Raise the Curtain for Act II: Tax Shelter Reform and the New Film Tax Credit Regime

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PRÉCIS

Quand, il y a sept ans, notre article sur l'industrie cinématographique canadienne paraissait dans cette revue, la vague de réforme fiscale était à un point tournant pour une industrie que l'on prévoyait sur le point de devenir florissante. D'importantes modifications avaient été introduites en vue de réduire, de 100 à 30 pour cent, le taux de déduction pour amortissement à l'égard des productions portant visa. De nouveaux marchés pour la télévision et les vidéocassettes, inconnus à peine cinq ans auparavant, voyaient le jour. Et, malgré la réforme fiscale, les spécialistes prédisaient avec optimisme une nouvelle phase de croissance pour l'industrie de la télévision canadienne, croissance fondée sur un partenariat entre le secteur privé et les organismes publics de financement, les distributeurs internationaux et les nouveaux réseaux américains.

En rétrospective, il appert que plusieurs de ces prévisions étaient modérées. Au cours des trois dernières années, pas moins de sept sociétés de production canadiennes ont obtenu collectivement plus de 150 000 000 $ par voie d'appels publics à l'épargne. Les marchés financiers ont «découvert» les sociétés de production et de distribution canadiennes et ont créé un capital de base permettant une expansion future.

La confiance du gouvernement du Canada dans l'établissement d'une industrie cinématographique vibrante apte à exprimer la culture canadienne s'est manifestée sous forme de budgets affectés à des organismes gouvernementaux de financement et d'abris fiscaux au financement. Ce partenariat entre le secteur public et le secteur privé a produit non seulement des résultats tangibles pour l'industrie cinématographique, à savoir la création d'un nombre important d'emplois désormais maintenus par le secteur privé grâce à un capital de base stable, mais aussi des résultats intangibles que procure l'exportation à travers le monde des valeurs culturelles canadiennes.

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Au cours des dernières années, l'industrie canadienne du divertissement a connu un essor sans pareil. Alimentées par une demande sans cesse croissante d'émissions de télévision de qualité, les entreprises oeuvrant dans ce secteur sont devenues des joueurs clés sur le marché mondial. La super autoroute de l'information en pleine expansion et la multitude de possibilités qu'elle offre, ainsi que l'apport de fabricants canadiens de logiciels dans sa mise en oeuvre, captent l'attention du public. Déjà le nombre de longs métrages et d'émissions pour la télévision produits par des sociétés de production canadiennes dépasse toute production antérieure. La numérisation, les effets spéciaux produits par ordinateur et les nouveaux développements en technologie interactive sont autant de nouvelles possibilités tout autant pour les productions mettant en vedette des acteurs que pour les productions animées.

Au nombre des facteurs ayant contribué à créer cette vague d'activité, il y a la dévaluation du dollar canadien en regard du dollar américain; les restrictions strictes portant sur les sources de financement aux États-Unis; le nombre important de traités internationaux de coproduction conclus avec le Canada; les compétences des maisons de production canadiennes et leur excellente réputation qui commence à se faire connaître à l'étranger. Certains autres secteurs de l'industrie du divertissement bénéficient également des retombées de cette croissance, par exemple les entreprises de postproduction du son et des images, les studios de tournage et d'enregistrement musical, ainsi que les concepteurs d'effets spéciaux.

Dans le passé, les sociétés canadiennes assuraient le financement de la production de films par divers moyens : prêts d'institutions financières, préventes de droits de diffusion, avances de sociétés de distribution et subventions ou programmes d'organismes gouvernementaux (Téléfilm, sur la scène nationale, et autres organismes provinciaux). Mais, alors que le nombre de projets de l'industrie cinématographique canadienne prolifère, les sources traditionnelles de financement demeurent limitées. Par surcroît, les mesures de réduction du déficit des gouvernements fédéral et provinciaux ont sérieusement nui aux budgets affectés à Téléfilm et aux divers programmes provinciaux (surtout en Ontario), se soldant par une diminution des fonds qu'ils sont en mesure d'offrir.

En plus des sources traditionnelles de financement, les promotions d'abris fiscaux se sont avérées une source inestimable de fonds pour l'industrie cinématographique, procurant aux producteurs de films entre 8 et 12 pour cent du budget d'une production. Cependant, à la fin de l'année 1995, cette source de financement n'existera plus. Dans son budget de 1995, le gouvernement fédéral a annoncé qu'il remplacerait les avantages présentement liés aux abris fiscaux par un régime de crédit d'impôt remboursable.

Cet article explique la fin de l'abri fiscal comme source de financement et la montée d'un crédit d'impôt remboursable comme mécanisme de remplacement. Bien qu'une certaine emphase ait été mise sur le régime d'avantages fiscaux pour l'industrie cinématographique, la discussion

porte sur les abris fiscaux dans leur ensemble et sera valable pour les mécanismes qui seront utilisés après 1995.

ABSTRACT

Seven years ago, when we last wrote about the Canadian film industry in this publication, the tide of tax reform was just about to turn on an industry that was projected to be on the verge of blossoming. Drastic changes had been introduced to reduce the capital cost allowance rate for certified productions from 100 percent to 30 percent. New markets had emerged for television and video exploitation that had been unthought of as little as five years before. Industry experts were optimistically predicting a new growth surge for the Canadian television industry, notwithstanding tax reform, based on successful partnerships with government financing agencies, international distributors, and emerging US networks.

Seven years later, with the benefit of hindsight, many of these predictions seem to have been conservative. In the past three years, no fewer than seven Canadian production companies have publicly listed their shares, having raised collectively in excess of $150,000,000. The financial markets have "discovered" Canadian production and distribution companies and have created a capital base on which future expansion can be built.

