Stretching Your R&D Budget Through Partnerships and Alliances

Tuesday, October 20, 2009

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Stretching Your R&D Budget Through Partnerships and Alliances

Tuesday, October 20, 2009
7:30 a.m. – 11:00 a.m.

Agenda

7:30 AM – 8:00 AM	Registration and Networking
8:00 AM – 8:10 AM	CONNECT Welcome: Bethany Kraynack, Program Director, CONNECT Opening Remarks: Sean Barr, Consul & Trade Commissioner, Consulate of Canada
8:10 AM – 9:10 AM	Canada's Research & Development Tax Credit Program and Additional Incentives Martin Vezina, Tax Partner, Deloitte & Touche (Montreal) Bruce McCarley, Partner, Deloitte & Touche (Toronto)
9:10 AM – 9:45 AM	San Diego Case Study: Ambit BioSciences Scott Salka, CEO
9:45 AM – 10:00 AM	Break
10:00 AM – 11:00 AM	Corporate Structuring John Hiscock, Partner, Gowlings Lafleur Henderson (Waterloo)
11:00 AM	Closing

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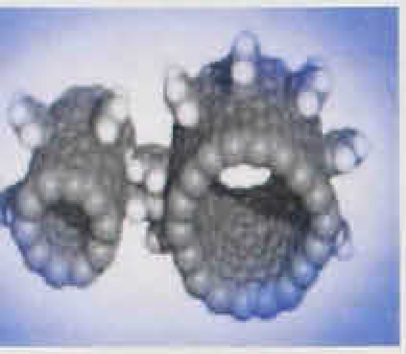

Innovation, entrepreneurship and a dynamic economy are on Canada's mind. To prove it, Canada has one of the most favourable tax treatments for scientific research and experimental development (SR&ED) expenditures in the world.

Canada's SR&ED Program

Generally, in addition to tax deductions for SR&ED expenditures, a tax credit is also available based on qualifying SR&ED expenditures carried out in Canada.

Small Canadian-controlled private corporations (CCPCs), with taxable income of up to $300,000 and taxable capital of up to $10 million, can receive a refundable tax credit of 35% of qualifying current and capital SR&ED expenditures, to a maximum of $2 million of expenditures per year. Over the $2 million SR&ED expenditure threshold, the credit rate is reduced to 20%, of which 40% may be refundable.

Most other Canadian corporations, proprietorships, partnerships and trusts can receive a non-refundable tax credit of 20% of qualifying SR&ED expenditures. (See Table 1)

To top all of this off, various provinces have their own additional tax incentive programs (ranging from a 10% to 35% credit) for SR&ED activities carried out in their respective provinces. (See Table 2)

Two alternatives are available in calculating qualifying SR&ED expenditures. The traditional method allows specific identification of direct and overhead SR&ED expenditures. The proxy method alleviates the burden of identifying actual SR&ED overhead costs by allowing a proxy amount for overhead expenditures to be calculated based on a maximum of 65% of direct SR&ED salaries and wages.

The benefits of doing SR&ED in Canada are numerous. A refundable tax credit represents a reinjection of cash back into a company, which in turn can be used for sustaining future SR&ED activities. The potential exceeds $700,000 of tax refund per year. A non-refundable tax credit can be used to offset Canadian federal taxes payable in the current year, in the previous three years, and/or in the next 10 years. Furthermore, the company can choose not to deduct its SR&ED expenditures in the current year, and these expenditures can be carried forward indefinitely to reduce income in any future year.

Other benefits of carrying out SR&ED activities in Canada include use of favourable exchange rates, access to a world-class infrastructure, a superior workforce, easy access to markets, operations in the same time zones, protection and retention of intellectual property, and lower overall business costs.

How can U.S. companies qualify for the Canadian SR&ED tax benefits?

Through a Canadian subsidiary of a U.S. parent

The Canadian subsidiary can carry out qualifying SR&ED activities in Canada and, through deducting the expenditures and claiming the 20% tax credit, the subsidiary can significantly reduce or even eliminate Canadian taxes payable.

The U.S. parent can contract the Canadian subsidiary to carry out the SR&ED activities on their behalf, in which case the U.S. parent will own the rights to the SR&ED, and the Canadian subsidiary can still make use of the SR&ED tax incentive program.

Through a Canadian-controlled private corporation

A CCPC is a private corporation that is not controlled directly or indirectly by a public corporation, a non-resident, or a combination of the two, and is a resident of Canada. A U.S. corporation can set up a CCPC in Canada so long as it owns 50% or less of the company's shares and the shares do not have any special rights attached to them. Traditionally, non-residents set up CCPCs in Canada by having a Canadian investor such as a venture-capital firm or research institution hold the remaining shares.

Canada

SR&ED carried out by a CCPC is eligible for a refundable tax credit of 35%. Additionally, CCPCs enjoy various other tax advantages, including access to a small business deduction, which results in a reduced income tax rate.

Eligible criteria and activities

For the purpose of the tax program, SR&ED is defined as "systematic investigation or search carried out in a field of science or technology by the means of experiment or analysis." Only SR&ED that is done in Canada qualifies under the program. Claimants can carry out the SR&ED in-house or contract it to a third party to be done on their behalf.

Eligible activities can include experimental development, applied research, basic research, and support work. Activities not eligible for benefits under the SR&ED program include research in the social sciences or humanities; commercial production of a new or improved material, device or product; the commercial use of a new or improved process; style changes; market research or sales promotion; quality control or routine testing of materials, devices, products or processes; routine data collection; and prospecting, exploring, or drilling for or producing minerals, petroleum or natural gas.

For more information on eligible activities, please contact the Canada Revenue Agency (CRA) to ensure that you can qualify for the program. The CRA offers up-front review and preliminary opinion on the eligibility of projects for the SR&ED program.

