



EQUITY SHARES

1. INTRODUCTION

1.1 Purpose and Application

The *Small Business Venture Capital Act*, (the "Act") under Part 1 requires that all registered venture capital corporations ("VCCs") invest at least 80% of their equity capital within 2 fiscal years in "eligible investments". Also, under Part 2 of the Act, a registered eligible business corporation ("EBC") must only issue "equity shares"¹ to investors if it wants to provide them with tax credits.

For an investment to qualify as an "eligible investment"² for a VCC under the Act, it must consist of the acquisition of "equity shares" of a small business. For the most part, the "equity shares" must be issued directly by the small business to the VCC. There are exceptions to this requirement with respect to the VCC acquisition of prescribed convertible debt, prescribed units of a limited partnership and the acquisition of "equity shares" through an affiliate of a small business. These "indirect" investments by a VCC will be discussed under section 3 of this policy statement.

With respect to an EBC all "equity shares" must be issued directly to eligible investors.

The Act defines an "equity share" under section 1(1) to mean:

- a. a share or class of shares whether or not the share carries voting rights,
- b. any warrants, options or rights entitling their holders to purchase or acquire the shares referred to under (a), or
- c. other prescribed securities.

The prescribed rights and restrictions referred to in this definition are set out in section 3 of the regulations under the Act.

¹ The Act requires a small business to satisfy other requirements in order to obtain registration as an EBC (see also sections 28.2, 28.4, 28.5 and 28.6 of the Act).

² The Act requires that an investment by a VCC satisfy certain other requirements to qualify as an "eligible investment" (see also sections 10, 12, 13, 14, and 15 of the Act).

This policy statement provides information about equity shares under the Act. All program users are advised to read this policy statement before issuing shares or making equity investments in eligible small businesses. Program staff will routinely apply the principles contained in this policy statement when reviewing applications and filings under the program.

1.2 Tax Credit for Risk Capital Investment

The Equity Capital Program was created to encourage equity investment in eligible small businesses in British Columbia. To recognize the risk element involved in making equity investments, the Province provides a 30% tax credit to investors who invest in small businesses under the program.

The tax incentive is provided to compensate investors for putting their funds at risk. Where repayment of capital and investment returns are reasonably assured, financing ought to be available through unassisted sources and payment of a tax credit is not justifiable.

1.3 Safeguarding the Intent of the Act

Past government experience with tax incentive programs has proven that some protections against participants creatively structuring around the objectives of the program are needed to prevent abuse and avoid undue risk to tax revenues.

As a result, the program administrator is authorized under the Act to review both the form and substance of a transaction to determine compliance with the Act. If the substance of a transaction is contrary to the Act, the transaction will not be permitted even if the technical requirements of the Act have been met. Generally, it is considered to be contrary to the Act for program users to "structure around" the objectives of the program or to attempt to do indirectly what cannot be done directly.

2. DISCUSSION

2.1 Characteristics of Equity Capital

The following fundamental characteristics of venture, risk or equity capital (collectively called "equity capital") were used in developing the policy positions set out in this policy statement.

At Risk Investment: An equity investment is at risk both as to return of capital and return on capital. Equity is a residual claim on assets and earnings after all other obligations have been met.

Return Out of Profits/Gains: Equity returns are not fixed obligations, but instead are contingent on earnings or appreciation in the value of the small business. If there are no profits or appreciation, there is no equity return.

Longer Term, Patient Capital: An equity investment is committed for a longer, often indefinite term and usually cannot be removed on demand.

2.2 Equity Share Characteristics

The definition of an equity share under section 1(1) of the Act specifically states that the share may or may not carry voting rights to elect a company's board of directors.

The equity share definition also states that the share cannot carry prescribed rights and restrictions. This requirement recognizes that VCCs or EBC investors (herein referred to as "investors") may invest in voting preferred, as well as common, shares or in unit offerings of a small business. However, some limitations are necessary to ensure that the investors hold a true equity investment that is at risk both as to return of capital and return on capital.