The faith that the Canadian government had in the expression of Canadian culture through the development of a vibrant film industry has been reflected over the years through significant budgetary allocations to government funding agencies and through tax-assisted financing. This partnership of the private and public sectors has generated tangible dividends to the industry through significant job creation, which can now be sustained by the private sector through a stable capital base, as well as intangible benefits through the worldwide export of Canadian cultural values.

Over the last few years, the Canadian entertainment industry has experienced unprecedented growth. Fuelled by an ever-increasing demand for quality television programming, Canadian entertainment-related businesses have become key players within the global marketplace. The limitless possibilities of an expanding information superhighway and the participation of Canadian software manufacturers in its development have captured the public's imagination. In particular, Canadian production companies are generating more motion pictures and television programs than ever before. Digitization, computerized special effects, and new forays into interactive technologies are creating new possibilities for production in live action and in animation.

A number of factors have combined to create this surge of activity, including the decline of the Canadian dollar against the US dollar, severe restrictions in US sources of financing, Canada's wide array of international coproduction treaties, and the growing international reputation and expertise of Canadian production houses. This growth has

also had a tremendous impact on other sectors of the entertainment industry such as sound and picture postproduction facilities, studio facilities, music recording, and special effects designers.

Traditionally, Canadian companies have financed the production of films through a combination of various sources including financial institutions, broadcast licence presales, distribution advances, and government agency incentives and programs (through Telefilm at the federal level and provincial agencies now established from coast to coast). However, while the quantum of projects undertaken within the Canadian film industry continues to multiply, traditional sources of financing have remained limited. Furthermore, the deficit-cutting efforts of the federal and provincial governments have severely reduced budget allocations for Telefilm and various provincial programs (particularly in Ontario), resulting in decreased availability of funding from these programs.

In addition to traditional financing sources, tax-sheltered investment vehicles have proven to be an invaluable source of funding for the film industry by providing film producers with between 8 and 12 percent of their production budgets. As of the end of 1995, however, this source will no longer be available. In its 1995 federal budget, the federal government announced that it would be replacing the current tax shelter incentives with a refundable tax credit system.

This article examines in detail the demise of the tax shelter as a source of financing and the rise of the refundable tax credit as a replacement mechanism. Although particular emphasis is placed on the use of tax shelters in the film industry, the discussion is intended to relate to tax shelters in general and will be relevant for structures to be used after 1995.

OVERVIEW: RECENT CHANGES IN FISCAL POLICY

The Income Tax Act[1] has long contained rules designed to promote the production of films[2] and television programs that have certain required minima of "Canadian content."[3] These rules have generally provided tax incentives to private investors who invest in such films or television programs, referred to in the Act as "certified productions."[4] Specifically,

[1] For the purposes of this article, the term "film" may be used generically to represent a theatrical motion picture, a film and television production, or a videotape.

[2] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

[3] For an in-depth background to the rules relating to certified productions, both before and after income tax reform, see Norman Bacal and Richard Lewin, "Once Bitten, Twice Shy? The Canadian Film Industry Revisited," in *Report of Proceedings of the Thirty-Eighth Tax Conference*, 1986 Conference Report (Toronto: Canadian Tax Foundation, 1987), 46:1-33; and Norman Bacal, "Not Just Another Sequel: The Canadian Motion Picture Industry After Tax Reform" (1988), vol. 88, no. 3 *Canadian Tax Journal* 547-77.

[4] The tax incentives are limited to films and television programs that are certified by the minister of Canadian heritage (formerly the minister of communications) to be a "certified production" under regulation 1104(2) of the Act.

investors were able to purchase the copyright in a certified production, either directly or through a partnership, and then deduct the accelerated capital cost allowance (CCA) provided for such properties.[5] As the Canadian production industry has matured and expanded, the amount of investment in certified productions has mushroomed. At the same time, tax shelter structures that had been developed for certified productions were being adapted and used for computer software syndications.[6] Consequently, a virtual marketplace of tax shelter syndications had developed by 1994, with promoters competing among themselves for potential investors. This competition led many tax shelter promoters to increase the after-tax return to investors by making the investment more aggressive from an income tax perspective.

The increasing aggressiveness of tax shelter syndications, along with the growing cost to the fisc caused by expanding investment, was not lost on the federal Department of Finance. Consequently, the 1994 federal budget contained the first of a series of measures aimed at curbing perceived abuses with respect to tax shelter financing vehicles and the gross amount of investment in such syndications.[7] The 1994 budget proposals were intended to prevent indefinite deferrals of income tax through the creation and maintenance of negative adjusted cost bases in limited partnership interests.

The next government assault on tax shelters came on December 1, 1994 in the form of a joint press release[8] issued by the Department of Finance and Revenue Canada regarding the use of limited recourse debt in tax shelter transactions. Draft legislation implementing the proposals contained in the press release was subsequently tabled on April 26, 1995.[9] The limited recourse debt rules were intended to prevent the deduction by

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[5] Certified productions constitute capital properties described in class 10(w) of schedule II to the Regulations. As such, they are entitled to a CCA rate of 30 percent. Furthermore, regulation 1100(1)(l) provides for an additional CCA deduction in a year equal to the lesser of the income earned in the year in respect of the production and the remaining undepreciated capital cost of the production.

[6] Given the 100 percent rate of CCA applicable to computer software (other than systems software) and the general lack of regulation before December 1, 1994, the structures for such syndications were remarkably similar to film tax shelters before 1976 when there was little, if any, restriction on certified production tax shelter structures.

