A Tax Expenditure Analysis of Labour-Sponsored Venture Capital Corporations

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PRÉCIS

Une caractéristique importante de la santé de l'économie canadienne est le succès des petites et moyennes entreprises (PME). Aujourd'hui, les PME emploient plus de la moitié des travailleurs canadiens et elles sont responsables de la moitié des activités de recherche et de développement exécutées dans le secteur privé au Canada. Malgré leur importance, les PME éprouvent des difficultés à lever du capital de démarrage et d'expansion.

En 1985, le gouvernement fédéral a cherché à corriger cet échec du marché au moyen d'encouragements fiscaux. Un certain nombre d'encouragements ont été offerts afin d'encourager les caisses de retraite à investir dans du capital de risque. Après un certain succès initial, les caisses de retraite ont largement abandonné ce genre d'investissement au début des années 1990. Toutefois, un autre encouragement mis en place en 1985, l'octroi d'un crédit d'impôt fédéral rattaché aux particuliers qui investissent dans des sociétés à capital de risque de travailleurs (SCRT), a permis de créer le véhicule qui constitue maintenant la plus grande source de capital de risque au Canada. Présentement, le gouvernement fédéral et celui de sept provinces accordent un crédit d'impôt aux particuliers qui investissent dans des SCRT. Une SCRT est une société à capital de risque établie en vertu d'une loi habilitante (fédérale ou provinciale) et parrainée par un syndicat. Les SCRT visent à promouvoir certains objectifs de politiques publiques, comme le renforcement des comptes de capital de risque, la solution aux lacunes de financement des

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PME, la création et la protection des emplois et la définition d'un nouveau rôle pour les syndicats et les travailleurs dans l'économie canadienne.

La croissance des SCRT a coûté cher au gouvernement. Après la saison des régimes enregistrés d'épargne-retraite (REER) de 1996, au cours de laquelle les SCRT avaient levé environ 1,2 G$ (à un coût total pour le gouvernement d'environ 470 M$, excluant le coût lié aux déductions au titre des REER), les gouvernements fédéral et provinciaux ont considérablement réduit le crédit d'impôt au titre des SCRT. Les investissements dans les SCRT ont chuté à 650 M$ en 1996-97 et à un peu plus de 500 M$ en 1997-98. Aujourd'hui, un certain nombre de SCRT demandent au gouvernement fédéral d'annuler les modifications apportées en 1996.

Étant donné les demandes de ces groupes de pression, le gouvernement devrait vérifier attentivement si le coût de la dépense fiscale liée aux SCRT est justifié. L'historique, la structure actuelle, les coûts et les avantages de la dépense fiscale liée aux SCRT sont examinés dans cet article, plus particulièrement, le fait de savoir si la dépense permet d'atteindre les objectifs du gouvernement en matière de politiques publiques.

Un certain nombre de critiques ont été exprimées au sujet de la dépense fiscale liée aux SCRT. Selon les auteurs, certaines de ces critiques sont prématurées. Cependant, certaines autres semblent bien fondées. Premièrement, certaines SCRT ont beaucoup tardé à investir le montant requis de capital dans les PME. Deuxièmement, la dépense fiscale liée aux SCRT n'a généralement pas permis de régler le problème de la petite entreprise du marché du capital de risque. Troisièmement, la participation des syndicats dans un certain nombre de SCRT, surtout en Ontario, est presque nulle. Enfin, un encouragement fiscal n'est peut-être pas le moyen approprié pour faciliter le nouveau rôle des syndicats dans le secteur, soit à titre de conseillers en placement ou à titre d'investisseurs dans du capital à un risque élevé.

En conclusion, l'article comprend un relevé de plusieurs solutions de rechange qui pourraient permettre de mieux régler les besoins de financement des PME, dont certaines ne nécessitent aucune dépense gouvernementale. Finalement, les SCRT pourraient être une solution à court terme à l'échec du marché en matière de financement du capital de risque. Cependant, les solutions à long terme doivent être axées sur les causes de l'échec du marché plutôt que sur les symptômes.

ABSTRACT

A significant determinant of the health of Canada's economy is the success of small and medium-sized enterprises (SMEs). Today, SMEs employ over half of all Canadian employees and are responsible for half of the private sector research and development performed in Canada. Despite their importance, SMEs have difficulties attracting startup and expansion capital.

In 1985, the federal government sought to correct this market failure through tax incentives. A number of incentives were offered to encourage pension funds to invest in venture capital. After some initial success, pension funds largely abandoned venture capital investment in the early 1990s. However, another 1985 incentive—the introduction of a matching federal tax credit available to individuals who invest in labour-sponsored venture capital corporations (LSVCCs)—created the vehicle that is now the largest source of venture capital in Canada. Currently, the federal and seven provincial governments offer a tax credit to individuals who invest in LSVCCs. An LSVCC is a venture capital corporation established under enabling legislation (federal or provincial) and sponsored by a labour organization. LSVCCs are intended to advance certain public policy goals, such as strengthening venture capital pools, addressing gaps in the financing of SMEs, creating and protecting employment, and defining a new role for unions and workers in the Canadian economy.

The growth of LSVCCs has been achieved at a substantial cost to government. After the 1996 registered retirement savings plan (RRSP) season, in which LSVCCs raised almost $1.2 billion (with an aggregate government cost of approximately $470 million, excluding the cost associated with RRSP deductions), the federal and provincial governments dramatically reduced the LSVCC tax credit. Investment in LSVCCs declined to $650 million in 1996-97 and just over $500 million in 1997-98. Today, a number of LSVCCs are petitioning the federal government to reverse the 1996 changes.

In the face of these lobbying efforts, the government should carefully consider whether the cost of the LSVCC tax expenditure is justified. This article examines the history, current structure, and costs and benefits of the LSVCC tax expenditure; in particular, the article considers whether the expenditure achieves the government's policy objectives.

A number of criticisms have been levied against the LSVCC tax expenditure. In the authors' view, some of these criticisms are premature. However, a few criticisms appear well founded: first, some LSVCCs have been extremely slow to invest the requisite amount of capital in SMEs; second, the LSVCC tax expenditure has generally failed to address the low end of the venture capital market; third, labour's involvement in a number of LSVCCs, particularly in Ontario, is essentially non-existent; and finally, a tax incentive may not be the appropriate mechanism to facilitate a new role for labour in industry, as either an investment adviser or an investor in high-risk venture capital.

The article concludes with a survey of several alternatives that may better address the financing needs of SMEs, some of which do not require government expenditure. Ultimately, LSVCCs may be a short-term solution to the market failure associated with venture capital financing. However, long-term solutions must focus on the causes of the market failure rather than its symptoms.

INTRODUCTION

Over the last 50 years, Canadian economic development policy appears to have been oriented primarily toward the needs of big business, with little attention being paid to local entrepreneurship.[1] This orientation fails to recognize that the role of big business in job creation and economic prosperity has been declining for close to two decades.[2] In the decade leading up to 1987, small business accounted for 80 percent of the new jobs created and one-half of the research and development performed by private sector firms in Canada.[3] In the 1980s, the number of businesses in Canada grew by 40 percent, and most of that growth was accounted for by small business.[4] By June 1997, 96 percent of registered businesses in Canada had fewer than 50 employees.[5] In 1995, employers with fewer than 50 employees were employing 30 percent of all Canadian employees; employers with fewer than 500 employees were employing over 54 percent of all Canadian employees.[6] Many private and public sector leaders

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[1] Canada, House of Commons, *Taking Care of Small Business: Report of the Standing Committee on Industry* (Ottawa: Supply and Services, October 1994), 2.

[2] D.L. Birch, "Who Creates Jobs?" [1981], no. 65 *The Public Interest*.

[3] Canada, Department of Industry, Science and Technology, *Small Business in Canada: Growing To Meet Tomorrow*, a report to Parliament by the Minister of State (Small Business and Tourism) (Ottawa: Supply and Services, 1989), 5.

[4] Supra footnote 1, at 2.

[5] Statistics Canada, Business Register, "Canadian Business Patterns" (June 1997, unpublished).

[6] These statistics include both private and public sector employees, but do not include self-employed individuals. According to the October 1997 labour force survey, there were more than 2.25 million self-employed individuals, which exceeded the total number of employees in the public sector at that time (just over 2 million): Statistics Canada, *Labour Force Update*, Autumn 1997, "The Self Employed," catalogue no. 71-005-XPB, 6. The following table sets out the number of Canadians employed by firms of various sizes in 1995: Statistics Canada, Small Business and Special Surveys Division (1997, unpublished).

Size of firm (number of employees)	*Number of employees (000s)*	*Percentage of employees in firms of that size or smaller*
Fewer than 5	989.5	8.87
5-19.9	1,283.8	20.53
20-49.9	1,151	30.67
50-99.9	877.8	38.53
100-499.9	1,804.8	54.65
500+	5,059.2	100

These figures include public sector employees. It is difficult to eliminate those employees from the data because many of the categories used by Statistics Canada may include both private and public sector employees (for example, education services and health care services). However, if the most obvious public sector employees are removed (government service industries), the importance of SMEs in the private sector increases significantly. The vast majority of these public sector employees (over 900,000) are in the 500+ category in the above table. If employees in this category are removed, SMEs employed 59.2 percent of all employees, while SMEs with fewer than 50 employees employed 33.4 percent of all employees.

have identified the importance of finding effective ways to supply adequate capital to fuel the growth of small and medium-sized enterprises (SMEs),[7] especially those engaged in technology-intensive processes and manufacturing.[8]

Canadian government policies and programs assist SMEs in various ways. In federal and provincial income tax legislation, there are a number of special tax incentives for SMEs. These measures are usually justified on the basis that SMEs face greater difficulties obtaining capital than do larger corporations. The primary tax incentives in the Income Tax Act[9] directed at SMEs are the small business deduction in section 125,[10] the capital gains exemption for qualified small business corporation shares in subsection 110.6(2.1),[11] the employee stock option provisions in subsection 7(1.1) and paragraph 110(1)(d.1),[12] and the deduction for allowable business investment losses (ABILs) in paragraph 3(d).[13] Other significant

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[7] SMEs are generally described as firms with fewer than 500 employees and less than $50 million in assets: Standing Committee on Industry, supra footnote 1, at 2.

[8] A good overview of the older literature, the statistical impact of SMEs, and the difficulties faced by SMEs in attracting investment is provided in Mary Macdonald and John Perry, *Pension Funds and Venture Capital: The Critical Links Between Savings, Investment, Technology, and Jobs* (Ottawa: Science Council of Canada, 1985), chapter 1.

[9] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

[10] A Canadian-controlled private corporation (CCPC) is entitled to a tax credit of 16 percent of its first $200,000 of income from an active business carried on in Canada. In general terms, the small business deduction reduces the federal tax rate to 12 percent. All of the provinces and territories provide a similar tax credit. The federal credit is phased out once the small business corporation has taxable capital employed in Canada in excess of $10 million and is eliminated entirely when taxable capital employed in Canada reaches $15 million.

[11] See below under the heading "Conclusions: Tax Expenditure Alternatives: Reduction of Capital Gains Tax on Dispositions of Small Business Investments."

[12] Generally, if an employee receives an option to purchase shares of his or her corporate employer, the difference between the fair market value of the shares and the price paid for the shares (including any amount paid for the option) is an employee benefit that is included in the employee's income in the year the shares are acquired (subsection 7(1)). However, arm's-length employees of a CCPC are not taxed on the employee benefit until the year in which the shares are sold (subsection 7(1.1)). In addition, so long as the employee of a CCPC holds the shares for at least two years before their disposition, the employee may deduct one-quarter of the benefit (paragraph 110(1)(d.1)) even if the option price was less than the fair market value of the shares at the time the option was granted (one of the general conditions applicable to the one-quarter deduction for other employees in paragraph 110(1)(d)).

[13] ABILs arise when a taxpayer disposes of shares or debt of a small business corporation at a loss. Although limited to three-quarters of such loss, ABILs may be deducted from all income rather than only taxable capital gains of the taxpayer. As with the capital gains exemption, the relief arises only when the taxpayer disposes of the shares or debt.

One tax incentive that specifically targeted the ability of SMEs to raise conventional financing was the small business development bond (SBDB) provisions in section 15.1. Historically, the Act has contained provisions designed to assist corporations in financial

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tax incentives in the Act that can benefit SMEs, although not limited specifically to them, include the manufacturing and processing tax credit in section 125.1, investment tax credits (ITCs) in section 127, and the deduction for expenditures on scientific research and experimental development (SR & ED) in section 37. The ITC and SR & ED provisions are designed to stimulate new capital expenditure in Canada on certain buildings, equipment, and machinery, and to encourage Canadian firms to undertake research and development in Canada; by their very nature, they tend to favour primarily capital-intensive firms.[14]

Most of the incentives discussed above tend to assist established SMEs and are not particularly geared toward SMEs in the startup phase or those seeking new capital. The latter face a number of barriers. Banks and other

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[13] Continued . . .
difficulty since 1935, when the income bond provisions were introduced. Under these provisions, interest on an income bond was treated as a dividend for tax purposes and therefore permitted after-tax financing. Under the original income bond provisions, the only precondition for dividend treatment was that the debtor company had to make a profit before interest was payable. In 1978, when the preferred share rules were introduced, the income bond provisions were limited to debtor corporations in financial difficulty (see the definition of "income bond" in subsection 248(1)).

The SBDB provisions, applicable to corporate borrowers, were originally introduced in 1980 as a temporary measure to provide some relief against the high cost of borrowing when a corporation was either refinancing in a time of financial difficulty or expanding. The original definition of a qualifying debt obligation included, in addition to a loan made to a corporation in financial difficulty, a loan whose proceeds were used to make certain specified expenditures or to acquire certain specified property. Similar to the income bond provisions, the SBDB provisions allowed financial institutions to provide after-tax financing to qualified small business corporations. The incentive was originally intended to apply to SBDBs issued before the end of 1981. In the November 12, 1981 budget, it was announced that the incentive would be extended for a further year (until the end of 1982) and expanded to include qualifying debt issued to individuals and partnerships (the small business bond [SBB] provisions in section 15.2). However, when the legislation was introduced (SC 1980-81-82-83, c. 140, sections 8 and 9), the definition of qualifying debt obligation in subsection 15.1(3) was amended to limit the use of SBDBs for expansion purposes to SBDBs issued before February 1, 1982, and the SBB provisions were limited from the outset (November 12, 1981) to businesses in financial difficulty. Subsequently, SBDB and SBB provisions remained limited to SMEs that were in financial difficulty.

The provisions were further extended to the end of 1985 and again until the end of 1987. After a four-year hiatus, the provisions were reintroduced in the 1992 budget for SBDBs and SBBs issued after February 25, 1992 and before 1993 (again, applicable only to SMEs in financial difficulty). The December 2, 1992 economic statement extended the provisions for two further years, to the end of 1994. The provisions have not been extended since, nor have they been reintroduced. Since the maximum period for which a qualified SBDB or SBB could be issued was five years, the incentive will effectively disappear at the end of 1999. For a tax expenditure analysis of the SBDB (and distressed preferred share) provisions, see Tim Edgar, "Distressed Preferred Shares and Small Business Development Bonds: A Tax Expenditure Analysis" (1994), vol. 42, no. 3 *Canadian Tax Journal* 659-708.

[14] Although qualifying small businesses are entitled to a greater refundable ITC in certain cases: see section 127.1. The credit is refundable to smaller CCPCs whose income does not exceed the business limit determined for the small business deduction. It has been suggested that refundable ITCs have been critical to the cash flow of some small software firms.

lending institutions, the conventional sources of capital, are often loath to lend money to SMEs, primarily because they cannot provide adequate security. If banks are willing to extend credit, it is often at rates higher than those granted to larger corporations. As a result, SMEs may be forced to seek venture capital as the only viable source of financing available. Venture capital is "capital invested [in] or loaned to a company that is generally unsecured, lacks liquidity, and is subject to a significant degree of risk."[15]

This article examines the vehicle that is now the largest source of venture capital in Canada—labour-sponsored venture capital corporations (LSVCCs). Briefly, an LSVCC is a venture capital corporation established by virtue of enabling legislation (federal or provincial) and sponsored by a trade union or other specified employee organization. LSVCCs are intended to advance certain public policy goals, such as strengthening the national venture capital market and provincial submarkets, addressing gaps in SME financing, creating and protecting employment, and defining a new role for unions and workers in the Canadian economy. LSVCCs have been remarkably successful at raising capital that is ear-marked for investment in SMEs. This success has been achieved at a substantial cost to government, since most of the investment in LSVCCs has been funded indirectly by the federal government and a number of provincial governments through tax credits.

LSVCCs are relatively new sources of SME financing, and their effect is still largely undetermined. Certainly, they have achieved the first objective of creating a substantial pool of venture capital; the question is whether they will fulfil the remaining policy objectives, including the appropriate investment of this venture capital in SMEs. Given this uncertainty and the size of the expenditure to government, the tax incentive provided for investment in LSVCCs warrants analysis. A comprehensive tax expenditure analysis of LSVCCs should consider questions similar to those applied to any direct spending program:[16]

- How much does the expenditure cost? Are there mechanisms built into the program to control the costs?
- Is the expenditure structured to produce a favourable cost-benefit ratio?
- Does the expenditure produce an effective response to the identified problem?

This article examines these questions and also considers alternatives that might better address the capital requirements of SMEs.

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[15] Lawrence Teltscher, "Small Business Financing," in *Income Tax and Goods and Services Tax Considerations in Corporate Financing*, 1992 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1993), 6:1-67, at 6:44.

[16] Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures* (Cambridge: Harvard University Press, 1985), 112-13.

Historical Development of the LSVCC Regime

In the Beginning

Beginning in 1976 with Quebec's "SODEQ" legislation,[17] a number of provincial governments introduced venture capital corporation (VCC) schemes in order to enhance the supply of venture capital for SMEs.[18] Various provincial tax incentives, such as tax credits, deductions, or grants, offered under these measures stimulate investment in VCCs. VCCs were adopted to perform two functions: first, the provision of capital through the acquisition and holding of securities in SMEs; and second, the provision of business and managerial expertise to SMEs. Further to the first function, a VCC must invest a specified percentage (generally 70 percent) of its capital in eligible investments. An eligible investment is typically a small business[19] primarily involved in specified activities, such as scientific research and development, manufacturing and processing, or tourism.

The Act does not include specific tax incentives for investment in the provincial VCCs; however, any prescribed assistance given by a provincial government to investors with respect to an investment in prescribed VCCs will not reduce the adjusted cost base of the investors' shares.[20] In addition, dividends received by a prescribed VCC from a qualifying corporation in which it invests are exempt from part IV tax.[21]

The First LSVCC

In 1983, Quebec enacted legislation that established the first LSVCC, the Fonds de solidarité des travailleurs du Québec (FSTQ).[22] The purpose of the legislation was to establish a fund, directed by the Fédération du travailleurs du Québec (FTQ), Quebec's largest trade union, that would invest in Quebec SMEs in order to create, maintain, or preserve jobs and to facilitate the training of employees in economic and financial matters. The genesis of the FSTQ was the economic recession of 1981-1983. In the wake of that recession, labour leaders had become convinced that labour

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[17] An Act Respecting Corporations for the Development of Québec Business Firms, SQ 1976, c. 33.

[18] The various provincial incentives are discussed in Peter E. McQuillan, "An Analysis of Venture Capital Incentives," in *Income Tax Considerations in Corporate Financing*, 1986 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1986), 169-253. See also Teltscher, supra footnote 15, at 6:50-64.

[19] In Ontario, defined as a business with fewer than 150 employees: section 1(1) definition of "small business," in the Small Business Development Corporations Act, RSO 1990, c. S.12, as amended; and section 7 of the Small Business Development Corporations Regulations, RRO 1990, O. Reg. 1020.

[20] Clause 53(2)(k)(i)(C).

[21] Section 186.2.

[22] Act To Establish the Fonds de solidarité des travailleurs du Québec, SQ 1983, c. 58 (now RSQ F-3.2.1) (herein referred to as "FSTQ Act"). Quebec added a second LSVCC in 1995, Fondaction, created by the Act To Establish Fondaction, le Fonds de développement de la Confédération des syndicats nationaux pour la coopération et l'emploi, SQ 1995, c. 48 (now RSQ F-3.1.2) (herein referred to as "Fondaction Act").

should be more directly involved in the capital markets. In Quebec, the labour movement was particularly alarmed by the permanent employment losses, plant closures, and production and investment relocation[23] that followed the election of the Parti Québécois government in 1976. In 1982, the FTQ (particularly former President Louis Laberge) suggested the idea of a labour-sponsored investment fund as a vehicle for stimulating economic development in Quebec. This proposal received the backing of the Parti Québécois government and some high-profile business and financial leaders at the Sommet du Québec in 1982, and the fund was created by special legislation in 1983. Both the Quebec and federal governments provided seed money in the form of a loan to FSTQ. Each government provided $10 million (the Quebec government in 1984 and the federal government in 1987). These loans were later converted to class G shares, which are non-voting, non-transferable, non-redeemable, and without dividend rights.[24] Originally, individuals resident in Quebec who invested in the FSTQ were entitled to a provincial tax credit of 35 percent on the first $3,500 invested in shares of the fund.[25]

The 1985 Federal Budget: Sowing the Seeds

In the 1985 federal budget, the minister of finance introduced a number of measures to stimulate venture capital investment, specifically that of registered pension and other retirement plans. The main venture capital incentives introduced in the budget were

- a matching federal tax credit for individuals who invested in provincial LSVCCs;
- the extension of "qualified investments" for registered retirement savings plan (RRSP) purposes to private corporations engaged in active business and to prescribed VCCs;
- small business investment corporation (SBIC) provisions;[26]
- small business investment limited partnership (SBILP) provisions;
- small business investment trust (SBIT) provisions; and

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[23] Canadian Labour Market and Productivity Centre, *The Role and Performance of Labour-Sponsored Investment Funds in the Canadian Economy: An Institutional Profile* (mimeograph, November 1995), 67.

[24] The $20 million has been characterized as a grant by those who have done studies of FSTQ: see, for example, infra footnote 160.

[25] The rate and maximum investment entitled to the provincial tax credit have varied over time. The 35 percent credit on a maximum investment of $3,500 applied for 1983 and 1984. In 1985, the credit was reduced to 20 percent on a maximum investment of $3,500. The maximum investment was increased to $5,000 in 1992. In 1996, the tax credit was reduced to 15 percent on a maximum investment of $3,500.

[26] SBICs are tax-exempt investment vehicles for registered pension plans (RPPs) in "small business securities." Basically, small business securities are shares or debt of private corporations that are engaged in an active business and whose assets do not exceed $50 million. The main SBIC provisions are in paragraph 149(1)(o.3) and regulation 5101.

• the three-to-one leveraging of "small business investments" for the purpose of the tax penalty applicable to a pension fund whose foreign property exceeds 10 percent of the fund's total assets.

The last four measures were aimed primarily at pension funds. Pension funds were a very significant source of capital,[27] but they made only limited venture capital investments in SMEs.[28] Unlike their US counterparts, Canadian pension funds did not have strong ties to the venture capital industry, and the federal budget proposals aimed to encourage them to increase their investments in this area.