Table 1:

Illustration of the federal SR&ED program on $5 million of qualified SR&ED expenditures (all figures in C$) (Note that doing SR&ED in a province with its own R&D tax incentive program will considerably increase the amounts shown here):

	Small Canadian-controlled Private Corporations				Large Public or Foreign-controlled Corporations			
	Credit Rate	% Refund	Refundable Tax Credit (Cash Back)	Non-Refundable Tax Credit (Reduce Taxes)	Credit Rate	% Refund	Refundable Tax Credit (Cash Back)	Non-Refundable Tax Credit (Reduce Taxes)
First $2 million in SR&ED expenditures	35%	100%	$700,000	–	20%	–	–	$400,000
Remaining $3 million in SR&ED expenditures	20%	40%	$240,000	$360,000	20%	–	–	$600,000
Total			**$940,000**	**$360,000**			–	**$1,000,000**

Table 2:

Combined Provincial and Federal SR&ED tax credits

	Small Canadian-controlled Private Corporations					Large Public or Foreign-controlled Corporations				
	Provincial Credit		Federal Credit		Combined Credit Rate[1]	Provincial Credit		Federal Credit		Combined Credit Rate[1]
	Rate	Refund?	Rate	Refund?		Rate	Refund?	Rate	Refund?	
Alberta	–	–	35%	Yes	35.00%	–	–	20%	No	20%
British Columbia	10%	Yes	35%	Yes	41.50%	10%	No	20%	No	28%
Manitoba	20%	No	35%	Yes	48.00%	20%	No	20%	No	36%
New Brunswick	15%	Yes	35%	Yes	44.75%	15%	Yes	20%	No	32%
Newfoundland	15%	Yes	35%	Yes	44.75%	15%	Yes	20%	No	32%
Nova Scotia	15%	Yes	35%	Yes	44.75%	15%	Yes	20%	No	32%
Ontario[2]	10%	Yes	35%	Yes	41.50%	–	–	20%	No	20%
Prince Edward Is.	–	–	35%	Yes	35.00%	–	–	20%	No	20%
Quebec[2,3]	37.5%	Yes	35%	Yes	60.94%	17.5%	Yes	20%	No	34%
Saskatchewan	15%	No	35%	Yes	44.75%	15%	No	20%	No	32%

1 In calculating the combined credit, the federal tax credit is reduced by the provincial tax credit receivable.
2 Ontario and Quebec offer additional R&D programs, which are not covered by the scope of this table.
3 In Quebec, only R&D wages are eligible for R&D tax credits, not materials, equipment or overhead.

Additional information on Canada's SR&ED

- CRA's SR&ED Web site: http://www.cra-arc.gc.ca/taxcredit/sred/menu-e.html.
- An introduction to the SR&ED Program: http://www.cra-arc.gc.ca/E/pub/tg/t4052/t4052-04e.pdf
- CRA's SR&ED services and workshops: http://www.cra-arc.gc.ca/taxcredit/sred/services-e.html
- Provincial and territorial governments SR&ED Programs: http://www.cra-arc.gc.ca/taxcredit/sred/prov-e.html

Deloitte.

Stretching your R&D budget through Partnerships and Alliances

CONNECT
San Diego, October 20, 2009

Martin Vézina
Bruce McCarley
Deloitte & Touche LLP

Outline

I. Introduction

- Excellent scientific R&D facilities and academic institutions in Canada
- Many R&D-oriented companies
- Tax incentives among most generous in the world for R&D, particularly for small(ish) businesses
- May find some advantage to consider corporate structure to optimize value of incentives

II. R&D Tax Credits

- Eligible activities
  – Pure or applied research
  – Experimental development
  – Activities in support
- Must submit a technical description outlining
  – Advancement in the research field
  – Uncertainty in the realization of the objective
  – Activities performed

II. R&D Tax Credits (Cont'd)
a) Contract Funded R&D

- R&D activities must be related to the business of the corporation
- Contract payment restrictions
  – From a Canadian source
    - R&D expenditures may be reduced by the amount received
  – From a foreign source
    - R&D expenditures are not reduced by the amount received
- Key questions:
  – Who carries the financial risk if technology solution under development doesn't work?
  – Who owns the IP?
  – Wording of the contract is very important

II. R&D Tax Credits (Cont'd)
b) Federal R&D Tax Credit

- Eligible expenses
  – Labor
  – Subcontracts
  – Material consumed or transformed
  – Equipment rental
  – Overhead
  – Capital expenditures

II. R&D Tax Credits (Cont'd)
b) Federal R&D Tax Credit (Cont'd)

- Tax credit rates
  - For U.S. controlled corporations
    - 20% non-refundable
  - For Canadian-controlled private corporations ("CCPC")
    - 35% refundable on first $3M of qualifying expenditures
    - 20% partially or non-refundable on excess

II. R&D Tax Credits (Cont'd)
c) Québec R&D Tax Credit

- Tax credit rates
  - For U.S. controlled corporations
    - 17.5% refundable
  - For Canadian controlled corporations
    - 37.5% refundable on first $3M of qualifying expenditures
    - 17.5% refundable on excess
- Qualifying expenditures
  - Salaries and wages
  - 50% of Québec contractors costs

II. R&D Tax Credits (Cont'd)
d) Québec - Precompetitive Research Tax Credit

- Enhanced tax credit rate – 35%
- Also available to U.S. controlled corporations
- Must have a Permanent Establishment in Québec
- Qualified expenditures include:
  - Salaries
  - 80% of contracts costs (arm's length)
  - Materials
  - Overhead (up to 65% of salaries)
  - Equipment rental
  - Capital expenditures

II. R&D Tax Credits (Cont'd)
e) What is Precompetitive Research

- Joint venture agreement between private parties at arm's length
  - Common scientific or technological interest in a research project
    - May aim for different utilization of the technology developed
  - Risks, responsibility and IP sharing
    - Allow parties to reduce their investment to develop the technology
  - Advanced ruling required from the Québec tax authorities for each project

II. R&D Tax Credits (Cont'd)
f) Québec – University Research Tax Credit

- 28% of payments to prescribed entities
  - Universities, research centres etc…
  - Advanced ruling must be obtained from the Québec tax authorities
- Also available for U.S. controlled corporations