[7] The measures contained in the 1994 federal budget have now become part of the Act as a result of Parliament's passing of Bill C-59, An Act To Amend the Income Tax Act and the Income Tax Application Rules; SC 1995, c. 3.

[8] Canada, Department of Finance, *Release*, no. 94-112, December 1, 1994 (herein referred to as "the press release").

[9] The April 26, 1995 draft legislation, which was described as technical amendments, dealt with a wide variety of income tax matters. (Canada, Department of Finance, Draft Amendments to the Income Tax Act, the Income Tax Application Rules, the Canada Pension Plan, the Children's Special Allowances Act, the Customs Act, the Old Age Security Act, the Unemployment Insurance Act and a Related Act, April 26, 1995.) The provisions implementing the proposals of the press release are found in proposed section 143.2 of the Act and are herein referred to as "the limited recourse debt rules" or "the LRD rules."

investors of expenditures made with borrowed funds unless the lender had full recourse to the investors for the repayment of such funds. On December 14, 1995, these rules were modified by draft legislation.[10]

Meanwhile, in 1994 the Department of Finance and the Department of Canadian Heritage ("Heritage Canada") were also investigating whether the current film industry tax incentives were the most appropriate or efficient method of providing a government subsidy. The investigation took the form of a detailed study[11] carried out on behalf of Heritage Canada as well as a series of meetings with television and film industry representatives. By December 1994, the government announced its intention to find a replacement financing mechanism for the CCA tax shelter system.

The February 27, 1995 federal budget proposed to eliminate all of the current CCA incentives for certified productions, replacing the financing for producers with a refundable tax credit. Draft legislation implementing these proposals was released on July 19, 1995.[12] The draft legislation proposes a Canadian film or video production credit of up to 12 percent of the cost of production (net of assistance). The credit is described more fully below; however, many of the details had been left for regulations, which were not tabled in draft form until December 12, 1995.[13] Recognizing that it would take some time to finalize the regulations and implement the new tax credit system, the government agreed to maintain the current tax shelter system until the end of 1995. In other words, in 1995 there was a dual system whereby film producers had the option of taking the benefit from either the CCA system or the tax credit system, but not both.

SPECIFIC LEGISLATIVE CHANGES

1994 Federal Budget and Negative Cost Bases

Before February 22, 1994, there was no specific prohibition against creating a negative adjusted cost base (ACB) in a partnership interest.[14] A negative ACB is created where the aggregate of a partner's capital contributions and the partner's share of partnership income is exceeded by the

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[10] Canada, Department of Finance, *Release*, no. 95-108, December 14, 1995 (herein referred to as "the December 14, 1995 draft legislation").

[11] The written report, dated October 1994, was prepared by Ernst & Young. The report was to be the first in a series. The first stage dealt with possible replacement mechanisms for tax shelter financing. The second stage is to consider the feasibility of extending a government tax credit to other cultural industries (for example, music and fine arts).

[12] Canada, Department of Finance, Draft Amendments to the Income Tax Act, the Excise Act, the Office of the Superintendent of Financial Institutions Act, the Old Age Security Act, and the Canada Shipping Act Arising out of the 1995 Budget, July 19, 1995.

[13] Canada, Department of Finance, *Release*, no. 95-104, December 12, 1995 (herein referred to as "the December 12, 1995 draft regulations").

[14] The negative ACB is tolerated by virtue of the exception contained in subsection 40(3). Although there was no specific provision in the Act prohibiting a negative ACB, Revenue Canada had indicated in *Interpretation Bulletin* IT-471R, May 17, 1991, that the cessation of partnership business could give rise to a deemed realization of a capital gain equal to the negative ACB.

aggregate of partnership distributions received by the partner and the partner's share of partnership losses.[15]

Effective from the date of the 1994 budget, a negative ACB in a limited partnership interest will have immediate tax implications. New subsection 40(3.1) of the Act triggers a capital gain in the hands of a limited partner if, at the end of any fiscal year of the partnership, the ACB of the partnership interest is negative.[16] The amount of the capital gain is equal to the negative ACB, three-quarters of which constitutes a taxable capital gain.

As a result of subsection 40(3.1), many structures that involve leveraged tax losses will become less attractive to tax shelter investors. The following example, which is based on the typical certified production tax shelter structure used in 1994, illustrates the effect of subsection 40(3.1):[17]

> An investor subscribes for an interest in a partnership that will acquire a certified production. The subscription price for the partnership interest is $1,000. The investor pays 25 percent of the partnership subscription price in cash and borrows the rest from a lender that deals at arm's length with the investor and the partnership (in most instances, a bank or other financial institution). The partnership itself then borrows an additional $1,000 per investor and purchases the certified production. In addition, the partnership obtains a revenue guarantee from a bona fide film distributor,[18] the investor's share of which will be sufficient to discharge the investor's obligations to the lender. The revenue guarantee is payable to the partnership during its fiscal year following the year in which the investor subscribed for the partnership interest.

Investor cash	$ 250	
Investor leverage	$ 750[19]	
ACB of partnership unit	$1,000	$1,000
Amount borrowed by partnership	$1,000	
Cost of certified production	$2,000	
First-year share of partnership loss:		
CCA (30 percent of $2,000)	($ 600)	($ 600)
ACB of unit at end of first year	$ 400	$ 400

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[15] Based on the interaction of paragraphs 53(1)(e), 53(2)(c), and 53(2)(e) and the exception for partnerships from the application of the deemed realization of capital gains in respect of a negative ACB provided for in subsection 40(3).