The last three measures were designed to relax the "foreign property" rules applicable to registered pension funds. At that time, part XI of the Act imposed a tax on pension funds whose foreign property exceeded 10 percent of the fund's total assets.[29] "Foreign property," defined in subsection 206(1), includes any interests in a partnership or trust, except as prescribed by regulation. Regulation 5100(1.1), introduced as part of the 1985 budget measures, prescribes that interests of a limited partner in an SBILP and interests in an SBIT are not foreign property. The requirements of SBILPs and SBITs are set out in regulations 5102 and 5103, respectively. Finally, the budget introduced paragraph 206(2)(c), which effectively permits a pension fund to hold $3 of additional foreign property for every $1 of small business properties[30] to a maximum of 20 percent of the total assets of the fund.

These measures had some initial impact on venture capital investment by Canadian pension funds; however, it was short-lived. In the late 1980s, venture capital investment by both US and Canadian pension funds dropped considerably, primarily because of the poor performance of the investments. Although venture capital investment by US pension funds recovered in the early 1990s, investment by Canadian pension funds never has.[31]

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[27] By the end of 1983, trusteed pension assets were worth an estimated $84 billion and total pension-related assets (including the Canada and Quebec Pension Plans, federal superannuation accounts, and trusteed pensions) were worth an estimated $196 billion: Macdonald and Perry, supra footnote 8, at 15.

[28] Macdonald and Perry, ibid., at 45, estimated that only $72 million or 0.3 percent of the assets of Canada's largest pension funds and $25 million or 1 percent of the assets of small and medium funds were invested in venture capital.

[29] The 10 percent threshold was increased to 20 percent in 2 percent annual increments beginning in 1990.

[30] Small business properties include small business securities (supra footnote 26), shares of SBICs, interests of a limited partner in SBILPs, and interests in SBITs.

[31] We are not aware of any statistics in the public domain concerning the level of venture capital investment by pension funds. Evidently, in 1987, Canadian pension funds invested approximately $200 million annually as venture capital; between 1988 and 1997, they invested no more than $100 million annually. The major distinction between the investment by Canadian pension funds and US pension funds is that the latter reduced their investments in venture capital at the end of the 1980s; they did not flee from venture capital as many Canadian pension funds did. The only real exceptions in Canada were the

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The effect of the 1985 budget proposals specifically targeting pension plans has to date proved insignificant.[32]

In contrast, the introduction of a federal tax credit for investment by individuals in LSVCCs[33] was the catalyst that created a venture capital pool so large that by the end of the 1996 RRSP season, LSVCCs had raised sufficient capital to satisfy venture capital needs for more than three years.[34] Given the significance of LSVCCs as a source of venture capital and the cost of the scheme to the federal government, it is unfortunate that there was no debate preceding either the introduction of the federal tax credit in 1985 or the introduction of a federal LSVCC regime in 1988.

1985-1995: Years of Growth

At the time of the 1985 federal budget, only one LSVCC existed in Canada, FSTQ. However, the federal government "encouraged other provinces to come along with their regimes to encourage labour-sponsored venture capital funds."[35] Over the next 10 years, a number of provinces did so. Some provinces established their own legislative requirements for LSVCCs;[36] others extended a provincial credit to certain federally registered LSVCCs, introduced in the February 1988 federal budget.[37]

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31 Continued . . .
pension funds in Quebec, such the Caisse de dépôt et placement (Quebec's public pension fund) and a number of company pension plans (such as Bombardier Inc.), which maintained venture capital investment. Since 1989, venture capital investment by Canadian pension funds has been almost exclusively from Quebec funds.

Arguably, the 1985 amendments led to the decline in pension fund investments. As it turned out, the late 1980s was the end of the economic cycle, and the federal tax incentives may have prompted venture capital investment by pension funds at the worst possible time. The returns experienced by the pension funds were much lower than they expected and may have been a significant "scare factor."

32 Evidently, outside Quebec, a few pension funds have started to make venture capital investment again, almost exclusively through venture capital pools. In 1997, pension funds committed $237 million (of which $156 million came from pension funds outside Quebec) to venture capital pools. Whether this trend will continue remains to be seen.

33 Section 127.4. As originally enacted, the credit applied so long as the provincial credit did not exceed 20 percent of the cost of the individual's shares of the LSVCC. The maximum federal credit was $700, so that the credit applied only to the first $3,500 invested in a prescribed LSVCC. Quebec reduced its provincial credit to the same rate and maximum amount with effect from May 23, 1985: SQ 1987, c. 67, section 153.

34 Canada, Department of Finance, 1996 Budget, Budget Plan, annex 5, Tax Measures: Supplementary Information and Notice of Ways and Means Motions, March 6, 1996.

35 Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Finance*, 34th Parliament, 3d session, 1991, issue no. 22, November 20, 1991, 29.

36 The following provinces have established their own schemes (year established in parentheses): Quebec (1983); Saskatchewan (1986); British Columbia (1989); Manitoba (1991-92); Ontario (1992); Nova Scotia (1993); New Brunswick (1994). As noted, supra footnote 22, Quebec established a second LSVCC in 1995.

37 Since 1993, New Brunswick has also extended a provincial credit to prescribed federally registered LSVCCs (currently three). Nova Scotia also extends a provincial credit
(The footnote is continued on the next page.)

When the minister of finance announced the establishment of measures for national LSVCCs, he stated that the credit would be available for investment in LSVCCs "that meet criteria similar to existing criteria applying to [FSTQ]."[38] However, the draft legislation, introduced in a January 12, 1990 press release, included some material differences from the Quebec scheme.[39] The first national LSVCC, Working Ventures Canadian, sponsored by the Canadian Federation of Labour, was launched in February 1990. The federal government has provided that fund with a total grant of $14.55 million in monthly instalments over the period from 1988 to 1995.[40]

Ontario introduced LSVCC legislation as a follow-up measure to the New Democratic Party's first budget, presented in the legislature on April 29, 1991. Like Quebec in the early 1980s, Ontario also was experiencing a severe economic depression in the early 1990s. The 1991 budget called for a "new economic strategy based on broad social partnerships" in which government, labour, business, and community groups would participate.[41]

The Ontario LSVCC regime was introduced as part of Bill 150. Bill 150 also included legislation governing employee ownership labour-sponsored venture capital corporations (EOLSVCCs) (now contained in part II of the Community Small Business Investment Funds Act).[42] The

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[37] Continued . . .
to prescribed federally registered LSVCCs (currently four), in addition to its own regime (under which no LSVCC has yet been established). Prince Edward Island introduced a provincial LSVCC tax credit for prescribed federally registered LSVCCs in 1992 but eliminated the credit in the province's 1997 budget, with effect from April 9, 1997.

[38] Canada, Department of Finance, 1988 Budget, Budget Papers, February 10, 1988, 8.

[39] These differences, particularly the holding period requirements, the investment requirements (particularly during the initial years of a fund), and the consequences of failure to meet the investment requirements, are considered in detail in the following section of the article.

[40] The grant was provided pursuant to an agreement dated May 6, 1988, whereby the minister of regional industrial expansion (representing Canada) agreed to pay the sum of $15 million. The amount was later reduced owing to federal cutbacks. The fund is required to use the grant "to assist in the establishment, development, promotion and operation of, and investment through" the fund. It is not repayable unless the fund "misappropriates the grant, or does not carry out in a satisfactory fashion the activities for which the grant was intended": see Working Ventures Canadian Fund Inc., *1994 Annual Report*, 23.

[41] Ontario, Ministry of Treasury and Economics, 1991 Ontario Budget, Budget Paper E, "Ontario in the 1990s: Promoting Equitable Structural Change," April 29, 1991, 101.

[42] According to Paul Johnson, parliamentary assistant to the minister of revenue, who introduced Bill 150 on behalf of Shelley Wark-Martyn, minister of revenue, Bill 150 "puts into place a plan for business, labour and government to work as partners to help Ontario meet the challenges of the changing economic environment. The Ontario investment and worker ownership program is an example of the government's commitment to create and maintain jobs, improve labour-management relations, increase productivity and competitiveness and bring stability to Ontario's economy." (Ontario, *Debates*, December 16, 1991, 4322.) It is not necessary to deal with the EOLSVCC regime in detail here. In brief, it was intended to be an incentive to employees to invest in shares of their employer businesses
(The footnote is continued on the next page.)

Ontario LSVCC regime was modelled on the 1988 federal regime. Bill 150 was the subject of substantial debate in the legislature, but that debate concentrated primarily on the EOLSVCC regime. Opposition members appeared to support the promotion of venture capital investment generally, but they expressed concerns about several features of the proposed LSVCC regime: that the LSVCC must be sponsored by a labour union to the exclusion of other employee organizations (or, indeed, be sponsored by employees at all); that the government significantly underestimated the tax expenditure involved; that the tax benefit offered to investors was too generous; and that the general body of taxpayers was assuming most of the risk involved. One criticism that hindsight certainly bears out is that the level of investment in LSVCCs anticipated by the government of the day was drastically understated.

Table 1 sets out all of the LSVCCs and the provinces in which a matching tax credit is currently available.

In 1992, investment in an LSVCC was made significantly more attractive, from an investor's tax perspective, in two ways. First, effective for 1992 and subsequent years, the maximum federal credit was increased to $1,000, so that the credit was available for up to $5,000 invested in an LSVCC.[43] Second, the tax credit was available directly to the individual investor if the individual's RRSP acquired shares of an LSVCC.[44] Consider an individual in the highest marginal tax bracket (assumed to be 50 percent, combined federal and provincial) who made a $5,000 contribution to an RRSP that was used to purchase shares of an LSVCC. As a consequence of the RRSP deduction (assuming that the individual had enough room under the RRSP contribution limit to claim the full amount), the cost of the shares was effectively reduced to $2,500. The individual also received a 20 percent federal tax credit ($1,000) and a corresponding 20 percent provincial tax credit (another $1,000). Of the $5,000 investment, the individual investor risked only $500, or 10 percent of the cost, while the federal and provincial governments effectively paid the remaining 90 percent.[45]

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42 Continued . . .
by offering a tax credit for the acquisition of such shares. See generally Robin MacKnight, "ESOP's Fable: Gargoyles, Tax Policy, and Employee Ownership in Ontario," in *Report of Proceedings of the Forty-Sixth Tax Conference*, 1994 Conference Report (Toronto: Canadian Tax Foundation, 1995), 22:1-36.

43 The provinces introduced corresponding increases in the provincial credit in the same year.

44 See subsection 127.4(3), as amended by SC 1994, c. 8, section 17(2), and the definition of "qualifying trust" added by SC 1994, c. 8, section 17(1). Previously, the individual could obtain the benefit of both the LSVCC tax credit and the RRSP deduction by acquiring the shares personally and then transferring them to his or her RRSP as a contribution in kind. Shares of a prescribed VCC had been qualified investments for RRSP purposes since October 31, 1985: see regulations 4900(6)(a) and 5100(1)(b). Under regulation 6700, a prescribed VCC includes all of the prescribed LSVCCs.

45 It is perhaps inappropriate to include the federal and provincial tax expenditure associated with RRSP contributions since the expenditure is incurred regardless of the nature of the RRSP investment. See infra footnote 166.

Table 1 LSVCCs and Provinces Offering Matching Credit, 1998

Fund	Provinces offering credit[a]
The BEST Discoveries	Ont.
Canadian Medical Discoveries	Ont., NS, NB
Canadian Science & Technology Growth	Ont.
Canadian Venture Opportunity	Ont.
Capital Alliance Ventures	Ont.
Centerfire Growth	Ont.
CI Covington	Ont.
Crocus Investment	Man.
DGC Entertainment Ventures	Ont.
ENSIS Growth	Man.
FESA Enterprise Venture Capital	Ont.
First Ontario	Ont.
Fondaction	Que.
FSTQ	Que.
Innovacap Capital Corp.	Ont.
Retrocom Growth	Ont., NS
Sportfund	Ont.
Tourism and Entertainment Growth	Ont.
Triax Growth	Ont., NB, NS
Trillium Capital Growth	Ont.
VenGrowth Investment	Ont.
Workers Investment Fund	NB
Working Opportunity Fund (EVCC)	BC
Working Ventures Canadian	Ont., Sask., NS, NB

[a] Prince Edward Island formerly offered a tax credit for investments in Canadian Medical Discoveries and Working Ventures Canadian, but it eliminated the provincial tax credit in 1997.

From the individual's perspective, even if the LSVCC generated only a 2 percent annual return over five years, the return at the end of that period ($520.40) would exceed the cost of the investment. If the individual chose to sell the shares at that time, the gain on the actual cash invested would be $5,020.40, assuming that the proceeds remained in the individual's RRSP.

These amendments had a powerful impact on investment in LSVCCs. Table 2 shows the amount invested in LSVCCs annually between 1985, when the federal credit was first introduced, and 1995.

Investment in LSVCCs increased from approximately $70 million for the 1990 taxation year to over $1 billion for the 1995 taxation year (including the 1996 RRSP season). By March 1997, LSVCCs had more than $3.7 billion in assets.[46] In 1992, investment in LSVCCs doubled from the 1991 levels, and in 1993 through 1995, the amount invested in LSVCCs almost doubled each year.[47] Working Ventures Canadian, which is federally registered and registered or prescribed in a number of provinces,

[46] Based on figures provided by Macdonald & Associates Limited, Toronto, March 1997 (unpublished).

[47] The decline from 1992 to 1993 is accounted for almost entirely by the cap that the Quebec government placed on investment in FSTQ in 1993. See infra footnote 93.

Table 2 Investment in LSVCCs, Annually, 1985-1995

Year	Amount ($000)
1985	9,465
1986	44,235
1987	62,480
1988	67,200
1989	68,505
1990	69,505
1991	147,835
1992	309,610
1993	292,100
1994	556,560
1995	1,172,420

Source: Derived from annual tax expenditure figures provided by the Department of Finance (unpublished). The amount is based on the federal tax credit for LSVCC investment in the taxation year. The credit applies to shares purchased in the year or within 60 days after the end of the year (similar to the RRSP deduction). The majority of LSVCC shares are purchased during "RRSP season," in January or February of the following year; for simplicity, these amounts are reflected in the taxation year for which the credit is given. The amounts shown in the table do not include investments made in LSVCCs for which no federal tax credit was given (which includes circumstances in which a provincial tax credit was given on an annual investment that exceeded the maximum investment for federal tax credit purposes).

raised $350 million in an unexpected 1996 RRSP season (reflected in the total raised in 1995 in table 2)—$200 million more than the LSVCC's projected fundraising target.[48] As a result, Working Ventures Canadian temporarily halted the sale of its shares and has not as yet resumed sales.[49]

The success of LSVCCs, particularly outside Quebec, was driven by two factors: first, the generous tax benefits to investors; and second, a very successful marketing campaign, particularly on the part of Working Ventures Canadian, which made LSVCCs a household word. Their success was clearly evidenced by the extraordinary level of investment activity during the 1995 and 1996 RRSP seasons. The government incentives amount to a huge subsidy to investors[50] and are a significant tax expenditure. The annual federal government expenditure was equal to 20 percent of the amount shown in table 2, and almost the entire amount each year also benefited from a matching provincial credit.[51] Between 1991 and 1995, the federal expenditure alone rose from $29.5 million to $234.5 million, an eight-fold increase.

48 "Working Ventures Puts Capital Raising Efforts on Hold," Canada News Wire, releases (June 1996).

49 One of us was advised that sales may not recommence until fall 1998.

50 Analysis of the tax incentive should consider only the LSVCC tax credit. Individuals who contribute to an RRSP are entitled to the RRSP deduction regardless of the nature of the RRSP's investments.

51 Only Alberta and Newfoundland do not provide a provincial credit. Prince Edward Island offered a provincial credit from 1992 to April 9, 1997. Although some individuals

(The footnote is continued on the next page.)

1996: Forecasting a Drought?

Following the 1996 RRSP season, it became obvious that the federal and provincial governments would have to reconsider their approach to LSVCCs.[52] It was not simply the amount invested in LSVCCs (and the corresponding depletion of federal and provincial tax revenues) that concerned the governments when planning their 1996 budgets. There were other aspects of LSVCC schemes that also raised concerns. Three primary issues were the holding period requirements for investors, the investment requirements for LSVCCs, and the consequences to an LSVCC of failure to meet the investment requirements. Each of these issues is considered in detail in the next section of this article. Below is a summary of the adjustment strategies incorporated into the 1996 federal and Ontario budgets.

March 1996 Federal Budget

One of the primary objectives of the 1996 federal budget amendments in this area was to reduce the amount invested in LSVCCs. Short of eliminating the tax credit completely, the federal government had four ways in which it could accomplish this goal:

1) reduce the rate of the tax credit;

2) reduce the total value of the tax credit;

3) lengthen the holding period requirement; and

4) introduce a "cooling-off period"[53] for taxpayers who redeem shares of LSVCCs.

All four means were employed in the measures introduced in 1996. The tax credit was reduced to 15 percent, and the maximum amount of the credit was fixed at $525 (equivalent to a maximum investment of $3,500).[54] The holding period was lengthened from five years to eight years. Finally, a three-year cooling-off period was introduced.

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51 Continued . . .
resident in these and other provinces have invested in LSVCCs in circumstances where only a federal tax credit has been available, their investment has been insignificant compared to investment that benefited from both a federal and a provincial tax credit.

52 Evidently, many investors, particularly in Ontario, purchased LSVCC shares in $10,000 blocks in the 1996 RRSP season in order to maximize their investment (and corresponding tax credits and RRSP deductions) for both the 1995 and 1996 taxation years. On the basis of the federal tax expenditure figures for 1996 (used in table 2) and the figures prepared by Macdonald & Associates Limited for the period between March 1995 and February 1996 (see infra footnote 59), we estimate that approximately $58 million was invested in LSVCCs in January-February 1996 in order to obtain a 1996 tax credit.

53 A cooling-off period refers to a period following a redemption of LSVCC shares during which the individual is not entitled to a tax credit for purchasing shares of an LSVCC.

54 Subsection 127.4(5) and paragraph 127.4(6)(a).

May 1996 Ontario Budget

Ontario introduced parallel measures in its 1996 budget and also a number of additional requirements. Corresponding to the federal changes, the Ontario budget reduced the rate and the maximum amount of the credit (matching the federal rate and amount), extended the holding period from five years to eight years, and introduced a three-year cooling-off period.[55] Ontario also introduced a provision that would suspend tax credits where an LSVCC failed to meet its investment targets in the time required under the legislation; significantly reduced the period within which an Ontario LSVCC must meet its investment requirements; and introduced a refundable tax that would be imposed on an LSVCC that failed to meet or maintain the investment requirements by the end of a particular taxation year. The refundable tax is designed to recapture the provincial LSVCC tax credit on the amount of the investment shortfall.[56]

Other Provinces

All of the other provinces with LSVCC legislation have reduced the rate and (apart from British Columbia) the amount of the provincial credit, and (where applicable) all have increased their holding period requirement to eight years. A number of provinces have also introduced a cooling-off period.[57]

Impact of 1996 Budget Changes

The federal government expected to save approximately $145 million over three years as a consequence of the 1996 budget amendments.[58] The amount raised by LSVCCs in 1996-97, following the 1996 RRSP season and including the 1997 RRSP season, was approximately half of the amount

[55] The last two changes were originally announced in the 1996 budget but were not introduced in the legislation incorporating the 1996 budget measures. These amendments were incorporated along with the 1997 budget measures (see below) in Bill 164, which received royal assent on December 18, 1997, SO 1997, c. 43. Evidently, the legislation was delayed so that the province could match the wording of the federal legislation on these matters. The extended holding period applies to shares issued after May 6, 1996: see section 14.1(1)(a)(vi) and section 14.1(3) of the Community Small Business Investment Funds Act (as the Labour Sponsored Venture Capital Corporations Act was renamed by SO 1997, c. 43, schedule C). The cooling-off period applies to redemptions of shares after December 31, 1996: see section 8(8.1.2) of the Ontario Income Tax Act, RSO 1990, c. I.2, as amended.

[56] Section 28(3) of the Community Small Business Investment Funds Act.

[57] In addition to Ontario, the following provincial regimes have cooling-off periods (number of years in parentheses; cooling-off periods that do not affect full credit also noted in parentheses): British Columbia (two years; cannot claim tax credit to extent of credit on shares redeemed or otherwise transferred); Saskatchewan (three years); and Manitoba (three years).

[58] 1996 Budget, supra footnote 34, Budget Plan, at 143, table A5.1. The projections were broken down by year and by the reduction associated with the reduced tax credit and the reduced contribution limit.

raised in the previous year.[59] Based on this figure, the federal government's tax expenditure in 1996 was approximately $97.5 million or $137 million less than its cost in 1995.[60] The most significant drop in investment was in Ontario. While the two Quebec funds raised approximately 85 percent of the amounts raised in 1995, the Ontario funds raised approximately 30 percent of the amounts raised in 1995.[61]

The impact of the 1996 budget changes continued through 1997 (including the 1998 RRSP season). The capital raised by LSVCCs during 1997-98 (March 1-February 28) was approximately $504 million, compared to almost $650 million in the previous year and almost $1.2 billion in 1995-96.[62] Table 3 shows the amounts raised by LSVCCs in 1996-97 and 1997-98 and their total assets as of March 2, 1998.

1997: Targeting Small Businesses

Background: Quebec's Initiatives

Both the federal and Ontario budgets in 1997 contained measures to enhance venture capital investment in small businesses and focused on LSVCCs as a major vehicle for this investment. As the history of venture capital regimes has illustrated, Quebec has generally led the field in new initiatives. Similarly here, Quebec's FSTQ began targeting small businesses as early as 1991.

In 1991, the SOLIDEQ limited partnership was established between FSTQ and the Union des municipalités régionales de comtés du Québec (UMRCQ), at which time FSTQ made an initial $10 million investment in the limited partnership. In 1996, FSTQ invested an additional $20 million. SOLIDEQ's purpose is to contribute to the development of employment in

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[59] According to figures supplied by Macdonald & Associates Limited, $647 million was raised by LSVCCs between March 1996 and February 1997, compared to $1,230 million invested between March 1995 and February 1996. The source of the remaining figures in this section is Macdonald & Associates Limited, Toronto, March 1997 (unpublished).

[60] In other words, the government met 94.5 percent of its target reductions in one year.

[61] The fact that Working Ventures Canadian had halted share sales since June 1996 also may have affected the decline in Ontario. However, we suspect that the predominant cause of the decline in Ontario related to the federal and Ontario legislative amendments. Most LSVCC share sales in Ontario are made through professional brokers, and many professional brokers stopped marketing LSVCC shares because of the decline in the rate and maximum amount of the tax credit. According to one LSVCC manager, brokers were not interested in selling the smaller amounts because of the decrease in commission: Catherine Mulroney, "Report on Venture Capital," *The Globe & Mail*, April 22, 1997. Evidently, the doubling-up strategy employed in 1996 (supra footnote 52) was used by investors again in the 1998 RRSP season, perhaps at the suggestion of investment dealers in order to increase commissions.

The effect in Ontario varied from fund to fund. For example, First Ontario's investment dropped by only 30 percent, probably because of the volume of shares sold through union-trained salespeople: see below under the heading "Eligible Investor."

[62] Based on figures provided by Macdonald & Associates Limited, Toronto (unpublished).

