

STRUCTURING MORTGAGE INVESTMENT CORPORATIONS IN CANADA

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The Product

Mortgage investment corporations (“**MICs**”) are investment management companies holding a portfolio of loans secured against Canadian real property and certain similar assets and generally generate most of their income through interest and mortgage borrower fees. For investors, these corporations provide a unique opportunity to gain exposure to a diversified pool of mortgage assets through a single security. MICs are subject to a special tax regime under the *Income Tax Act* (“**ITA**”), whereby MICs distribute income generated by the MIC to shareholders by way of a dividend that is generally taxed in the hands of Canadian-resident taxable investors as interest income (i.e., the preferential tax treatment ordinarily applicable to dividends generally does not apply). As MICs are generally eligible to claim a deduction in respect of amounts distributed to shareholders as dividends, in practice MICs are generally not subject to material Canadian income tax.

Value Proposition for Investors

Generally, private MICs raise capital by issuing shares to investors at a fixed dollar amount per share. These funds are used to invest in a portfolio of mortgages with more flexible financing terms than those of traditional chartered banks. Interest income generated from these mortgages and any profits after deducting operating expenses and management fees of the MIC is customarily distributed to shareholders as dividends. Accordingly, the objective is for investors to be able to access stable, long-term cash flows generated by a large capital base.

Dividends received by shareholders of a MIC are generally classified as interest income for purposes of the ITA. Capital gains realized by an investor on the shares of a MIC are generally subject to the normal treatment of capital gains under the ITA (i.e., in most circumstances, taxed at one-half the rate of tax on ordinary income). The ITA includes a mechanism for MICs to effectively distribute out some or all net capital gains in a year to shareholders in the form of “capital gains dividends”, which are generally subject to tax in the hands of a shareholder as deemed capital gains. MICs are generally able to deduct from their taxable income amounts paid to shareholders as dividends; accordingly, in practice, MICs are rarely subject to material Canadian income

tax because it is customary to distribute out all or substantially all of a MICs income in a year.

Under the ITA, shares of MICs are “qualified investments” (subject to certain exceptions) for the purposes of most deferred income tax plans, including Registered Disability Savings Plans, Registered Retirement Savings Plans, Registered Retirement Income Funds, Registered Education Savings Plans, Deferred Profit Savings Plans, First Home Savings Accounts and Tax Free Savings Accounts, thereby potentially making it an attractive investment for retail investors.

Qualifying as a MIC and Capital Structure

Qualifying as MIC

The ITA imposes detailed requirements for a corporation to qualify as a MIC. While certain requirements are relaxed until shortly after the end of the MIC’s first fiscal year-end, the following criteria must generally be satisfied for a corporation to qualify for and maintain its status as, a MIC:

- resident in Canada for purposes of the ITA and incorporated under the laws of Canada or a province (special rules apply to corporations incorporated before June 18, 1971);
- only undertaking is investing of funds of the corporation and it does not manage or develop any real or immovable property;
- none of the property of the corporation consists of
 - i. debts owing to the corporation secured on real or immovable property located outside Canada,
 - ii. debts owing to the corporation by non-resident persons, except debts secured on real or immovable property situated in Canada,
 - iii. shares of the capital stock of corporations not resident in Canada, or
 - iv. real or immovable property situated outside Canada, or any leasehold interest in such property;
- there are 20 or more shareholders of the corporation and no shareholder of the corporation (together with certain persons related to the shareholder) owns, directly or indirectly, more than 25% of the issued shares of any class of the capital stock of the MIC (certain “look-through” rules apply in respect of trusts and partnerships);
- holders of preferred shares have a right, after payment of preferred dividends and payment of dividends in a like amount per share to the holders of the common shares, to participant *pari passu* with the holders of common shares in any further dividend payments;
- at least 50% of the cost amount of all property of the corporation is invested in:
 - i. debts secured by mortgages, hypotecs or in any other manner on “houses” (as defined in the

National Housing Act) or on property included within a “housing project” (as defined in the National Housing Act as it read on June 16, 1999);

- ii. deposits in the records of most Canadian banks or credit unions; and
 - iii. money;
- the cost amount to the corporation of all real or immovable property, including leasehold interests in such property (excluding certain amounts acquired by foreclosure or pursuant to a debtor default) does not exceed 25% of the cost amount of all its property; and
 - it complies with the liability thresholds under the ITA.

In light of the above requirements, MICs must be mindful where a mortgagor defaults and the MIC engages in foreclosure proceedings not to take any steps that would cause it to cease to be a MIC under the ITA (for example, it would need to be careful that it is not “managing or developing” any real or immovable property as a consequence of any such foreclosure proceeding).

Capital Structure

Private MICs typically issued two classes of shares, common and preferred. Common shares are typically issued to MIC founders, directors and officers.

Common Shares have voting rights, are typically not entitled to dividends and have no redemption feature but participate in the distribution of MIC assets after preferred shareholders receive accrued but unpaid dividends.

Preferred shares are typically issued to investors and receive all the economic benefits of the MIC assets.

Preferred shares do not typically have voting rights, are redeemable at the option of the holder, and in some instances, by the MIC. On winding up or liquidation of the MIC, preferred shareholders are typically entitled to receive the redemption value of each preferred share as well as any declared but unpaid dividends. After this preferred distribution, preferred shareholders typically participate equally with common shareholders pro rata with respect to any further distributions.