[16] Subsection 40(3.1) also applies to "specified members" of general partnerships. The term "specified member" is defined in subsection 248(1) of the Act and includes any partner who is not actively engaged in the partnership business on a regular, continuous, and substantial basis unless the partner carries on a business similar to that of the partnership. A specific anti-avoidance rule is contained in proposed subsection 248(28) in relation to a person who is not a specified member in order to avoid the application of subsection 40(3.1) or section 127.52 (alternative minimum tax).

[17] This examples does not take into account the effects of the LRD rules or the measures contained in the 1995 federal budget.

[18] The revenue guarantee in this example would be considered a prescribed revenue guarantee for the purposes of subparagraph 96(2.2)(d)(ii) and a revenue guarantee that meets the criteria of regulation 1100(21)(d).

[19] For simplicity, it is assumed that the leverage does not bear interest.

Second-year income from revenue guarantee	$ 750	
Second-year deduction for CCA	($ 750)	
Partnership income in second year	$ 0	$ 0
Distribution of revenue guarantee to investor to repay leverage	($ 750)	($ 750)
ACB at end of second year		($ 350)

In this example, a negative ACB is created at the end of the second year because the aggregate of the investor's share of partnership losses and distributions ($600 + $750) exceeds the aggregate of the investor's contributions to the partnership and share of partnership income ($1,000). Before the addition of subsection 40(3.1), the negative ACB would have had no immediate tax consequences. Under the new rules, however, the investor will be deemed to have disposed of its partnership interest at the end of the second year for nil consideration and to have immediately reacquired the interest at a nil cost. This deemed disposition will trigger a capital gain equal to the negative ACB (that is, $350 in the example), three-quarters of which will have to be included in the investor's taxable income for the year.[20]

To deal with the effects of subsection 40(3.1), the use of leverage at the partnership level may no longer be appropriate[21] where it results in the creation of a negative ACB. Furthermore, as will be dicussed more fully below, limited partnership borrowings will automatically be deemed to be limited recourse debt pursuant to the limited recourse debt rules.[22] Consequently, income-deferral structures now require the use of long-term leverage at the investor level.

The Limited Recourse Debt Rules

With tax reform in 1987, the federal government began introducing legislation that eliminated high rates of deduction for various capital assets and the flowthrough of deductions to investors not actively engaged in a business. Examples abound and include the reduction of the rate of CCA for certified productions from 100 percent to 30 percent, restrictions relating to class 29 assets, limitations relating to partnerships carrying on scientific research that prevent the flowthrough of deductions to passive investors, the introduction of leasing property rules for tangible property, and numerous modifications to the "at-risk" rules. Curiously, computer software continues to qualify for CCA at the 100 percent rate. Over the past few years, there had been a consequential development of a tax

[20] Section 38.

[21] Subject to transitional rules for certain transactions commenced before April 26, 1995.

[22] Proposed subsection 143.2(8). Transitional rules announced subsequent to the release of the LRD rules provide some relief for certain transactions that commenced before April 26, 1995. These rules are further described below.

shelter industry for computer software. Unlike the film industry, which has seen regulation restrict the terms of indebtedness, the type and length of guarantees, the degree of minimum Canadian content to qualify for tax benefits, and audit requirements on costs, software investments were virtually unregulated (with the exception of the restrictions on guarantees contained in the "at-risk" rules). Furthermore, no system is in place to regulate the cost of computer software that investors may acquire and no restrictions require the software to be developed in Canada. As a result, numerous offshore corporations sold software licences to Canadian investors in 1993 and 1994 at prices up to 100 times the cost of development. In most cases, investors agreed to make payments to promoters of 70 to 80 percent of the investment 10 to 15 years in the future. The promoters in these transactions generally covenant to meet certain minimum performance standards. Investors purchase interests on the assumption that they may set off their future obligations to the promoters in the event that the promoters fail to meet their performance standards.

During 1994, the federal government became increasingly concerned that tax shelters, especially those involving computer software, were being designed to artificially increase or accelerate an investor's deductions. The specific concern was that structures were being created whereby investors used leverage either to acquire an investment or to incur expenditures, but were not at any economic risk with respect to the repayment of the financing. Consequently, the ministers of finance and national revenue issued the press release on December 1, 1994 directed at what were perceived to be abusive tax shelter structures. The minister of finance indicated that he would be introducing new measures into the Act effective December 1, 1994, which would be directed at the type of tax shelter structures described above. In addition, the press release stated that Revenue Canada would increase its review and audit of tax shelters.

Draft legislation containing the LRD rules was released on April 26, 1995 and modified on December 14, 1995. Some of these rules are effective as of December 1, 1994 and others as of April 27, 1995. The LRD rules represent the broadest attempt ever made to curtail the use by investors of leverage in tax shelters.[23] Under the rules, costs incurred by tax shelter investments[24] or in acquiring tax shelter investments will be reduced

[23] Since the early 1970s, Revenue Canada has challenged the use of various forms of leverage. See the line of cases cited in *Mandel v. The Queen*, 78 DTC 6518 (FCA). The history of leverage in relation to the financing of films is outlined in greater detail in Bacal and Lewin, supra footnote 3. In 1976, the regulations relating to certified productions were modified to ensure that investor debt to a film producer could not exceed four years in length (regulation 1104(2), definition of "certified productions," paragraph (e)). The first limited recourse rules relating to partnerships were tabled in 1994. Those rules provided that limited recourse debt used to finance the purchase of a partnership interest reduced the adjusted cost base of the interest (subparagraph 53(2)(c)(i.3)). However, the LRD rules, which are far more extensive, exclude the application of subparagraph 53(2)(c)(i.3) in respect of "tax shelter investments" as defined in proposed section 143.2.

