Advance Tax Credit Financing

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Corporations that are in need of liquidities can, simply put, not afford to wait until the end of the fiscal year to receive payment of refundable tax credits. For this reason, some lenders offer to advance funds to eligible taxpaying corporations (hereinafter "Taxpayers") in the form of a loan, while taking security on their future tax credits as collateral ("Advance Tax Credit Financing"). Below, we outline key aspects of Advance Tax Credit Financing, with particular regard to tax credits for scientific research and development, as well as those for film or video production and post-production services.

TAX CREDIT ASSISTANCE IN QUEBEC

Taxpayers carrying out certain designated economic activities may qualify for government support, particularly in the form of refundable tax credits. Such areas of activity include scientific research and development, market diversification in the manufacturing industry, e-business solutions, design, publishing, film production and post-production, and more.

An important distinction must be made between non-refundable and refundable tax credits. Whereas non-refundable tax credits reduce or limit income tax payable, and will be limited by the amount of tax effectively owing by the Taxpayer in question, refundable tax credits can be granted to the Taxpayer even if it has no income tax payable. Hence, a Taxpayer entitled to a refundable tax credit can receive more funds from the government than the amount of tax it has paid.[1]

In order to qualify for tax credits, including refundable tax credits, a Taxpayer will be required to comply with certain basic criteria over the course of its fiscal year. However, in many cases, it will be possible to apply to Revenue Quebec and/or the Canada Revenue Agency for an Advance Ruling prior to relying on the tax credit, in order to determine whether or not the Taxpayer will qualify at the year's end. Assuming that the eligibility criteria have been met, once the Taxpayer's taxation year has passed (generally within six months of its end), the Taxpayer files the relevant tax credit forms with the relevant tax authority, along with its income tax return.

SCIENTIFIC RESEARCH AND DEVELOPMENT ("R&D")

Both the Canadian and Quebec governments offer refundable tax credits for R&D. In order to qualify, the research activity in question must relate to either basic and applied research or to experimental development. Further, the Taxpayer will be entitled to claim the cost of support work that supports it directly. For example, for the Quebec tax credit, this will include engineering work, data collection, design, operations research and testing.

In an R&D context, a Taxpayer will be eligible for tax credits for salaries and wages paid in the course of conducting its activities. For Quebec alone, such credits can account for as much as 35%, at the federal level, and 30% at the Quebec level, of wages and salaries, and can apply against payments made to contractors and subcontractors subject to certain thresholds. In addition, Taxpayers may receive tax credits of up to 28% for pre-competitive research in private partnerships, university research, or for fees and dues paid to a research consortium of which the Taxpayer is a member.

Lastly, although both governments exercise some degree of control over the areas of activity that qualify for tax credits, they are hardly restrictive, as neither requires that the projects developed continue their activities in Quebec or Canada upon completion of their R&D phase, when they are ready to move into production.

FILM & VIDEO PRODUCTION SERVICES

Much like the tax credits for R&D, refundable tax credits may be issued both federally and provincially for film or video production services. Indeed, the federal *Film or Video Production Services Tax Credit* ("**PSTC**") will provide a credit equivalent to 16% of qualified "Canadian labour expenditures".[2] The *Québec Tax Credit for Film Production Services* ("**QPSTC**") provides a base refundable tax credit at a rate of 20% of eligible production costs, including qualified labour costs, which are roughly equivalent to qualified Canadian labour expenditures under the PTSC, as adapted to Quebec, but also provides credits for the costs of qualified properties and the costs of acquiring or renting properties. Furthermore, the QPSTC provides an additional 16% tax credit for eligible expenditures that relate to computer-aided animation and special effects, for a total tax credit of 36% for such expenses. The 2015-2016 provincial budget extended these tax incentives in certain circumstances.

In order to qualify for the PSTC and QPSTC, both governments clearly define the eligibility criteria. Apart from requirements regarding the corporations applying for the credit, in both jurisdictions, productions are subject to similar minimal aggregate expenditure requirements. These expenditures encompass every phase of production from the screenplay to postproduction and compression for distribution.

In Quebec, a television series or a pilot program must have minimum aggregate expenditures of $100,000 per episode of 30 minutes or less. For episodes exceeding 30 minutes in length, the minimum is $200,000, and for films, it is a minimum of $1,000,000.[3] Furthermore, the production must not fall into one of the categories of excluded productions, such as talk shows, sporting events or reality television.[4] As mentioned above, productions that use computer-aided animation and special effects will benefit from an additional 16% tax credit, which will be applicable to the production phase of special effects, including principal photography in front of a backdrop for chroma keying (i.e. a green screen).

TAKING SECURITY – ADVANCE TAX CREDIT FINANCING

Although the *Financial Administration Act*[5] clearly states that Crown (i.e. Her Majesty in right of Canada) debts are not assignable[6], which would seemingly hinder federal tax credits from being offered as security, both the Quebec *Taxation Act*[7] and the *Canadian Income Tax Act*[8] provide that corporations may assign or hypothecate the right to claim amounts payable under each respective Act.

