% for royalties.

It is noteworthy that the repayment of loan principal as well as returns of "paid-up capital" on shares of a Canadian private corporation (generally equal to the equity contributed to the corporation) are not subject to Canadian withholding tax.

Taxation Upon Exit

In general, non-residents of Canada are not subject to Canadian taxation upon the sale of their shares of a Canadian private company unless those shares have, in the last 60 months, derived more than 50% of their value from Canadian real and/or resource property. Consequently, an exit transaction by way of sale will frequently not be subject to Canadian taxation.

Governmental Tax Incentives

The Canadian federal and provincial governments provide generous tax incentives for the performance of scientific research and experimental development (SR&ED) in Canada (and in the relevant province). Where a corporation incurs expenditures that qualify as SR&ED for tax purposes, such expenditures may generally be deducted in the current year in computing taxable income. In addition, in the foreign private equity context, a federal investment tax credit equal to 15% of qualifying SR&ED expenditures may be available. Provincial tax credits are also available.

6 Key Differences Between Canada and the United States

What American Investors Need to Know

1 | Canada's Provinces Make Key Rules

Like the United States, Canada has a federal system of government. However, under Canada's constitutional division of powers, the country's 10 provinces tend to be more powerful than the U.S. states. Commercial law is a good example: U.S.-Canada cross-border transactions will often involve a multiplicity of provincial laws and regulations in accomplishing what in the United States would be dealt with predominantly under federal law. For example, environmental and employment law are primarily provincial responsibilities in Canada.

Securities law is a particularly interesting case. Unlike so-called "Blue Sky Laws" in force in U.S. states, Canadian provincial securities laws are central to the regulation of the securities markets. That is because Canada has no federal securities law and no national securities regulator. Each province regulates securities matters under its jurisdiction through its own provincial securities commission. Reflecting the fact that the province of Ontario is the home jurisdiction of the Toronto Stock Exchange (TSX) and the principal regulator for the majority of Canadian reporting issuers, the Ontario Securities Commission (OSC) has taken a particularly active role in the development of securities law through the introduction of various regulatory instruments, policies and rules. As such, the OSC tends to exercise a very broad regulatory and disciplinary jurisdiction and is arguably the closest Canadian equivalent to the Securities and Exchange Commission. However, the securities commissions of Alberta, British Columbia and Quebec are also active in policy-making and enforcement.

In order to achieve greater consistency and reduce compliance costs, many substantive aspects of securities regulation have been harmonized by means of "national instruments" or "national policies," which are essentially "model" regulations that are agreed to and independently adopted by each of the provincial regulators. Among the many topics covered by national instruments and policies are registration and prospectus requirements (and exemptions) as well as continuous disclosure requirements.

2 | General Tax Considerations

Canada's tax regime for corporations and individuals is primarily governed by the federal *Income Tax Act* (ITA), as well as by laws establishing provincial corporate taxes and sales taxes, among others. Generally, the ITA levies income tax on each person (including corporations) who is "resident" in Canada in a particular taxation year. Unlike the U.S., Canada does not levy tax based on citizenship. In general, non-residents of Canada are subject to tax only on their Canadian source income, including income from a business or from employment carried on in Canada, and income from the disposition of "taxable Canadian properties" (generally, Canadian real/resource properties).

Typically, there are three basic options for a U.S. corporation (i.e., non-Canadian) to carry on business in Canada. The first is to operate through a wholly-owned Canadian subsidiary. The second is for the U.S. corporation to conduct its Canadian business directly as an unincorporated branch. Assuming that the U.S. corporation is entitled to the benefits of the Canada-U.S. Income Tax Convention, the third option involves ensuring that there is no ongoing physical presence in Canada since profits are generally taxable only to the extent that the U.S. corporation has a "permanent establishment" in Canada.

Broadly speaking, the taxation of current operations and distributions does not depend to any great extent on whether a U.S. corporation carries on business in Canada through a branch or through a Canadian corporation. Both a branch and a subsidiary are subject to tax on a net basis in respect of income from carrying on business in Canada. In addition, given Canada's branch profits tax, any repatriation of profits from Canada to the U.S. is generally taxed at the same tax rate, whether the U.S. corporation operates through a branch in Canada or operates through a Canadian subsidiary that pays dividends to its U.S. shareholder (although, in some instances, there may be a deferral advantage to using a Canadian subsidiary).