Table 3 Capital Raised by LSVCCs in 1996 and 1997 and Total Assets of LSVCCs as of March 2, 1998[a]

Fund	Amount raised ($000) 1996-97	Amount raised ($000) 1997-98	Total assets ($000)
The BEST Discoveries	8,200	5,000	13,200
Canadian Medical Discoveries	76,498	15,939	271,437
Canadian Science & Technology Growth	7,956	6,952	14,908
Canadian Venture Opportunity	1,400	0	14,540
Capital Alliance Ventures	10,000	2,000	44,000
Centrefire Growth	1,700	1,000	2,700
CI Covington	50,000	35,000	137,000
Crocus Investment	12,000	17,000	87,000
DGC Entertainment Ventures	650	100	7,310
ENSIS Growth	na	4,100	4,100
FESA Enterprise Venture Capital	400	0	8,150
First Ontario	7,400	6,500	28,500
Fondaction	11,100	15,000	33,500
FSTQ	355,000	300,000	2,023,000
Innovacap Capital Corp.	500	0	500
Retrocom Growth	5,400	3,500	37,500
Sportfund	0	0	13,500
Tourism and Entertainment Growth	0	0	200
Triax Growth	21,500	8,000	174,000
Trillium Capital Growth	1,000	0	7,670
VenGrowth Investment	44,000	57,000	192,000
Workers Investment Fund	500	300	750
Working Opportunity Fund (EVCC)	32,000	27,000	184,000
Working Ventures Canadian	0	0	819,100
Total	647,204	504,391	4,118,565

[a] These figures do not include amounts raised in March 1998 during the extended RRSP season for individuals affected by the ice storm in eastern Ontario, Quebec, New Brunswick, and Nova Scotia.

Source: Macdonald & Associates Limited, Toronto, 1998, unpublished.

local regions of Quebec by financing local investment funds (SOLIDEs).[63] Each SOLIDE manages an investment fund of $500,000,[64] with which it makes investments of between $5,000 and $50,000 in small businesses. Currently, there are over 80 SOLIDEs in operation or under development in Quebec with over $40 million in aggregate capital.[65]

[63] Sociétés locales d'investissement pour le développement de l'emploi (Local investment corporations for the development of employment).

[64] Half of the $500,000 is provided, on a matching basis, by SOLIDEQ. The other investors in a SOLIDE are community-level partners. Since 1994, regional municipalities (MRCs) have been permitted to invest directly in SOLIDEs.

[65] Working Ventures Canadian established a similar investment pool with the Ottawa Carleton Economic Development Corporation in 1994. The regional pool, called the Metro

(The footnote is continued on the next page.)

In October 1995, the Quebec government and FSTQ jointly announced a framework agreement for the establishment of 16 regional solidarity funds to maintain and create jobs in regions of Quebec. FSTQ capitalized each regional solidarity fund with an initial investment of $6 million ($96 million in the aggregate). The regional funds make investments ranging from $50,000 to $500,000 in SMEs for startup, early development, expansion, or restructuring.

FSTQ's total investment in the 16 regional funds and SOLIDEQ cannot exceed 20 percent of the net assets of FSTQ. Evidently, FSTQ's investments in these funds are considered qualifying investments whether or not these funds have actually invested the money in SMEs.

February 1997 Federal Budget

In the 1997 budget, the federal government added a carrot designed to encourage federal LSVCCs to invest in small businesses. Essentially, every dollar that an LSVCC invests after February 17, 1997 in a corporation whose total assets do not exceed $10 million (as opposed to the usual $50 million limit) counts as $1.50 toward meeting the 60 percent investment threshold. A second major change announced in the 1997 federal budget was the addition of a federal tax for provincially registered LSVCCs that failed to meet their investment requirements under provincial legislation. The 1997 budget also introduced a number of other minor amendments applicable to the LSVCC provisions.[66]

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[65] Continued . . .
Ottawa Investment Venture (MOTIVE), was allocated $2.5 million for investments ranging from $100,000 to $750,000: see Edward T. Jackson and François Lamontagne, *Adding Value: The Economic and Social Impacts of Labour-Sponsored Venture Capital Corporations on Their Investee Firms* (Ottawa: Canadian Labour Market and Productivity Centre, November 1995), 82. Unlike the SOLIDEs in Quebec, Working Ventures Canadian maintains a hands-on interest in the investment decisions of MOTIVE.

[66] For example, the definition of "eligible investment" was amended so that only one-half of the number of employees who work less than 20 hours per week is taken into account for the purposes of the 500 employee limitation. Ontario amended its legislation in a similar manner in 1997. In addition, the federal shortfall tax was further amended in two respects: first, to accommodate LSVCCs that increase their level of SME investment over the course of a year, the shortfall is determined by subtracting the greater of the cost of eligible investments determined at the particular time and the amount equal to one-half of the cost of eligible investments at the beginning of the particular year and one-half of the cost of eligible investments at the end of the particular year (see term "B" in proposed subsection 204.82(2.1)); and second, the shareholder's equity at the end of a particular year must generally be determined without reference to a redemption of shares that is expected to occur after the end of the year, subject to transitional rules that are designed to account for the increase in the holding period of LSVCC shares from five years to eight years (see proposed paragraphs 204.82(2.2)(b) and (c)).

May 1997 Ontario Budget

Ontario's 1997 budget increased the minimum investment levels of LSVCCs in small businesses[67] and introduced the community small business investment fund (CSBIF) program.[68] The legislation contains specific provisions to encourage Ontario LSVCCs to invest in CSBIFs. In particular, an LSVCC can set aside capital in a segregated account for CSBIFs between July 1, 1997 and December 31, 1998.[69] Each dollar set aside may count as $2 either toward the LSVCC's small business investment requirement or against penalty taxes owing by the LSVCC in 1997 or 1998.[70] The

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[67] The Ontario small business investment and maintenance requirements are contained in sections 18.1(3) and (4) of the Community Small Business Investment Funds Act and are discussed in the next section of the article under the heading "Investment Requirements."

[68] New part III.1 of the Community Small Business Investment Funds Act. A number of amendments to the CSBIF program were proposed in the 1998 Ontario budget: see Ontario, Ministry of Finance, 1998 Ontario Budget, Paper C, "Details of Revenue Measures," May 5, 1998, 84-85. These proposals are incorporated into this discussion. The CSBIF program is similar in many respects to Quebec's SOLIDE program. A CSBIF must be sponsored by a municipality, First Nation council, or university (section 18.3). The only eligible investors in a CSBIF are Ontario LSVCCs, qualifying financial institutions, and other prescribed persons or entities (definition of "eligible investor" in section 18.2). No regulations have been released under the legislation; however, the May 6, 1997 Ontario budget announcement suggested that prescribed investors may include the sponsor and certain individuals (local private investors or "angels"). A CSBIF must have a maximum capitalization of $10 million, and no investor can invest more than $5 million. Each CSBIF has 30 months to invest in eligible investments at least 35 percent of the capital raised in the investment period and six years to invest 70 percent. For these purposes, an "eligible investment" includes shares or debt of a Canadian corporation or partnership whose gross assets do not exceed $1 million and which carries on business at a location in the community (section 18.8 and definition of "eligible business" in section 18.2(1) of the Community Small Business Investment Funds Act). Certain types of businesses and investments to be used for certain purposes are specifically excluded. Except in limited circumstances, the CSBIF cannot generally invest more than $250,000 in a particular eligible business (ibid., section 20(5)). If the CSBIF fails to meet its investment requirements, the shareholders are subject to a tax on the shortfall (ibid., section 28.1(1)). The tax is intended to recapture the tax credit previously granted to the shareholder in respect of its investment in the CSBIF. The tax may be refunded if the CSBIF meets its investment requirements in the year following the year in which the tax was imposed (ibid., section 28.1(2)).

[69] Community Small Business Investment Funds Act, section 24.1(1).

[70] Ibid., section 24.1(2). Consider the following hypothetical example. Suppose that an LSVCC falls short of its 1997 general SME investment requirements by $100 million and is facing an investment level tax of $15 million. If it pays the penalty, it can obtain a refund of the penalty if it meets its investment requirements (for example, by the end of 1998) and maintains those requirements throughout a full calendar year (for example, throughout 1999) and continues to maintain those requirements and applies for a refund within three years after the year in which the penalty was incurred (for example, in 2000). In effect, the LSVCC will have lost the time value of $15 million. Alternatively, the LSVCC can set aside $7.5 million for investment in a CSBIF before the end of 1998, which the minister can allow as a credit of $15 million toward its 1997 investment level tax, thereby eliminating that tax liability. The LSVCC will then have until the end of 1998 to attain its investment requirements in order to avoid a penalty at the end of 1998. It is unlikely that the LSVCC would apply the $15 million credit toward its small business

(The footnote is continued on the next page.)

capital set aside (and any accrued interest thereon) in respect of the LSVCC's 1997 investment requirements must be invested in a CSBIF on or before December 31, 1998, and funds set aside in respect of the LSVCC's 1998 investment requirements must be transferred to a CSBIF by the end of 1999.[71] Otherwise, capital invested by an LSVCC in a CSBIF will count toward the LSVCC's small business investment requirement and general eligible investment requirement only after the CSBIF reinvests the amount in eligible investments.[72] The legislation further provides an incentive for financial institutions to invest in CSBIFs before the end of 1998 by providing them with a tax credit equal to 30 percent of the equity capital invested in a CSBIF.[73] The 1998 Ontario budget proposed a 15 percent tax credit for individuals investing between $150,000 and $500,000 in a CSBIF.

STRUCTURE OF THE LSVCC TAX EXPENDITURE

The primary rationale for the federal and all of the provincial LSVCC regimes is to permit the establishment of one or more LSVCCs that will invest in SMEs carrying on a significant portion of their business in the jurisdiction concerned. The federal tax credit discussed previously applies to investments in LSVCCs established under the various provincial regimes effective from the year in which each regime was established.

Despite the similarity in the overall policy objectives of the federal and provincial schemes, there are a number of important differences. The salient features of the current federal and provincial regimes governing LSVCCs are summarized in the appendix to this article. We provide a more detailed discussion of the objectives of the LSVCC regimes in the next section. First, we will review some of their more technical aspects, in particular, the following:

- the requirements for registration as an LSVCC;
- the governance of the LSVCC (and, in particular, the involvement of the labour organization that sponsored the LSVCC);

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70 Continued . . .
investment requirement because the amount credited toward that requirement (effectively 7 percent of its total capital) does little to help the LSVCC to meet its 70 percent eligible investment requirement. In January 1998, Working Ventures Canadian set aside $15 million for investment in CSBIFs in order to offset its anticipated $30 million Ontario tax penalty for 1997: "Working Ventures Commits $15 Million to Ontario's Community Small Business Investment Funds Program," *Press Release*, January 19, 1998.

71 The investment requirement was amended by the 1998 budget. As the provision was originally enacted (section 24.1(3) of the Community Small Business Investment Funds Act), capital set aside during 1997 was required to have been invested in a CSBIF by June 18, 1998.

72 Ibid., section 24.1(4). The amount of the credit toward these two requirements is based on the LSVCC's pro rata ownership of class A shares of the CSBIF. The May 5, 1998 Ontario budget indicated that the province planned to ask the federal government to recognize an LSVCC's investment in a CSBIF as eligible for the federal incentive ($1.50 per $1 investment) for federally registered LSVCCs to invest in small business.

73 Ibid., section 24.1(4.1), and the Ontario Corporations Tax Act, RSO 1990, c. C.40, as amended, section 66.1(4.5).

• annual limits (if any) on the amount of capital that can be raised (or the amount of government incentive that is available);

• eligible investments of the LSVCC;

• the minimum amount of the LSVCC's assets that must be invested in eligible investments and the time within which this minimum investment level must be met;

• the consequences to the LSVCC of any failure to meet the investment requirements;

• eligible investors (who are entitled to a tax credit for investment in an LSVCC) and the amount of the credit available; and

• the holding period requirements for a shareholder.

This discussion is generally limited to the federal, Ontario, and Quebec regimes,[74] although reference is made to the other provincial regimes where necessary for illustrative purposes.

Requirements for Registration as an LSVCC

The federal tax credit is available for investment in the capital stock of a prescribed LSVCC. A prescribed LSVCC is defined in regulation 6701 as a corporation established by or registered under certain specified provincial statutes[75] or a corporation that is a "registered labour-sponsored venture capital corporation." A "registered labour-sponsored venture capital corporation" is defined as a corporation registered under subsection 204.81(1), whose registration has not been revoked.[76] Although the federal tax credit is available to all prescribed LSVCCs, the registration and investment requirements in part X.3 of the Act are limited to federally registered LSVCCs.[77] There are several LSVCCs that are registered both provincially and federally so that the funds may sell shares to investors outside the province in which they were originally established. These dual (or multiple) registrants must comply with both the federal and applicable provincial requirements, particularly the investment requirements. Where these requirements differ, the LSVCC must comply with the most stringent in order to avoid any related penalties.

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[74] On the basis of tax expenditure figures prepared by the Department of Finance (unpublished), LSVCC investment in Ontario and Quebec has accounted for more than 85 percent of the total investment in LSVCCs in every year since the federal tax credit was introduced.

[75] All of the provincial LSVCC regimes are included in the regulations. In 1997, Manitoba introduced new LSVCC legislation in order to expand the number of provincial LSVCCs from the previously authorized one (Crocus Investment). Regulation 6701 will be amended to include the new Manitoba legislation.

[76] Subsection 248(1).

[77] The word "registered" was deleted from the title of part X.3 as part of the 1997 budget amendments because of the creation of a shortfall penalty applicable to provincially registered LSVCCs. See above under the heading "1997: Targeting Small Businesses: February 1997 Federal Budget."

Section 204.81 authorizes the minister of national revenue to register a corporation as an LSVCC where the corporation meets the conditions set out in subsection 204.81(1). In order to obtain the minister's approval, an "eligible labour body"[78] must have caused the corporation to be incorporated under the Canada Business Corporations Act.[79] All of the provincial regimes require the LSVCC to be sponsored by a specified employee organization.[80]

The number of LSVCCs that can be registered under the federal and various provincial regimes varies. The federal and Ontario regimes permit an unlimited number of LSVCCs. Quebec's regime is limited to two LSVCCs, each specifically incorporated under and governed by a separate provincial statute. Neither of the Quebec LSVCCs is (or can be) registered federally.

The business activities of an LSVCC are restricted under all of the regimes. Under the federal regime, the articles of incorporation of the LSVCC must restrict the LSVCC's business activities to assisting the development of eligible business entities; creating, maintaining, and protecting jobs by advising such entities; and investing its funds in eligible investments and reserves.[81] Restrictions are also imposed on the types of businesses in which the LSVCC may invest and the proportion of its assets that may be invested in such businesses. The articles must also restrict the conditions under which the shares of the LSVCC may be redeemed or transferred.[82] The various provincial regimes have similar registration requirements. All of the provincial regimes restrict the business activities of the LSVCC in a manner similar to that in the federal legislation[83] and limit the conditions under which shares of the LSVCC can be redeemed or transferred.[84]

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[78] Defined in section 204.8 as a "trade union . . . that represents employees in more than one province, or an organization that is composed of 2 or more such unions."

[79] RSC 1985, c. C-44, as amended (herein referred to as "the CBCA").

[80] The various provincial statutes either specify the sponsoring organization (as in Quebec, Manitoba before the adoption of the new LSVCC legislation, and New Brunswick in the case of Workers Investment Fund) or define the types of employee organizations that may be sponsoring organizations. If an LSVCC seeks dual registration (that is, both provincial and federal), the sponsoring organization must meet the requirements of both the federal and relevant provincial legislation. In addition, since a federally registered LSVCC must be incorporated under the CBCA, the provincial legislation must either specifically apply to federally registered LSVCCs or permit a provincial LSVCC to incorporate under the CBCA.

[81] Subparagraph 204.81(1)(c)(i). "Eligible business entity," "eligible investment," and "reserves" are discussed below under the heading "Eligible Investments."

[82] Subparagraphs 204.81(1)(c)(v) and (vii).

[83] See, for example, Community Small Business Investment Funds Act, section 14(1)(d); and FSTQ Act, section 13.

[84] See, for example, Community Small Business Investment Funds Act, section 14(1)(e); and FSTQ Act, section 24.

Governance of the LSVCC

As noted above, all LSVCCs must be sponsored by a specified employee organization. However, the sponsor may not necessarily have originally conceived of the fund. It has not been uncommon, particularly in Ontario, for the promoters of a potential fund to seek out an employee organization to act as the fund's sponsor. In practice, under many of the Ontario funds, the sponsoring organization may have little or no active involvement in the ongoing governance of the LSVCC, although it may receive annual fees from the LSVCC.[85] These LSVCCs are commonly referred to as "rent-a-union" funds—funds established as venture capital pools with little or no concern for the "labour-sponsored" objectives of the LSVCC regime.[86]

The federal regime and all of the provincial regimes also require some portion of the board of directors of the LSVCC to be appointed by the sponsoring organization. At least half of the board of directors of a federally registered LSVCC must be appointed by the sponsoring organization.[87] Ten of FSTQ's 16 directors must be appointed by the FTQ,[88] while 4 of Fondaction's 11 directors must be appointed by its sponsoring organization (Confédération des syndicats nationaux [CSN]) and 2 must be appointed by another specified union.[89] Ontario's legislation provides that a majority of the board of directors must be appointed by the labour organizations that hold class B shares of the LSVCC.[90] Under the federal and various provincial statutes, the sponsoring organization's involvement in this respect is limited to the appointment of directors. The directors so appointed need not be members of the sponsoring organization. Evidently, it is not uncommon, particularly in Ontario, for the sponsoring organization to appoint individuals recommended by the management of the LSVCC.

The unlimited number of LSVCCs and the lack of involvement by sponsoring unions in many of the Ontario LSVCCs may be a product of the history of Ontario's regime. There were a number of labour groups (including the Canadian Union of Public Employees and the Canadian Auto Workers [CAW]) that were opposed to the idea of labour funds, and the

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85 Canadian Labour Market and Productivity Centre, supra footnote 23, at 19. The fee may be a percentage of annual net asset value or a fixed fee. These fees may or may not be disclosed in the financial statements of the fund.

86 For example, Joel Albin, the founder of Sportfund, described the conception of that fund as follows (quoted in Eugene Ellmen, "Reforming Capitalism" (January/February 1996), 74 *The Canadian Forum* 9-14, at 14): "When I saw what the labour-sponsored vehicle offered with tax breaks, I thought . . . if I can structure it in a way that I could get my investors those tax breaks, then why not? It would be . . . negligent not to as a corporate finance person."

87 Subparagraph 204.81(1)(c)(iii).

88 FSTQ Act, section 4.

89 Fondaction Act, section 4.

90 Paragraph (c) of the definition of "Class B share" in section 1 and section 14(1)(c)(ii) of the Community Small Business Investment Funds Act.

Ontario Federation of Labour (OFL) "had difficulty coming to grips with the idea of labour funds."[91] Given the criticism or uncertainty expressed by some of Ontario's largest unions, it was perhaps inevitable that the Ontario LSVCC regime would allow any union to sponsor an LSVCC. However, it certainly would have been possible to design the legislation in a manner that would have ensured the active participation of the sponsoring union in the management of a registered LSVCC.

Capital-Raising Limitations

The annual cost of the LSVCC tax expenditure to the federal and provincial governments is directly related to the amount of capital that the LSVCC raises each year. Four provinces—British Columbia,[92] Saskatchewan, Manitoba, and Nova Scotia—incorporated expenditure caps in their legislation, either by restricting the amount of capital that provincially registered LSVCCs can raise or by restricting the aggregate tax credits that the government will provide.

None of the federal, Ontario, or Quebec regimes include such limitations, and therefore the annual expenditure of these governments can only be estimated in advance and finally determined with hindsight. Quebec imposed a limitation on the amount of new capital that FSTQ could raise between March 2, 1993 and November 4, 1994 because of "the difficult situation of public finances."[93] The amount of capital raised by federal

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[91] Ellmen, supra footnote 86, at 13. The opposition of CAW and the OFL was expressed during the debates on Bill 150: Ontario, *Debates*, December 17, 1991, 4363. Indeed, portions of a letter sent by Bob White, then president of CAW, were read during those debates. The quoted extracts from his letter suggest that CAW's concern was that there was no evidence to suggest that there was a venture capital shortage in Ontario, and even if there were, CAW questioned "why workers—rather than those with the capital and those who are in the business of 'risks'—should be placed at the centre of any solution." (Quoted by Mr. Turnbull, Ontario, *Debates*, December 17, 1991, 4374).

[92] Section 12(1) of the British Columbia Employee Investment Act, RSBC 1996, c. 112, as amended, provides that the equity capital of an LSVCC must not exceed $5 million if the LSVCC is not a reporting issuer, or $20 million if the LSVCC is a reporting issuer. However, section 12(2) allows the lieutenant governor in council to exempt an LSVCC from these limits if such exemption is "in the public interest." The limits have been waived for Working Opportunity Fund (EVCC), the only LSVCC registered in British Columbia to date. Working Opportunity Fund (EVCC) is permitted to raise up to $40 million of capital annually.

[93] An original ceiling of $75 million was announced in the 1993-94 budget applicable to the period from March 2, 1993 to March 1, 1994: Québec, Ministère des Finances, 1993-1994 Budget, Budget Speech and Additional Information, appendix A, May 20, 1993, 9. However, the ceiling was increased to $97 million primarily because of the volume of FSTQ shares that were purchased automatically through payroll deduction and employee benefit plans. In the 1994-95 budget, the ceiling was increased to $100 million for the period from March 2, 1994 to March 1, 1995: Québec, Ministère des Finances, 1994-1995 Budget, Budget Speech and Additional Information, appendix A, May 12, 1994, 83. However, the ceiling for 1994-95 was subsequently eliminated, as promised in the Parti Québécois's election campaign: press release and *Information Bulletin* 94-4, issued by the Ministère des Finances, November 4, 1994 (reproduced in *Quebec Tax Reporter*, vol. 2 (Toronto: CCH Canadian) (looseleaf), paragraph 201-349).

and Ontario LSVCCs during the 1996 RRSP season (that is, in January and February 1996) probably came as a surprise to these governments and prompted many of the amendments contained in the federal and Ontario 1996 budgets.[94]

Eligible Investments

All of the LSVCC regimes restrict the nature of the investments that an LSVCC can make. All of the regimes contain a definition of the types of venture capital investments that the regime is designed to promote (commonly referred to as "eligible investments"); some regimes also contain a definition of other permitted investments (commonly referred to as "reserves").

The nature of the eligible investments varies among the regimes. Eligible investments of federally registered LSVCCs, defined in section 204.8, are generally limited to shares and debt[95] issued to the LSVCC by an "eligible business entity." In effect, the LSVCC must be the first holder of these securities; eligible investments do not include secondary market purchases. An "eligible business entity," also defined in section 204.8, is a Canadian partnership or taxable Canadian corporation, all or substantially all of the property of which is attributable to property used in a "specified active business," or shares or debt of other eligible business entities, or a combination of the two. A "specified active business," again defined in section 204.8, is an active business carried on in Canada where at least 50 percent of the full-time employees are employed in Canada and at least 50 percent of the salaries are reasonably attributable to services performed in Canada. There are no limitations on the nature of the "active business" carried on by the entity. The following conditions must also be satisfied at the time that the shares or debt of the eligible business entity are acquired: the eligible business entity must have total assets not in excess of $50 million and 500 or fewer employees, and the total investment by the LSVCC in the particular eligible business entity cannot exceed the lesser of $10 million[96] and 10 percent of the shareholders' equity of the LSVCC.[97]

Ontario's legislation similarly limits the eligible investments of an LSVCC to shares or debt of an "eligible business,"[98] and limitations are

[94] Investment in LSVCCs in Quebec increased by 70 percent from 1994 to 1995 whereas the increase in Ontario was 167 percent. British Columbia was the only province in which investment decreased in this period. In Nova Scotia, investment increased by close to 500 percent. The remaining provinces with LSVCC schemes saw the following increases (in parentheses): Prince Edward Island (236 percent); New Brunswick (159 percent); Manitoba (122 percent); Saskatchewan (81 percent). The overall increase across Canada was 110 percent. Source: Department of Finance (unpublished).