MIC Management Fees

Larger Canadian MICs are typically managed by affiliated management entities controlled by principals of the MIC under a management and administration agreement where the manager provides for services related to the administration of the MIC’s mortgage portfolio and business. In exchange for these services, MICs typically pay the manager any combination of the following or other fees: general management fee typically based on a percentage of assets under management or all mortgage receivables, origination fees based on the amount of each mortgage investment and/or servicing fees relating to the management of mortgage payments.

Additionally, MICs may distribute some proportion of fees paid directly by borrowers to the manager, including

commitment fees paid to guarantee disbursements of loans as well as renewal fees.

Alternatively, a MIC may utilize a performance based fee structure, whereby the manager is paid a percentage of the MIC's total profits per year, subject to a minimum and maximum annual payment based on a percentage of aggregate outstanding mortgage balances. MICs also typically reimburse managers for any reasonable and necessary out-of-pocket disbursements related to the services provided, excluding expenses such as wages, rent and utilities.

MIC Mortgage Registration Requirements

Ontario – Registration with the [Financial Services Regulatory Authority of Ontario](#)

In Ontario, individuals and businesses conducting mortgage brokering and administration activities are also governed by the *Mortgage Brokerages, Lenders and Administrators Act, 2006*, c 29 (“**MBLA**”), and must be licensed with the Financial Services Regulatory Authority of Ontario (“**FSRA**”). For the purposes of the MBLA, a person or entity “deals in mortgages”, if, amongst other activities, they solicit another person or entity to lend money on the security of real property. In addition, a person or entity is “administering mortgages” if they receive payments from a borrower under a mortgage on behalf of another person or entity and remit payments to or on behalf of that person or entity. Accordingly, no person or entity may deal in or administer mortgages in Ontario unless they have a brokerage license or fall under an exemption.

Acquiring a license requires filing a Mortgage Brokerage License Application with the FSRA, and maintaining a license requires complying with certain financial reporting and disclosure requirements. Specific investor information forms, suitability assessments, and disclosure statement forms must be filed for both non-qualified syndicated mortgage transactions as well as brokered transactions.

British Columbia – Registration with the BC Financial Services Authority

Under the B.C. *Mortgage Brokers Act* (“**MBA**”), British Columbia-based MICs are required to register with the BC Financial Services Authority as a “mortgage broker”, the definition of which captures generally any legal person who lends money secured by land in or outside of British Columbia. Furthermore, each MIC is required to have at least one “submortgage broker” registered under the MBA, where a “submortgage broker” is defined as any person who, in British Columbia, actively engages in any activities of the mortgage broker as an employee, director, or partner.

Capital Raising Requirements

Eligible Investors

To distribute securities to investors, MICs must do so filing a prospectus or relying on an exemption from the

prospectus requirements under National Instrument 45-106 – *Prospectus Exemptions* or under the *Securities Act*, RSO 1990, c S.5, as applicable. The most commonly relied on prospectus exemptions for private MICs distributing securities are the “accredited investor” exemption (the “**AI Exemption**”), the “offering memorandum” exemption (the “**OM Exemption**”) and to a lesser extent, the “family, friends and business associates” exemption (the “**Family, Friends and Business Associates Exemption**”).

Investors under the AI Exemption are typically higher net worth investors than those who may only meet the threshold to invest under the OM Exemption (depending on the jurisdiction in Canada) and are likely to invest higher amounts of capital. There are many ways to qualify as an accredited investor, the most typical being: (a) having financial assets net of any related liabilities that exceeds \$1 million; (b) having net assets exceeding \$5 million; or (c) net income that exceeds \$200,000, or exceeding \$300,000 combined with a spouse, in the 2 most recent calendar years and reasonably expects to exceed that net income level in the current calendar year.

Investors under the OM Exemption typically have a lower net worth than accredited investors and depending on the jurisdiction in Canada are subject to caps respecting the amount of capital they can invest. For example, in Ontario under the OM Exemption an “eligible investor” is able to invest up to \$30,000, or \$100,000 if such investor receives suitability advice from a registrant, whereas a “non-eligible investor” can only invest up to \$10,000. There are many ways to qualify as an “eligible investor,” the most typical being an individual having: (a) net assets either alone or with their spouse exceeding \$400,000; or (b) net income that exceeds \$75,000, or exceeding \$125,000 combined with a spouse, in the 2 most recent calendar years and who, in either case, reasonably expects to exceed that net income in the current calendar year.

Unlike the AI Exemption and the OM Exemption that are based on investors satisfying prescribed financial criteria, investors under the Family, Friends and Business Associates Exemption are eligible to invest in a MIC based on having a pre-established and prescribed relationship to the MIC, its directors, executive officers, control persons or affiliates.

Solicitation Registration Requirements

When soliciting investment for a private MIC, MIC management must ensure they are not engaging in activities deemed by securities regulators to be in the business of trading requiring registration as an exempt market dealer under provincial securities laws. Alternatively, a related entity of the MIC may seek registration as an exempt market dealer enabling it to engage in this activity (this registration can be limited to selling securities of the MIC as opposed to being able to sell securities of third party entities other than the MIC) or the MIC may engage an already registered exempt market dealer to sell MIC securities for a commission.

Related Articles

Please refer to our article about Structuring Private Equity Real Estate Funds in Canada [[here](#)] and Practical Considerations for Structuring Private REITS [[here](#)].

If you have any questions regarding structuring a MIC, members of McMillan's Capital Markets Group, Private Equity Group, Tax Group and Real Estate Group would be pleased to assist you.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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