II. R&D Tax Credits (Cont'd)
g) Québec Tax Holiday for Foreign Researchers

- 5 years personal tax holiday (under certain conditions) for certain foreign individuals (researchers, experts …) moving and living in Québec
- Deduction in the calculation of the taxable income
  - 100% of the salary or income for year 1 and year 2
  - 75% for year 3
  - 50% for year 4
  - 25% for year 5
  - Equivalent to 70% over 5 years
  - Only applicable to the Québec provincial tax

II. R&D Tax Credits (Cont'd)
h) Ontario R&D Tax Credit

- Tax credit rates
  - For small corporations
    - 10% refundable on first $3M of qualifying expenditures
    - 4.5% non-refundable
  - For large corporations
    - 4.5% non-refundable
- Eligible expenses equivalent to the federal
  - Limited to 40% of capital expenditures (only for the 10% credit)

II. R&D Tax Credits (Cont'd)
i) Ontario Business Research Institutes Tax Credit ("OBRITC")

- 20% refundable tax credit
- Expenditure limit of $20M per year (associated basis)
- Eligible Research Institute
  - A university or college of applied arts and technology in Ontario whose annual operating grant from the government of Ontario is based on enrolment;
  - An Ontario centre of excellence or network of such centres; or
  - A non-profit organization or a hospital research institute that meets the requirements of Ontario regulations

II. R&D Tax Credits (Cont'd)
j) Other Provincial R&D Credits

- Newfoundland and Labrador
  - 15% refundable credit
- Nova Scotia
  - 15% refundable credit
- New Brunswick
  - 15% refundable credit
- Manitoba
  - 20% non-refundable credit
- Saskatchewan
  - 15% non-refundable credit
- Alberta
  - 10% refundable credit (Maximum $400K)
- British Columbia
  - 10% refundable credit for qualifying CCPCs (non-refundable for U.S. controlled corporations)

II. R&D Tax Credits (Cont'd)
k) Example

- 20 eligible employees @ $50K/year
- 100% of their work is related to eligible activities
- Subcontractors: $200,000
- Equipment: $100,000
- Overhead: $650,000
- Total expenditures of $1,950,000

II. R&D Tax Credits (Cont'd)
k) Example (cont'd)

R&D Tax Credits						
	Federal	Québec	**Total**	Federal	Ontario	**Total**
U.S. Controlled Corporations	$ 351,500	$ 192,500	**$ 544,000**	$ 372,450	$ 87,750	**$ 460,200**
CCPC	$ 538,125	$ 412,500	**$ 950,625**	$ 585,638	$ 276,750	**$ 862,388**

- Savings between 24% and 28% for a U.S. controlled corporation
- Savings between 44% and 49% for a CCPC

II. R&D Tax Credits (Cont'd)
k) Example (cont'd)

Detailed calculation (U.S. Controlled Corporations)			
	Federal	Québec	Total
Salaries	$ 1,000,000	$ 1,000,000	
Overhead	650,000*		
Subcontracts	200,000	100,000**	
Equipment	100,000		
Québec R&D tax credit	(192,500)		
	$ 1,757,500	$ 1,100,000	
Federal tax credit @ 20% and Québec tax credit @ 17.5%	$ 351,500	$ 192,500	$ 544,000

* Proxy method used, represents 65% of salaries
**Only 50% of the subcontractors are eligible costs for the Québec tax credit.

II. R&D Tax Credits (Cont'd)
k) Example (cont'd)

Detailed calculation (U.S. Controlled Corporations)			
	Federal	Ontario	Total
Salaries	$ 1,000,000	$ 1,000,000	
Overhead	650,000*	650,000*	
Subcontracts	200,000	200,000	
Equipment	100,000	100,000	
Ontario R&D tax credit	(87,750)		
	$ 1,862,250	$ 1,950,000	
Federal tax credit @ 20% and Ontario tax Credit @ 4.5%	$ 372,450	$ 87,750	$ 460,200

*Proxy method used, represents 65% of salaries

II. R&D Tax Credits (Cont'd)
l) U.S. Example

- 20 eligible employees @ $50K/year
- 100% of their work is related to eligible activities
- Subcontractors: $200,000
- Supplies: $100,000
- Total expenditures of $1,300,000
- Credit Method: Federal - Alternative Simplified Credit ("ASC")
  California – Regular Credit

Note: Capital Equipment is not a qualified research expenditure

II. R&D Tax Credits (Cont'd)
l) U.S. Example (cont'd)

Year	Qualified Research Expenditures ("QREs")
2008	$1.05M
2007	$1.0M
2006	$950K

Average QREs $1M

Fixed Base % = 16%

Year	Gross Receipts
2008	
2007	
2006	
2005	

Average gross receipts $5M

II. R&D Tax Credits (Cont'd)
l) U.S. Example (cont'd)

U.S. R&D tax credits		
Federal	California	Total
$ 102,200	$ 64,500	$ 166,700

II. R&D Tax Credits (Cont'd)
l) U.S. Example (cont'd)

Detailed calculation Federal – ASC	
Salaries	$ 1,000,000
Subcontracts	130,000
Supplies	100,000
Total QREs	1,230,000
Less 50% avg prior 3 yr QREs	(500,000)
Incremental QREs	730,000
Credit rate	14%
Alternative simplified credit	$ 102,200

II. R&D Tax Credits (Cont'd)
l) U.S. Example (cont'd)

Detailed calculation California – Regular Credit	
QREs	$ 1,230,000
FB%	16%
Avg Prior 4 Yrs GR	5,000,000
Calculated base amount (16% x $5m)	800,000A
50% limitation QREs (50% x $1.23m)	615,000B
Applicable base amount (greater of A&B)	800,000
Incremental QREs ($1.23m - $800k)	430,000
Credit rate	15%
California credit	$ 64,500

II. R&D Tax Credits (Cont'd)
l) U.S. Example (cont'd)

R&D Tax Credits			
	Canada		United States
	Federal & Québec	Federal & Ontario	U.S. Federal & California
U.S. Controlled Corporations	$ 544,000	$ 460,200	$ 166,700
CPCC	$ 950,625	$ 862,388	N/A