[24] As defined in proposed subsection 143.2(1).

in most instances by the amount of limited recourse debt or by any benefit or amount that limits loss. It was originally proposed that expenditures incurred by limited partnerships or by other partnerships where investors are not actively involved in the business would also be ignored to the extent of any debt incurred by the partnership[25] unless the partners assume personal liability for the debt. This proposal, however, was withdrawn by the December 14, 1995 draft legislation after discussions between the minister of finance with various sectors of the business community. Furthermore, investor debt cannot exceed 10 years in length and the interest on the debt must be paid annually in order not to constitute limited recourse debt.[26] No industries have been exempted from the application of the LRD rules.

In putting forth these rules, the Department of Finance has gone a long way toward ensuring that investors finance tax shelter investments only where they are confident that their debt can be serviced annually and repaid within 10 years. As a necessary consequence, investors may be more conscientious about the types of investments they make and the inherent nature of the real risk involved with the investment.

It is expected that the debt service requirement alone will result in a significant reduction in the types of projects that will attract tax shelter investment. For example, a software project that has been inflated in value[27] will be far less likely to attract investors in the future because it will require significant amounts of revenue to meet the annual interest payments. If the income projections fail to materialize, investors will most likely have to personally finance the annual carrying charges on the debt.

The application of the LRD rules is limited to those investments that constitute a "tax shelter investment"[28] (TSI). The LRD rules provide that (1) any expenditure incurred by a taxpayer[29] that itself is a TSI, (2) any expenditure that constitutes a taxpayer's TSI, and (3) the cost or capital cost of an interest in a TSI will be reduced by the "limited-recourse amount"[30] (LRA) of a taxpayer, by the LRA of another taxpayer who does not deal at arm's length with the taxpayer, or by the LRA of a person who

[25] Proposed subsection 143.2(8).

[26] Proposed subsection 143.2(7).

[27] The inflated value allowed for an increased CCA deduction. In many instances, the vendor of computer software was either an offshore corporation or a non-taxable entity. Often, the software was being sold for anywhere from 10 to 100 times the development costs, based on management projections of future sales of the software that was being developed. Only hindsight will demonstrate whether such valuations were reasonable in the circumstances. Each case will be a question of fact based on the particular situation.

[28] The term "tax shelter investment" is defined in proposed subsection 143.2(1) and is described below.

[29] Pursuant to proposed subsection 143.2(1), a partnership is deemed to be a taxpayer for the purposes of these provisions.

[30] The term "limited-recourse amount" is defined in proposed subsection 143.2(1) and is described below.

holds an interest in the taxpayer, if the LRA may reasonably be considered to relate to the expenditure. The cost of the expenditure will also be reduced by a taxpayer's "at-risk adjustment"[31] in respect of the expenditure.[32]

For example, if an individual who has borrowed $800 on a limited recourse basis invests $1,000 in a computer software limited partnership, the cost of his or her interest in the partnership will be reduced by $800. Furthermore, the cost to the tax shelter of the software purchased with the proceeds of the debt will be reduced to $200.

To appreciate fully the broad scope of the LRD rules, it is necessary to examine the lengthy definitions of terms such as "tax shelter investment,"[33] "limited-recourse amount,"[34] and "at-risk adjustment."

"Tax Shelter Investment"

For the LRD rules to apply, the investment must be considered a TSI. A TSI, however, was originally defined far more broadly than what would ordinarily be considered a "tax shelter"[35] for the purposes of the Act. The April 26, 1995 version of the definition also deemed certain partnership

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[31] The term "at-risk adjustment" is defined in proposed subsection 143.2(2) and is described below.

[32] The reduction will occur by virtue of proposed subsection 143.2(6). The provision reads in full as follows:

> Notwithstanding any other provision of this Act, the amount of any expenditure that is, or is the cost or capital cost of, a taxpayer's tax shelter investment, and the amount of any expenditure of a taxpayer an interest in which is a tax shelter investment, shall be reduced to the amount, if any, by which
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> (a) the amount of the taxpayer's expenditure otherwise determined,
>
> exceeds
>
> (b) the total of
>
> (i) the limited-recourse amounts of the taxpayer, of a taxpayer who holds an interest, directly or indirectly, in the taxpayer, or of a taxpayer not dealing at arm's length with the taxpayer, that can reasonably be considered to relate to the expenditure, and
>
> (ii) the taxpayer's at-risk adjustment in respect of the expenditure.

[33] Defined in proposed subsection 143.2(1) as follows:

> "tax shelter investment" means
>
> (a) a property, outlay or expense that would be a tax shelter within the meaning assigned by the definition "tax shelter" in subsection 237.1(1) if that definition were read without reference to "a flow-through share or," and
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> (b) in the case of a member of a partnership who is a limited partner of the partnership or is a member of the partnership who was a specified member of the partnership at all times since becoming a member of the partnership, the member's interest in the partnership.

[34] Defined in proposed subsection 143.2(1) as follows:

> "limited-recourse amount" means the unpaid principal amount of any indebtedness for which recourse is limited, either immediately or in the future and either absolutely or contingently.

[35] The term "tax shelter" is defined in subsection 237.1(1).

interests that would otherwise not constitute tax shelters to be TSIs. Specifically, a TSI included an interest in a partnership in the case of (1) any member of the partnership whose liability is limited and (2) anyone who has been a "specified member" (with limited or unlimited liability) of the partnership at all times since becoming a member of the partnership.[36] Essentially, this meant that where a person becomes a member of a limited partnership, the limited partnership interest would be a TSI. A person who becomes a member of a general partnership and who was not actively engaged in the business of the partnership or a similar business was also to be considered to have acquired a TSI, even if the member has unlimited liability in respect of the partnership.