2.3 Unit Offerings

Unit offerings include warrants, options or rights and often are attached to an equity share issued to investors. Unit offerings such as warrants, options, or rights (collectively referred to as "warrants") will be considered to be an equity share provided the following conditions are met:

- the warrant component of the unit can fairly be valued at zero;
- each warrant has an exercise price which is equal to or higher than the original issue price paid for the unit;
- the warrant is non-transferable;
- the warrant has a set expiry date;
- the warrant can only be exchanged for the equity shares of the small business, and
- any proceeds from the issue of the unit are not used by the small business or EBC for uses prohibited under section 12 or 28.93.

2.4 Prohibited Rights and Restrictions

The wording of regulation section 3(1)³ setting out the prescribed rights and restrictions are very general. The following comments are provided to assist program users in understanding some of the specific types of rights and restrictions that would be prohibited under this section.

³ S. 3(1) Subject to the Act, prescribed rights and restrictions, for the purposes of the definition of "equity share" in the Act, are rights and restrictions attached to the share or rights and restrictions contained in or forming part of an agreement, commitment or understanding in respect of the share that

- (a) create a debt between the holder or beneficial owner of the share and any other person,
- (b) impair or will impair the ability of a venture capital corporation to maintain the levels of equity capital invested in eligible investments required by section 8 of the Act,
- (c) impair or will impair the ability of a corporation, in which a venture capital corporation has made an eligible investment, to carry on an ongoing business with a reasonable expectation of profit, or
- (d) will entitle the holder or beneficial owner of the share to reduce the impact of any loss he will sustain in holding or disposing of the share.

a). Debt and Risk Reduction Mechanisms

Mechanisms which create a debt between the small business and the investors or which downsize the risk to the investors of holding a small business investment will be considered prescribed rights and restrictions under section 3(1). Generally, this also means that the rights and restrictions attached to the share or rights and restrictions contained in or forming part of an agreement, commitment or understanding in respect of the share cannot provide a financial guarantee or other security to the investors in respect of the investment in a small business.

b). Retraction Rights and Puts

A retraction right⁴ or put⁵ which is exercised at the option of the investors may, depending on wording of the right or put, impair the ability of a small business to carry on an ongoing business with a reasonable expectation of profit or entitle the investors to reduce the impact of any loss in holding the shares in violation of section 3(1) of the regulations.

As a result, retraction rights or puts will be permitted only where the price paid to the investors under the retraction right or put does not exceed the fair market value of the shares. If the parties are unable to agree as to the fair market value of the shares at the time the retraction right or put is exercised, the parties may agree to appoint an independent third person (e.g. a chartered business valuator) to determine fair market value.

A retraction right or put at a fixed price in excess of fair market value will not be permitted because the fixed price downsizes the risk to the investors of holding the small business shares.

The terms of any retraction right or put must provide that the retraction or put can only be exercised where its operation would not threaten the existence of the small business. Generally, this means that retraction rights or puts which would create a working capital deficiency, or cause a small business to be in default of an arms' length loan will not be allowed.

The terms of any retraction right or put must also provide that the retraction or put is not exercisable until at least five years have passed since the issuance of the equity shares. This five-year period is required to comply with regulation section 8(2) which would otherwise deem the value of the investment to be zero.

⁴ For the purposes of this policy statement, "retraction right" means:

- (i) an acquisition of shares by the small business pursuant to a special right attached to the shares which entitles the investors to require the small business to acquire the shares;
- (ii) a purchase of shares by the small business pursuant to a prior agreement between the small business and the investors which obligated the small business to make the purchase; and
- (iii) a redemption of shares where such redemption was made pursuant to a prior agreement between the small business and the investors which obligated the small business to make the redemption.

⁵ For the purposes of this policy statement, "put" means a right that entitles the investors to require a party other than the small business to purchase the shares.