II. R&D Tax Credits (Cont'd)
m) Comparison of Canadian & U.S. R&D Incentives

	Canadian SR&ED Credit	U.S. R&E Credit
Volume-Based or Incremental	Volume-Based	Incremental
Base Period/Amount Calculation:	No	Yes
Refundability:	Yes for CCPCs and some provincial incentives	Non-refundable but refundable for some state incentives
Location	R&D must be performed in Canada	R&D must be performed in the U S
Eligible Expenditures	•Wages •100% of contract research •Materials •Overhead	•Wages •65% of contract research expenditures •Supplies
Capital Expenditures	Eligible for credit	Not eligible for credit

II. R&D Tax Credits (Cont'd)
m) Comparison of Canadian & U.S. R&D Incentives

	Canadian SR&ED Credit	U.S. R&E Credit
Unused Credits	Credits can be carried back 3 years or forward 20 years	Credits must be carried back to the previous taxation year or forward to 20 years
Administration	Need to identify all projects being claimed and file technical descriptions for top 20 projects with the return	Taxpayer files tax return and provides documentation upon request during audit
Local Incentives	Available in many provinces	Available in many states
Internal-Use Software Standards	N/A	Additional thresholds of innovation must be demonstrated to qualify

II. R&D Tax Credits (Cont'd)
n) Benefits for Canadian Subsidiaries of U.S. Corporations

- For U.S. tax purposes, the refundable tax credit of a Canadian subsidiary is considered as a grant
  - Does not reduce the income tax paid in Canada for the determination of the U.S. foreign tax credit
- For U.S. GAAP purposes, the refundable credit is booked as an EBIT item

II. R&D Tax Credits (Cont'd)
o) Other Incentives

- Multimedia (Salary and production costs)
  - Québec: 26.25% to 37.5%
  - Ontario: 25% to 30% (proposed rates : 35% - 40%)
- eBusiness (Salary)
  - Québec: 30% maximum $20,000 per employee per year
- Biotechnology Center (Salary and equipment)
  - Québec: 30%

Conclusions

- Canadian R&D tax incentives are significant
- Provinces also offer significant incentives for R&D and other activities
  - Biotech
  - Multimedia
  - eBusiness
  - …

III. Corporate Tax Matters

- General points re Canadian taxation
  - no inter-corporate consolidation within a related group
  - flow through entities
    - Partnerships
    - Limited partnerships
    - Trusts
    - For cross border structures unlimited liability corporations (Nova Scotia British Columbia and Alberta corporations)
  - use of different entities a significant tax planning tool (and potential liability!)

III. Corporate Tax Matters
a) Canada – declining corporate tax rates

Canadian Corporate Tax Rates	Quebec	Ontario	Alberta	B.C.
2009				
Federal	19.0%	19.0%	19.0%	19.0%
Selected Provincial	11.9%	14.0%	10.0%	11.0%
Total Combined Rate	30.9%	33.0%	29.0%	30.0%
Fully Implemented (2013)				
Federal	15.0%	15.0%	15.0%	15.0%
Selected Provincial	11.9%	10.0%*	10.0%	10.0%
Total Combined Rate	26.9%	25.0%	25.0%	25.0%

* This rate is proposed and currently not yet enacted

III. Corporate Tax Matters
a) Canada – declining corporate tax rates

- Comparison with U.S. Federal and California Corporate income tax rates

Corporate Tax Rates	
2009	
U.S. Federal	34%
California	8.84%
Total Combined Rate	**42.84%**

III. Corporate Tax Matters

b) 2009 Federal and Provincial budgets
  - 2009 Federal and Provincial budgets

c) Changes to the Canada U.S. Tax Treaty
  - Rates of withholding taxes
  - Permanent establishment – services
  - Entity classification
  - Limitation on benefits provision

  (Refer to Appendix 6 for details)

d) Indirect taxes
  - Harmonization of Federal and Provincial regimes

  (Refer to Appendix 7 for details)

e) Integration of Federal and Ontario corporate tax regimes

  (Refer to Appendix 8 for details)

IV. Appendix 1
Recent Canadian Tax Developments – 2009 Federal Budget

- For manufacturing and processing equipment, a 50% straight line capital cost allowance ("CCA") rate has been extended for equipment acquired in 2010 and 2011. The half year rule will apply
- The limit of the taxable income phase-out range of the expenditure limit for the enhanced ITC rate of 35% on qualified SR&ED expenditures increases accordingly to between $500,000 and $800,000

IV. Appendix 2
Recent Canadian Tax Developments – 2009 Ontario Budget

- Beginning July 1, 2010, the Ontario Retail Sales Tax will be harmonized with the Federal Goods and Services Tax to create a federally administered single sales tax at a rate of 13%
- Corporate income tax rates will be cut beginning July 1, 2010 from 14% to 12% and further reduced to 10% over the following three years (11.5%, 11% and 10% on July 1 of each subsequent year). In addition, the rate on M&P and resource sectors will decline from 12% to 10%
- Effective June 30, 2010, corporate minimum tax (CMT) will be reduced from 4% to 2.7% and a corporation or an associated group with under $50M in total assets or under $100M in annual gross revenues will not pay CMT

IV. Appendix 2
Recent Canadian Tax Developments – 2009 Ontario Budget (cont'd)

- The Ontario Film and Television Tax Credit enhanced rate of 35% and the Ontario Production Services Tax Credit enhanced rate of 25% will be permanent
- 100% of eligible labor expenses paid to arm's length parties for qualifying expenditures incurred after March 26, 2009 will be allowed for purposes of the Ontario Computer Animation and Special Effects Tax Credit

IV. Appendix 3
Recent Canadian Tax Developments – 2009 B.C. Budget

- The general corporate tax rate of 11% remains unchanged in 2009, however, effective January 1, 2010 the rate will fall to 10.5% and 10% in 2011.
- B.C. Film Tax Credits can now be carried forward indefinitely. In addition, effective January 1, 2009, the requirement to have a corporation that is B.C.-controlled to qualify for this tax credit have been eliminated