The business community reacted strongly to these proposals, which restricted the terms of indebtedness in any limited partnership or any passive partnership investment, whether or not it was tax-motivated. Consequently, the modifications tabled in December 1995 no longer refer to limited partnership interests or to specified members of general partnerships.

A TSI is currently defined as a property, an outlay, or an expense that is a tax shelter for the purposes of subsection 237.1(1) and consideration or an expense in respect of a flowthrough share. In addition, a taxpayer's interest in a partnership will be considered a TSI where:

(i) an interest in the taxpayer is a TSI;

(ii) another interest in the partnership is a TSI;

(iii) the taxpayer's interest in the partnership entitles the taxpayer directly or indirectly to a share of the income or loss of a particular partnership where:

(A) another taxpayer holding a partnership interest is entitled, directly or indirectly, to a share of the income or loss of the particular partnership; and

(B) the other taxpayer's partnership interest is a TSI.

This definition requires examination of relationships outside the control of a taxpayer that may cause a partnership interest to constitute a TSI. For example, X is a member of partnership 1, which in turn is a member of partnership 2. Where the interest of any member of partnership 1 is a TSI, X's interest will be a TSI. Where partnership 1 is a TSI, its interest in partnership 2 will be a TSI. The wording of subparagraph (iii) is more difficult to follow. If partnership 2 is entitled to a share of the income of partnership 3, does the wording of clause (A) mean that if any partner's interest in partnership 3 is a TSI, then X's interest in partnership 1 will be a TSI? The reference in clause (A) to "another taxpayer holding a partnership interest" appears to be a reference to the particular partnership in

[36] "Specified member" is defined in subsection 248(1). A specified member is any partner other than one who is actively engaged in the activities of the partnership business (excluding financing) or carries on a business similar to that carried on by the partnership on a regular, continuous, and substantial basis throughout that period of the year during which the business of the partnership is ordinarily carried on and during which he or she is a member of the partnership.

subparagraph (iii). However, it may also refer to the partnership interest of the taxpayer referred to at the beginning of subparagraph (iii). The context seems to support either interpretation.

Aside from partnership interests, any investment that would constitute a "tax shelter" under the Act will automatically be deemed a TSI.[37] To determine whether an investment qualifies as a tax shelter, it is necessary to look at the statements and representations made to investors in connection with the acquisition of the property.[38] If representations are made that the aggregate of the amount of losses and any other expenses in respect of the investment that will be deductible within four years of the acquisition of the investment and the amount of any "prescribed benefits"[39] expected to be received or enjoyed in respect of the investment exceed the cost of the investment, then the investment is a tax shelter. Consequently, in determining whether an investment is a tax shelter for these purposes, it is necessary to examine the promoter's representations to investors, the loss projections contained in the material distributed, the carrying costs associated with the investment, the cost of the investment, and the prescribed benefits available.

The term "prescribed benefits" means any amount that may reasonably be expected (having regard to statements or representations made in respect of the tax shelter) to be received or to be made available to the investor or to a person with whom the investor does not deal at arm's length where the receipt or availability of the amount would reduce the impact of any loss that the investor may sustain by virtue of acquiring, holding, or disposing of the interest in the tax shelter. Prescribed benefits include amounts owed at any time by the investor or anyone who does not deal at arm's length with the investor in any one of the following circumstances:[40]

1) the liability to pay the amount is contingent;

2) payment of the amount is or will be guaranteed, secured by, or indemnified by various persons (including the promoter);

3) the right to collect all or part of the purchase price is limited or restricted; or

4) where payments are due in foreign currencies, it may reasonably be expected, at the time the investment is made, that future currency devaluations would significantly reduce the Canadian-dollar currency impact of the repayment.

Prescribed benefits also include any form of government or other public assistance, as well as any revenue guarantee or other agreements in

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[37] Although the definition of "tax shelter" ordinarily excludes flowthrough shares, this exclusion does not apply for the purposes of the LRD rules.

[38] Subsection 237.1(1).

[39] The term "prescribed benefits" is defined in regulation 231(6) and is described below.

[40] Regulation 231(6)(a).

respect of which revenue may be earned to the extent that such amounts may reasonably be considered to ensure a return of all or a portion of the investor's outlays in respect of the tax shelter.[41] In addition, where there is an agreement or an arrangement to allow for the disposition of the interest in the tax shelter (whether absolute or contingent),[42] the proceeds to which the investor would be entitled on the disposition will constitute a prescribed benefit.[43] Any amount that is owed to the promoter or to a person with whom the promoter does not deal at arm's length by the investor or by a person with whom the investor does not deal at arm's length in respect of the acquisition of an interest in the tax shelter will also constitute a prescribed benefit.[44]

Finally, a draft regulation released on December 14, 1995 added a new item to the list of prescribed benefits. Specifically, proposed regulation 231(6.1) provides that an LRA under section 143.2 is a prescribed benefit. By way of exception, an LRA will not constitute a prescribed benefit where indebtedness is an LRA only because it is not repayable within a reasonable period not exceeding 10 years where the debtor is

- a partnership at least 90 percent of the fair market value of the property of which is attributable to tangible property located in Canada and at least 90 percent of the value of all interests in which are held by limited partners of the partnership; or
- a member of a partnership that has fewer than six members.

In the latter case, an exception is made where:

1) the partnership is a member of another partnership;

2) there is a limited partner of the partnership;

3) less than 90 percent of the fair market value of the property of the partnership is attributable to tangible property located in Canada; or

4) it is reasonable to conclude that one of the main reasons for the existence of the partnership is to avoid the application of section 231 to the member's indebtedness.

