Keeping Canadian start-ups Canadian

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There are many Canadian tax benefits associated with starting a business in a corporation created under Canadian federal or provincial law, which is a necessary (but not sufficient) condition for a corporation to qualify as a "Canadian-controlled private corporation" (CCPC):

- CCPC status is one of the requirements for a corporation's shares to constitute "qualified small business corporation shares", which Canadian-resident individuals may claim the lifetime capital gains exemption (LCGE) of $1.25 million on;
- CCPCs receive preferential tax treatment on scientific research and experimental development (SR&ED) expenditures, which the government recently expanded in the 2025 federal budget to increase the existing 35 per cent SR&ED refundable tax credit to up to $2.1 million of a CCPC's first $6 million of qualifying expenditures;[1]
- holders of employee stock options issued by CCPCs receive preferential tax treatment relative to those issued by other corporations;
- CCPCs are taxed at lower rates on up to $500,000 of active business income under the "small business deduction"; and
- only CCPCs can be "eligible small business corporations", the shares of which may qualify for a tax-deferred exchange in certain circumstances.[2]

These and other factors make Canada a great choice as a place to incorporate a technology sector start-up venture.[3]

Our tax system needs to help more

That said, there is certainly much more Canada could do with its tax system to support the innovation sector and those who invest in it (as discussed at length elsewhere)[4]. For example, as of yet no action has been taken on the proposal in the Liberal platform from the 2025 election to extend flow-through share financing to the innovation sector, nor on the previous government's consultation to establish a patent box regime to support commercialization of IP developed in Canada (implementation of which was also promised in the Liberal election platform). Lower personal tax rates (which could be funded by shifting Canada's tax mix more towards consumption taxes and away from income taxes) would help to keep entrepreneurs, investors and highly-skilled workers here and attract new ones. Canada also urgently needs to respond to recent U.S. tax

measures such as the 50 per cent increase in the investor exemption for gains on qualified small business stock and expanding permissible investments for tax-exempts such as 401(k) plans. Creating a federal counterpart to the new Québec tax credit for research, innovation and commercialization would also help level the playing field with the U.S.. The U.K. Seed Enterprise Investment Scheme and Enterprise Investment Scheme are other examples of effective programs providing tax-advantaged support to high-risk early-stage business.

Financing remains a particular challenge, as many small-to-mid-sized Canadian technology companies and their founders know. Capital pools in Canada are simply not as deep as elsewhere, and frequently Canadian start-ups trying to scale up are forced to look outside Canada to find funding required to grow and thrive.[5] This makes it vitally important to remove impediments and create incentives for Canadian capital (both taxable and tax-exempt) to increase its investment in the Canadian innovation sector, particularly at the small-to-mid-size level where Canadian corporations often turn to non-resident (typically American) investors.

Non-resident investment in Canadian technology corporations

Increasing the level of Canadian investment in our technology sector benefits Canada's tax base. Non-residents of Canada are generally not subject to Canadian capital gains taxation on shares of Canadian technology companies, since Canada only taxes non-residents on capital gains from "taxable Canadian property" (which for shares is limited to those deriving their value primarily from land in Canada). As such, when Canadian investors rather than foreign ones finance Canada's innovation sector, the future gains enhance Canada's tax base even if taxed at low rates: anything above zero is a net increase in potential tax revenue relative to investment from foreign sources.

Bringing in non-resident investors potentially impacts a Canadian corporation's ability to qualify as a CCPC. This is because a corporation cannot qualify as a CCPC if:

- it is controlled either in law (i.e., majority voting power) or in fact by one or more non-residents of Canada and/or public corporations; or
- all of its shares that are in fact owned by non-residents (or public corporations) would, if aggregated together, constitute control at law (i.e., majority voting power) of the corporation.

The fact that contingent rights to acquire or redeem shares or control the votes attached to shares (present or future) are taken into account when applying these tests makes it challenging to accommodate a significant non-resident investor (or many smaller ones) while retaining CCPC status.[6] As such, Canadian technology companies can find themselves caught between inadequate access to domestic capital and Canadian tax rules that penalize them for relying on foreign investors.

In the past various strategies have been tried to mitigate the impact of foreign investment on a Canadian corporation's CCPC status. These include so-called "straddle structures", whereby Canadian and U.S. corporations are created as sister entities with the same shareholders, with different business functions divided between them. These arrangements have generally proven to be expensive to create and maintain and very

unwieldy to administer. As a result, Canadian start-ups have for the most part either managed to limit foreign investment to what is permissible within the constraints of the CCPC rules or simply abandon CCPC status and the associated tax benefits.

