# Advance Tax Credit Financing

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## Summary

From a cash flow perspective, many corporations in need of liquidities cannot afford to wait until the end of the fiscal year to receive payment of refundable tax credits. To remedy this issue, some lenders offer an advance on funds in the form of a loan to an eligible taxpaying corporation (Taxpayer). These lenders take security on the Taxpayer's future tax credits as collateral (Advance Tax Credit Financing). In this article, we will explore Advance Tax Credit Financing in Québec, with particular emphasis on tax credits for scientific research and development (SR&D), and the tax credits for film or video production and post-production services.

## Tax Credit Assistance in Canada With a Focus on Québec

Taxpayers who carry out certain designated economic activities may qualify for government support in the form of refundable tax credits. These designated economic activities include, among others: research and development, market diversification in the manufacturing industry, e-business solutions, design, publishing, and film production and post-production.

There are key distinctions to be made between a refundable and non-refundable tax credit. Refundable tax credits can be granted to a Taxpayer even when it does not have payable income tax. A non-refundable tax credit, on the other hand, only reduces or limits income tax payable and is consequently limited by the amount of tax effectively owed by the Taxpayer. Therefore, Taxpayers who incur eligible expenditures but do not generate taxable income for the fiscal year would still be entitled to refundable tax credits and would consequently receive more funds from the government than the amount of tax it payed.

To be eligible for tax credits (mainly, the aforementioned refundable tax credits), a Taxpayer must comply with certain basic criteria over the course of its fiscal year. To facilitate the process, a Taxpayer could apply to Revenu Québec (RQ) and/or the Canada Revenue Agency (CRA) for an advanced ruling, in order to determine whether or not it would qualify for a tax credit at year's end. An eligible Taxpayer would need to file the proper tax credit forms with the relevant tax authority (RQ and/or CRA), along with its income tax return.

## Scientific Research and Development (SR&D)

Both RQ and CRA offer refundable tax credits to Taxpayers who work in SR&D. To qualify for the SR&D tax credit, the work in question must either be basic and applied research or experimental development. The Taxpayer will also be entitled to claim the cost of support work that directly supports its SR&D, for instance the engineering work, data collection, design, operations research and testing.

A Taxpayer is also eligible for a SR&D tax credit for salaries and wages paid in the course of conducting its activities. In Québec, these credits could be worth as much as 37.5 per cent at the federal level, and 30 per cent at the provincial level, of wages, salaries and payments made to contractors and subcontractors, subject to certain thresholds. Furthermore, a Taxpayer could receive a SR&D tax credit of up to 28 per cent 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.

Neither RQ nor the CRA require SR&D projects subject of the tax credit application to continue their activities in Québec or even Canada upon completion of the SR&D phase.

## Film and Video Production Services

Similar to the SR&D tax credits, refundable tax credits may be issued by both RQ and the CRA for film or video production services. The federal *Film or Video Production* Service Tax Credit (PSTC) grants a tax credit with a basic rate worth 16 per cent of the Canadian labour expenditures[1]. To be an eligible corporation for the PSTC, a Taxpayer would need to have a taxable Canadian permanent establishment and their primary business would need to be film or video production or production services in Canada.

The Québec Tax Credit for Film Production Services (QPSTC) provides a basic refundable tax credit of 20 per cent of all-spend production costs. These all-spend production costs, include qualified labour costs, a broad concept adapted to Québec that is roughly equivalent to Canadian labour expenditures under the PTSC, the costs of qualified properties, and the costs of acquiring or renting properties. Furthermore, the QPSTC provides an additional 16 per cent tax credit for qualified labour-based computer-aided special effects, animation and shooting of scenes in front of a chromatic screen. Corporations that are established in Québec whose activities are primarily in the film and television production business are eligible for this tax credit. These eligible corporations do not need to be controlled by Québec residents. Tax exempted corporations, corporations controlled by tax exempted corporations and corporations holding a broadcasting licence issued by the CRTC are excluded from the QPSTC.

For both the PSTC and the QPSTC, corporations applying the credits are subject to similar minimal aggregate expenditure requirements that encompass all the phases of production from screenplay to postproduction and compression for distribution.