The term "limited partner" refers to the definition in subsection 96(2).

The logic of this provision seems to be circular. An LRA only has meaning in relation to a TSI. A TSI, in many cases, is linked to an expense or an acquisition being considered a tax shelter under the Act. Qualification as a tax shelter is tied to representations made that deductible amounts will at least equal the investment less prescribed benefits. In many cases, if there are limited prescribed benefits but there is debt that would otherwise be an LRA (for example, because interest is charged at

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[41] Regulation 231(6)(b).

[42] Otherwise than as a consequence of the death the investor.

[43] Regulation 231(6)(c).

[44] Regulation 231(6)(d).

less than the prescribed rate), there is arguably a problem in the application of the provision. The debt can be an LRA only if the partnership is a tax shelter (since the deeming provision in subsection 143.2(7) applies only for the purpose of section 143.2) and the partnership will be a tax shelter only if the debt creates a prescribed benefit because it is an LRA. It seems an inappropriate case of "bootstrapping" to argue otherwise, but the inclusion of new regulation 231(6.1) to deem an LRA to be a prescribed benefit appears to attempt to do just that.

To see the scope of the tax shelter definitions, assume that the cost of an investment is $1,000 and that projected deductions over the four years following the investment, including all projected carrying charges, will be $600. In any of the following situations, the investment will be considered a tax shelter:

1) any combination of prescribed benefits totals more than $400 ($1,000 cost less $600 of projected deductions);

2) the investor owes more than $400 to the promoter;

3) the investor owes more than $400 to some other person but the debt is guaranteed by the promoter or by another person who is receiving a payment in order to provide the guarantee; or

4) there is a revenue guarantee greater than $400.

Similarly, a real estate investment funded by a $250 cash downpayment and a $750 limited recourse mortgage will be considered a tax shelter if projected deductions, including carrying costs, exceed $250 over the first four years.

"Limited-Recourse Amount"

Once it is determined that a particular investment is a TSI, it is necessary to ascertain whether there is a related LRA. An LRA is the unpaid principal amount of any indebtedness for which recourse is limited either immediately or in the future and either absolutely or contingently.[45] If the indebtedness is incurred by a partnership and recourse against any member of the partnership in respect of the indebtedness is limited either immediately or in the future and either absolutely or contingently, the indebtedness is deemed to be an LRA.[46] As a result, any limited partnership borrowing is considered to be an LRA. Where a partnership borrows and each investor assumes the liability personally, there is still some question whether the debt is an LRA. For example, if the liability of each partner is limited to its pro rata share of the debt, it is arguable that the partner's liability is limited. Absent any specific decision on this matter by Revenue Canada, it may be argued that unless liability on the indebtedness is joint and several, recourse is limited and therefore the debt is an LRA. This result is illogical when compared with the situation where each

[45] Proposed subsection 143.2(1).

[46] Proposed subsection 143.2(8).

limited partner borrows a pro rata share of full recourse debt and contributes the borrowed funds to the partnership. In this case there is no LRA. The other interesting aspect of this definition is that if recourse against *any* particular partner is limited, the debt will still be considered to be an LRA in respect of *all* members of the partnership. Although this result appears to be unduly onerous, Finance officials have confirmed that this is the intent of the legislation.

The LRD rules apply to the principal amount of *any* indebtedness. Therefore, loans and any unpaid balance of purchase price can be considered to be LRAs. However, the rules may have even broader application. For example, assume that a limited partnership has accrued liabilities in the ordinary course of business at year-end. To the extent that any invoices are outstanding, these accounts payable could be considered indebtedness where recourse against the limited partners is limited and thus could be deemed to be LRAs. As a result of such a determination, the deduction of the expenses related to the accounts payable will be precluded until the payables were in fact paid.[47] Revenue Canada, in a private opinion, has recently confirmed this position.

Even where the indebtedness is full recourse to the borrowers, it will still be deemed to be an LRA unless:

1) bona fide arrangements were made at the time the indebtedness arose for repayment of the debt and all interest within a reasonable period not exceeding 10 years; and

2) interest is payable at least annually at a rate equal to or greater than the lesser of (a) the rate prescribed under the Act[48] at the time the indebtedness arose, and (b) the prescribed rate from time to time during the term of the indebtedness, and the interest is paid in respect of the indebtedness no later than 30 days after the end of each taxation year of the debtor that the debt is outstanding.

As a result, any indebtedness with a term exceeding 10 years is automatically an LRA. If the term of the debt is less than 10 years, it must still be reasonable in the circumstances. Since in any particular circumstance reasonableness will be a question of fact, Revenue Canada could reassess any tax shelter investment on the basis that the term of the debt is not reasonable in the circumstances and that therefore the debt constitutes an LRA.

As noted above, bona fide arrangements for repayment must be made at the time the debt arises to ensure that the indebtedness will not be deemed to be an LRA. There is an established body of jurisprudence and administrative policy that applies in determining whether bona fide arrangements have been made for debt repayment. Essentially, to the extent

[47] Proposed subsection 143.2(9) would allow the deduction at the time the LRA was repaid.