[95] Eligible investments also include a guarantee in respect of a debt of an eligible business entity (which is not, strictly speaking, an investment) and an option or right to acquire shares of an eligible business entity.

[96] The 1997 budget proposes to raise this limit to $15 million.

[97] Section 204.8, paragraphs (e), (f), and (g) of the definition of "eligible investment."

[98] Section 18 of the Community Small Business Investment Funds Act.

imposed on the nature of the business and use of the capital invested by the LSVCC. For example, the business cannot have as its principal purpose the derivation of income from real estate or property (including interest, dividends, rents, or royalties), and the business cannot be a personal services business. In addition, the business cannot use the investment made by the LSVCC for certain purposes, including relending, investing in land (other than land incidental to the eligible business activities of the business), paying dividends, or making partnership draws.[99] The LSVCC must be the first holder of the eligible investment,[100] and the investment in a particular eligible business cannot exceed 10 percent of the shareholders' equity of the LSVCC.[101]

The two Quebec statutes contain distinct definitions of qualifying SMEs for investment purposes. FSTQ must invest in SMEs with less than $50 million in total assets and not more than $20 million in net assets, while Fondaction must invest in SMEs with less than $100 million in total assets and not more than $40 million in net assets (although two-thirds of the 60 percent qualified investment threshold must be investment in companies with less than $50 million in total assets and not more than $20 million in net assets). In both cases, the majority of the SME's employees must be resident in Quebec; however, the maximum number of employees is not stipulated. Both funds are permitted to invest up to 20 percent of their previous year's net assets in secondary market purchases. The funds are also permitted to take a majority position in investee firms.

The other provincial regimes contain similar definitions of eligible investments. Some of the provinces specify the nature of the business in which the SME must be or cannot be involved. For example, British Columbia's legislation previously required that the eligible business must be substantially engaged in British Columbia in manufacturing or processing, research and development, tourism, aquaculture, or other prescribed business activities.[102] Under Manitoba's legislation, certain types of businesses (for example, professional practices, agriculture, and the development, lease, or sale of real property) do not qualify as eligible investments.[103]

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99 See generally section 18(1)(d) of the Community Small Business Investment Funds Act. In addition, the business cannot use the investment made by the LSVCC for the following purposes: reinvestment outside Canada; the acquisition of securities of another person; generally, the financing of the acquisition of goods or services provided to the business by the LSVCC; the return of capital to a shareholder or partner; the payment of the principal amount of any outstanding liabilities owed to a shareholder of the LSVCC; or the carrying on of business outside Canada.

100 Section 18(1)(b) of the Community Small Business Investment Funds Act.

101 Ibid., section 18(1)(e).

102 Section 15(1)(c) of the British Columbia Employee Investment Act. Section 15(1) was repealed and replaced by SBC 1997, c. 27, section 16, effective October 16, 1997 by BC Reg. 1167/97.

103 Labour Sponsored Venture Capital Corporations Regulations, Man. Reg. 239/97, section 10.

Most of the regimes require that the LSVCC be the first holder of the eligible investments; however, some permit secondary market purchases in certain circumstances. For example, in British Columbia, an LSVCC may acquire shares in the secondary market[104] if the purchase will

- result in job preservation,
- assist the eligible business in dealing with the departure of an employee investor or a venture capital investor,
- facilitate an orderly succession if an owner of an eligible business is retiring, or
- provide some other substantial economic benefit to the eligible business or to British Columbia.

Finally, all of the regimes restrict the amount that the LSVCC can invest in a particular business to either a specified maximum amount or a specified amount of the LSVCC's shareholders' equity, or both. In some jurisdictions, a fund is precluded from owning a controlling interest in the business[105] unless certain conditions are met.[106]

Investment Requirements

All of the LSVCC regimes require a certain minimum percentage of the LSVCC's equity to be invested in eligible investments. However, the minimum investment level, the time period within which this level must be met, and the consequences of failure to meet this level (discussed in the following section) vary.

The investment level requirements may distinguish between two time periods, discussed in turn below. The federal and certain provincial regimes assume that an LSVCC requires an initial startup period to amass sufficient venture capital and to research appropriate investment opportunities. During this time, the LSVCC is not required to invest any of its capital in SMEs in order to avoid potential penalties. After the startup period—or, for other regimes, from the time of establishment of the

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[104] Section 15(1)(a)(iv) of the British Columbia Employee Investment Act, as added by SBC 1997, c. 27, section 16, effective October 16, 1997 by BC Reg. 1167/97.

[105] See, for example, section 18(1)(c) of the Ontario Community Small Business Investment Funds Act, and section 17(1) of the British Columbia Employee Investment Act.

[106] Under British Columbia's regime (see section 17(2) of the British Columbia Employee Investment Act), the LSVCC can acquire control of the business if the administrator is satisfied that the investment will result in substantial employee participation in either the startup and operation of a new business or the restructuring of an existing business to facilitate the transfer of control from a person or group of persons to widely dispersed ownership by residents of Canada, or if the administrator is satisfied that the eligible business is or will be in financial difficulty. In Ontario, majority control may be permitted if the minister is satisfied that it will assist in preventing the insolvency of the eligible business, restoring the eligible business to solvency, or transferring control of the eligible business to another person (sections 18(5) and (6) of the Community Small Business Investment Funds Act).

LSVCC—a specified minimum percentage of equity capital must be invested in eligible investments within a specified time period.

Startup Period

The federal regime is the most generous, allowing for a five-year startup period. During this time, a federally registered LSVCC must invest at least 80 percent of its share capital in eligible investments or reserves.[107] This requirement is not very onerous because the LSVCC's investment in reserves can account for most, if not all, of this 80 percent quota (although, by the end of the fifth year, the LSVCC must have invested at least 60 percent of its equity in SMEs in order to avoid deficiency penalties in the following year). Where the LSVCC invests substantial funds in reserves, the tax expenditure is effectively financing investment in government bonds, guaranteed investment certificates (GICs), and bank deposits. Oddly, the length of the startup period corresponded exactly to the holding period requirement of shareholders before 1996.

Neither Ontario nor Quebec provides for a startup period, although before the 1996 amendments, the time period allowed an Ontario LSVCC to meet its ongoing investment requirements was quite generous (as noted below).

Ongoing Investment Requirements

Under the federal regime, following the startup period, an LSVCC must invest at least 60 percent[108] of the lesser of the current year's and the previous year's shareholders' equity in eligible investments in order to avoid investment deficiency taxes and penalties.[109] Reserves no longer

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[107] "Eligible investments" are described above under the heading "Eligible Investments." "Reserves" are defined in section 204.8 and include cash and bank deposits, government bonds, bonds of a public company, GICs, and qualified investment contracts. The requirement is imposed under subsection 204.82(1), which levies a tax on the LSVCC equal to 20 percent of the shortfall.

[108] The 60 percent threshold has been relaxed to some degree by the 1997 federal budget, where the LSVCC invests in small businesses: see above under the heading "1997: Targeting Small Business: February 1997 Federal Budget."

[109] For taxation years that end after 1994 and before March 1997, the threshold can be based on the least of the shareholders' equity in the current year, in the previous taxation year, or in the second preceding taxation year: see proposed paragraph 204.82(2)(a.1), originally introduced in Bill C-69 and reintroduced in Bill C-28, An Act To Amend the Income Tax Act, the Income Tax Application Rules, the Bankruptcy and Insolvency Act, the Canada Pension Plan, the Children's Special Allowances Act, the Companies' Creditors Arrangements Act, the Cultural Property Export and Import Act, the Customs Act, the Customs Tariff, the Employment Insurance Act, the Excise Tax Act, the Federal-Provincial Fiscal Arrangements Act, the Income Tax Conventions Interpretation Act, the Old Age Security Act, the Tax Court of Canada Act, the Tax Rebate Discounting Act, the Unemployment Insurance Act, the Western Grain Transition Payments Act and Certain Acts Related to the Income Tax Act, as passed by the House of Commons April 21, 1998. This amendment was introduced primarily so that Working Ventures Canadian would have a longer time period to invest the significant amount of additional capital it raised in the 1996 RRSP season.

count toward this threshold. For example, an LSVCC with a calendar-year fiscal period will have approximately 10 months to invest 60 percent of new capital raised during RRSP season in qualified SMEs in order to avoid penalties in the following year. Although, as discussed earlier, the 1997 federal budget introduced incentives for federally registered LSVCCs to invest in small businesses, there is no specific requirement that they do so.

Ontario significantly tightened its eligible investment requirements in its 1996 budget. Before May 1996, the Ontario legislation effectively gave LSVCCs almost three years to invest new capital in qualified investments,[110] although there was no startup period available to newly registered LSVCCs. As a consequence of the 1996 amendments, an Ontario LSVCC must now invest at least 50 percent of the capital raised during the first 60 days of the year and after the first 60 days of the previous year (the investment period) in eligible SMEs by the end of the year; 70 percent must be invested in eligible SMEs by the end of the following year. In addition, a specified portion of these amounts must be invested in "small businesses."[111] A small business is defined as an "eligible business"[112] whose total assets do not exceed $5 million and whose total number of employees does not exceed 50.[113] Ontario also restricts the amount that an LSVCC can invest in listed companies to no more than 15 percent of the LSVCC's investment limit.

[110] Section 17(1) of the Labour Sponsored Venture Capital Corporations Act, SO 1992, c. 18, applicable before May 7, 1996. Under this provision, an LSVCC had two years following the year in which new equity capital was issued to invest at least 70 percent of such capital in eligible investments. In effect, an LSVCC with a calendar-year fiscal period had almost three years to invest capital raised during the RRSP season.

[111] The requirement to invest in small businesses was first introduced in the May 5, 1994 budget (SO 1994, c. 17, section 86). As originally introduced, the provision required an Ontario LSVCC to invest in small businesses if what was an eligible business at the time the LSVCC first made its investment grew beyond the size limits stipulated in the legislation ($50 million in assets and 500 employees). The amount of small business investment required in these circumstances was to be prescribed by regulation, but no regulations were passed. The May 7, 1996 Ontario budget introduced a mandatory small business investment component for all Ontario LSVCCs. Under section 18.1(3) of the Community Small Business Investment Funds Act, an Ontario LSVCC must invest in small businesses the following percentages of new equity capital that is required to be invested in eligible businesses: 10 percent (that is, 5 percent by the end of the year and 7 percent by the end of the following year) of the equity capital received on or before March 1, 1997; 15 percent of the equity capital received between March 2, 1997 and March 1, 1999; and 20 percent (or the prescribed percentage) of the equity capital received in each investment period (from the 61st day of the year to the 60th day of the following year) thereafter.

[112] An "eligible business" is defined as a taxable Canadian corporation or Canadian partnership that pays at least one-half of its salaries to employees whose ordinary place of employment is in Ontario, that has at least one-half of its employees engaged in eligible business activities carried on in Ontario, whose total assets do not exceed $50 million, and whose total employees do not exceed 500.

[113] Community Small Business Investment Funds Act, section 18.1(5).

Quebec requires that, in each fiscal year, FSTQ must invest, on average, at least 60 percent of its previous year's average net assets in eligible investments.[114] Fondaction also must meet this requirement; in addition, as noted earlier, it must invest at least two-thirds of its average net assets in Quebec enterprises with less than $50 million in total assets and not more than $20 million in net assets.[115] Quebec has incentives for FSTQ to invest in smaller businesses through the regional fund and SOLIDE schemes; evidently, investment in those funds qualifies as an eligible investment even if the regional fund or SOLIDE has not fully invested its capital in eligible small businesses. There are no requirements that FSTQ or Fondaction specifically invest in small businesses.

In the other provinces, the investment thresholds and the periods within which the threshold must be met vary. Most of those provinces adopt the federal thresholds. However, British Columbia requires that 80 percent of the LSVCC's shareholders' equity be invested in eligible investments within three years, while Manitoba requires LSVCCs with shareholders' equity in excess of $10 million to meet a 75 percent threshold.

Apart from the federal, Ontario, and Quebec regimes, only Manitoba has specific provisions designed to encourage investment in small business. Manitoba requires that at least 25 percent of an LSVCC's investments must be for $1 million or less.[116]

Consequences of Failure To Meet Investment Requirements

Before 1996, only the federal regime imposed a tax and monetary penalties on an LSVCC for failure to meet its investment requirements. A federally registered LSVCC that fails to meet its investment requirements after the startup period is liable to pay a monthly tax equal to 1⁄60 of the prescribed rate of interest on the investment deficiency.[117] As noted above, the investment requirements are based on the lesser of the shareholders' equity in the preceding year and that in the current year; in effect, when shareholders' equity increases substantially early in a year (for example, during RRSP season), a further year of deferral is allowed because the minimum investment requirement for the purposes of the tax does not need to be met until the year following the increase.

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[114] FSTQ Act, section 15. Average net assets and average investments are determined by adding the net assets or investments at the beginning and end of the particular year and dividing by two. FSTQ's fiscal period ends on June 30 (changed from November 1 in 1995). Assuming that a significant amount of FSTQ's capital is raised during RRSP season, the fund has a minimum of 16 months to invest new capital in qualified SMEs.

[115] Fondaction Act, section 16.

[116] Labour Sponsored Venture Capital Corporations Regulations, Man. Reg. 239/97, section 8(3).

[117] Subsection 204.82(2). On an annualized basis, the tax is equivalent to 20 percent of the investment deficiency multiplied by the prescribed rate of interest.

If a deficiency continues for 12 consecutive months, an additional tax and penalty are imposed.[118] The additional tax is equal to 20 percent of the average monthly investment shortfall in the 12-month period. The penalty is equal to the amount of the additional tax. The effect of the tax and penalty is to claw back the federal tax credit to the extent of the investment deficiency.[119] The additional tax and 80 percent of the penalty may be refunded if the fund subsequently meets the investment requirements for 12 consecutive months.[120]

The minister may revoke an LSVCC's registration if the additional tax under subsection 204.82(3) was payable for three or more taxation years or if the LSVCC had a monthly deficiency in 18 or more months in any 36-month period.[121]

Before the 1997 federal budget, the federal tax and penalties applied only to federally registered LSVCCs; they did not apply to LSVCCs that were registered only in a province and failed to meet the provincial investment requirements. Before Ontario introduced its shortfall tax in 1996, an LSVCC registered only in a province was not subject to a provincial tax or monetary penalty for failure to meet its investment requirements unless the registration of the fund was revoked—a penalty that has not been used to date. In the 1997 budget, the federal government introduced a federal tax equal to any provincial tax or penalty (but not interest) imposed on a provincially registered LSVCC for failure to meet its investment requirements.[122] This federal tax is refundable to the same extent that the provincial tax or penalty is refundable. In addition, if a provincial LSVCC is wound up or deregistered and as a consequence is required to pay a provincial tax or penalty (as is currently the case, for example, in Ontario, Saskatchewan, and Nova Scotia), the LSVCC will be required to pay a federal tax in the same amount.[123]

As noted earlier, in the 1996 Ontario budget, a refundable tax was introduced which will be imposed on an LSVCC that fails to meet or maintain its investment requirements by the end of a particular taxation

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[118] Subsections 204.82(3) and (4).

[119] Consider an LSVCC that raised $100 million (after its startup period) at a time when the federal tax credit was 20 percent. If the LSVCC invested the entire amount in reserves for a continuous 12-month period, the tax imposed under subsection 204.82(3) would equal 20 percent of $60 million (the investment deficiency, since the LSVCC only needs to invest 60 percent of the shareholders' equity in eligible investments) or $12 million. The total tax and penalty, $24 million, is greater than the total federal tax credits on the $100 million raised ($20 million). When the federal tax credit was reduced to 15 percent in 1996, the rate of this tax was not correspondingly reduced.

[120] Section 204.83.

[121] Paragraphs 204.81(6)(i) and (l), respectively. Subsection 204.81(6) lists a number of other circumstances in which an LSVCC's registration may be revoked.

[122] See draft subsection 204.82(5), introduced in Bill C-28, supra footnote 109.

[123] See draft subsection 204.85(2), introduced in Bill C-28, ibid.

year. The tax, which is currently 15 percent of the shortfall amount, is designed to recapture the provincial LSVCC tax credit on the shortfall.[124] The tax is refunded if, within two years after the year in which the shortfall tax was imposed, the LSVCC meets the investment requirements throughout a full calendar year and continues to meet these requirements.[125] As a consequence of the 1997 federal budget amendments, a corresponding federal tax of 15 percent also would be levied. The federal tax would be refunded if the LSVCC successfully applied to the Ontario government for a refund of the provincial tax. If an Ontario-registered LSVCC has its registration revoked, it will be required to repay an amount equal to the total provincial tax credits provided.[126] An equivalent amount is now to be imposed as a federal tax. Finally, an Ontario LSVCC that fails to meet its investment requirements cannot issue tax credit certificates in respect of share issuances until such time as the LSVCC provides the minister with a certificate indicating that it is now complying with its requirements.[127]

Quebec restricts FSTQ's or Fondaction's ability to raise further capital until its investment targets are met.[128] The remaining provinces compel LSVCCs to meet their investment targets with the threat of deregistration, although, to date, no province has deregistered an LSVCC for this reason.[129]

Eligible Investor

Under the federal and all provincial LSVCC schemes, the tax credit is available only to individuals resident in the appropriate jurisdiction. British Columbia previously limited its tax credit to persons who were employed in British Columbia on a continuing basis for at least 20 hours per week; this restriction was removed as part of the 1997 changes to the legislation.[130] In all jurisdictions, the tax credit is provided to the individual even if the subscription for shares is made by the individual's RRSP or a spousal RRSP.

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124 Section 28(3) of the Community Small Business Investment Funds Act.

125 Ibid., section 28(2).

126 Ibid., section 27(1).

127 Ibid., section 25.1(3), introduced with effect from May 7, 1996.

128 See, for example, FSTQ Act, section 15.1. The extent of the restriction depends on the amount of the investment shortfall. If the FSTQ has invested 50 to 59 percent of its previous year's net assets in SMEs, its fundraising will be capped at 75 percent of the funds raised in the previous year. If FSTQ has invested 40 to 49 percent of its previous year's net assets, the cap will be 50 percent, and if the fund has invested 30 to 39 percent of those assets, the cap will be 25 percent. If the fund has invested less than 30 percent of its previous year's net capital assets, it will not be permitted to raise any new funds.

129 The investment requirements and penalties imposed on provincially registered LSVCCs are summarized in the appendix to this article.

130 See paragraph (b) of the definition of "eligible investor" in section 1 of the British Columbia Employee Investment Act, repealed by SBC 1997, c. 27, section 11, effective October 16, 1997 by BC Reg. 1167/97.

Various approaches are used to market shares of LSVCCs. The federal funds and most Ontario funds are sold primarily through investment dealers. For the most part, investment dealers have marketed these funds primarily on the basis of the tax credit available to investors. As a consequence of the drop in the rate and value of the tax credit in 1996, this form of marketing has declined significantly.[131] In Ontario, First Ontario and Retrocom Growth are probably the only funds that actively market shares to members of their sponsoring unions. Members of the sponsoring unions of First Ontario are seconded to and trained by Promittere Securities Limited to sell shares of the fund. The fund pays the employees' salaries and expenses while they are seconded. First Ontario also permits investment through payroll deduction plans. Retrocom Growth markets its shares exclusively through professional investment brokers and dealers, although the fund officers direct the brokers and dealers to target members of the sponsoring unions.[132]

From the inception of FSTQ, union members were specifically targeted as potential investors:

> In the beginning, the [FSTQ] obtained a virtual exemption from the *Commission des valeurs mobilieres du Québec* to undertake shareholder recruitment using volunteer union agents and resources that reached FTQ members in union and workplace settings. Though monitored by securities regulators, the fund effectively directs the promotional efforts of this sales force, which recently numbered over 2,000 active volunteers and operated chiefly out of some forty permanent and temporary offices set up across Quebec.[133]

FSTQ trains sales personnel in accordance with procedures acceptable to the securities regulators. The acquisition of shares by union members is also enhanced through payroll deduction plans. Under the FSTQ legislation, employers are required to establish payroll deduction plans and remit deductions to the FSTQ if a group of employees (at least 50 employees or 20 percent of the workforce) so request.[134] Employers can also purchase shares for employees as a benefit under collective bargaining agreements. As of June 30, 1996, there were 2,454 deduction provisions negotiated in collective agreements, of which 786 were employer-paid benefits.[135] Similarly, Fondaction's shares are sold exclusively by agents trained by its union sponsor, CSN. These agents market shares to both union members and members of the public.

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[131] See supra footnote 61.

[132] Midland Walwyn Capital Inc. is the principal distributor of the fund. Under the terms of its agency agreement, Midland Walwyn has agreed to offer members of the sponsoring unions special terms for RRSP and registered retirement income fund accounts.

[133] Canadian Labour Market and Productivity Centre, supra footnote 23, at 70.

[134] FSTQ Act, section 24.

[135] Fonds de Solidarité des Travailleurs du Québec 1996 Annual Report, 11.

A number of funds in other provinces also actively seek union-member investors. Working Opportunity Fund (EVCC), in British Columbia, has obtained the agreement of a number of large employers in the province to offer payroll deduction plans, although the vast majority of its shares are sold through commercial brokers. In addition, the sponsor of the union (a corporation equally owned by seven trade unions) owns 50 percent of an investment dealer that actively solicits union members. Manitoba's Crocus Investment markets its shares through registered dealers, including a wholly owned subsidiary of the fund, Crocus Capital Inc. Sales representatives of Crocus Capital may be seconded from employers or unions. These representatives target primarily union members. New Brunswick's legislation governing Workers Investment Fund contains provisions authorizing the establishment of payroll deduction plans. The fund also sells shares through agents trained by the fund's sponsor, the New Brunswick Federation of Labour. These agents specifically target union members.

Amount of Tax Credit

Currently, an individual is entitled to a federal tax credit equal to 15 percent of the cost of shares of a prescribed LSVCC, with a maximum credit of $525.[136] If the individual is resident in a province and purchases shares of a provincially registered or prescribed LSVCC, the individual will also be entitled to the provincial tax credit. In all provinces except British Columbia, the credit is equal in value to the federal credit. In British Columbia, the rate of the tax credit is also 15 percent, but the individual is entitled to a maximum annual credit of $2,000 and a maximum lifetime credit of $10,000.[137]

Holding Period Requirements

As discussed earlier, LSVCCs are intended to provide venture capital to qualifying SMEs. It may be a number of years before the capital provided to a SME generates returns. Accordingly, these venture capital investments, by their very nature, must be "patient capital."

The need to finance share redemptions may, however, result in the premature withdrawal of an LSVCC's investment. The reserves of an LSVCC are intended to finance these redemptions, so that its patient capital need not be withdrawn prematurely. Patient capital is also maintained through the holding period requirements.[138] Since FSTQ was established, individual

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[136] The rate and maximum amount of the federal and provincial tax credits have varied over time, as described above under the heading "Historical Development of the LSVCC Regime." The credit will be denied if the cooling-off period provisions apply: see below under the heading "Holding Period Requirements."