Provincial: Section 1055.2, Taxation Act

Despite any inconsistent provision of any law, a corporation may assign or hypothecate the right to claim an amount payable to it under this Act.

The assignment or hypothec is not binding on the State and, as a result, the following rules apply:

(a) the <u>Minister retains discretion to pay or not to pay the amount to the assignee or creditor</u>;

(b) the assignment or hypothec does not create any liability of the State to the assignee or creditor; and

(c) the rights of the assignee or creditor are subject to the rights conferred on the State by section 31 of the Tax Administration Act (chapter A-6.002) and any right to compensation of which the State may avail itself.

Federal: Section 220, Income Tax Act

[...]

(6) <u>Notwithstanding section 67 of the Financial Administration Act</u> and any other provision of a law of Canada or a province, <u>a corporation may assign any amount payable to it under this Act</u>.

(7) An assignment referred to in subsection 220(6) <u>is not binding on Her Majesty in right of Canada</u> and, without limiting the generality of the foregoing,
(a) the <u>Minister is not required to pay to the assignee the assigned amount</u>;

(b) the assignment does not create any liability of

Her Majesty in right of Canada to the assignee; and

(c) the rights of the assignee are subject to all equitable

and statutory rights of set-off in favour of Her Majesty in right of Canada.

[Emphasis added]

As these tax credits are refundable, they hold value irrespective of the Taxpayer's revenues for the taxation year and they may, to a certain extent, be offered up as collateral to lenders. However, as we will see, owing to the discretion retained by the Minister and the fact that the value of the tax credits is contingent on a number of other variables, securing collateral on tax credits is a delicate matter.

Indeed, further complicating the equation is the fact that both the *Taxation Act* and the *Income Tax Act* specifically state that the assignment or hypothec is not binding on the State and thus the Minister retains the discretion to pay or not to pay the tax credits directly to the creditor. Taking effective security on tax credits is obviously a rather intricate business practice, which will require lenders to retain specialized counsel, as the requisite security documents will call for specific measures to be put in place. For example, documents will include those allowing a lender to speak directly to the Minister in order to keep up-to-date on tax credit payment amounts, projected payment dates and those ensuring payments are made to the lender as assignee of the Taxpayer.

Among other covenants, when financing tax credits for Film Production Services in Quebec, the borrower (the "**Producer**") will, for example, undertake to remain eligible for the tax credit in question, and will also provide the lender with a power of attorney to receive, sign, execute, deliver and file any and all necessary documentation with SODEC, or to otherwise communicate with SODEC regarding any matters pertaining to the Producer. Furthermore, the Producer will release SODEC from the obligation to maintain its confidentiality and allow it to provide the lender with any relevant information it should require. In this manner, the lender will gain a certain degree of control over the Producer's eligibility for the tax credit. In addition, hypothecs will be taken on the universality of claims as well as on specific incorporeal property (which will include rights to the script and movie), thereby providing recourse to the lender whether the credits are issued to the Producer, or whether they remain owing. However, one must also take into account that the receivables generated may be too far into the future from a cash-flow perspective to provide adequate collateral, or that the main intellectual property rights may not be owned by, but simply licensed to, the Producer.

Additional guarantees may also be offered up to lenders financing Taxpayers based on their eligibility for future tax credits. Indeed, Investissement Québec, a government agent, has put in place a number of programs that either issue loans or guarantee loans for advances on refundable tax credits. In most cases, in order to apply, the borrower will be asked to provide an eligibility certificate from Revenue Québec, verifying that it qualifies for the tax credit in question. When available, the additional security provided by Investissement Québec as guarantor may reduce the lending institution's risk, and possibly reduce borrowing costs.

With regard to the movie and television businesses, a few Canadian banks and a number of specialized lenders are engaged in the practice of financing film and television tax credits. In all cases, whether financing movies, television or R&D, financiers will ask for opinions from legal counsel, who must be well versed in local laws, but also in the workings of intra-provincial and, if needed, foreign legislation regarding this very particular type of financing

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[1] In essence, if a Taxpayer incurs eligible expenditures investing in research and development, but generates no taxable income for the fiscal year, as is often the case in the early stages of a business development project, the Taxpayer will not have any taxes owing at the end of the year, but will nonetheless be entitled to receive funds from government in the form of refundable tax credits as it will be deemed to have paid taxes. The refundable tax credit will be based on a percentage of the eligible expenditures incurred in the fiscal year.

[2] Canadian labour expenditures, as defined at paragraph 125.5(1) of the *Income Tax Act*, (R.S.C. (1985), c. 1.), will include only such salaries and wages paid to individuals who were resident in Canada at the time the payments were made.

[3] *An Act Respecting the Sectoral Parameters of Certain Fiscal Measures*, C.Q.L.R., c. P-5.1, Div II, s. 5.4.

[4] *Id.*, s. 5.6.

[5] R.S.C. (1985), c. F-11.

[6] *Id.*, s. 67(a).

[7] C.Q.L.R., c. I-3, s. 1055.2.

[8] Cited above, note 2, s. 220.