What about emigrating to the U.S.?

In some cases U.S. investors considering an investment in a Canadian start-up have asked the founders to move the corporation to the United States, so as to make the corporation governed by the corporate law of a U.S. state (typically Delaware) rather than whatever Canadian corporate statute it currently exists under. Indeed, the recent announcement by Y-Combinator that it would not invest in Canadian-incorporated entities (which was quickly reversed) had been made on the premise "that our top-performing Canadian companies reincorporated in the US."

Effect on Tax Residency

When a Canadian corporation changes its governing law to a jurisdiction outside of Canada, it may or may not still be considered to be a resident of Canada for Canadian tax purposes depending on the facts. If its "mind and management" is not located in Canada, it will cease to be a resident of Canada for Canadian tax purposes.[7] Conversely, if its "mind and management" remains in Canada post-reincorporation, Canadian domestic law considers it to still be a Canadian resident (and subject to Canadian tax on its worldwide income), unless the tax treaty (if any) Canada has with the country in which the corporation emigrated to includes a "tiebreaker" rule providing that where both countries assert a corporation to be resident, it will be deemed to be resident in the country under whose corporate law the corporation exists (i.e., country of governing law trumps location of mind and management). The Canada-United States Income Tax Convention (the Treaty) includes just such a tie-breaker rule, meaning that a Canadian corporation that changes its governing law to Delaware or another U.S. state will cease to be a resident of Canada for Canadian tax purposes.

Ceasing to be resident in Canada: Effect on emigrated corporation

It is important to understand that ceasing to be a resident of Canada for Canadian tax purposes is a significant event usually accompanied by materially adverse tax consequences. There is generally a "settling up" of matters within the Canadian tax system for the emigrating corporation, which is accomplished in two ways.

First of all, an emigrating corporation is deemed for Canadian tax purposes to have disposed of all of its property for fair market value proceeds of disposition immediately before emigrating (and to have a tax year-end), such that all gains and losses are deemed to be realized, *viz.*, all properties are marked to market. In most cases the primary value of a tech sector corporation's assets are its intellectual property and goodwill, which often have little or no cost basis for tax purposes, with the result that the gains realized could be quite substantial.[8] However, in some cases the corporation may have tax loss carryfowards from previous years (or unused deductions for tax purposes in the current year) that may offset some or all of the income created from realizing all accrued gains.[9]

In addition, a special departure tax is levied on the emigrating corporation, based on its net surplus (the fair market value of its assets less the sum of its debts and the paid-up capital of its shares). The rate of such tax is 25 per cent of its net surplus, but if the corporation is emigrating to a country with a Canadian tax treaty, the 25 per cent rate is reduced to the most favourable dividend withholding tax rate in that treaty (5 per cent in the case of the U.S.). This departure tax is roughly comparable to what would occur if the corporation were liquidated and its net assets distributed to shareholders who are non-residents of Canada. It cannot be reduced by any loss carryforwards the corporation may have, nor by the fact that some or even most of its shareholders are in fact Canadian residents. Note that where the corporation emigrates to the U.S., this may be a taxable event for existing U.S.-resident shareholders under American tax laws, depending on the circumstances.

Post-departure, an emigrated corporation that is no longer a resident of Canada for Canadian tax purposes will generally be subject to Canadian tax only on its Canadian-source income.[10] This means that to the extent the corporation still has offices, employees and assets located in Canada, any income attributable to them will generally be considered to be subject to Canadian corporate income tax as a Canadian branch of a foreign corporation. Foreign corporations carrying on business in Canada are required to file a Canadian corporate income tax return and determine what portion of their income is attributable to the Canadian branch. As such, emigrating a Canadian corporation to another country while leaving a significant portion of its operations here tends to make little sense from a tax perspective.

Ceasing to be Resident in Canada: Effect on Canadian-Resident Shareholders

The taxation of Canadian shareholders of a corporation that has reincorporated in the U.S. will change significantly once that corporation is no longer a Canadian tax resident. Since the corporation will no longer be a CCPC, capital gains on its shares will not be eligible for the LCGE going forward. Because the corporate emigration itself will not cause a shareholder to be deemed to have disposed of their shares of the corporation, some form of self-help planning before it ceases to be a CCPC will be needed to utilize any LCGE that may be available to Canadian-resident individuals to absorb accrued but unrealized gains on their shares. In either case, Canada will continue to tax Canadian residents on any existing and future gains on those shares when they are ultimately sold.