[137] British Columbia Employee Investment Act, section 24. The maximum annual and lifetime tax credit apply to the combined amount of provincial tax credits available for investment in venture capital plans (British Columbia's LSVCCs) and in employee share ownership plans.

[138] Of course, the holding period requirements also avoid abuse of the tax credit by investors.

investors generally have been required to hold their shares until the age of retirement (65),[139] although shares could be redeemed earlier in limited circumstances (such as terminal illness). This requirement ensures that the funds available to FSTQ for investment constitute patient capital. There is little need for FSTQ to maintain a substantial reserve in order to fund annual redemptions.

Before 1996, under both the federal and Ontario legislation, the minimum holding period was only five years,[140] after which individuals were free to redeem their shares. However, a five-year holding period may not produce the necessary patient capital required of venture capital investments because the LSVCC could face significant redemption notices in the sixth year after shares are sold. When the federal government first introduced its LSVCC provisions, the proposed holding period was eight years.[141] The period was reduced to five years in an amendment made by the Standing Committee on Finance in its report to the House on December 2, 1991. The committee evidently regarded this amendment as a "rather small change."[142] As discussed earlier, in both the federal and Ontario 1996 budgets, the holding period was extended to eight years,[143] the same holding period originally proposed in 1985. The 1996 federal budget also introduced part XII.5, an investor-level tax designed to claw back the federal tax credit in the event that the investor redeems shares before the end of the eight-year holding period.

Again as noted earlier, the federal and Ontario governments introduced a further change in 1996, the addition of a cooling-off period, which was

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[139] In 1989, the legislation was amended to permit individuals who retire at the age of 60 to redeem their shares: SQ 1989, c. 5, section 6(1).

[140] An exception to the five-year rule applied to individuals who reached the retirement age, left the workforce, or became non-resident. As originally introduced, the federal legislation and Ontario legislation permitted individuals who had reached the age of 65, or who had retired from the workforce, or who became non-resident, to redeem their shares after only two years of ownership: subparagraph 204.81(1)(c)(vi) of the Act, and sections 14(e)(i) and (ii) of the Ontario Community Small Business Investment Funds Act. The two-year holding periods were eliminated in the 1996 Ontario and federal budgets.

[141] Proposed clause 204.81(1)(c)(v)(F) in the draft legislation attached to Canada, Department of Finance, *Release*, no. 90-006, January 12, 1990 and in Bill C-18, An Act To Amend the Income Tax Act, the Canada Pension Plan, the Cultural Property Export and Import Act, the Income Tax Conventions Interpretation Act, the Tax Court of Canada Act, the Unemployment Insurance Act, the Canada-Newfoundland Atlantic Accord Implementation Act, the Canada-Nova Scotia Offshore Petroleum Resources Implementation Act and Certain Related Acts, first reading May 30, 1991.

[142] Minutes of Proceedings and Evidence of the Standing Committee on Finance, 34th Parliament, 3d session, 1991, issue no. 29, December 2, 1991, 31. Working Ventures Canadian began raising capital in 1990. Before this announced change, investors in Working Ventures Canadian were buying shares on the assumption that they would have to hold them for eight years.

[143] However, a share acquired before March 5, 1996 need only be held for five years from the day on which it was issued before it can be redeemed. Similar grandfathering provisions apply in the various provincial regimes, noted below.

similarly intended to discourage redemptions of LSVCC shares. In effect, if an individual redeems any shares of an LSVCC, he or she is precluded from claiming a federal or Ontario LSVCC tax credit for three taxation years (the year of redemption and the following two years).[144]

Problems can still arise if a significant number of shareholders attempt to redeem their shares at the same time. It is a common provision in the prospectuses of Ontario LSVCCs and federally registered LSVCCs that the fund reserves the right not to redeem class A shares having an aggregate redemption price exceeding 20 percent of the net asset value of the fund at the end of the preceding fiscal year.[145]

OBJECTIVES OF THE LSVCC TAX EXPENDITURE

The national economy and many local and regional economies are dependent on the success of SMEs. However, conventional forms of startup and expansion financing, such as term loans and operating loans and public share offerings, are often not available to SMEs. Banks and other financial institutions generally view SMEs as high-risk loan candidates and may be unwilling to extend credit. Where banks are prepared to extend credit, it is often at higher rates than those granted to larger corporations.[146] Furthermore, SMEs are generally unable to raise capital through public equity markets.[147] As a consequence, private venture capital is one of the only available sources of capital for SMEs. Because of the general perception that there has been an insufficient supply of private venture capital, both the federal and provincial governments have sought to redress this market failure and assist SMEs in overcoming the barriers that inhibit their supply of capital. The barriers are especially pronounced with respect to SMEs involved in value-added processes, technology, and innovation.[148] The LSVCC regimes were established as one means of generating the necessary venture capital for investment in SMEs.

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[144] Subsection 127.4(3) of the Act, and section 8(8.1.2) of the Ontario Income Tax Act, supra footnote 55. There are a number of limited exceptions in subsection 127.4(4)—for example, if the individual dies, or if the individual redeems shares during the requisite eight-year holding period and is thereby required to repay the federal LSVCC tax credit under part XII.5. Section 8(8.1.3) of the Ontario Income Tax Act contains similar exemptions.

[145] See, for example, the prospectuses for Working Ventures Canadian, Canadian Medical Discoveries, Capital Alliance Ventures, and First Ontario. Crocus Investment (Manitoba) does not have a similar provision; however, the redemption of its shares is subject to any restrictions under corporate or securities laws. Working Opportunity Fund (EVCC) (British Columbia) limits redemptions if they would exceed either 20 percent of the fund's retained earnings or 50 percent of the fund's net earnings after taxes for the previous fiscal year.

[146] The failure of banks and other financial institutions to extend debt financing to SMEs is not generally viewed as a market failure: Neil Brooks, "Taxation of Closely-Held Corporations: The Partnership Option and the Lower Rate of Tax" (1986), vol. 3, no. 4 *Australian Tax Forum* 381-509, at 483.

[147] The inability of SMEs to access equity financing, in contrast to debt financing, is often perceived as a market failure: Brooks, ibid.

[148] Jackson and Lamontagne, supra footnote 65.

The objectives of the LSVCC tax expenditure may be divided into two broad categories. The first category comprises those objectives associated with venture capital generally: to build a sufficient and efficient source of venture capital in national and regional markets to provide the necessary capital to SMEs. The second category comprises social and ethical objectives peculiar to the "labour-sponsored" component: to facilitate a new role for unions and workers in the economy.[149]

Strengthening of National and Regional Venture Capital Markets

Resource and structural needs of the struggling institutional venture capital market in the 1980s and early 1990s served as the primary impetus for the establishment of LSVCCs, among a host of other provisions designed to create greater venture capital investment. Government intervention was considered necessary because of a perceived "market failure": the existing sources of venture capital (including VCCs, private venture capitalists, and pension funds) were simply insufficient to provide the capital that SMEs required. Furthermore, the venture capital market that did exist was confined primarily to central Canada, where venture capitalists tended to congregate and invest.[150] Because private venture capitalists generally take a more proactive role in the management of investee firms, venture capital investment has tended to be localized. Either venture capital resources have not existed in outlying regions, or where they have existed, they have quickly dried up during economic recessions, as they did in Quebec in the early 1980s and in Ontario a decade later.

A major problem with venture capital financing in the past has been the volatility of the flow of investment capital in terms of both time and location. LSVCCs are intended to create a more stable supply of venture capital, which can be channelled to regions of the country that might otherwise lack such funds. The creation of a sufficient pool of venture capital was achieved by attracting individuals who would not otherwise

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[149] The Canadian Labour Market and Productivity Centre, supra footnote 23, at 15-59, suggested 10 salient characteristics of LSVCCs: (1) responsiveness to public policy concerns; (2) interest in Canadian private equity markets geared to risk; (3) interest in addressing capital supply barriers to firms in certain sectors; (4) organization and direction by a legitimate labour body; (5) mandates that guide investments according to economic and social goals; (6) capital resource mobilization on a provincial basis; (7) participation by a broad base of average working people; (8) a commitment to provide market returns to shareholders; (9) involvement of workers and unions in enterprise-based decisions; and (10) facilitation of cooperation between business and labour. Vaillancourt, infra footnote 185, regroups these characteristics under four headings: (A) increased supply of venture capital (which includes 1, 2, 3, and 6 above); (B) increased employment (1 and 5 above); (C) better investment vehicle (7 and 8 above); and (D) increased labour involvement (4, 9, and 10 above). Our two broad categories also encompass these objectives: sufficient and efficient source of venture capital (A and C); social and ethical objectives peculiar to the "labour-sponsored" component (B and D).

[150] Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Finance*, 35th Parliament, 1st session, 1994-95, issue no. 103, April 4, 1995, 18.

make venture capital investments, particularly union members, first-time investors, and middle income earners.[151] The tax credit has proven to be an effective means of creating a substantial venture capital pool.

The stability of the venture capital pool is ensured through a combination of the holding period requirements for LSVCC investors and the ability of LSVCCs to invest a portion of their capital in reserves to cover share redemptions. An eight-year holding period more accurately reflects the average time line of a venture capital investment. The federal government's decision in 1991 to reduce the originally proposed holding period from eight years to five years, while better for LSVCC share sales, was inappropriate.

Regional investment is achieved in a number of ways. First, the eligible investments of all LSVCCs are generally limited to businesses operating in the governing jurisdiction (Canada or the particular province). The SOLIDEs and regional investment funds in Quebec, and the CSBIFs in Ontario, may serve to direct venture capital to more remote regions that traditionally have had difficulty attracting such investment. In Atlantic Canada, a region that has historically experienced a serious shortage of venture capital, three provinces—Nova Scotia, New Brunswick, and, until recently, Prince Edward Island—extended a tax credit to individuals resident in the province who invested in prescribed national funds. Presumably, the provincial authorities would register a national fund only if it agreed to invest in the province an amount relative to the capital raised in the province.[152] Working Ventures Canadian, which was registered in all three provinces, was responsible for almost 100 percent of the institutional venture capital investment in Atlantic Canada in 1993-1994.[153]

A New Role for Unions and Workers in the Economy

What is supposed to distinguish LSVCCs from other venture capital initiatives is the intended role of unions and workers. Unlike private sources of venture capital, LSVCCs espouse objectives that extend beyond profit maximization. A feature common to the LSVCC legislation in all jurisdictions is that an employee organization, such as a trade union, must sponsor the LSVCC. Along with officially establishing the fund, the sponsoring union must generally appoint at least half and in some jurisdictions a majority of the members of the board of directors of the LSVCC. The rationale behind these requirements is that Canadian unions and union members become involved and influence investment and financing decisions of the LSVCC at the highest levels. At least in theory, LSVCCs give unions and union members an opportunity to play a constructive role in the investment process.

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151 Jackson and Lamontagne, supra footnote 65, at 3.

152 In Nova Scotia, this requirement is specified in reg. 12(2)(b) of the Equity Tax Credit Act Regulations, NS Reg. 18/94, as amended.

153 Canadian Labour Market and Productivity Centre, supra footnote 23, at 50.

Five LSVCCs—FSTQ (Quebec), Working Opportunity Fund (EVCC) (British Columbia), Crocus Investment (Manitoba), First Ontario (Ontario), and Workers Investment Fund (New Brunswick)—signed a statement expressing their views of the characteristics of an LSVCC.[154] The statement suggests that the sponsoring organization should be a labour body whose membership exceeds 100,000, or a provincial labour body sponsored by the Canadian Labour Congress; the initiative to create the LSVCC should come from the sponsoring organization; the board of directors should be controlled by the sponsoring organization; and major decisions of the fund should be made by the board of directors.[155]

With respect to the nature of the investments made by the LSVCC, the statement provides:

> II. *A commitment to meeting economic and social goals in making investments.*
>
> These economic and social goals extend beyond the provision of equity capital to small and medium sized enterprises. Common goals include:
>
> - a commitment to job retention and job creation;
> - a commitment to regional economic development;
> - the use of social audit as part of the fund's investment analysis of a potential investee company; audit criteria may include the company's commitment to workplace safety and health, sound environmental practices, ethical employment practices, and co-operative labour relations;
> - a commitment to changing labour-management relations within investee companies. Activities in this area may focus on employee ownership, participative management or financial education for employees of investee companies.
>
> Funds may also have additional unique economic and social goals.
>
> This commitment to meeting economic and social goals should be reflected:
>
> - in the mandate of the fund;
> - in mechanisms created as part of the investment analysis; and
> - as part of the fund's post-investment activity.
>
> III. *A commitment to provide an equitable rate of return to shareholders.*
>
> IV. *A commitment to provide risk capital in a diversified portfolio.*

LSVCCs are also intended to attract workers as an important source of venture capital, primarily through the recruitment of union members affiliated with the sponsoring union or unions. Some jurisdictions specifically encourage employee participation through payroll deduction plans.[156] Some funds educate and train union members to act as sales agents for the

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[154] "What Constitutes a Labour Sponsored Investment Fund?—A Defining Statement." This statement is reproduced in the literature made available by First Ontario; it is also reproduced in Ellmen, supra footnote 86, at 11.

[155] "What Constitutes a Labour Sponsored Investment Fund?" supra footnote 154, at clause I.

[156] See above under the heading, "Eligible Investor."

fund.[157] Finally, LSVCCs may improve worker productivity through worker participation and employee ownership, and "through education . . . strengthen labour's understanding of, commitment to and confidence in the Canadian economy."[158] The defining statement agreed to by the five LSVCCs referred to above also reflects these objectives:

> V. *A commitment to participation by a broad base of average working people*;
>
> • distinct structures or marketing initiatives aimed at working people (an example would be the secondment of sales representatives from the labour movement);
>
> • access and direct marketing to members of unions;
>
> • composition of the fund's investor group such that a significant number are members of legitimate labour bodies;
>
> • specific educational programs providing economic education to working people.
>
> VI. *Facilitation of co-operation between labour and business.*
>
> This could be reflected in many different ways, including business and labour representation on an investment advisory committee, institutional investment by business groups, promotion of participative management practices at investee companies, and so on.

Some of the provincial legislation explicitly adopts some of these objectives.[159] For example, the legislation in most provinces refers specifically to job creation, maintenance, and protection. The legislation in British Columbia, Quebec, and New Brunswick lists as an objective the education of workers in economic matters. Manitoba's legislation and Quebec's legislation concerning Fondaction include environmental objectives as well as the involvement of workers in firm governance. Manitoba's legislation also refers to workplace safety as an appropriate investment criterion for LSVCCs.

TAX EXPENDITURE ANALYSIS OF LSVCC REGIMES

LSVCCs function as instruments of public policy, particularly with respect to employment and business development, the supply of long-term capital to SMEs in key sectors, and the involvement of labour in venture capital investment. LSVCCs must remain relevant and accountable to these public policy concerns to justify continued expenditure. To ensure this responsiveness, governments have incorporated into the legislative framework detailed standards, milestones and restrictions governing the management and investment of LSVCCs.

This section considers whether LSVCCs are meeting their stated objectives. It begins with a review of the economic literature in which cost-benefit analyses of the LSVCC regime have been undertaken.

157 Ibid.

158 Jackson and Lamontagne, supra footnote 65, at 4.

159 See "Objectives of LSVCC legislation" in the appendix table.

Cost-Benefit Analysis of the LSVCC Regime: A Review of the Economic Literature

LSVCCs are the largest single instrument of government support for venture capital formation in Canada. Because of their newness and the long-term nature of the objectives they are intended to achieve, it is virtually impossible to undertake a cost-benefit analysis of the full range of LSVCC programs. However, a number of studies have attempted to perform a cost-benefit analysis of the LSVCC tax expenditure associated with FSTQ. The first of these was undertaken by Suret in 1993.[160] His rather brief study examined the fiscal and investor costs[161] of FSTQ and concluded that "the cost of the FSTQ seems very high, and the funds effectively invested in Québec enterprises are not very important. This results in poor performance indicators."[162] His study indicated that the cost of each dollar invested by FSTQ ranged from $2 to $4, depending on the method used to value FSTQ's portfolio.

Suret's study cannot properly be called a cost-benefit analysis of FSTQ from the governments' perspective.[163] Rather, it was a calculation of the unit cost to the federal and Quebec governments of venture capital investments made by FSTQ. In addition, the manner in which Suret calculated the cost is problematic. The cost was determined by dividing the aggregate cost of the FSTQ tax expenditure over the period of FSTQ's existence by the cost (or value) of FSTQ's venture capital investments at a particular point in time. This rather simplistic equation fails to account for the fact that FSTQ must redeem shares of retiring shareholders (including those who retired during this time period), and therefore such funds would not have been available for investment.

The Suret study can also be criticized because it failed to consider the benefits generated by FSTQ's venture capital investment, which may include

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[160] Jean Marc Suret, *The Fonds de Solidarité des Travailleurs du Québec: A Cost Benefit Analysis* (Sainte Foy: Université Laval, December 1993). See also Jean Marc Suret, "Le Gouvernement du Québec et le Financement des Enterprises: Les Mauvaise réponses à un Faux Problème," in Filip Palda, ed., *L'État Interventionniste* (Vancouver: Fraser Institute, 1994), 113-68.

[161] The fiscal costs included the federal and provincial tax credits, the combined federal-provincial $20 million grant (see supra footnote 24 and corresponding text), and an interest component (on the rationale that the tax expenditures increased the governments' deficits and therefore required the governments to borrow more money). The investor costs included the opportunity loss resulting from the relatively poor performance of an investment in FSTQ (even taking into account the tax credit) compared to an equivalent net investment (that is, after deducting the tax credits and RRSP deductions available to an investor in FSTQ) in a mutual growth fund outside an RRSP. The investor costs are considered further below under the heading "Public Policy Objectives of LSVCCs: Better Investment Vehicle."

[162] Suret, *The Fonds de Solidarité des Travailleurs du Québec*, supra footnote 160, at 14-15.

[163] Although it does include a cost-benefit analysis from the point of view of an investor in FSTQ: ibid., at 11. See also below under the heading "Public Policy Objectives of LSVCCs: Better Investment Vehicle."

- increased tax revenue from investee firms and from job creation;
- savings in program spending, such as social assistance and unemployment insurance, as a result of jobs created and maintained;
- increased revenue from suppliers to investee firms and from consumer spending; and
- less quantifiable measures, such as worker education, employee ownership, and the stimulation of regional development.

A cost-benefit analysis of the LSVCC tax expenditure should consider job creation and other multiplier effects—the very benefits that LSVCCs are intended to achieve. The additional tax paid by investee firms and their employees as a consequence of the investment should be included in the calculation and may result in a significantly lower net expenditure. The cost should also take into account any tax payable by the LSVCC.[164]

In response to Suret's study, FSTQ commissioned its own cost-benefit analysis ("the 1994 FSTQ study").[165] The 1994 FSTQ study calculated the fiscal cost per dollar of venture capital investment of FSTQ to be $1.35, which included the fiscal cost of the RRSP deduction available to investors.[166] In order to determine the fiscal benefit to the governments, the study first examined the net fiscal cost resulting from FSTQ's investment in four investee firms.[167] The net fiscal cost was determined by subtracting

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[164] At the federal level, LSVCCs are taxed in accordance with the rules applicable to mutual fund corporations. Accordingly, dividends received from taxable Canadian corporations are effectively exempt from tax; income taxes paid on taxable capital gains are refundable when capital gains dividends are paid to shareholders; and a portion of an LSVCC's tax on other investment income is also refundable when ordinary (that is, taxable) dividends are paid to shareholders. Provincial income taxes generally apply in a similar manner, although Quebec effectively exempts its LSVCCs from income tax. An LSVCC may also be liable for federal large corporations tax and provincial capital taxes.

[165] Pierre Lamonde, Yvon Martineau, and Don Allen, *Impact Économique et Fiscal des Investissements du Fonds de Solidarité des Travailleurs du Québec (FTQ), 1984-1993* (Montreal: INRS-Urbanisation, October 1994). An executive summary of the study, in English, was prepared by the Canadian Labour Market and Productivity Centre.

[166] As the executive summary (ibid.) indicates, the fiscal cost of RRSP contributions is more difficult to determine because it includes factors such as the income level of the investors, the time that the RRSP will remain outstanding, and the present value of the future tax revenues when the RRSP contributions are withdrawn. Other factors also were taken into account, such as the expected rate of return on RRSP investments, future fiscal benefits such as increased goods and services tax (GST) and provincial sales tax (PST) revenues that result from higher disposable income after retirement, and decreased federal guaranteed income supplements. It is questionable whether the fiscal cost of RRSP contributions should be included in the calculation of the cost of the LSVCC tax expenditure because the RRSP deduction would be available for any investment made through an RRSP. The only basis upon which the cost of the RRSP contribution should be included is that the individuals who invest in FSTQ would not otherwise have made an RRSP contribution at all. As discussed below, the 1996 update of this report modified the calculation to take into account an individual's potential uses of the funds otherwise invested in FSTQ.

[167] The four firms chosen were described as "rescue operations" because they probably would not have survived without FSTQ's investment: supra footnote 165 (executive summary), at 3-4.

the fiscal benefits from the gross fiscal cost (using the figure of $1.35 per dollar of investment) of FSTQ's investment in these firms. The fiscal benefits included direct benefits,[168] indirect benefits,[169] and induced benefits.[170] The study indicated that the governments' fiscal costs of the LSVCC investment were recovered in respect of these four investee firms, on average, in four years, and that thereafter the governments derived a significant gain. The study then used a similar methodology to determine the governments' net fiscal costs for all of FSTQ's investment portfolio as of October 31, 1993—in other words, FSTQ's impact on the Quebec economy. The study suggested that the federal and Quebec governments recovered their total investment in approximately three years. It was estimated that FSTQ's venture capital investments created over 15,000 full-time jobs,[171] more than half of which were in the manufacturing sector; over $964 million of value-added;[172] and approximately $149 million of Quebec government revenue and $110 million of federal government revenue.[173] Finally, the study concluded that FSTQ had a significant impact on Quebec's regional economies, providing not only economic and fiscal benefits, but also social and other benefits resulting from increased employment, improved employee relations and organizational structures, and the use of new technologies.[174]

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[168] Direct benefits included the avoided cost of social assistance that the governments would have had to make had the investee firms closed down; income tax revenues from salaries paid to the investee firms' employees (which took into consideration the possibility that employees may have found work elsewhere, received unemployment insurance or social assistance, or become inactive); and GST and PST revenues from the purchase of goods and services made by the investee companies and their employees. A number of direct benefits were excluded from the calculation owing to the difficulty of determining values. These included avoided social and health costs associated with massive layoffs, company and worker contributions to unemployment insurance and to the Quebec Pension Plan, municipal taxes, and corporate taxes of the investee firms.

[169] Indirect benefits included government revenues derived from the purchase of goods and services and the payment of salaries by the investee companies' suppliers.

[170] Induced benefits included the increase in consumer spending derived from employees' salaries.

[171] This included jobs not only in investee firms, but also through indirect and induced benefits (supra footnotes 169 and 170) generated by FSTQ investment.

[172] Value-added refers to the "value of production which derived from the transformation activity of a firm," being the "difference between the value of production and the cost of goods and services required for that production": supra footnote 165 (executive summary), footnote 6, at 11. Again, both indirect and induced benefits were taken into account.

