

HEDGE FUNDS & STRUCTURED PRODUCTS BULLETIN

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CHANGES TO LABOUR-SPONSORED INVESTMENT FUND LEGISLATION IN ONTARIO

On September 30, 2005, the Minister of Finance (Ontario) (the "Minister") announced that the provincial labour-sponsored investment fund ("LSIF") tax credit would be eliminated at the end of the 2010 taxation year and that the LSIF industry would be consulted in connection with developing rules to assist with the transition of the LSIF program to a federal-only tax credit in Ontario. As a result of such consultations, the Government of Ontario proposed in the 2006 Ontario Budget to introduce amendments to the *Community Small Business Investment Funds Act* (the "Act") that would:

1. provide LSIFs more flexibility in the management of their portfolios by expanding the types of investments they can hold;
2. parallel the corresponding federal program's investment rules and restrictions; and
3. create wind-up rules.

The amendments described above were implemented by *Bill 81, Budget Measures Act, 2006*, which received Royal Assent on May 18, 2006.

SIGNIFICANT AMENDMENTS

Significant amendments to the provisions of the Act relating to LSIFs are summarized below.

Investments

The Act has been amended to remove: (a) the limit on investments by an LSIF in corporations publicly listed on a recognized stock exchange; and (b) the requirement that an LSIF invest a part of its capital in small businesses having not more than 50 employees and gross assets that do not exceed \$5 million. These amendments apply in respect of 2005 and subsequent calendar years. The Act previously prohibited an LSIF from investing in listed companies if the cost of such investments exceeded 25% of the total cost of all investments made in eligible businesses by the LSIF.

The amount that an LSIF may invest in any one business or group of related businesses has been increased from \$15 million to \$20 million.

In addition, the definition of "reserves" in the Act has been amended to permit an LSIF to hold shares that are listed on a Canadian or foreign stock exchange prescribed under the *Income Tax Act* (Canada) (the "ITA"). Tiers 1 and 2 of the TSX Venture Exchange, the Toronto Stock Exchange and the Montreal Stock Exchange are all prescribed stock exchanges in Canada under the ITA. Prescribed stock exchanges outside of Canada consist of the major stock exchanges in several developed countries, and include NASDAQ, the New York Stock Exchange, the London Stock Exchange, the Australian Stock Exchange, the Paris Stock Exchange and the Frankfurt Stock Exchange.

Pacing Requirements

The formula relating to required investment levels by LSIFs (the "pacing requirement") has been amended to require an LSIF to invest 60% of its equity capital in eligible investments in eligible businesses for 2005 and later

years. The pacing requirement was previously 70%. The formula has also been amended to clarify that amounts paid by an LSIF under a guarantee will be included in the calculation of its losses if the amount in respect of the guarantee is deemed to be a qualifying debt obligation under the Act.

Dispositions

The time period during which an LSIF is deemed to continue to hold an eligible investment after its disposition has been extended from nine months to 24 months for dispositions of eligible investments on or after January 1, 2005. Accordingly, eligible investments that are disposed of after such date will continue to be counted for a 24 month period when determining whether an LSIF is satisfying the pacing requirement under the Act.

Qualifying Debt Obligations

The definition of “qualifying debt obligation” in the Act has been amended to clarify the type of security that an LSIF may take back as part of a qualifying debt obligation. The new definition of “qualifying debt obligation” provides that if a debt obligation is secured, it must be secured by: (a) a security interest in one or more assets of the investee business, provided that the security agreement does not prevent the borrower from dealing with its assets in the ordinary course of business before any default; (b) a guarantee from any person; or (c) a combination of (a) and (b). Further, the requirement that a debt obligation be subordinate to all other debt has been replaced with the requirement that the debt obligation not entitle the holder to rank ahead of any other secured creditor of the issuer in realizing on the same security.

Follow-on Investments

A new provision in the Act provides that a follow-on investment by an LSIF in a business that no longer meets the definition of an eligible business only because it is either larger than 500 employees or has more than \$50 million in assets would still be counted as an eligible investment, provided that: (a) when the LSIF made its initial investment the investee business met the definition of an eligible business; and (b) the LSIF continues to hold the initial investment.

Material Changes

The Act has been amended to provide that if a material change occurs on or after January 1, 2005 such that an investment held by a LSIF ceases to be an eligible investment, the investment will still be considered to be an eligible investment for 24 months.

Wind-up Provisions

The Act has been amended to include new rules relating to the winding-up or dissolution of an LSIF. An LSIF choosing to wind-up or dissolve is required to notify the Minister. Any public statement of an LSIF's intention to wind-up will be considered to be notification to the Minister.

An LSIF that notifies the Minister after August 29, 2005 and before February 1, 2007 of its intention to wind-up or dissolve will be subject to the following rules: (a) the LSIF will no longer be eligible to issue tax credits following the notification; (b) Class A shares redeemed or cancelled within a reasonable period of time before the wind-up will not be subject to the claw back of the LSIF tax credit applicable in respect of Class A shares that are redeemed or cancelled less than eight years from the date of issue; (c) the LSIF will be exempt from the pacing requirements while winding-up; (d) the LSIF will be exempt from the requirement to notify the Minister of material changes to its investments while winding-up; and (e) the LSIF will be permitted to return stated capital to shareholders without penalty.

An LSIF that notifies the Minister after January 31, 2007 that it proposes to wind-up or dissolve may use the new wind-up rules only if less than 20% of the amount of equity capital that it raised within the eight years before the notice is given was raised in the 24 months preceding the date of such notice. Shares issued as part of an arrangement

for the purchase of substantially all of the assets of another LSIF are excluded in determining the amount of equity capital raised in the final 24 months for this purpose.

The Act requires an LSIF to pay to the Minister an amount of money (calculated pursuant to a formula provided in the Act) in the event an LSIF proposes to wind-up or dissolve. A new provision to the Act provides that the foregoing does not apply if an LSIF notifies the Minister after August 29, 2005 and before February 1, 2007 of its intention to wind-up or dissolve. An LSIF that notifies the Minister after January 31, 2007 that it proposes to wind-up or dissolve after that day will be similarly exempt from the requirements to pay the amount described above provided that the LSIF complies with applicable wind-up rules.

ALL PROPOSED AMENDMENTS ENACTED

With the enactment of the amendments to the Act under Bill 81, Ontario has completed the implementation of the entire set of proposed transition rules accompanying the phase out of the LSIF tax credit in the province. The amendments described above are designed to facilitate the orderly wind-up of the LSIF tax credit program in Ontario.

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The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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