Given the above, there are a number of important matters to be considered when deciding whether to establish a Canadian branch or subsidiary. For example, in contrast with the U.S. system, Canada's system does not provide for consolidated returns that allow the profits of one corporation in a related group to be offset by losses in another (absent the use of certain loss-utilization transactions). Therefore, if a U.S. corporation's Canadian operation were to be divided between two or more Canadian corporations, losses in one of those Canadian corporations could not generally be used to shelter income earned by the other(s).

Similarly, if the new Canadian operation were expected to operate at a loss in its initial stage, it might be preferable to establish a branch of the U.S. corporation so as to permit the latter to deduct the loss in computing its tax liability in its home jurisdiction. However, the use of an Alberta, British Columbia or Nova Scotia unlimited liability company (ULC) as the Canadian subsidiary may provide the same result for U.S. tax purposes (for example, by using the check-the-box rules). ULCs are treated no differently than any other corporation resident in Canada for Canadian income tax purposes. Note that, in certain circumstances, the Canada-U.S. Income Tax Convention may limit the treaty benefits available to ULCs. The rules regarding the application of the Canada-U.S. Income Tax Convention can be relatively complex and fact-dependent.

3 | Canadian Amalgamations vs. U.S. Mergers

Amalgamation is a good example of a Canadian concept that bears a strong superficial resemblance to a U.S. concept – merger, in this case – while actually differing from it in some important points of detail. Under Canadian law, an amalgamation is a statutory means of combining two or more corporations in the same jurisdiction into one continuing amalgamated corporation possessing all of the property, assets, rights and liabilities of each of the amalgamating corporations. Unlike a U.S. merger, a Canadian amalgamation does not include the concept of a "surviving corporation", nor do any of the amalgamating corporations cease to exist upon amalgamation. Rather, in an amalgamation the amalgamated corporation takes on the identity (and all of the obligations and rights) of each of its predecessor corporations. An analogy that is often used is that of two streams joining to form a single river. An amalgamation is generally tax neutral, although it does trigger a taxation year-end for each of the amalgamating corporations.

4 | Employment Law

Legislative jurisdiction over labor and employment matters is shared by the provincial and federal governments. An employer may be regulated under federal law or provincial law, but not both.

In general terms, Canadian employment law bears some similarity to California's employment law, which is more favorable toward employees than the law in many other states. One especially noteworthy feature of Canadian employment law is that Canada does not have the U.S. concept of "employment at will": under

Canadian law, a contractual employer-employee relationship is implied by law whether or not a formal written agreement exists. Canadian employment legislation sets out minimum standards of employment applicable to all employees (unionized and non-unionized) and, in particular, the length of notice and severance pay required upon termination of employment. It should also be noted that each province has legislation dealing with mass terminations (which require certain governmental filings). Written employment contracts may provide for notice or pay in lieu of notice so long as the notice is not less than that which is required by minimum standards legislation. Absent a written contract, common law courts will imply an obligation to provide reasonable notice of termination. Common law notice can be significant: courts have imposed up to two years severance for senior, C-level, long-standing employees.

Canada has a universal publicly-funded health care system that covers physician visits, hospital care and medical procedures of most types. This provides significant cost benefits to employers carrying on business in Canada. However, employers in Canada typically do provide health care benefits with respect to costs that are generally not covered under the public health system, such as the costs of dental care, prescription drugs, corrective lenses and physiotherapy.

Canadian courts are generally cautious about enforcing post-employment non-competition and non-solicitation agreements, although they tend to give more latitude to the latter. To be enforceable, such post-employment covenants must be clearly drafted, reasonable in duration and scope, and must not be broader than is necessary to protect the employer's legitimate business interests. Non-competition agreements in the context of the sale of a business are generally enforced more readily, provided that the employee receives consideration sufficient to justify such protection.

There are two other important points to note. First, Canadian courts do not recognize the concept of inevitable disclosure. Second, most employees are covered by the overtime pay provisions contained in Canadian employment standards legislation with the exception of certain specifically exempted classes of employees.

5 | Competition/Antitrust and Foreign Investment Review

M&A transactions may be subject to scrutiny by the Competition Bureau, the federal antitrust authority. The Competition Bureau generally must be notified if (1) the parties to a transaction, together with affiliates, exceed C$400 million in total assets in Canada or in total gross annual revenues from sales in, from or into Canada and (2) the target to the transaction exceeds C$86 million (indexed annually) in total assets in Canada or in total gross annual revenues from sales in or from Canada. Sometimes, for transactions whose impact on competition in Canada is minimal, it is possible to obtain an Advance Ruling Certificate (ARC) or a waiver that permits a transaction to proceed without notification, or to proceed before the expiry of the waiting period.