[173] Including income taxes on salaries, sales taxes, unemployment insurance, and additions to the Quebec Pension Plan and Quebec health plan.

[174] For example, in the Mauricie–Bois-Francs region, where FSTQ invested $46 million in the four investee firms noted above as well as $1.5 million in a regional fund, the fund's involvement resulted in a direct gain of 720 jobs in the four investee firms rather than a loss of 1,519 jobs. The study also suggested that there were other benefits, such as better employee relations, enhanced productivity, specialization of production, and the ability to undertake low-volume production at competitive costs. The latter benefits were

(The footnote is continued on the next page.)

The 1994 FSTQ study was updated in 1996 ("the 1996 FSTQ study").[175] The 1996 FSTQ study used "improved" methodologies to determine the fiscal cost of the LSVCC tax expenditure to the federal and Quebec governments.[176] Based on the new methodologies, the fiscal cost per dollar of venture capital investment for the 1984-1993 period was $0.75 rather than $1.35, as calculated in the earlier study; the fiscal cost for the 1984-1995 period was $0.80.[177] Two alternative methods were used to determine the recovery period of the governments' expenditure. The first method was similar to that employed in the earlier study and determined that the recovery period was approximately 2.2 years.[178] Under the second method, a determination was made of what would have happened to the investee firm if FSTQ had not invested: if the firm would not have existed without FSTQ's investment, 100 percent of the fiscal benefits generated by the investee firm were attributed to FSTQ (rather than its pro rata share based on its percentage interest in the common shares of the company); if the

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174 Continued . . .
derived primarily from the use of new technologies acquired with FSTQ's investments. Increased sales brought considerable business to local and regional suppliers, and increased salaries were an "important, direct contribution to the regional economy" (supra footnote 165 (executive summary), at 10).

175 Pierre Lamonde, Daniel Denis, and Don Allen, *Retombées Économiques et Fiscales des Investissements du Fonds de Solidarité des Travailleurs du Québec (FTQ), 1984-1995* (December 1996, unpublished). A summary of the study, in English, was prepared by FSTQ.

176 The 1996 FSTQ study calculated the net fiscal cost of the expenditure by comparing the alternative ways in which an investor would have used the amount otherwise invested in shares of FSTQ. The model considered four scenarios: investment in FSTQ shares (through an RRSP); investment in other RRSP-sheltered investments; investment in assets outside an RRSP; and consumer expenditure. The fiscal cost of the LSVCC expenditure was the difference between the fiscal revenue derived under the first scenario and the fiscal revenue derived under a reasonable combination of the remaining three scenarios. The data used in the 1996 simulation were based on the income data of the individuals who actually invested in FSTQ rather than hypothetical taxpayers at postulated income levels.

The methodology used to determine the cost per dollar of venture capital invested also was changed. Rather than simply taking the net fiscal cost (as determined above) and dividing by the cost of FSTQ's venture capital portfolio as shown on its balance sheet at a point in time (which was the method used in the 1994 FSTQ study and by Suret), the capitalization was determined on an annual flow basis—that is, the sum of the annual investments made by FSTQ over the period corresponding to the tax expenditure. For the period 1984-1995 (the years in which the tax expenditure was incurred), the annual investments made to the period ending June 30, 1996 were taken into account. The study suggests that this calculation produced a conservative figure because, in reality, FSTQ had until the end of 1997 to invest funds (to meet the 60 percent venture capital investment threshold) received from share subscriptions in the 1996 RRSP season.

177 It appears that both the 1994 and 1996 FSTQ studies included in total venture capital investment, funds committed but undisbursed, as well as funds invested in the regional funds and SOLIDEs, even if these funds had not actually invested their capital in SMEs. For these reasons, the actual amount of venture capital investment by FSTQ may have been overstated.

178 This calculation included federal employment insurance payments. Excluding employment insurance, the recovery period was determined to be 2.4 years.

firm would have survived in any event, 0 percent was attributed to FSTQ. Under this method, the recovery period for both governments' investment was calculated to be 1.2 years.[179] Finally, the 1996 FSTQ study estimated the total fiscal costs recovered as of December 31, 1996. Under the first recovery period method, the study concluded that the governments had recovered 73 percent of their total costs to date; under the second method, they had recovered 88 percent.

In 1997, FSTQ commissioned a further study ("the 1997 FSTQ study") to compare the economic benefits of the LSVCC tax expenditure applicable to FSTQ with the economic benefits of an increase in disposable income generated by a general reduction in personal income tax rates.[180] The report concluded that the benefits associated with increased disposable income—primarily, consumer spending (including the number of jobs thereby supported, value-added, and increased tax revenue)—were significantly less than the benefits associated with the LSVCC tax expenditure.[181] In addition, the benefits of the latter were recurrent (so long as the investee firms continued to operate) whereas the reduction in personal income taxes gave rise to a one-time benefit. The 1997 FSTQ study also updated the recovery period calculations of the 1996 FSTQ study in order to take into account social security spending saved by the Quebec government as a consequence of FSTQ investments.[182] The report estimated that when

[179] The recovery period was 1.4 years if federal employment insurance was not taken into account.

[180] SECOR, Les investissements du Fonds: Une Comparaison de ses Impacts Économiques et une Évaluation de ses Coûts Évités (March 10, 1997, unpublished). A summary of the report, in English, was prepared by FSTQ.

[181] The study was based on the cost to the federal and Quebec governments ($207 million) associated with investment in FSTQ in 1995. On the basis of a general reduction in personal income tax rates that would cost the governments an equivalent amount, and the average savings rate in Quebec, the study estimated that consumer spending would have risen by $194 million. The following table, reproduced from the English summary of the report, summarizes the study's findings:

Comparison of direct and indirect impacts for the costs incurred by both levels of government in 1995 ($207 million)

	General reduction in personal income tax	*Support to Fund shareholders*
Labour (person-years)	2,370	5,814/year
Value-added (in thousands)	$128,261	$391,793/year
Quebec government revenues (in thousands)	$25,041	$58,187/year
Canadian government revenues (in thousands)	$20,096	$37,041/year

The study is premised on the fact that Quebec individuals will spend almost 94 percent of their tax savings. Another school of thought is that some portion of tax savings will be used for investment purposes that will have continuing economic benefits.

[182] Although these savings were taken into account in the 1994 FSTQ study (and in the 1995 CLMPC study, discussed below), they do not appear to have been taken into account in the 1996 FSTQ study.

these savings are taken into account, the recovery period was reduced to between 0.8 and 1.4 years.

The Canadian Labour Market and Productivity Centre also undertook a cost-benefit analysis of LSVCCs following the Suret report ("the 1995 CLMPC study").[183] This study examined 10 investee firms, 7 of FSTQ and 3 of British Columbia's Working Opportunity Fund (EVCC). The study also examined other qualitative benefits generated by LSVCCs. With respect to the fiscal analysis, the study adopted the fiscal cost figure of $1.35 per dollar of venture capital investment from the 1994 FSTQ study. The methodologies used to determine the fiscal benefits were similar to those in the 1994 FSTQ study (although corporate income taxes paid by the investee firms also were taken into account). This study estimated that the payback period was less than three years.[184]

The conclusions of the FSTQ studies and the 1995 CLMPC study are disputed in a study by Vaillancourt prepared for a 1995 conference sponsored by Industry Canada.[185] After providing an overview of the history and structure of the tax expenditure, Vaillancourt's study focuses on two issues: how the LSVCC tax expenditure is distributed among taxpayer investors; and whether the tax expenditure has had an impact on employment. With respect to the first issue, the study concludes that the LSVCC tax expenditure is regressive; that is, its use is concentrated among higher-income taxpayers.[186] In order to determine the effect of LSVCCs on employment, Vaillancourt introduces a variable representing FSTQ into a conventional model for sector-specific employment. His study examines the effect of the FSTQ variable in six specific manufacturing sectors and in the manufacturing sector as a whole and concludes that the FSTQ variable has "no significant impact on employment in the sectors studied."[187]

Vaillancourt also joins Suret in questioning whether the supply of venture capital in Canada, before the introduction of LSVCCs, was inadequate. In a comment on Vaillancourt's study, Smith[188] shares the concern. Smith compares the 10-year compounded rate of return for FSTQ (to 1995) and the 5-year return for Working Ventures Canadian (to 1995) with the rate of return for three-month Canadian treasury bills over the same periods.

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[183] Jackson and Lamontagne, supra footnote 65.

[184] The differences in methodology between the 1994 FSTQ study and the 1995 CLMPC study stemmed primarily from the use of different multipliers and assumptions in their modelling.

[185] François Vaillancourt, "Labour-Sponsored Venture Capital Funds in Canada: Institutional Aspects, Tax Expenditures and Employment Creation," in Paul J.N. Halpern, ed., *Financing Growth in Canada* (Calgary: University of Calgary Press, 1997), 571-92.

[186] The regressivity of the LSVCC tax credit is considered further below under the heading "Public Policy Objectives of LSVCCs: Better Investment Vehicle."

[187] Vaillancourt, supra footnote 185, at 587.

[188] Brian F. Smith, "Comment," in *Financing Growth in Canada*, supra footnote 185, 674-77.

In both cases, the LSVCCs underperformed treasury bills.[189] Smith concludes that "[s]ince the realized rate of return of venture capital in Canada does not exceed the expected risk-adjusted rate, this would suggest that the supply of venture capital is adequate."[190]

We are not qualified to evaluate the conflicting conclusions reached in the economic literature. However, we will make a few general observations.

First, from the perspective of the federal and provincial governments, the cost-benefit analysis must relate to the governments' costs and benefits—what benefits accrue to the governments in return for the costs incurred (in the form of tax credits and, possibly, in the form of RRSP deductions)[191]—rather than the investor's cost and benefits. The Suret study does not undertake a cost-benefit analysis from the governments' perspective. The FSTQ studies and Vaillancourt's study do. Vaillancourt's study is limited primarily to the question whether additional employment is generated by FSTQ; in the FSTQ studies, additional employment is one benefit, albeit an important one. The three FSTQ studies have continually reduced the pay-back period of the tax expenditure to the governments. Although we are not qualified to evaluate the modelling used in the study, a pay-back period of less than two years is suspect because FSTQ has at least 16 months to invest new capital raised during an RRSP season and it only needs to invest 60 percent of new capital in SMEs.

Second, the FSTQ studies rely on a significant amount of microeconomic data when designing the macroeconomic model to determine the impact of FSTQ. Vaillancourt's study does not consider microeconomic data; it simply inserts a variable for FSTQ in a conventional macroeconomic employment model. It seems intuitive that the evaluation of a targeted tax expenditure should consider microeconomic data. In a report on the Industry Canada conference, Brean questions the validity of Vaillancourt's conclusion that FSTQ has had no impact on employment:

> [T]he relationship between finance and employment—dependent, as it is, on investment—seems unlikely to be adequately captured by the augmented employment function. Earlier in the conference, in an exercise focused exclusively on the elasticity of investment with respect to the cost of capital, Chirinko and Meyer[192] could not report conclusive results. The chances

[189] Smith acknowledges that the return to the investor in the LSVCC, on an after-tax basis, is considerably higher.

[190] Supra footnote 188, at 675.

[191] Since a taxpayer will get an RRSP deduction regardless of the nature of the investment made by the RRSP, arguably the RRSP deduction should not be taken into account (see, for example, Vaillancourt, supra footnote 185, at 581). However, if a taxpayer would not have made an RRSP contribution but for the LSVCC tax credit, it is arguable that the governments' cost of the RRSP deduction should be taken into account. The 1995 FSTQ study was based on the latter proposition. See also infra footnote 216.

[192] Robert S. Chirinko and Andrew P. Meyer, "The User Cost of Capital and Investment Spending: Implications for Canadian Firms," in *Financing Growth in Canada*, supra footnote 185, 17-69. This study sought to determine the sensitivity of Canadian investment spending with respect to the user cost of capital; the study reached inconclusive results.

> of observing a significant relationship, if such a relationship could exist, are even slimmer in Vaillancourt's specification, since the finance/investment/employment effects with which he is concerned involve the investment:cost-of-capital elasticity *plus* the relationship between investment and employment.[193]

Finally, in our view, it is probably still too early to undertake a cost-benefit analysis of LSVCCs because of the longer time horizon associated with venture capital investments. FSTQ, the oldest LSVCC, has been actively investing only since 1986, while Working Ventures Canadian (the first federal fund) has been active for less than a decade and the Ontario funds have been active for only a few years. Given that it can take up to 10 years before any profits from venture capital are earned,[194] the various cost-benefit analyses are arguably premature.

Although we believe that it is premature to perform a comprehensive cost-benefit analysis, it is possible—indeed, necessary—to examine whether the LSVCC tax expenditure, as currently structured, most efficiently meets its objectives and whether these objectives are appropriate.

Public Policy Objectives of LSVCCs

Strengthening of National and Regional Venture Capital Markets

There is little doubt that the LSVCC tax expenditure has been successful in creating substantial pools of investment capital. There is also evidence to support the proposition that the LSVCC tax expenditure has led to venture capital investment in SMEs in regions of Canada that previously experienced a shortage of such funding. Nevertheless, the greatest criticism of the LSVCC tax expenditure is that the intended beneficiaries of the expenditure—SMEs—have seen a disturbingly low proportion of the capital raised by LSVCCs. Until recently, a substantial amount of the money invested in a number of LSVCCs has been reinvested in risk-free government securities rather than SMEs.

A number of reasons have been suggested for this deficiency in targeted venture capital investment.

First, newly registered funds may have focused more on raising capital than on investigating appropriate venture capital investments. Here the fault lies in the structure of the LSVCC tax expenditure, particularly in Ontario. A few of Ontario's "rent-a-union" funds were established by financiers who were perhaps more concerned with obtaining tax credits for their investor clients than with making venture capital investments. However, most of the "rent-a-union" funds are managed by seasoned venture capitalists (although they do not necessarily subscribe to the "labour-sponsored" objectives of the LSVCC regime).

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193 Donald J.S. Brean, "Conference Report," in *Financing Growth in Canada*, supra footnote 185, 691-727, at 713.

194 Jack M. Mintz, "Policy Perspectives on Capital Market Issues," ibid., 729-52, at 745.

Second, it has been suggested that the definition of eligible investments is too narrow. In 1994, Working Ventures Canadian lobbied the federal government to ease the rules concerning eligible investments in SMEs.[195] In particular, Working Ventures Canadian proposed that LSVCCs be allowed to invest in previously issued equity of a SME (that is, secondary market purchases) rather than only newly issued shares. However, allowing LSVCCs to invest in previously issued equity would ignore the primary rationale for the tax expenditure: to solve the problems facing SMEs that want to finance startup, research and development, and expansion, but do not have access to the public equity markets. Secondary market purchases do not provide new capital to SMEs. The proposal, if accepted, would only compound the difficulties that SMEs face because LSVCCs would be free to invest in the safest of SME investments—SMEs with proven track records of success—to the exclusion of younger SMEs. The proposal was rejected, and rightly so.[196]

Third, there is the problem of timing the capitalization of an LSVCC and the identification of appropriate venture capital investments. An LSVCC may want to build a capitalization threshold before it selects its investments, although it is doubtful whether there is any critical size that a fund must reach before active investing commences.[197] The primary concern is the time lag between capitalization of the LSVCC and its commitment of those funds to venture capital investment. One obvious problem is that LSVCCs tend to receive the bulk of new capital during RRSP season, whereas venture capital investment opportunities do not follow a similar seasonal pattern. While the LSVCC searches for appropriate investments for new capital, the money that the fund has must be invested somewhere; it is only prudent to invest it in relatively safe and highly liquid securities. The LSVCC regimes in the various jurisdictions accommodate this time lag to varying degrees. However, the time lag for a number of funds between capitalization and venture capital investment has been excessive. A more likely reason for lengthy time lags is the unfamiliar financial environment in which the LSVCC invests.[198] The crucial issue is whether an LSVCC has the management capability to properly invest the funds raised on a year-over-year basis, and there are a number of factors that affect this ability. The number of experienced venture capitalists in Canada is relatively small (compared to the United States),[199] and we question

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195 "Investment Rules for Funds Relaxed," *The Globe and Mail*, May 6, 1994.

196 A few of the provinces allow secondary market purchases in limited circumstances. See above under the heading "Eligible Investments."

197 See, for example, the views expressed by LSVCCs themselves in Rudy Luukko, "How Big Is Too Big for Labour Funds?" *The Toronto Star*, January 18, 1998.

198 Standing Committee on Finance, supra footnote 150, at 18.

199 For a comparison of the Canadian and US private equity markets, see Andrew Carragher and Darren Kelly, "An Evaluative Comparison of the Canadian and American

(The footnote is continued on the next page.)

whether there is sufficient quantity and depth of expertise in Canada to advise existing public and private venture capital pools. We suspect that some LSVCC investment decision-making authority is the hands of more conservative or unseasoned investment managers who do not have a proven track record in the venture capital industry.

A fourth reason that has been offered as justification for the slow rate of venture capital investment is that LSVCCs must keep a certain percentage of their assets in liquid investments to promote diversification and to manage redemptions. There are two reasons why concerns about managing redemptions do not constitute an acceptable rationale. First, the investment restrictions on LSVCCs allow a certain percentage of the fund's capital to be invested in liquid securities precisely to ensure that the LSVCC can fund redemptions without resorting to the sale of its investments in SMEs (which are highly illiquid). Setting aside capital in addition to the prescribed percentage is excessive and undermines the purpose for which LSVCCs were established. Second, there is a minimum holding period that applies to investors in all LSVCCs. Outside Quebec, investors must now hold their shares for a minimum of eight years. The holding period provides a further buffer to protect the LSVCC from unmanageable redemptions. In addition, both the federal and the Ontario regimes have introduced a three-year cooling-off period in order to discourage redemptions, and the prospectuses of most LSVCCs include internal caps on annual redemptions.

The investment problems faced by many LSVCCs stem from their success in raising capital. As mentioned earlier, in 1996, Working Ventures Canadian sought to raise $150 million of new capital. The amount actually raised during RRSP season that year was $350 million. Faced with such a huge and unexpected influx of capital, the fund could not maintain a fast enough pace of investment to continue to meet the minimum investment requirements. Working Ventures Canadian has been criticized for its slow pace in making venture capital investments. As of June 1996, the fund was managing more than $885 million; when it halted sales of its shares that year after unexpected fundraising success during RRSP season, only 19 percent of its assets were invested in SMEs. This kind of investment structure is certainly not the intent of the LSVCC regime and cannot justify the generous tax breaks offered to LSVCC investors.[200]

One solution—which to varying degrees has been adopted by the federal and Ontario governments—is to increase the size of the penalties

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[199] Continued . . .
Private Equity Markets" [Spring 1998], *The Journal of Private Equity* 23-39. Carragher and Kelly suggest, at 29, that "successful venture capital investing requires sector expertise" and that "Canada's economy is too small to allow a large number of venture capitalists enough deal flow to develop expertise."

[200] Since June 1996, Working Ventures Canadian has vastly increased its SME investment. In 1996, it invested $143 million in SMEs and in 1997, $155 million (*Press Release*, Toronto, April 2, 1998).

applicable to a fund's investment shortfall to the point where the LSVCC will invest to avoid those penalties. There are a number of difficulties with this solution. A key concern is that it may force LSVCCs to make imprudent investments in order to meet the statutory investment requirements. The problem is compounded by the fact that the success of the 1996 RRSP season created an oversupply of venture capital. Further, if LSVCCs fail to provide a reasonable rate of return to investors, there is a greater likelihood that they will be faced with substantial redemption notices at the earliest possible date.[201] The solution also ignores the root of the problem, which is that the rate at which capital flows into the funds exceeds the rate at which it can reasonably be invested. Consequently, it is extremely difficult for LSVCCs to invest in eligible investments quickly enough to continue to meet and maintain the required investment levels. As discussed previously, Working Ventures Canadian was forced to halt sales after the 1996 RRSP season in an attempt to catch up on the investment requirements and minimize penalties. This was the first time that an LSVCC imposed its own limit on capital raising and suggests that the appropriate short-term solution is not increased penalties, but rather the adoption of a mechanism that would link the tax incentives used by LSVCCs for asset accumulation to their rate of SME investment.[202]

Since 1995, SME investment by LSVCCs has grown considerably. In 1995, LSVCCs invested $182 million in 119 businesses; in 1996, the investment increased to $404 million in 203 businesses, and in 1997, $671 million in 388 businesses.[203] We hope that this growth has not been driven by the threat of investment deficiency penalties but rather is attributable to a growing level of expertise on the part of the funds' investment managers.

Venture Capital for Small Businesses

The failure of LSVCCs to achieve their investment objectives is particularly pronounced at the low end of the venture capital market. There remains a scarcity of venture capital available to small businesses that require startup financing.[204] The 1997 federal and Ontario budgets proposed certain measures to encourage increased investment in small businesses. We suggest that these proposals are misguided for two reasons.

First, an effective reduction in the prescribed SME investment requirements will allow funds to invest more of their capital in liquid investments without penalty. While the proposal may encourage some investment in

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201 This problem is not present in Quebec, where investors are required to hold their shares until retirement.

202 This solution is used in Quebec and was adopted by Ontario (together with increased monetary penalties) in the May 7, 1996 Ontario budget.

203 Macdonald & Associates Limited, Toronto 1998 (unpublished).

204 The average size of an LSVCC's investment in 1995, 1996, and 1997 was $1.5 million, $2.0 million, and $1.7 million, respectively: ibid.

small businesses (or at least in other pools of funds that are supposed to invest in small businesses), it will result in a more generous government subsidy to investors for investment in treasury bills and other risk-free investments.

Second, and more important, LSVCCs are not the most appropriate source of capital for many of these small businesses. Many small business owners prefer to finance startup with their own funds and those of friends and business associates (so-called love capital).[205] Attempting to direct LSVCC investment to these small businesses is therefore misguided. Instead, governments should target the formation of love capital, which could be better achieved through other means.[206]

Competition in Venture Capital Markets

An issue raised in connection with LSVCCs is whether the generous tax incentive that facilitated their entry into the venture capital market has created distortions in that market. The tax expenditure is targeted to increase competition in the formal capital markets by increasing venture capital funding. Unfortunately, the relatively easy money assembled by LSVCCs may give them a competitive edge over more established private venture capital firms. Arguably, governments' efforts to intensify competition in the marketplace through the expenditure may, in fact, be producing the opposite effect. Further exploration of this issue requires detailed economic analysis, which is beyond the scope of this article.[207]

Increased Employment

A fundamental objective of LSVCCs in all jurisdictions is to protect, maintain, and increase employment within the jurisdiction. As discussed above, the economic literature contains conflicting conclusions regarding the impact of LSVCCs on employment. However, there are a few general observations that can be made.

Substantial venture capital investment will likely have an initial direct and probably significant impact on employment. Its effect may take the form of jobs saved (for example, if the investment by the LSVCC averted closure of the investee firm) or new jobs created. The more problematic

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[205] Philip Shirley, "Venture Capital" (May 1994), 15 *Fiscal Studies* 98-104, at 99. Love capital may account for as much as 90 percent of early-stage financing arrangements of $1 million or less: Gordon Sharwood, "The Special Problems of the Small Deal" (June 1989), *Sharwood Report*, cited in Standing Committee on Industry, supra footnote 1, at 44.