If a U.S.-reincorporated corporation pays dividends, U.S. dividend withholding tax will generally apply at the rate of 30 per cent. Canadian residents entitled to benefits under the Canada-United States Income Tax Convention can generally claim a reduced 15 per cent dividend withholding tax rate under Article X(2) of the Treaty.[11] Canada will also tax such dividends, at rates higher than dividends from Canadian corporations and typically with a credit given for U.S. withholding taxes paid. In general, the integration provisions of the Canadian tax system (e.g., capital dividends, the dividend tax credit, etc.) that try to equalize the tax burden on income/gains earned by a Canadian corporation and distributed to a Canadian-resident shareholder with the tax that would have arisen had the Canadian-resident shareholder earned the same income/gains directly will no longer apply. This means that careful pre-emigration planning must be undertaken to maximize these benefits for Canadian-resident shareholders before they cease to be available.

Somersault transactions

Another form of transaction sometimes considered is a somersault, whereby a new foreign holding corporation is interposed between the Canadian corporation and its shareholders. In this transaction, the existing shareholders transfer their existing shares to the new foreign holding company (Parentco), but the Canadian corporation remains governed by Canadian corporate law and does not cease to be a Canadian tax resident. This will result in the loss of CCPC status for the Canadian corporation, but does not trigger the emigration taxes described above.

For Canadian-resident shareholders, the transfer of their shares to Parentco in exchange for Parentco shares will cause any accrued gains to be realized for Canadian tax purposes, which may not be problematic depending on the size of the gains and whether the LCGE or other tax shelter exists to absorb them. If a taxable exchange is not acceptable to Canadian-resident shareholders, deferral of their Canadian tax otherwise triggered by the exchange can be provided to them by using an "exchangeable share" structure, whereby such shareholders (but not foreign shareholders) hold shares of a Canadian subsidiary of Parentco that mirror the economics of (and eventually will be exchanged for) the same Parentco shares that non-Canadian shareholders are receiving. Such a structure involves some cost and complexity, and so is not appropriate in all cases. An example of such a transaction is the corporate reorganization of Starton Therapeutics Inc. (a British Columbia corporation) to become a subsidiary of Starton Holdings, Inc. (a newly-created Delaware corporation) completed on Nov. 5, 2025.

Conclusion

The Canadian innovation sector represents Canada's tax base of the future. It needs and deserves greater support from our tax system to grow and create national champions capable of competing with their foreign peers. Many of these changes are reasonably simple to make, and require only the willingness to invest in our own economy and the will to implement. The cost of not making them is to see more of our start-ups and the people who work for them leave or invest outside of Canada. The time to act is now.

Footnotes

[1] Under these budget proposals (now before Parliament as Bill C-15), this enhanced refundable tax credit will be extended to eligible Canadian-incorporated public corporations as well.

[2] Other benefits of CCPC status include (1) potential enhanced deductibility of losses as "business investment losses" for shareholders of a CCPC, (2) a longer period to pay taxes owing and more generous treatment on paying tax instalments, and (3) a shorter "normal re-assessment period" for the CRA to re-assess past taxation years.

[3] Outside of a tax context, other forms of Canadian government assistance such as the National Research Council of Canada Industrial Research Assistance Program (NRC IRAP) also require claimants to be incorporated in Canada.

[4] See Suarez, "Productivity, Innovation and How Canada's Tax System Can Help", 2025.

[5] See for example the February 2026 submission "Recommendations on the Proposed $750M Early Growth-Stage Funding Envelope Budget 2025" by the Canadian Venture Capital and Private Equity Association: "domestic capacity declines sharply as companies move into Series B and growth financings, where reliance on foreign capital remains high".

[6] In fact, a corporation that would be a CCPC but for rights owned by non-residents and/or public corporations to acquire shares may be a "substantive CCPC", which is essentially the worst of both worlds, i.e., the disadvantages of not being a CCPC with none of the (few) accompanying benefits.

[7] For a discussion of corporate "mind and management", see here, under 3., Residence for Canadian Tax Purposes: Corporations and Trusts.

[8] For this purpose fair market value is determined under ordinary valuation principles: there is no tax version of the concept.

[9] If the corporation has previously undergone an acquisition of control, this could prevent pre-acquisition-of-control losses from being used thereafter (i.e., to absorb gains deemed realized on emigration): see here.

[10] For a discussion of when non-residents with Canadian business activities are subject to Canadian income tax see here.

[11] For a discussion of tax treaties and the Canada-U.S. Income Tax Convention in particular, see here.

By

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