The Québec film industry is heavily influenced by SODEC, which was instituted in 1995 to promote and support the development of cultural enterprises in Québec. SODEC designs programs, administers public financial assistance, provides funding, and manages tax measures for businesses in Québec's cultural and communication industries. In order to obtain a tax credit, the owner of the copyright or their designee needs SODEC to approve their application for an approval certificate, certifying that the production satisfies the form and content criteria imposed on a production that gives rise to the QPSTC. After SODEC issues the approval certificate, the eligible corporation must apply to SODEC for an advanced ruling which would identify the corporation and the elements which could benefit from a tax credit. Once SODEC grants an approval certificate and an advanced ruling, the corporation could submit its application for the tax credit to RQ along with the documents it received from SODEC.

## Taking Security – Advance Tax Credit Financing

Both the *Taxation Act*[2] and the *Income Tax Act*[3], provide exceptions to the general rule that Crown debts are not assignable[4] as they allow corporations to assign or hypothecate the right to claim amounts payable under each respective Act. Consequently, federal tax credits can conceivably be offered as security to lenders.

### 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 the *Taxation Act*.

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

**(*a*) the Minister retains discretion to pay or not to pay the amount to the assignee or creditor;**

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

(7) An assignment referred to in subsection 220(6) is not binding on Her Majesty in right of Canada and, without limiting the generality of the foregoing,

(a) the Minister is not required to pay to the assignee the assigned amount;

(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.

RQ's Authorization to Transfer a Tax Refund to a Third Party form[5], states that the eligible third party who can have a tax credit transferred to them must either be SODEC, Investissement Québec or a financial institution. However, article 1055.2 of the *Taxation Act,* does not make reference to this restrictive list of third parties and consequently, it would seem that in practice any lender who regularly lends in the industry could apply for the transfer of a tax credit. We note that no such form even exists for the refundable federal tax credit under the *Income Tax Act* and that sending a letter to the same effect to the CRA is not necessarily effective (though, in Québec, RQ administers both the federal and the provincial tax credits).

As explained above, these refundable tax credits hold value irrespective of a Taxpayer's revenues for the taxation year, and can consequently be offered as collateral to lenders. However, due to the Minister's discretion and because the value of the tax credit is contingent on several external factors, securing collateral on tax credits can be a very delicate issue.

Both the provincial *Taxation Act* and the federal *Income Tax Act*, stipulates that the Minister has the discretion to pay the tax credits directly to the creditor, rendering the assignment or hypothec unbinding on the State. Taking effective security on tax credits is an intricate business operation, which would certainly require assistance from specialized legal counsel especially since the required documents call for unique measures to be put in place. One illustration of these unique measures would be an authorization allowing a lender to speak directly to the Minister, on behalf of the Taxpayer, in order to stay informed on the projected payment amounts and dates.

When financing tax credits for film production services in Québec, the borrower (Producer) must agree to undertake certain assurances, to allow the lender to gain some control over their eligibility. For instance, the Producer must commit to remain eligible for the tax credit in question at all relevant times. The Producer must also agree to grant the lender with a power of attorney allowing the lender to receive, sign, execute and file any documentation or otherwise communicate with any government authority on behalf of them. Another common procedure in these instances is to release SODEC from the obligation of confidentiality, allowing the lender to access relevant information it should require pertaining to the Producer's eligibility for the tax credit.

Lenders often tend to take hypothecs on the universality of claims as well as specific incorporeal property (including rights to the script or movie). These hypothecs would provide a recourse to the lenders if the credits are not issued to the Producers. The challenge with said hypothecs is that the receivables generated may be too far into the future from a cash-flow perspective to provide efficient collateral.

Investissement Québec, a government agent, has put a number of programs in place that either issue or guarantee loans for advances on refundable tax credits as additional guarantees offered to lenders who finance Taxpayers. Generally, in order to qualify, the borrower must provide an eligibility certificate from RQ, as proof that it qualifies for the tax credit in Québec. Investissement Québec's additional security is meant to reduce the lending institution's risk and borrowing costs.

A few Canadian banks and other specialized lenders are engaged in the practice of financing film and television tax credits. U.S. lenders in the film financing space also grapple with these issues, even when it is only postproduction of a movie that is being performed in Québec. In all cases, whether financing movies, television or SR&D, financiers should seek opinions from well versed legal counsel. As this is a very particular type of financing, legal counsel should be versed in local, intra-provincial, and foreign legislation focusing mainly on tax and financing law.

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

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

[3] R.S.C. (1985), c.1. s. 220

[4] R.S.C. (1985), c. F-II s. 67(a)

[5] Revenu Québec, Form CO-1055.2-T

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