Mergers and acquisitions can also be subject to scrutiny by federal foreign investment review authorities. Under the relevant legislation (the *Investment Canada Act*), the federal government has a mandate to screen proposed foreign investments to ensure that they are likely to produce a "net benefit to Canada." U.S. (and other non-Canadian) investors must generally file an application with Industry Canada (a federal government department) where the enterprise value of the Canadian business of which direct control is being acquired exceeds C$600 million, provided the target is not a cultural business. In addition, a national security review may be required where the government believes that an investment may be injurious to national security. Even where it applies, the foreign investment review process is usually straightforward and nearly always ends with an approval.

The *Investment Canada Act* has attracted considerable political and media attention in recent years. Developments of note include the

2008 rejection of U.S.-based Alliant Techsystems Inc.'s proposed acquisition of the information systems business of MacDonald, Dettwiler and Associates Ltd., the federal government lawsuit against U.S. Steel Corporation for alleged breach of its undertakings given in respect of its acquisition of control of Stelco Inc., the 2010 rejection of Australia-based BHP Billiton's hostile takeover bid for Potash Corporation of Saskatchewan and the concurrent approval in late 2012 of CNOOC Ltd.'s bid for Nexen and Petronas' bid for Progress Energy. In addition, changes instituted in 2012 and 2013 impose some additional restrictions on acquisitions by state-owned enterprises.

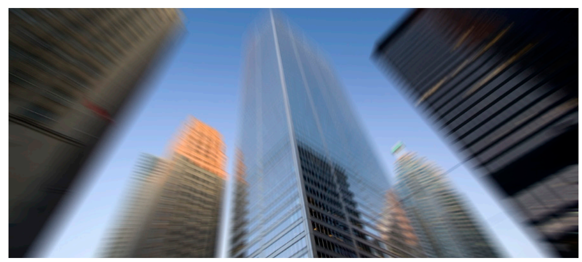
While these events have led some to question the message that Canada is sending to international investors, careful examination of the facts of each case suggests that they are not indicative of any wider protectionist trend. For example, the proposed Alliant transaction involved Canadian Radarsat satellite technology, which it is understood may have been considered essential to national security. In the case of U.S. Steel, it seems likely that the Government of Canada felt compelled to act, given the extreme level of alleged non-compliance with the undertakings the company had made as a condition of the Stelco takeover – Canadian facilities were closed while U.S. Steel continued operations at some of its American facilities. In the Potash Corporation situation, numerous unique features were present, including the disproportionate economic significance of the company's business to a single, relatively small province.

Other recent matters suggest no significant increased trend to protectionism, including the Canadian government's approval of several high-profile acquisitions by state-owned enterprises in recent years, including investments by PetroChina, Sinopec, Korea National Oil Corporation, CNOOC, Petronas and Abu Dhabi's TAQA.

Nevertheless, there is little doubt that, in some cases, foreign takeover reviews will occur against a backdrop of intense media, public and political scrutiny. Investors involved in attempted high-profile acquisitions of Canadian companies must carefully consider these and other government relations aspects of their proposed transactions.

6 | Litigation

In many respects, U.S. attorneys would be comfortable practicing in Canadian courts. For one thing, the legal system in Canada is based on the common law (except in Quebec, as noted below). For another, procedure is generally quite similar – Ontario's *Rules of Civil Procedure*, for example, are modeled on the U.S. Federal Rules of Civil Procedure. However, there are a number of significant distinctions that affect the form and substance of litigation in Canada. Some of these are merely matters of terminology or etiquette: e.g., lawyers are not generally called "attorneys" in Canada and often appear in court "gowned" in the English style. Other differences are substantive. For instance, the province of Quebec is a civil code jurisdiction in the tradition of continental Europe (although criminal law in Canada is a federal matter and essentially uniform across the country, including in Quebec).



Because Canada is a member of the Commonwealth of Nations, its courts often recognize, as non-binding but nevertheless persuasive, legal principles developed in jurisdictions such as England, Australia and New Zealand. U.S. jurisprudence has historically been less influential in Canada, although in the area of corporate law it is increasingly cited in judicial reasons. Another difference that a U.S. attorney would notice is that commercial law in Canada (outside Quebec) is less codified than its American counterpart, with traditional common law jurisprudence continuing to be a significant source of the legal principles that govern this area. (Canada has no equivalent of the Uniform Commercial Code, for example, although elements of the UCC are mirrored in specific statutes.) A final difference, deriving from the simple fact that Canada is a smaller country with less litigation overall, is that legal precedent can be more sparse in certain areas of corporate and commercial law that are relatively settled by prior judicial rulings in the U.S.