[206] Some alternatives are discussed below under the heading "Conclusions."

[207] Vaillancourt, supra footnote 185, at 590, suggested that the monopoly position of LSVCCs in certain provinces (for example, British Columbia, Manitoba, and Quebec) "puts small firms of [the] province . . . in a weaker bargaining position than they would be in a multifund province." No economic evidence is put forward in support of the statement, although it has some intuitive appeal. Vaillancourt suggests, as a solution, that the federal tax credit be made available only in provinces that allow unrestricted access to all LSVCCs for tax credit and investment purposes.

issue is whether this impact is sustained over the medium to long term. Further economic analysis is required in this respect.

A second consideration is the importance of this objective in the investment decision-making process of LSVCCs relative to other criteria, such as ensuring a reasonable return to investors. For example, it has been suggested that FSTQ may have undertaken some high-risk rescue operations primarily to save union jobs. More generally, FSTQ's investment policy specifically states that it grants priority to proposals from enterprises with workers who are members of unions affiliated with the Quebec Federation of Labour.

Better Investment Vehicle

LSVCCs are intended to attract a broad range of investors, including union members, first-time investors, and middle income earners. In addition, to be competitive in the capital marketplace, they need to provide a satisfactory rate of return to investors.

As discussed earlier, a number of funds specifically target members of the sponsoring union (or unions) as investors. Some funds also benefit from payroll deduction plans. However, most of Ontario's funds (with the notable exceptions of First Ontario and Retrocom Growth) sell shares exclusively through professional investment dealers.

Vaillancourt's study of the LSVCC tax expenditure criticized the expenditure as being regressive over the $15,000 to $100,000 income range of taxpayers. Vaillancourt measured this regressivity by comparing the incidence of the LSVCC tax credit with the incidence of tax credits generally for taxpayers grouped according to their income. There is no doubt that the LSVCC tax credit will exhibit some degree of regressivity. The credit is designed to promote investment, and the ability to save and invest obviously increases as a person's income increases. However, to criticize the credit as regressive on the basis of a comparison with the incidence of all non-refundable tax credits is inappropriate. The most significant non-refundable tax credit, the personal tax credit, substantially exceeds all other tax credits, and its incidence is dependent simply on the number of individuals in each income bracket.[208] In order to determine whether the LSVCC tax credit has successfully attracted a broader range of investors, it is more appropriate to compare its incidence with the incidence of other tax expenditures that promote savings and investment.

Table 4 illustrates the results when the same methodology employed by Vaillancourt is applied to the dividend tax credit, the RRSP deduction,

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[208] In the 1993 taxation year (the year used by Vaillancourt to illustrate the regressivity of the LSVCC tax credit), the government estimated that personal tax credits totalled over $17 billion. Since over 42 percent of all tax filers were in income brackets below $15,000 and the number of taxpayers in higher brackets progressively decreases, it becomes readily apparent that the incidence of tax credits generally will decrease over progressively higher income brackets, whereas the incidence of tax credits to induce savings should increase.

and the capital gains exemption. In terms of the degree of regressivity, the LSVCC tax credit compares favourably with these savings-related tax expenditures. It is significantly less regressive than the dividend tax credit and the capital gains exemption. Although it is more regressive than the RRSP deduction over lower income brackets (to approximately $40,000), it is less regressive over the higher income brackets. On the basis of the results in table 4, the LSVCC tax expenditure may claim success in attracting lower income earners who might not otherwise have saved or invested at all.

Vaillancourt also indicated that the tax credit available to FSTQ investors became more regressive between 1986 and 1993, and that the incidence of the LSVCC credit in 1993 was more regressive in Ontario than in Quebec. These conclusions are not surprising. The difference between Quebec and Ontario can be explained by the manner in which funds were marketed in the two provinces in 1993. FSTQ was the only fund active in Quebec, while Working Ventures Canadian was effectively the only fund actively marketing in Ontario. Working Ventures Canadian shares were sold exclusively by professional investment dealers and were therefore likely to be better known among higher income earners. In addition, the shares were sold aggressively on the basis of the tax savings available to investors, and these savings increased as an individual's income increased because of the RRSP deduction. In this context, it is helpful to recall that the amount of the credit (and RRSP deduction) available increased in 1992, and the credit was specifically extended to investment through RRSPs in 1992. The savings through RRSP investment likely explains the increase in regressivity evident in Quebec between 1986 and 1993.

The investment return has not been critically examined in any economic literature. Suret's 1993 study of the LSVCC tax expenditure calculated the opportunity loss to investors as part of the overall cost of each dollar invested by FSTQ in venture capital. In order to determine the opportunity loss, Suret compared the after-tax accumulated value of an investment in FSTQ with an equivalent non-RRSP investment in a growth mutual fund. On the basis of a number of assumptions—a 25-year holding period (assuming that FSTQ shareholders are on average 40 years old and will hold their shares until age 65), an FSTQ rate of return of 5.39 percent, and a growth mutual fund rate of return of 12 percent—a $10 investment in FSTQ would be worth $37.17 at the time the investor turned 65 while an equivalent after-tax investment ($2)[209] in the growth mutual fund would be worth $34. However, assuming that the investor withdrew the aggregate return on the FSTQ investment from the investor's RRSP on retirement, the after-tax accumulated value of the FSTQ investment would be only $26.26, giving rise to an opportunity loss of $7.71 for each $10 invested. In sum, the taxpayer was worse off financially by investing in

[209] Assuming that the taxpayer's average tax rate is 40 percent, the $10 investment would give rise to a $10 RRSP deduction (or tax saved of $4) plus $4 of federal and Quebec tax credits. Accordingly, an equivalent after-tax non-RRSP investment would be $2.

Table 4 Incidence of LSVCC Tax Credit and Other Tax Expenditures That Promote Saving/Investment, 1993

	TE/taxpayers				TE/income assessed				TE/federal tax			
Income groups ($000s)	LSVCC (1)	DTC (2)	RRSP (3)	CGD (4)	LSVCC (5)	DTC (6)	RRSP (7)	CGD (8)	LSVCC (9)	DTC (10)	RRSP (11)	CGD (12)
0-10	0.0	0.0	0.0	0.0	0.0	0.2	0.2	0.1	0.3	3.0	2.9	1.1
10-15	0.1	0.1	0.1	0.0	0.1	0.2	0.3	0.1	0.4	0.7	1.1	0.3
15-20	0.3	0.2	0.4	0.1	0.4	0.3	0.5	0.2	0.8	0.5	1.0	0.3
20-25	0.4	0.3	0.6	0.2	0.5	0.3	0.7	0.2	0.6	0.4	1.0	0.2
25-30	0.7	0.6	0.9	0.2	0.7	0.5	0.8	0.2	0.8	0.7	1.0	0.2
30-35	1.2	0.7	1.2	0.3	0.9	0.6	1.0	0.2	1.0	0.6	1.1	0.2
35-40	1.8	0.8	1.7	0.4	1.2	0.6	1.1	0.2	1.2	0.5	1.1	0.2
40-45	2.4	0.9	1.9	0.5	1.4	0.6	1.1	0.3	1.3	0.5	1.0	0.3
45-50	2.9	1.2	2.3	0.6	1.6	0.6	1.3	0.4	1.3	0.5	1.0	0.3
50-100	4.7	2.7	3.7	2.4	1.9	1.1	1.5	1.0	1.4	0.8	1.1	0.7
100+	4.7	32.2	9.2	44.3	0.6	4.1	1.2	5.7	0.4	2.5	0.7	3.4

Notes: All figures are derived from federal tax statistics.

Numbers are ratios of percentages.

TE tax expenditure (with respect to RRSP and CGD, the figures are based on the deductions claimed by taxpayers, rather than actual tax saved; if the ratios were based on tax saved, the figures in the table for these expenditures would be higher in the higher income brackets)

LSVCC labour-sponsored venture capital corporation tax credit

DTC dividend tax credit

RRSP deduction for contribution to registered retirement savings plan

CGD capital gains deduction ($500,000 for dispositions of qualified farm property and qualified small business corporation shares; $100,000 for other capital property)

Sources: Columns 1, 5, and 9 from François Vaillancourt, "Labour-Sponsored Venture Capital Funds in Canada: Institutional Aspects, Tax Expenditures and Employment Creation," in Paul J.N. Halpern, ed., *Financing Growth in Canada* (Calgary: University of Calgary Press, 1997), 571-92, at table 5. Columns 2, 3, 4, 6, 7, 8, 10, 11, and 12 calculated using data from Revenue Canada, *Tax Statistics on Individuals: 1993 Tax Year* (Ottawa: Revenue Canada, 1995), table 2.

FSTQ. Some of the assumptions used in this analysis can be questioned. For example, it is unlikely that an individual would completely collapse an RRSP on retirement; rather, he or she may convert it into a registered retirement income fund. In addition, the FSTQ rate of return has increased somewhat since 1993.

Table 5 compares the rate of return on an investment in an LSVCC with the rate of return on small- to mid-cap equity funds as well as other indices. To date, the rate of return on an LSVCC investment, not incorporating the tax benefits, is extremely low in comparison with small- to mid-cap equity funds. In part, the low rate is accounted for by high management-expense ratios.[210] However, little weight can be attached to most of the LSVCC return figures in table 5 because of the nature of an LSVCC's investments. Venture capital investments are highly illiquid and generally require a holding period of five to eight years or more. Few LSVCCs have investment portfolios that are mature enough to generate return figures that in any way reflect their relative success in venture capital investment.[211] In addition, the method by which SME investments are valued for financial statement purposes is highly conservative. Apart from the difficulty of valuing these investments, it is unlikely that they would be written up substantially before their disposition because their illiquidity obviously affects the value.[212]

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[210] The following table summarizes the management-expense ratios (MERs) of LSVCCs and various other mutual fund investments:

Comparison of management-expense ratios of LSVCCs and other mutual fund investments (as of March 31, 1998)

Type of investment	*MER (average in group)*
LSVCC	4.30
Canadian equity funds	2.19
Canadian small- to mid-cap equity funds	2.41
International equity funds	2.36
US equity funds	2.19

The MER for LSVCCs ranged from a low of 1.60 percent to a high of 6.64 percent.

[211] Probably FSTQ's portfolio is the only one mature enough to provide a sound basis for analysis. For example, even though Working Ventures Canadian was established in 1990, the average age of its venture capital portfolio is under two years. In addition, the return on venture capital tends to follow a "J-curve"—that is, poor investments appear soon after initial investment, while successful investments take a longer period of time to mature. Accordingly, LSVCCs with young venture capital portfolios will likely show poor returns.

[212] Duff Young, "Now's the Time To Buy Labour Funds," *The Globe and Mail*, January 31, 1998. Young states, "A typical move, for example, at many funds is to select the lowest of the valuator's range of price estimates for an illiquid holding. It has always been this way with venture capital because pricing didn't really matter when closed-end venture capital pools were the norm. Today's open-end mutual fund structure (where new people can come in, and old investors can redeem) is what makes the issue thorny." Young gives the example of CI Covington's investment in Playdium Entertainment Corp. CI Covington

(The footnote is continued on the next page.)

Table 5 Rate of Return on Investments in LSVCCs (for the Period Ended March 31, 1998)

	Rate of return		
Fund[a]	1 year	3 year	5 year
The BEST Discoveries	−1.5	—	—
Canadian Medical Discoveries	4.5	5.3	—
Canadian Science & Technology Growth	2.2	—	—
Canadian Venture Opportunity	−7.4	−8.3	—
Capital Alliance Ventures	1.6	4.0	—
Centerfire Growth	8.6	—	—
CI Covington	.3	5.7	—
Crocus Investment[b]	12.7	7.2	6.2
DGC Entertainment Ventures	1.5	5.4	—
ENSIS Growth	—	—	—
FESA Enterprise Venture Capital	−9.0	−3.2	—
First Ontario[b]	5.8	3.6	—
FSTQ[b]	7.0	9.4	6.6
Retrocom Growth	6.1	—	—
Sportfund	1.2	8.8	—
Triax Growth	11.9	—	—
Trillium Capital Growth	−10.3	−3.8	—
VenGrowth Investment	6.3	6.9	—
Workers Investment Fund[b]	0.0	—	—
Working Opportunity Fund (EVCC)[b]	6.4	7.4	5.3
Working Ventures Canadian	4.8	3.0	3.1
LSVCCs (average in group)	2.6	3.7	5.3
TSE 300 total return	31.3	22.9	18.5
Small- to mid-cap equity funds average	18.3	21.0	14.7
5-year average GIC rate	4.7	5.6	6.3

[a] Figures are not available for Fondaction, Innovacap Capital Corp., and Tourism and Entertainment Growth. [b] Signatories to the defining statement noted above under the heading "A New Role for Unions and Workers in the Economy." Note that, with the exception of the Workers Investment Fund, the signatories have generated investment returns that rank among the highest generated by LSVCCs.

Source: *The Globe and Mail*, Report on Mutual Funds, April 16, 1998.

Arguably, the after-tax rate of return from FSTQ or any LSVCC should be approximately equal to that of an equivalent non-tax-sheltered investment. Efficiency theory suggests that in a market-driven economy, the after-tax benefit of tax-sheltered behaviour should be approximately equal to the after-tax benefit of its unsheltered counterpart. That is, there would be an increase in tax-favoured behaviour (and therefore an increase in the

[212] Continued . . .
invested $2.5 million in debt convertible to common shares at the price of $0.925 per share. According to Young, "Recent financings for the growing company (some of which the Covington fund has participated in) have taken place at a share value of $5.75. Covington has reflected just a small part of this increase on its books."

cost of and/or a decrease in the return from the tax-sheltered behaviour) until the after-tax benefits are equalized (the tax benefits are competed away).[213] With respect to the LSVCC tax expenditure, the overall effect should be that the benefit of the expenditure is transferred to SMEs (the intended benefactors of the scheme) through a reduction in their cost of capital. Although the small- to mid-cap equity funds are not a perfect comparison, it is expected that the after-tax rate of return of an LSVCC investment would approximately equal the average investment return of small- to mid-cap equity funds. Assuming that this is the case,[214] the focus should be on the positive externalities generated by the resulting growth of SMEs rather than on the rate of return to investors.

In theory, the equalization of after-tax benefits arises if all of the tax-sheltered behaviour is undertaken by individuals in the highest marginal tax bracket. However, a "trickle-up phenomenon" results if the yield from the tax-exempt activity is raised in order to attract investors in lower tax brackets. In these circumstances, taxpayers in higher tax brackets would derive a windfall. As Bittker suggests, "For the rich, therefore, the best tax shelters are those that are patronized by the poor; on the other hand, the more exclusive the club, the less reason to join."[215] The LSVCC tax credit is aimed at lower-income Canadians. If the after-tax rate of return to those investors is equal to that from a non-tax-sheltered investment, there is an incentive for high income earners to invest in LSVCCs. This effect may explain the upward creep in the incidence of the credit in Quebec indicated by Vaillancourt. Alternatively, if the equalization of rates of return applies to high-income Canadians, it is not worthwhile for lower income earners to participate.

Increased Labour Involvement

Social goals of the LSVCC regimes, such as improved labour-management relations and increased involvement of labour in the capital markets, should not be dismissed in the analysis of LSVCCs. These may be important social initiatives; however, it is questionable whether they should be addressed through a tax expenditure aimed at venture capital. Three aspects of this objective are considered:

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213 See generally Boris I. Bittker, "Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?" (July 1979), 16 *San Diego Law Review* 735-48. Bittker's article contrasted equity theory and efficiency theory using US tax-exempt municipal bonds as an example.

214 It is obvious that a number of features of the LSVCC regimes may make this efficiency theory difficult to apply. First, there is no secondary market for LSVCC shares. Second, LSVCCs are open-ended funds and the subscription/redemption price for LSVCC shares is based on the net asset value per share. Finally, it is difficult to compare LSVCCs among themselves or against comparable non-tax-favoured investments because of the difficulty of predicting the return on an LSVCC's venture capital portfolio.

215 Bittker, supra footnote 213, at 744.

1) To what extent is labour really involved in LSVCC decision making?

2) Are investment decisions dictated by the concerns of labour organizations efficient?

3) Should government policy encourage lower-income Canadians to invest in venture capital?

It is unclear to what extent labour is involved in the governance of LSVCCs. Those funds that signed the "defining statement" described above appear to take the involvement of labour seriously. In Quebec, the involvement is mandated in the legislation. However, as stated earlier, particularly in Ontario, the sponsoring labour organization may take little or no active part in the ongoing governance of the LSVCC.

Even where the sponsoring union plays an active role in the governance of an LSVCC, the resulting investments are not necessarily ones that should be encouraged. The concern is that an LSVCC actually governed by its sponsoring labour organization may invest in unionized investee firms when there are other non-unionized firms that represent better investments. In other words, labour may be predisposed to invest in organized labour. The overarching objective of the LSVCC expenditure is to promote the growth of the Canadian economy. This objective is achieved, in part, by promoting the most efficient use of inputs and thereby promoting production efficiency. Investments designed to resuscitate crippled companies in an effort to save union jobs will not likely bring about the desired efficiencies. Rather, those investment decisions may be dictated by self-interest. Arguably, inefficient firms should fail. Where government expenditure is funding the preservation of inefficient firms to the exclusion of the promotion of potentially profitable firms, the Canadian economy is not advanced and its global competitiveness is diminished.

Finally, policy makers should consider carefully whether it is advisable to encourage lower-income employees to invest their personal savings in risky venture capital investments. Given recent concerns over the future availability of government assistance such as Canada Pension Plan benefits, it is questionable policy to encourage low-income Canadians to put their retirement savings at risk.[216] This concern is compounded by the fact that the LSVCC tax credit and tax saved through RRSP contributions are received personally by the taxpayer. To the extent that these savings are consumed and not reinvested, they will not be available on retirement. The only growth that the individual will benefit from on retirement is the rate of return generated by the LSVCC, which has been relatively poor to date.

[216] A survey of FSTQ shareholders undertaken in 1989 indicated that 45 percent of the shareholders invested for the first time in their lives in an RRSP when they acquired shares of FSTQ, and that 39 percent of the shareholders had only one RRSP (consisting of shares of FSTQ): Sorécom Inc. for the Fonds de solidarité des travailleurs du Québec, June 1989, unpublished.

CONCLUSIONS

Several LSVCCs have been lobbying the federal government to reverse the 1996 budget changes. The government is " 'seriously monitoring' the labour fund situation," although it has stated that it is too early to say whether any rule changes are warranted.[217] The government has echoed the fears of labour-sponsored funds that some provinces could face "shortages of venture capital."[218] In the face of these concerns and the current lobbying, the government should take the opportunity to consider whether the cost of the LSVCC expenditure is justified. Specifically, the government should consider

- why some LSVCCs remain unable to comply with minimum investment requirements;
- why the LSVCC tax expenditure has generally failed to address the low end of the venture capital market; and
- whether the objective of facilitating a new role for labour in industry is properly addressed by a venture capital tax expenditure.

We suggest that there may be alternative, less costly ways to target SMEs generally and the smallest businesses specifically. In some circumstances, government expenditure may not be necessary. The following is a survey of some of the alternatives that could be considered. It is not a comprehensive discussion of the vehicles available for the promotion and financing of SMEs. Rather, it is intended to stimulate consideration of these and other possible alternatives.

Tax Expenditure Alternatives

Qualified Investment for RRSPs

As observed earlier, many small businesses look to love capital as the primary source of startup financing. It is intuitively appealing that business owners be encouraged to employ their own funds and those of friends and business associates to finance the startup of a small business. Extending the definition of qualified investment to permit the use of RRSP savings could achieve this result.[219]

Currently, shares of an unlisted SME may be issued only to friends and business associates who remain at arm's length with the SME and acquire less than 10 percent of its shares of any class.[220] Removing these restrictions

[217] "Labour Funds Nose-Dive in 1997," *The Globe and Mail*, March 24, 1998.

[218] Ibid.

[219] This was suggested by the Standing Committee on Industry, supra footnote 1.

[220] Regulation 4900(6) excludes from the definition of "qualified investment" capital stock of an eligible corporation in which the annuitant under the RRSP is a designated shareholder of the corporation. "Designated shareholder" is defined in regulation 4901(2) and includes a taxpayer who is or is related to a person who owns at least 10 percent of the issued shares of any class of the capital stock of the corporation, a taxpayer that controls

(The footnote is continued on the next page.)

would enable owner-operators and others to purchase RRSP-eligible securities in qualifying small business corporations.[221] In limited circumstances, corporate debt may be a qualified investment, although corporate debt of SMEs would rarely qualify.[222] In our view, the government should not relax the restrictions on the issuance of debt to an RRSP. To do so would allow for abuse.[223]

There are three major concerns with allowing the issuance of RRSP eligible securities to non-arm's-length owners and associates. First, encouraging individuals to invest retirement savings in risky ventures may be considered contrary to the underlying rationale for the RRSP tax expenditure. Possibly, investment limits could be used to force individuals to diversify their RRSP portfolio and thereby reduce the risk.[224] Second, the use of RRSPs to finance SMEs may be considered inequitable in that this opportunity would benefit wealthy Canadians almost exclusively. Third, the tax shelter created could be too generous because owner-operators of small businesses could use RRSPs to shelter corporate income by distributing that income to shares held in the RRSP. A balance would need to be struck between inducing love capital and restricting the ability of investors to earn substantial tax-free income. Possibly, this balance could be addressed by establishing a predetermined limit on the dividend entitlement of shares issued to or held by an RRSP.

Reduction of Capital Gains Tax on Dispositions of Small Business Investments

The Act provides a $500,000 lifetime capital gains exemption for dispositions of shares of small business corporations; in addition, only 75 percent

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220 Continued . . .
the corporation, and a taxpayer that does not deal at arm's length with the corporation. Regulation 4900(12) excludes from the definition of "qualified investment" a corporation of which the annuitant is a connected shareholder. "Connected shareholder" is defined in regulation 4901(2) and includes a person who owns, directly or indirectly, not less than 10 percent of the issued shares of any class of the capital stock of the corporation.

221 A corporation in which RRSP-eligible securities may be purchased should be restricted to a small business corporation with an asset carrying value of $10 million or less. (Recall that this is the value that the federal government pinpointed in the 1997 federal budget.) It is necessary to ensure that the corporations in which RRSP eligible securities are being purchased are not simply portfolio holding companies. It is for this reason that qualifying investments must be in small business corporations. A small business corporation is defined in subsection 248(1) as a CCPC, all or substantially all of whose assets, on a fair market value basis, are used principally in an active business carried on in Canada, or are shares or indebtedness of other connected small business corporations, or are a combination of the two.

222 Regulation 4900(1)(i).

223 The corporation would deduct the interest payments, which the RRSP would receive tax-free. The result is an opportunity to effectively shelter corporate income completely from both corporate and shareholder-level tax.

224 Investment in securities issued by small business corporations could be limited to 20 percent of RRSP portfolios. This was suggested by the Standing Committee on Industry, supra footnote 1.

of all capital gains are subject to tax. It has been suggested that the rate of capital gains tax on small business investments should be further reduced[225] in order to stimulate investment. According to a 1994 Industry Canada report, reducing capital gains tax would be an effective means of encouraging individuals to invest in SMEs.[226] The report suggested that such a measure could be financed by a corresponding reduction in the tax credits earned by investors in LSVCCs.