IV. Appendix 4
Recent Canadian Tax Developments – 2009 Québec Budget

- A ten-year tax holiday has been introduced for new corporations (not the result of a merger of existing companies) incorporated between March 19, 2009 and April 1, 2014, dedicated to the commercialization of intellectual property developed in Québec universities and Québec public research centres
- Effective for productions beginning after March 19, 2009, the refundable tax credit for the production of shows and the refundable tax credit for the production of sound recordings will be increased from 29 1667% to 35% and the limit on production costs will be increased from 45% to 50%
- As of January 1, 2011, the rate of Québec sales tax will be increased from 7.5% to 8.5%

IV. Appendix 5
Recent Canadian Tax Developments – 2009 Alberta Budget

- A 10% credit on SR&ED expenditures up to $4M for a maximum credit of $400,000, refundable for all companies, for expenditures occurring after January 1, 2009
- Alberta will parallel the recent Federal budget changes related to the enhanced CCA claims

IV. Appendix 6
Canada – U.S. Tax Treaty Protocol

- Fifth Protocol to 1980 Canada-U.S. treaty signed on September 21, 2007
- Protocol contains significant unanticipated changes
- Changes to Article IV (Residence) require review of cross-border structures currently in place
  - Structures involving hybrid entities may be denied benefits when protocol takes effect
- Protocol received Canadian Royal Assent on December 14, 2007
- On September 23, 2008, U S. Senate ratified protocol
- Ratified on December 15, 2008
- Effective in respect of taxes withheld at source on February 1, 2009 and in respect of other taxes for taxation years beginning after December 31, 2009

IV. Appendix 6
Canada – U.S. Tax Treaty Protocol (cont'd)

- Eliminates WHT on non-contingent interest paid to unrelated persons
  - Canadian domestic law change effective January 1 2008
- Phases out WHT on non-contingent interest paid to related persons (10%-7%-4%-0%)
  - Retroactive to January 1 2008
- Eliminates WHT on guarantee fees as of January 1 2008
- Ensures 5% WHT on dividends received by companies through fiscally transparent entities (e.g., partnerships and LLCs)
  - Entity must be fiscally transparent under tax law of home country (e.g U.S. partnership v. Cayman reverse hybrid)
- Changes affecting income earned through or from certain hybrid entities will be effective January 1, 2010
  - Consider reorganizing current structures in 2009 to avoid 25-30% domestic WHT on dividends, interest or royalties

IV. Appendix 6
Canada – U.S. Tax Treaty Protocol (cont'd)

- Eliminates some or all benefits for certain dual resident companies
- Creates a PE for service business after 6 months of presence for one "project" or "connected" project
- "Authorized OECD Approach" to attribution of profits to a PE
- Provides for self-executing mandatory arbitration
- Modifies Article XVIII (Pensions and Annuities)

IV. Appendix 6
Canada – U.S. Tax Treaty Protocol (cont'd)

- Changes to PE Article: Services
- An enterprise of one State providing services in the other State will be deemed to provide them through a PE in the other State (the "Host State") if:
  1. services are performed in the Host State by an individual present in the Host State for an aggregate 183 days in any 12-mo period, and
  2. the revenues from such services are more than 50% of the business' gross active business revenues for those 183 days

  -- or --

  - services are provided in the Host State for an aggregate of 183 days in any 12-month period with respect to the same or connected project for customers who (i) are residents of the Host State, or (ii) maintain a PE in the Host State (if services provided in respect of such PE)
- Applies even if the premises are not under control of the service provider (contrary to Dudney decision in Canada)

IV. Appendix 6
Canada – U.S. Tax Treaty Protocol (cont'd)

- Limitation on Benefits (LOB) Provision
- Canada-U.S. Treaty extends the LOB provision to treaty benefits provided in Canada (previously applied only in respect of benefits granted by the U.S.)
- LOB seeks to prevent "treaty shopping" by residents of 3rd states, requiring that person seeking benefits not only be a Canadian or U.S. resident but also satisfy other tests
- As of February 1, 2009 applies to payments subject to withholding tax and for all other taxes, applies to taxation years commencing after December 31, 2008
- Must be considered in every situation where U.S. resident receives dividends, interest or royalties from a Canadian source or disposes of shares of a Canadian company
- Problem with determining "qualifying person" if a disregarded entity is an LLC, and is in ownership chain above Canada
- Technical Explanation ("TE") to the 2007 Protocol issued by the U.S. Treasury Department provides guidance on interpretation of various articles of the Protocol
  - The Canadian government publicly endorsed the TE and agrees with it

IV. Appendix 6
Canada – U.S. Tax Treaty Protocol (cont'd)

- Effective Dates
- **For withholding taxes:** applies to amounts paid or credited on or after the first day of the second month which begins after entry into force (retroactive for interest and guarantee fees)
- **For other taxes:** applies to taxable years beginning after 2008
- **Special effective dates:** denial of treaty benefits for certain hybrid entity structures and extended PE rule for services deferred (generally January 1, 2010)

IV. Appendix 6
Canada – U.S. Tax Treaty Protocol (cont'd)

Relief for LLCs and other fiscally transparent entities: Article IV(6)

- New Art IV(6) deems a person who is a resident of one State (home country) to have derived income profit or gain where home country tax law treats the amount as derived through a fiscally transparent entity (other than a resident of the source country) and because of fiscal transparency the treatment of the amount is the same under home country tax law as it would be if derived directly by the person
- Will require consultation with foreign advisors in some cases to determine application of foreign tax law
- Application through multiple entities

IV. Appendix 7
Indirect Taxes – Ontario and British Columbia Harmonized Sales Tax Regimes

- Effective July 1, 2010, Ontario and B.C. plan to harmonize their existing retail sales tax with the 5% GST to create a federally administered single sales tax in each province
- In Ontario, combined rate will be 13% and Ontario's portion will be 8%
- In B.C., combined rate will be 12% and B.C.'s portion will be 7%
- Value added tax structure whereby eligible businesses can recover the tax
- Generally, the Ontario and B.C. portion will each use the same rules and base as the GST