Redemption rights⁶ (as opposed to retraction rights or puts) are not subject to the above restrictions. Since redemption rights are triggered at the option of the small business (and not the investors), such rights are generally not considered to be prescribed rights or restrictions under section 3(1) of the regulations.

c). Sinking Funds

Sinking funds that require a small business to set aside funds to redeem or otherwise acquire shares held by investors may impair the ability of a small business to carry on an ongoing business with a reasonable expectation of profit. Such funds may also allow the investors to reduce the impact of any loss it will sustain in holding or disposing of the small business shares.

Sinking funds will be prohibited unless they are established and maintained in accordance with the following conditions:

- the fund is established only after proceeds from the issue of equity shares have been fully expended by the small business in an appropriate manner;
- the small business, at its sole discretion, must have access to use the fund for other purposes; and
- payments into the fund are made from net income⁷ of the small business.

d). Dividends

Dividends paid by a small business to investors may, depending on their rate and source of payments, form a prescribed right and restriction under regulation section 3(1). For example, an excessive dividend rate may impair the ability of a small business to carry on an ongoing business with a reasonable expectation of profit or may entitle the investors to reduce the impact of any loss they will sustain in holding the share. Dividends, which are not supported by a history of net earnings at the small business level, may also impair the ability of a VCC to maintain its eligible investment level as required by section 8 of the Act.

For that reason, dividends received by investors from a small business must satisfy the following requirements for those dividends to comply with section 3(1) of the regulations and section 8 of the Act pertaining to VCCs:

- dividends may not, directly or indirectly, be paid out of the capital of the small business and must be supported by earnings of the small business over the time period of the investment;

⁶ For the purposes of this policy statement, "redemption right" means:

- (i) an acquisition of shares by the small business, made at the option of the small business pursuant to a right of acquisition specified in the special rights and restrictions attached to the shares; and
- (ii) a purchase of shares by the small business, made at the option of the small business pursuant to a prior agreement between the small business and the investors.

⁷ For the purposes of this policy statement, "net income" means income after tax calculated in accordance with generally accepted accounting principles.

- dividends on equity shares may not exceed the cumulative net income⁸ of the small business since the issue of equity shares to the investors; and
- the dividend rate on equity shares (whether cumulative or non-cumulative) may not exceed 14% per annum.⁹

While it is not the intent of this policy to regulate and/or override a small business' obligations and requirements concerning the payment of dividends, it is intended to give guidance to investors as to the treatment of these payments in the hands of the investors. If an investor receives dividends from a small business which form a prescribed right or restriction under regulation section 3(1) and/or which result in a return of capital to the VCC in violation of section 8 or, an EBC to be in violation of section 28.3(b)(ii), the investors may be required to repay tax credits.

[Note: The payment of dividends by a small business is also subject to the requirements of section 12(1)(g) and 28.93(g)(iii) of the Act which provides that investor funds cannot be used directly or indirectly for the payment of dividends.]

e). Rights on Liquidation or Wind-up

An equity share held by investors in a small business may provide for distributions to the investors in the event of the liquidation, dissolution or winding-up of the small business in preference and priority to distributions to shareholders of other classes up to the amount of the VCC's investment together with any cumulative or non-cumulative dividends earned on those shares. Such preferences are not considered to be a prescribed right or restriction.

3. INDIRECT ACQUISITION OF EQUITY SHARES BY A VCC

A VCC may indirectly acquire equity shares of a small business pursuant to sections 1(1), 8(2), 10(1)(d) and 10(1)(e) under the Act. These sections refer to where a VCC indirectly acquires an "eligible investment" in a small business through:

- Acquiring equity shares of a small business through an affiliated business,
- Acquiring units of prescribed limited partnership that in turn acquires equity shares of one or more small businesses, and
- Acquiring convertible debt of a small business on a temporary basis.

3.1 Equity Shares of Affiliated Small Businesses

Under section 10(1)(d), a VCC may acquire equity shares of a small business through an affiliated business. A common example of this situation would involve a VCC investing in the equity shares of a small business through a "parent" company that in turn provides the capital to the operating business that qualifies for investment under section 10(1).