Contingency Fees

While contingency fees have been a mainstay in U.S. civil litigation since the 19th century, they are a relatively recent phenomenon in Canada. Lawyers may accept a contingency fee in civil proceedings, although not in criminal or quasi-criminal matters or family law matters. Fees are subject to court review and the test in every circumstance is whether the fee charged by the lawyer is fair and reasonable in all of the circumstances. The risk of negative costs awards (discussed below) can act also as a deterrent to spurious litigation.

Juries

More typical in U.S. civil cases, civil juries are relatively rare in Canada, with the exception of personal injury trials. Indeed, provincial statutes such as Ontario's *Courts of Justice Act* specifically prohibit juries in a wide range of circumstances (e.g., in proceedings involving injunctions, sale of real property, mortgage foreclosures, liens, trusts, rectification, specific performance of a contract, declaratory and equitable relief, and in any case involving a claim against a municipality). These exclusions are allowed because, in Canada, there is no constitutional right to a jury trial in civil disputes: a judge may order that a case proceed without a jury, as would typically happen where he or she takes the view that the issues are too complex for a jury (e.g. in a medical malpractice case). The infrequency of jury trials probably has an impact on the more modest damages awards in Canada, as discussed below.

Damages

As a general rule, damages awards in Canada are considerably more modest than those in the United States. For example, in a Canadian tort action, compensatory damages for loss of income, pain and suffering, and the cost of future care would rarely rise into the millions

of dollars, except in cases of catastrophic injury or in other exceptional circumstances. As well, an individual's expenses for cost of care are considerably less in Canada because of its public health care system that absorbs many of those costs. However, plaintiffs in tort actions are obliged to pursue recovery on behalf of and to reimburse the provincial health insurer for the cost of the plaintiff's care.

To succeed in a claim for punitive damages in Canada, the plaintiff needs to show that the defendant acted with "high-handed, malicious, arbitrary or highly reprehensible misconduct," according to the Supreme Court of Canada. Punitive damages are seen as exceptional, and judges view even a modest award of punitive damages as carrying sufficient stigma to achieve its objective of deterrence.

Where punitive damages are awarded, there are no hard and fast rules to quantify them; each case will turn on its own facts. However, courts have indicated that the amount of an award should be proportional to the gravity of the defendant's misconduct. In contrast to U.S. courts, the trend in Canada has been to award modest punitive damages claims. Awards in the rare cases that award punitive damages rarely exceed C$1 million, but most are well below this amount.

Costs

In most U.S. jurisdictions, litigants are expected to pay their own way, and losing parties are not generally required to pay more than a nominal amount of the winning party's legal costs. In Canada, the normal practice is that the loser pays the winner's costs. In the United States, this is often referred to as the "English rule" on costs. Note, however, that this does not mean that the winning party will receive complete indemnification from the losing party. In a typical case, the court will order the losing party to reimburse the winning party for between 50 and 60% of the winning party's attorney fees plus a substantial portion of the winning party's disbursements (for expert reports, court filing fees, photocopying, and so on). These are known in Ontario as costs on a "partial indemnity" basis.

In certain instances, the court will award costs on a more liberal "substantial indemnity" basis, which requires the losing party to pay a large majority of the winning party's legal costs. Substantial indemnity costs can be awarded where the losing party's position is considered to have been frivolous or vexatious or the losing party has instructed its lawyer to engage in behavior that the court is not prepared to condone, such as using "sharp practice" tactics or otherwise acting abusively. In extreme cases, the losing party's lawyer is required to pay costs personally.

There are also provisions in the rules of court of some provinces to encourage parties to make and accept reasonable offers to settle by ensuring that if they ignore a reasonable offer, they can be penalized in the awarding of costs. The same rule applies to interlocutory motions. If, for instance, a plaintiff wins at trial but is awarded a sum of money that is less than the defendant's formal pre-trial offer to settle, the court can order the plaintiff to pay the losing defendant's legal costs from the date of the formal offer, on a partial indemnity basis. Similarly, if the plaintiff achieves a result in excess of its own formal offer to settle, the losing defendant may be ordered to pay the plaintiff's legal costs incurred from the date of the offer on a substantial indemnity basis. In all instances, the decision to award costs is a matter of discretion for the judge.