IV. Appendix 7
Indirect Taxes – Ontario and British Columbia Harmonized Sales Tax Regimes

- Now is the time to consider and plan for implementation
  - Financial and budgeting
    - Additional costs and cost savings
    - Costing for purchases/sales
  - Contracts
    - Tax excluded vs. tax included
    - Transitional rules pre and post July 1, 2010
  - Systems and compliance processes
    - Correctly invoicing additional tax
    - Capturing additional input tax credits

IV. Appendix 8
Integration of Federal and Ontario Corporate Tax Regimes

- Bill 174 (enacted)
- Federal administration of Ontario corporate taxes
  - Corporate income tax
  - Corporate minimum tax
  - Capital tax
  - Ontario special additional tax (OSAT)
- Adopts federal definition of taxable income and federal administration provisions (results in $90 million annual Ontario corporate income tax cut due to harmonized tax base; up to $100 million annual savings in administrative costs)
- **Harmonized tax returns due for taxation years ending after December 31, 2008**

IV. Appendix 8
Integration of Federal and Ontario Corporate Tax Regimes (cont'd)

- Single point of contact for Ontario and federal corporate tax enquiries
- Transfer of the OMOR audit function to the CRA, i.e. the CRA would conduct CT23 audits, integrated with T2 audits, on behalf of OMOR
- Installment payments only to the CRA for taxation years ending after December 31, 2008
- Harmonized tax return for taxation years ending after December 31,2008
- Will rely on LCT rules for capital tax purposes
  - NBV/UCC differences will no longer be included for investment allowance purposes
- Federal statute barred periods apply (3 years for CCPC's, 4 years for other corporations)
- Consider tax provision implications

IV. Appendix 8
Integration of Federal and Ontario Corporate Tax Regimes (cont'd)

- Taxable income in Ontario will be calculated on the same basis as for federal purposes under the new rules
  - No longer any adjustments specific to Ontario
  - Eliminates the Ontario 5% withholding tax that applied to certain management fee, rent, and royalty payments to non-residents which was previously achieved through the 5/14 add-back
- Convert to Federal balances
  - Effective as at the first moment of the first taxation year that ends after December 31, 2008
  - Compare pools:
    - If federal exceeds Ontario, an Ontario tax payment will be required over a 5 year period commencing with the first taxation year ending after December 31, 2008
    - If Ontario attributes exceed federal, a non-refundable credit arises and can be applied against Ontario income taxes (not capital or CMT) over the 5 year period

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Outline

I. Introduction
II. Business Structures
III. Corporate Governance and Employment Issues
IV. Typical SRED Structure

Canadian Business Facts

- 33 million people
- 50 percent of population resides within 150 kilometre radius of its southern border with the United States
- 75% of exports go to the United States
- English and French are the two official languages
- Fastest rate of growth among G7 countries
- Highly educated workforce and highest computer literacy rates in G7
- Low cost of doing business
- More than Cdn. $12 billion invested in infrastructure
- Immigration policies supportive, strong economy, stable politics

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Business Structures and Applicable Law

- When establishing or acquiring a business in Canada, both federal laws and the laws of the province in which the business is conducted apply
- In Ontario, laws are based on common law (or judge-made law)
- In Quebec, the legal system is based on French civil law
- Laws governing how one carries on business are very similar to those found in the United States

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Choice of Business Structures

- Like the United States, Canada has a wide variety of legal structures that can be used to carry on business
- Selection or type of structure will depend upon nature of business activity, the type of financing, tax issues and potential liabilities associated with the type of business
- <u>Issues to consider include</u>:
  - ➢ the treatment of Canadian business income for tax purposes in the United States;
  - ➢ the need to isolate assets of the principal business from claims arising out of the Canadian business;
  - ➢ the criteria for availability of federal, provincial and municipal incentives
  - ➢ other Canadian tax considerations

Partnership

- A partnership is not a separate legal entity but a relationship that exists between the parties who carry on business in common with a view to profit
- Partners share in profits, losses and net proceeds on dissolution
- Most significant advantage is that flow through losses to its partners that may, subject to certain rules in the *Income Tax Act* (Canada), be used as deductions against the partners' other income
- Most significant disadvantage is that each partner is personally liable for the liabilities of the partnership and, therefore, personal assets are exposed

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Limited Partnership

- Limited partnerships can be used to limit this exposure
- A limited partnership's liability is limited to the extent of its investments in the limited partnership as long as the limited partner has a passive role in the business and governance of the limited partnership
- The business and governance are typically assumed by the general partner
- Limited access to federal credits and no access to certain provincial tax credits

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The Corporation – Structure of Choice

- If establishing a Canadian structure, typically would be a corporation with share capital
- Unlike many legal structures, the corporation is a legal entity separate from its owners
- The liabilities of the corporation are not the liabilities of the shareholders and are typically limited to the value of the assets a shareholder has invested to acquire its shareholdings
- It's the necessary structure for CCPC status

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Corporations – Practical Considerations

- Select jurisdiction of incorporation - federal or provincial
- Residency of Directors
  - Federal and Ontario jurisdictions require 25% of corporation's directors to be "resident Canadians" - individuals residing in Canada who are either Canadian citizens or Canadian permanent residents
  - Quebec has no residency requirements
  - Subject to liability relating to the environmental, tax, securities, pensions and employment

Corporate Governance - Restricting Power of Directors

- Power of directors can be limited by a unanimous shareholder agreement
- To the extent the powers of the directors are limited, the liability and obligation of the directors are transferred to the shareholders
- Restricting director power may affect CCPC status

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Corporate Governance - Disclosure Requirements

- Generally, there is no requirement to file the corporation's financial statements with a government body (except in the case of a public company)
- In most cases, the shareholders of a corporation can consent to waive the requirement for audited financial statements (except for public companies)
- The identity of the Canadian corporation's shareholders are not a matter of public record
- The identity of directors and officers are a matter of public record

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Corporate Governance - Meeting Requirements