⁸ For the purposes of this policy statement, "cumulative net income" means income after tax taking into account previous years' losses calculated in accordance with generally accepted accounting principles.

⁹ The reference to a maximum dividend rate of 14% does not necessarily restrict the total dividends paid by a small business to investors. This reference merely restricts the maximum dividend rate that can be attached as a preference to equity shares. If investors anticipate that a small business will generate earnings in excess of 14% per annum, it may wish to acquire common shares of the small business that carry no stated dividend rate.

This type of corporate structure is common with companies that are reporting issuers or listed on stock exchanges.

Under section 10(1)(e)(i) of the Act, the affiliate must acquire equity shares of the small business within the investment time frames prescribed under regulation 3.2.

3.2 Limited Partnership Units

Under section 10(1)(d) of the Act, a VCC may acquire equity shares of one or more small businesses through the acquisition of prescribed limited partnership units. The intent of allowing VCCs to invest in limited partnerships is to enable maximum program capital investment leverage through co investment with other traditional venture capital funds.

It is not the intention of the Act by permitting VCC investment in limited partnerships to enable VCC investors access to deductions provided under the *Income Tax Act* (Canada). Under section 10(1)(e)(ii) of the Act, the limited partnership must acquire equity shares of the small business within the investment time frames prescribed under regulation 3.2

In order for a limited partnership to qualify and remain as an “eligible investment” for a VCC under section 10(1)(d) of the Act and regulation 1(3.2) it must:

- be formed under the Partnership Act,
- be managed by a “general” partner that resides in British Columbia,
- maintain the investment pacing requirements under sections 8(2)(a) and 8(2)(b), and
- not provide any of its VCC investors with tax deductions or losses available under the *Income Tax Act* (Canada) that would reduce the risk of holding the units of the limited partnership.

Should a VCC be considering investing in a limited partnership it is advised that they first obtain an advance ruling from the ministry to confirm its eligibility.

3.4.1 Convertible Debentures

Under section 1(1) and regulation 1(3.1) of the Act, a VCC may hold convertible debt of a small business on a temporary basis. The intent of the Act is provide equity capital for small businesses.

However, that ministry is aware that a VCC may need to acquire a convertible debenture temporarily while the small business completes its financing from other investors.

In order for the convertible debt to qualify as an “eligible investment” for a VCC it must:

- not be secured with property that exceeds 50% of the debentures value,
- not prevent or penalize the borrower from incurring other debt,
- may not pay a rate of interest that exceeds 12% per annum calculated annually and not in advance, and
- must be converted into equity shares of the small business within 18 months from issuance.

Should a VCC be considering acquiring convertible debt in a small business, it is advised that they first obtain an advance ruling from the ministry to confirm the debenture’s eligibility.

4. CONSEQUENCES OF NON-COMPLIANCE

If a VCC or EBC investor makes an investment in a small business other than by way of equity shares, then that investment will not qualify under the Act. Ultimately, this could lead to revocation of the VCC's or EBC's registration and lead to a liability to repay previously issued tax credits. Since the consequences of non-compliance are extremely serious, program users are urged to discuss proposed investments with program staff as early as possible. An advance ruling process is also available to provide formal rulings on specific proposals.

5. CONCLUSION

This policy statement provides general guidelines for determining whether the shares of a small business meet the definition of "equity share" under the Act. It does not address every type of right or restriction that may be attached in some manner to the shares of a small business, nor does it replace or negate the requirements of the Act or accompanying regulations.

The policies contained in this statement have drawn on experiences derived from administering the program since 1985. As a result of these experiences, some past policy positions have been modified to ensure all equity share investments are made in accordance with both the technical requirements and "spirit and intent" of the Act.

If after reading this policy statement you have questions or would like clarification on a particular point, please visit our website at www.bcinbusiness.gov.bc.ca or call program staff at 250-952-0371 or 1-800-665-6597 (toll free).