The reasons often given for a lower tax on small business investment are twofold. First, a low rate is necessary to unlock the capital of non-institutional investors for investment. Second, the low rate is necessary to reward entrepreneurs and investors for the greater risks associated with small business investment.

In our view, there is little justification for preferential capital gains tax treatment of small business investment.[227] While there is little doubt that small business corporation shareholders who want to become former small business corporation shareholders benefit directly from lower (or non-existent) capital gains tax, it is not certain that such tax relief actually encourages upfront equity investment in small businesses. As the Ontario Fair Tax Commission noted, "[T]ax breaks at the 'back-end' of the investment cycle do not address the problem of access to capital or credit; they only benefit those who have, at least to some extent, solved that problem."[228] Entrepreneurs are generally motivated by the rewards (financial and other) of running their own business and are not dissuaded by the capital gains tax rate on sale. For most entrepreneurs, a capital gains exemption or reduced tax rate "is a subsidy rewarding them for what they would have done anyway, rather than an incentive to do what they

225 Alternatively, the Act could be amended to permit individuals to defer capital gains arising on the disposition of a qualified small business investment to the extent that the proceeds are reinvested in another qualified investment within a prescribed time period (similar to the rollover in subsection 44(1) for former business properties). A similar proposal was made by the Standing Committee on Industry, supra footnote 1.

226 Industry Canada, *Financing the New Economy: Towards a Positive Conspiracy* (Ottawa: Industry Canada, 1994). See also Carragher and Kelly, supra footnote 199, who suggest that Canada should lower the capital gains tax rate on investors in small business to 20 percent to promote venture capital investment.

227 See generally Rick Krever and Neil Brooks, *A Capital Gains Tax for New Zealand* (Wellington, NZ: Victoria University Press for the Institute of Policy Studies, 1990), 77-86, particularly 82-86. For a more colourful discussion of the preferential tax treatment of capital gains, see Louis Eisenstein, *The Ideologies of Taxation* (New York: Ronald Press, 1961), 93-105. For a review of recent US debates on capital gains tax reductions, see John W. Lee, "Critique of Current Congressional Capital Gains Contentions" (Summer 1995), 15 *Virginia Tax Review* 1-88.

228 Ontario, *Fair Taxation in a Changing World: Report of the Ontario Fair Tax Commission* (Toronto: University of Toronto Press, 1993), 349. In the US context, see J. Andrew Hoerner, "Capital Gains Cut Would Help Small Business—Or Would It?" (November 6, 1989), 45 *Tax Notes* 658-59.

otherwise would not have done."[229] As for other investors (that is, venture capitalists), there is little evidence to demonstrate that a reduction in the rate of tax on capital gains would result in increased investment.[230]

Registered Pension Plans

Registered pension plans (RPPs)[231] are the second-largest pool of capital in Canada. As discussed earlier, the federal government attempted in the 1985 budget to promote greater venture capital investment by RPPs. Despite some early success in this respect, RPPs largely abandoned venture capital during the recession of the early 1990s and have been very slow to return.[232] In a recent survey of members of the Pension Investment Association of Canada (PIAC), a number of "barriers" were identified that inhibit pension fund involvement in venture capital investment.[233] Six of these barriers were rated as important or very important by two-thirds to three-quarters of respondents:

1) investment is management-intensive and costly;
2) there are not enough qualified investment specialists;
3) there is a lack of critical market information;
4) returns are inadequate and unreliable;
5) it is difficult to measure long-term performance; and
6) there is the potential for high-profile failures.

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229 Lee, supra footnote 227, at 86.

230 Carragher and Kelly, supra footnote 199, at 24, suggested that the reduction of the US capital gains tax rate from 49.5 percent to 28 percent in 1978 "resulted in a tenfold increase in capital commitments over the previous year," while the further reduction to 20 percent in 1981 created "a twofold increase in venture capital commitments." However, a 1985 US Congressional Budget Office report "found (a) that the growth in the US venture capital industry was well underway before the 1978 capital gains tax cut took effect (following a rapid surge in demand for high-technology electronic products in the mid-seventies), and (b) that almost all of the increase in venture capital investment after 1978 came from tax-exempt pension funds and other entities that were unaffected by the tax changes": Krever and Brooks, supra footnote 227, at 83, citing United States, Congressional Budget Office, *Federal Financial Support for High-Technology Industries* (Washington, DC: Congressional Budget Office, 1985).

231 RPPs are discussed as a tax expenditure alternative because they and their contributors (employers and employees) benefit from significant tax incentives, even though RPPs are generally not designed to encourage investment in SMEs.

232 See supra footnotes 31 and 32 and corresponding text.

233 Canadian Labour Market and Productivity Centre, "Barriers to Pension Participation in Private Capital Markets that Supply New and Developing SME: A Survey of PIAC Members." The results of this survey were presented at the PIAC annual conference in April 1998: Kirk Falconer, "Pension Barriers to Financing Small and Medium-Sized Business in Canada," notes for a presentation to the Pension Investment Association of Canada, April 1998 (unpublished). It is anticipated that Canadian Labour Market and Productivity Centre's report will be published in the summer of 1998.

In addition, small and medium-sized funds (below $1 billion) indicated that they faced a "critical mass" barrier; that is, they lacked the "capability to diversify assets towards non-traditional investment."[234] Although not specifically mentioned, perhaps the competition of LSVCCs also has slowed the return of pension funds to venture capital investment.

It is unlikely that carrots such as those offered in the 1985 federal budget will lure back pension fund investment. Solutions must address the inefficiencies—primarily, lack of information and lack of expertise—in the equity capital markets.

Direct Expenditure Alternatives

Canada Investment Fund

During the 1993 federal election campaign, the Liberal party promised to invest $100 million in SMEs through the newly established Canada Investment Fund (CIF). The CIF was premised on the notion that the private venture capital market was too cautious and too short-sighted to undertake long-term high-risk investments. However, the CIF was widely rejected by witnesses who appeared before the Standing Committee on Industry.[235] It was generally felt that the federal government should not act as an equity investment partner in a venture capital pool.[236] Rather, it should use the promised CIF money to subsidize local and expert investment groups capable of raising venture capital from other institutional sources.

Business Development Bank of Canada

For a number of reasons, equity capital may be an unsuitable form of capital for many small private companies.[237] However, government incentives designed to stimulate small business financing have been almost exclusively aimed at encouraging equity capital. One government program that does provide debt financing to SMEs is the Business Development Bank of Canada (BDC). Generally, the BDC is a complementary lender to small SMEs.

The objectives of the BDC are to promote and assist in the establishment and development of business enterprises in Canada, giving particular

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[234] Falconer, supra footnote 233, at paragraph 11.

[235] Standing Committee on Industry, supra footnote 1, at 59.

[236] Direct expenditure through a vehicle such as the CIF may well place public funds in peril. The more cautious approach of venture capitalists stems from the losses that they incurred in the 1980s on bio-technology, computer software, and electronics investments. It would be better if equity investment decisions were made by private market actors that are farther up the "learning curve."

[237] By raising equity capital, the owner of a small business is forced to sell an interest in the business. Resulting co-ownership may result in conflicts of interest within the ownership structure since the objectives of the owner-operator may differ significantly from those of the venture capital equity holder. Furthermore, debt financing may be more attractive to small businesses because the interest paid on borrowed money is deductible.

attention to the needs of small businesses, especially those in the emerging and exporting markets.[238] The BDC offers a range of financial assistance to SMEs, including term loans to borrowers that have been turned down or offered loans with onerous terms by other financial institutions, and venture capital investments of up to $5 million.[239] The BDC has been one of only a handful of formal institutional sources of capital willing to entertain investments of less than $500,000 and to consider other factors in addition to security-based formulas in making lending decisions. As of March 31, 1994, the BDC (then the Federal Business Development Bank [FBDB])[240] had almost $3 billion in outstanding loans and guarantees to 13,732 customers, at an average amount of $216,000.[241]

The BDC's usefulness as a vehicle for promoting the growth of SMEs has, however, been hampered. Between 1980 and 1984, the FBDB lost $300 million in bad debts.[242] Consequently, in 1984, the federal government mandated that the FBDB break even each year; the bank subsequently made fewer small loans. In 1994, 37 percent of the FBDB's total lending was for amounts in excess of $500,000.[243] Only 11 percent of its lending was for amounts of less than $100,000.[244]

The BDC should be evaluated as a complement to the LSVCC tax expenditure. Instead of a reversal of the 1996 budget changes, perhaps funding to the BDC should be increased, particularly if the government perceives a particular need to target small businesses. There are two principal advantages to increasing the funding of the BDC.[245] First, the BDC provides SMEs with debt financing, which may be more desirable than equity financing to many small business owner-operators.[246] Second, the BDC

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238 Section 4 of the Business Development Bank of Canada Act, SC 1995, c. 28.

239 The venture capital investments may take the form of equity or debt financing. The BDC offers both venture loans, which combine the characteristics of term loans and venture capital, and more traditional equity venture capital.

240 As a consequence of section 3(1) of the Business Development Bank of Canada Act, effective July 13, 1995, the FBDB was continued under the name BDC.

241 Standing Committee on Industry, supra footnote 1, at 28.

242 Ibid.

243 Ibid., at 30.

244 Ibid.

245 Any potential disadvantages associated with the BDC also must be evaluated. For example, Carragher and Kelly, supra footnote 199, at 30, suggest that government programs to assist small business, such as the BDC, are highly inefficient and costly for two reasons: "Government program administrators have no personal incentive to fund companies with the best chances of success, and funding is provided without extensive industry due diligence or expert opinion."

246 In this respect, a distinction must be drawn between different types of SMEs. Some SMEs, referred to as "rapid growth" or "high growth" companies, require substantial equity capital to fund growth. For these companies, retained earnings that can be reinvested in the expanding business are preferable to interest deductions that significantly reduce retained earnings. For these SMEs, debt financing is inappropriate because of its impact on cash flow.

may be a better vehicle for ensuring that smaller businesses have access to financing. The best way to promote the development of smaller businesses—something that the LSVCC tax expenditure has generally failed to do—may be to increase the availability of debt financing.[247] A common difficulty faced by small businesses, particularly those in the knowledge-based information and technology economy, is the inability to provide the security required by traditional financial institutions. The BDC could provide early-stage financing to businesses whose primary assets include hard-to-value assets such as intellectual property.

Non-Expenditure Alternatives

Alternatives that provide financing for SMEs but do not involve government expenditure are obviously attractive. Three possible sources of capital are considered below: junior capital pools (JCPs) similar to those developed in Alberta, an expanded over-the-counter (OTC) market, and the private financial services industry. As stated earlier, one of the biggest obstacles facing SMEs that require expansion capital is access to public equity markets, both as a source of expansion capital and as an appropriate exit vehicle to others who provide expansion capital. Methods that improve access to public equity markets—such as the first two alternatives discussed below—should be given primary consideration.

JCPs[248]

JCPs are a source of expansion financing widely used in Alberta. JCPs allow SMEs access to public equity markets in the face of otherwise prohibitive costs.[249] JCPs are a creation of the Alberta Stock Exchange (ASE).[250] Investors establish a JCP by raising at least $100,000 of seed capital[251] through a subscription for shares. The JCP then raises additional

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[247] For example, one of the financial products offered by the BDC is patient capital. The patient capital product provides SMEs with long-term financing (generally up to $250,000) without diluting ownership.

[248] For a more comprehensive discussion of JCPs, see Michael J. Robinson, "Raising Equity Capital for Small and Medium-Sized Enterprises," in *Financing Growth in Canada*, supra footnote 185, 593-636.

[249] The objective of the JCP program has been stated as follows: "The Junior Capital Pool concept is designed to provide junior start up companies with an enhanced opportunity to become listed on the Alberta Stock Exchange thereby providing a viable and efficient mechanism to enable junior companies to raise further equity capital from the investing public." Alberta Stock Exchange, "Junior Capital Pool Companies," *Circular* no. 7, amended August 6, 1993, paragraph 1.1 (reproduced in CCH, *Canadian Securities Law Reporter*, vol. 5 (Toronto: CCH Canadian) (looseleaf), paragraph 710-007.

[250] The JCP program was initiated in November 1986 after public hearings examined the performance of a series of blind pools that had been introduced in Alberta in the first part of that year. Those blind pools were modelled on blind pool programs implemented in the United States in the early 1980s to assist startup firms in raising equity.

[251] The seed capital requirement has been increased four times: initially, it was $30,000; it was subsequently increased to $50,000, $75,000, and most recently $100,000.

equity capital through an initial public offering (IPO) of shares. The public invests on the basis that the funds will be used to buy an asset that will convert the JCP from an investment vehicle into an operating corporation. Traditionally, these assets have been oil and gas wells or mines, but there is no limitation on the nature of the asset. The critical feature of the JCP program is that the prospectus requirements for a JCP IPO are less onerous than those of a regular IPO. Generally, the JCP is required only to identify the seed capital purchasers and the line of business in which the JCP will pursue asset acquisitions. A JCP listing is transitory. The JCP has 18 months in which to complete a major transaction that will change the company from a JCP to a regularly listed ASE firm. The major transaction involves the acquisition of a Canadian-held asset worth at least $400,000 or an existing company. Essentially, the JCP program reduces the regulatory cost and burden of accessing the public equity markets.

The Alberta JCP program appears to have been successful in allowing small startup companies to become listed, thereby making it easier for them to access equity capital to finance their expansion and development.[252] Most important, the program does not involve any government expenditure apart from the costs of regulation. While the JCP program might not be exportable in its current form,[253] it suggests that high government expenditure may not be necessary to promote and develop SMEs. Programs that facilitate the entry of SMEs into the public equity markets may be more appropriate; they may be less expensive, and they may overcome the financing obstacles that smaller businesses, particularly rapid growth companies, have traditionally encountered when seeking capital from conventional sources.

Expanded OTC Market

Another possibility for increasing the access of SMEs to public equity markets is the development of a Canadian quotation service similar to NASDAQ in the United States. The Canadian unlisted exchange (the OTC market) is unsatisfactory because of its limited size and dependence on market makers. A quotation service that allows SMEs to locate investors and disseminate information cost-effectively would help to ensure that SMEs are able to acquire adequate venture capital financing.

Financial Institutions

Recently, the major Canadian banks have begun to focus on the small-company sector as an important client base. Banks are now making more

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[252] From an initial capital base of just under $77 million, JCP firms have raised $475 million in equity since the program was initiated: Robinson, supra footnote 249, at 616.

[253] The JCP program is a local program. As a consequence, underwriters and regulators are able to learn much about prospective JCP issuers before a JCP is listed. This close monitoring has helped to ensure that the JCPs that do come to market have strong management teams and a good chance of success. Whether similar success could be ensured in a program in Ontario or Quebec is uncertain.

business loans under $1 million, and financing opportunities for small businesses appear to be improving.[254] As of September 30, 1996, the Royal Bank had committed $11.3 billion in loans of less than $1 million to small businesses, up more than $2 billion from the previous year.[255] A similar trend is evident in the other major banks.

In addition, US lending institutions have begun to enter the Canadian marketplace. US lenders such as Wells Fargo, and other non-traditional US lenders such as GE Capital and AT&T Capital, have shown a willingness to offer loans to small Canadian businesses, though typically at higher rates because they are backed by less security.[256] Whether or not this trend is simply a fad—a result of the current economic boom in the United States—is unclear. These lenders may abandon venture capital financing in the event of an economic downturn.

Summary

The government should carefully consider whether any reversal of the 1996 budget measures is warranted. More important, in our view, the government should also consider whether the size of the LSVCC tax expenditure is justifiable. Perhaps LSVCCs are a short-term solution to correct deficiencies in the equity capital markets. Perhaps they will generate greater expertise in Canada's venture capital industry; perhaps, too, their success will stimulate greater investment in unsheltered venture capital pools. However, long-term solutions must address the causes of market failures rather than their symptoms.

254 "Do Banks Believe in Small Business?" *The Globe and Mail*, April 28, 1997.

255 Ibid.

256 Ibid.

APPENDIX

Summary of the Federal and Provincial Labour-Sponsored Venture Capital Corporation Regimes

Jurisdiction	Federal	British Columbia	Saskatchewan	Manitoba	Ontario	Quebec	New Brunswick	Nova Scotia
Governing legislation	Part X.3, Income Tax Act	Part 2 of the Employee Investment Act, RSBC 1996, c. 112, as amended	Labour-sponsored Venture Capital Corporations Act, SS, c. L-0.2	Labour Sponsored Venture Capital Corporations Act, CCSM, c. L12	Part III of the Community Small Business Investment Funds Act, SO 1992, c. 18, as amended (the former title of the statute, the Labour Sponsored Venture Capital Corporations Act, was replaced by SO, 1997, c. 43, sch. C., s. 1)	1) Act To Establish the Fonds de solidarité des travailleurs du Québec, RSQ F-3.2.1 2) Act To Establish Fondaction, le Fonds de développement de la Confédération des syndicats nationaux pour la coopération et l'emploi, RSQ F-3.1.2	An Act Respecting the Workers Investment Fund Inc., NBA 1994, c. 111 New Brunswick Income Tax Act, SNB, c. I-2, s. 2.3	Parts II and III of the Equity Tax Credit Act, SNS 1993, c. 3, as amended

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Appendix Continued

Jurisdiction	Federal	British Columbia	Saskatchewan	Manitoba	Ontario	Quebec	New Brunswick	Nova Scotia
Objectives of LSVCC legislation	Assist in the development of SMEs and create, maintain, and protect jobs	Invest in SMEs and educate employees in economic matters	Same as federal	Same as federal, plus investment criteria must consider employment practices, workplace safety, environmental and economic sustainability, and diversification in terms of industry sector, income, growth, and risk	Same as federal	1) Same as federal, plus promote training of workers in economic matters; stimulate Quebec economy by making strategic investments that benefit Quebec workers and enterprises; encourage investment by workers 2) Same as federal plus encourage investment by workers; develop management skills of workers in worker-controlled enterprises; encourage conformity with environmental laws and development of environmental policies	With respect to Workers Investment Fund, invest in SMEs to earn income, promote and maintain capital retention, job creation, job retention, economic stability, and awareness and involvement of workers in economic matters With respect to other prescribed LSVCCs, none specified	Invest in SMEs to create and maintain employment

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Appendix Continued

Jurisdiction	Federal	British Columbia	Saskatchewan	Manitoba	Ontario	Quebec	New Brunswick	Nova Scotia
Number of LSVCCs permitted	Unlimited	Unlimited (currently one registered: Working Opportunity Fund)	Unlimited (new registrations may be denied if annual tax expenditure exceeds $5 million)	Unlimited (currently two registered)	Unlimited	1) FSTQ 2) Fondaction	Unlimited (currently four prescribed, including Workers Investment Fund)	Unlimited (currently four prescribed)
Sponsoring organization	Trade union that represents employees in more than one province	Trade union, association or federation of trade unions, a corporation owned and controlled by one or more trade unions or associations or federations of trade unions, or a certified employee group	Trade union under the Trade Union Act	An employee organization	Trade union, association or federation of trade unions, or association or federation of worker representatives	1) Fédération des travailleurs du Québec (FTQ) 2) Confédération des syndicats nationaux (CSN)	With respect to the Workers Investment Fund, the New Brunswick Federation of Labour	For provincially registered funds, a trade union as defined in the Trade Union Act; otherwise, same as federal
Board of directors	At least ½ appointed by sponsoring organization	No specific provisions in legislation Articles of Working Opportunity Fund provide that the majority of its board must be elected by labour sponsor	At least ½ appointed by sponsoring organization	At least ½ appointed by the sponsoring organization	Majority elected by labour sponsor	1) 10 of 16 appointed by FTQ 2) 4 of 11 chosen by sponsoring organization, 2 by other union	Same as federal	For provincially registered funds, at least ½ appointed by sponsoring organization; otherwise, same as federal

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Appendix Continued

Jurisdiction	Federal	British Columbia	Saskatchewan	Manitoba	Ontario	Quebec	New Brunswick	Nova Scotia
Tax benefit	15% tax credit; maximum annual credit of $525	15% tax credit; maximum annual credit $2,000 (corresponding to investment of $13,333) ; maximum lifetime credit of $10,000 The maximum credits apply to shares acquired in employee venture capital plans (LSVCCs) and employee share ownership plans	Same as federal	Same as federal	Same as federal	Same as federal	Same as federal	Same as federal
Holding period	Eight years (previously five years)	Same as federal	Same as federal	Eight years (previously seven years)	Same as federal	Until retirement age (generally 65)	Same as federal	Same as federal
Cooling-off period	Three years (if any shares redeemed)	Two years (only to extent of credit on shares redeemed)	Same as federal	Same as federal	Same as federal	na	None	None
Capital-raising limits	None	$40 million annually	$10 million annually; $35 million aggregate	$60 million annually (in the aggregate)	None	None	None	Aggregate credits cannot exceed $5 million

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Appendix Continued

Jurisdiction	Federal	British Columbia	Saskatchewan	Manitoba	Ontario	Quebec	New Brunswick	Nova Scotia
Eligible investments	SME (no more than 500 employees and $50 million in assets); at least 50% of employees employed in Canada and at least 50% of salaries attributed to services rendered in Canada	SME paying at least 50% of salaries to employees regularly in the province, with less than $50 million in assets (some secondary market purchases are permitted)	SME with fewer than 300 employees in Saskatchewan	Same as federal except that at least 25% of investments must be for $1 million or less	SME as defined in federal legislation; at least 50% of salaries/wages paid to employees from a place of employment in Ontario; at least 50% of employees engaged in eligible activities carried on in Ontario	1) SME with less than $50 million in assets and not more than $20 million net assets; majority of employees resident in Quebec 2) SME with less than $100 million in assets and not more than $40 million net assets; majority of employees resident in Quebec; mainly worker-controlled enterprises, enterprises where workers have greater control over their work, environmentally concerned enterprises	Same as federal	SMEs as defined in federal legislation; at least 25% of salaries must be paid in province

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Appendix Concluded

Jurisdiction	Federal	British Columbia	Saskatchewan	Manitoba	Ontario	Quebec	New Brunswick	Nova Scotia
Investment requirements[a]	60% of capital accumulated by year-end must be invested in the following year	80% of capital within 3 years of time it was raised	35% of capital must be invested during first 2 years; after 2 years, 60% must be invested	20% of shareholders' equity within first year; 40% within second; 60% within third year; 75% once shareholders' equity exceeds $10 million	50% of capital raised during first 60 days of year and after first 60 days of the preceding year by end of the year; 70% by the end of the following year; at least 10% of above amounts must be invested in "small businesses" (total assets not more than $5 million and total employees not more than 50); no more than 15% may be invested in reporting issuers	1) 60% of the previous year's average net assets 2) Same as 1 but must also invest ⅔ in enterprises with less than $50 million in total assets and not more than $20 million in net assets 1) and 2) No more than 20% of net assets of fund at end of previous year may be invested in secondary market purchases	Same as federal	60% of equity raised in province must be invested in province
Consequences of failure to meet investment requirements	20% deficiency tax and penalties; registration may be revoked	Registration may be suspended or revoked	Registration may be revoked; tax credits repaid	Registration may be suspended or revoked	15% deficiency tax (refundable); registration may be revoked	Restriction on subsequent capital raising	None specified	Certificate of eligibility may be revoked

[a] Some regimes (for example, the federal, Manitoba, and Nova Scotia) have relaxed investment requirements during an initial startup period of the fund. This table does not list these relaxed investment requirements.