- As a general rule, meetings of directors need not take place in Canada and, in many cases, the same is true for shareholder meetings
- Meetings may typically be held by telephone conference or other electronic means
- Written resolutions (similar to a written consent) may be signed rather than holding meetings to approve matters

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Employment Law Issues

- Concept of "at will" employment is foreign to Canada
- Canadian law requires that "reasonable notice" be provided (or pay in lieu of such notice) if terminated without "cause"
- Usually Canadian employment agreements state that employee is entitled to at least the notice period provided in the applicable provincial legislation
- The legislated minimum notice period represents a floor (not a ceiling) on notice periods

Typical SRED Structures

- Notable features of corporate structures to maximize tax incentives
  - ➢ Preserve Canadian-controlled private corporation ("CCPC") status:
    - Only CCPCs eligible for enhanced ITCs
    - No control in <u>law</u> (*de juris* control):
      - Max. 50% voting shares held by non-residents and public corporations
      - Must count rights to acquire voting rights and voting shares
    - No control in <u>fact</u> (*de facto* control):
      - Restricted use of vetos to protect non-resident
      - Independent board of directors
    - Not a public corporation

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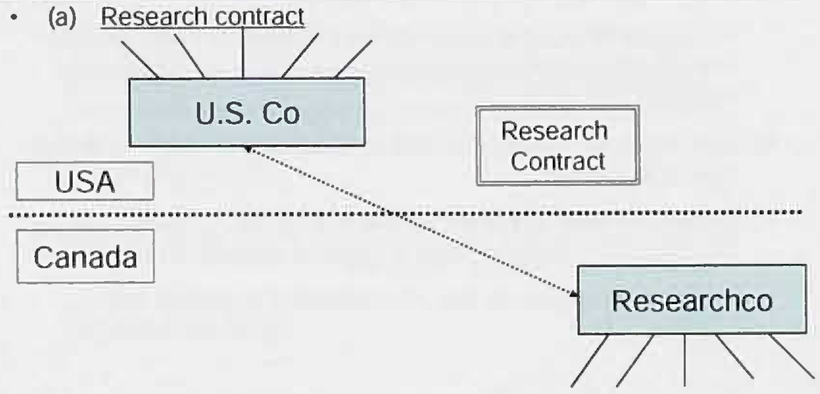
Typical Structures (cont'd)

- (a) <u>Research contract</u>



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Typical Structures (cont'd)

- Arm's length contract
- Researchco may contract with arm's length non-resident to perform SRED in Canada on behalf of the non-resident, non-resident may own resulting technology
- Therefore, Researchco that is a CCPC may enjoy full benefit of refundable ITCs at the enhanced 35% rate (plus applicable provincial incentives)
- Pricing = cost plus (after refundable tax credit) (or some variant)
- U.S. Co owns IP generated from research for all markets
- U.S. Co must not carry on business through a permanent establishment in Canada

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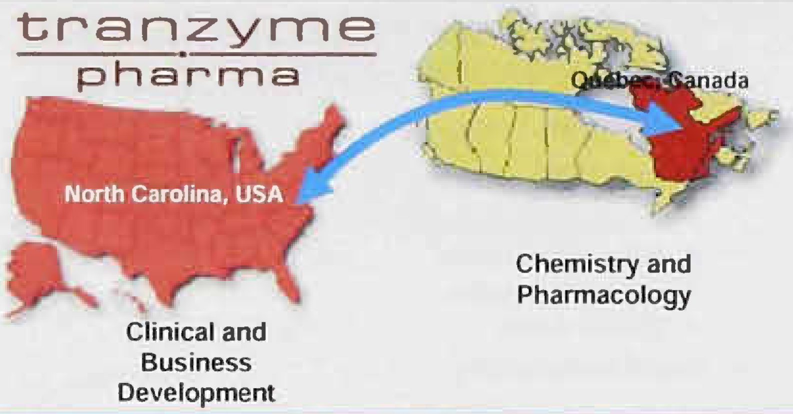
Typical Structures (cont'd)

- Possibilities for investments in Canada
  - CCPC status may be maintained for investments made in a Canadian entity (existing or new entity)
    - Contract research
  - Possibility to have key employees moving to Canada
  - Control in law and in fact must not be held by non-resident Canadians or public corporations



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Legacy Companies

- Tranzyme, Inc. (Delaware Corporation)
  - Proprietary biology technology
  - Experienced drug development team
  - Business development experience
  - Need chemistry, financing
- Neokimia Inc. (Canada Corporation)
  - Proprietary small-molecule chemistry
  - Experienced discovery team
  - Seeking screening capability, development and partnering experience
  - Need financing and liquidity

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Cross Border Synergies

- Canadian Advantages
  - Access to early-stage capital
  - Excellent knowledge & research base
  - Government funding & tax credits
- U.S. Advantages
  - Access to both early-stage and later-stage capital
  - Strong technology & IP development
  - Access to talented management
  - Access to capital markets and liquidity

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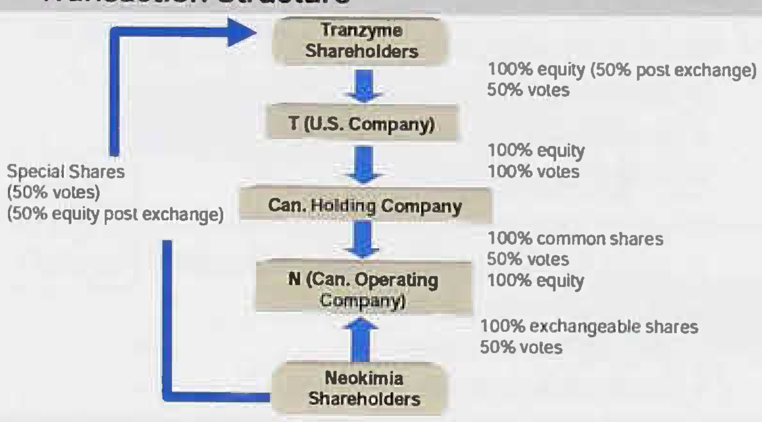
Structural Challenges

- Canadian investor criteria and mandates
- U.S. investor mandate and perspective
- Representative voting
- Maintain CCPC status
  - Access to SR&ED credits
  - Non-resident investors
  - Convertible securities
  - *De facto* control
- Flow of funds flexibility

Meeting the Challenges

- Canadian investment vehicle maintained
- U.S. company to be ultimate parent
- Mirrored voting
- CCPC status achieved

Transaction Structure



Transaction Structure (post-exchange)

Tranzyme Pharma Today

- Clinical stage (Ph IIb) drug discovery and development company
- Raised $32 million in May 2005
- Raised $20 million in November 2007
- No longer maintain CCPC status
- $4 million in non-dilutive SR&ED receipts
- Continuing investment vehicle for Canadian funding
- The Company maintains U.S. and Canadian operations. North Carolina site serves as corporate headquarters and center for business development, clinical development and regulatory activities. Medicinal chemistry, lead optimization and preclinical development activities based in Quebec
- In total, the Company employs 41 people, including 32 in research and development

Conclusion

- The bottom line is that Canada offers a place of opportunity for technology – somewhere that researchers, scientists and industry can find the knowledge, the infrastructure and, most of all, the supportive attitude that fosters success

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Scott Salka
CEO, Ambit Biosciences

M. Scott Salka was a co-founder of one of the first commercial genomics companies, Sequana Therapeutics, Inc. Founded in early 1993, Sequana was a pioneer in the effort to commercialize the international Human Genome Project. As Sequana's Vice President of Operations and Chief Financial Officer, Mr. Salka played key roles in financing the company through private and public stock offerings and in establishing research alliances with Glaxo, Boehringer Mannheim, Boehringer Ingelheim and Parke-Davis. After the sale of Sequana in 1998 and until joining Ambit in January 2001, Mr. Salka served as the President and Chief Executive Officer of two privately-held genomics companies, Arcaris, Inc., and 454 Corporation. Previously, Mr. Salka held various management positions at Burroughs Corporation, Unisys Corporation, and The BFGoodrich Company. He also served honorably in the United States Army's Special Forces as an advisor to several Central American governments on matters of internal defense. Mr. Salka received his B.S. in Finance from San Diego State University and his M.B.A. from Carnegie Mellon University.

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START-UP ACCOUNTING & TAXES • Budgeting & spreadsheets • Financial infrastructure • Projecting start-up and development costs • Reporting and controls	**TERMINOLOGY:** Pro Forma, EBITA, GAAP, Ratios, ROI, Valuation, Sarbanes Oxley, Balance sheet, Cash flow, Margins, Burn rate...
GETTING STARTED LEGALLY • Legal issues of business formation • Boards of directors and advisors • Planning basics & terminology	**TERMINOLOGY:** C-Corp, S-Corp, LLCs, Equity, Exits, Pro Forma, Milestones, Capital formation, Executive summary, Beta customers...
ESSENTIAL EMPLOYMENT LAW • Overview of legal issues and compliance • Basic labor & employment agreements • Management issues and red flags • Compliance and regulations • Insurance and risk management	**TERMINOLOGY:** EEOC, OSHA, Unions, Workers Compensation, Non-compete agreements, PPO, POS, PTO, PEO, HSA, Dependant care, FTE, PTE, Independent Contractor, 1099...
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VALUATION & FINANCIAL ANALYSIS • Importance of accurate financial statements • Creating projections • Playing the VC game	**TERMINOLOGY:** Price earnings ratio, ROI, Cash flow, Book value, Liquidity, Replacement value, Internal Rate of return, Pre-Money, Post-Money, PPS, Equity, Marketability, Capitalization…
MARKETING, SALES, & BUSINESS DEVELOPMENT • Identifying and entering a market • Timing and tactics • Building customer relationships	**TERMINOLOGY:** Image, Branding, Messaging, Positioning, Competitive landscape, Market niche, Adopter, Differentiating, Collateral...

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THE FDA PROCESS • The regulatory landscape • Legal issues and compliance- at all stages • Reimbursement issues	**MERGERS & ACQUISITIONS** • What are they and how do they work • Preparing for due diligence • Exits and expectations
ART OF THE TERM SHEET • Critical issues for founders • Understanding investors' concerns • Protective provisions and investor rights	**THE EMPLOYEE OWNERSHIP ALTERNATIVE** • Creating EO in your company • Funding growth without VC Capital • Building ownership culture
LAUNCHING A WEBSITE • Agreements with 3rd party vendors • Protecting your on-line IP • Marketing & advertising • End user agreements	**BUILDING YOUR IP PORTFOLIO** • Protecting your IP • Building a strategic portfolio • Identifying your value and competitive advantages
NEGOTIATING A FLEXIBLE LEASE • How to use commute/recruit studies • Putting a relocation team in place • Key lease or purchase agreement clauses	**DOING BUSINESS IN CHINA & INDIA** • Macroeconomics of Asian markets • Dealing with family-owned businesses • Developing new competitive strategies
INTRODUCTION TO IP • The fundamentals of Intellectual Property • What can you protect • What are the critical issues • Do's and don'ts of getting started	**INTERNATIONAL DISTRIBUTION** • Utilizing a risk management approach • Managing channel conflict • Understanding governing law to resolve disputes
PARTNERSHIPS & ALLIANCES • Alliances in an overall business strategy • Assessing your potential value • Characterizing and evaluating potential partners • Defining metrics and expectations	**PROTECTING AGAINST PRODUCT LIABILITY** • Importance of labels, warnings, and instructions • The differences between negligence, strict liability, or breach of warranty • Consumer Product Safety Improvement Act
ACCESSING GOVERNMENT GRANTS • Finding the right programs • Proposal writing • Preparation, administration and regulations • SBIR / STTR	**SOURCING ALTERNATIVE FINANCING** • Debt and venture debt • Traditional bank financing • Vendor and purchase order financing • Bootstrapping
AVOIDING LICENSING PITFALLS • Why license • Identifying and targeting opportunities • Due diligence & avoiding pitfalls	**EFFECTIVE PRODUCTION MANAGEMENT** • Prototyping and design • Systems and quality controls • Resource planning