[48] Regulation 4301 sets out the prescribed rate.

that the loan is made for a specific term (in this case, less than 10 years), the loan bears interest at commercial rates, and commercial terms of repayment are negotiated (including ordinary collateral security), bona fide arrangements will ordinarily be considered to be in place. Jurisprudence has held that demand loans, however, do not represent bona fide arrangements for repayment.[49]

"At-Risk Adjustment"

As mentioned above, the amount of expenditures is reduced not only by the amount of LRAs but also by an "at-risk adjustment."[50] This provision was designed to dovetail with the at-risk rules,[51] which otherwise limit losses that investors may deduct for tax purposes. An at-risk adjustment means any amount or benefit to which a taxpayer (or anyone who does not deal at arm's length with the taxpayer) may be entitled. The entitlement may be absolute or contingent and may arise immediately or in the future. The types of entitlements are very broad and include reimbursements, compensation, revenue guarantees, proceeds of disposition, and loans or any other form of indebtedness. The amount or benefit, however, must be granted for the purpose of reducing the impact, in whole or in part, of any loss that the taxpayer may sustain in respect of the expenditure. Where the expenditure is the cost or the capital cost of the property, the amount or benefit must reduce the impact of any loss from holding or disposing of the property. There are certain very limited exceptions to these benefit provisions, including:

1) a contract of insurance with an insurance corporation that deals at arm's length with the taxpayer (and, where the expenditure is the cost of an interest in the partnership, with each member of the partnership) under which the taxpayer is insured against any claim that arises as a result of a liability incurred in the ordinary course of carrying on the business of the taxpayer or partnership;

2) a benefit as a consequence of the death of the taxpayer; and

3) a benefit in respect of certain excluded obligations in respect of flowthrough shares.

Although the April 26, 1995 draft legislation did not contain an exemption from the at-risk adjustment for prescribed revenue guarantees given in connection with a certified production, an exemption was added in the December 14, 1995 draft legislation for revenue guarantees granted before 1996.

If the amount is also otherwise excluded from the cost because of another provision of the Act, it will not constitute an at-risk adjustment. This exclusion is designed to avoid any double counting of benefits. It

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[49] *Perlingieri v. MNR*, 93 DTC 158 (TCC).

[50] Proposed subsection 143.2(6).

[51] The at-risk rules are set out in subsection 96(2.2).

should be stressed that, as under the at-risk rules, the amount or benefit must limit the loss of the taxpayer in order to constitute an at-risk adjustment. As a result, to the extent that there are entitlements to amounts in the future, whether absolute or contingent, that may be earned or received in the ordinary course of business, those amounts will not necessarily constitute at-risk adjustments. Each case must to be examined on its own merits to determine whether the future amounts are to be recycled into business operations and therefore do not necessarily limit loss, or whether the future amounts are to be applied to reduce the losses otherwise suffered by investors. In the latter case, the at-risk adjustment will apply.

In order for the at-risk adjustment to mirror the at-risk rules, various provisions have been added for greater certainty. For example, where the taxpayer has a right, whether present, future, or contingent, to acquire property, the amount or benefit to which the taxpayer is entitled is considered to be not less than the fair market value of the property at that time.[52] Similarly, where a loan guarantee or security or similar indemnity is provided in respect of a loan, the benefit is considered to be not less than the total amount unpaid on the loan at that time as well as all other amounts outstanding in respect of the loan or obligation at that time.[53]

The at-risk adjustment does not apply to the cost of the partnership interest to which the at-risk rules would apply. Presumably, the resulting partnership loss would be governed by the at-risk rules.

Repayment of a Limited Recourse Amount

The provisions that grind cost for tax purposes are not intended to be permanent. To the extent that any limited recourse indebtedness is actually repaid or replaced with full recourse indebtedness, the previously denied deductions of costs will be recognized at the time of repayment.[54] However, there is an anti-avoidance provision that states that where an LRA is replaced by new limited recourse debt, the recognition of the expenditure continues to be denied. For example, to the extent that limited recourse financing is obtained in respect of a particular investment, the financing will not form part of the expenditure. If the debt is replaced at some point in the future by full recourse debt for which interest is not payable annually (that is, a deemed LRA), the limited recourse debt rules will continue to apply to deny the deduction of the expenditure.

Two new provisions were added in December 1995. Pursuant to subsection 143.2(7.1), a debtor is not considered to have made arrangements to repay debt within 10 years where the debtor's arrangement to repay can reasonably be considered to be part of a series of loans or other indebtedness and repayments that ends more than 10 years after it begins.

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[52] Proposed subsection 143.2(4).

[53] Proposed subsection 143.2(5).

[54] Proposed subsection 143.2(9).

Subsection 143.2(5.1) applies where "a taxpayer has paid an amount on account of the principal amount of an indebtedness that was, before that time, the unpaid principal amount of a loan or any other form of indebtedness to which subsection (2) applies . . . relating to an expenditure of the taxpayer." Essentially, where there has been a previous at-risk adjustment and the taxpayer has repaid an amount on account of the principal amount of indebtedness to which the adjustment has applied, the expenditure shall be deemed to have been made at the time of and to the extent of the repayment (subject to the overall provisions of subsection 143.2(6)). Subsection 143.2(5.1) would clearly apply where the at-risk adjustment was caused by a loan guarantee and the loan is subsequently repaid. It is less clear how this provision applies to other forms of benefits that are not specifically tied to a debt. This is because subsection 143.2(2) creates an at-risk adjustment in respect of an expenditure, rather than in respect of debt. Consequently, where there is a benefit that is not specifically tied to a debt (for example, a cash flow guarantee), the at-risk adjustment has not applied to the indebtedness as much as it has to the expenditure. Therefore, the repayment of debt with the proceeds of such benefit might not trigger the application of this provision.

Statute of Limitations

Ordinarily (other than in the case of fraud or gross misrepresentation), Revenue Canada cannot reassess an income tax return more than three years after the first assessment.[55] This limitation does not apply in respect of the application of the LRD rules.[56] As a result, there is no limitation as to the period within which Revenue Canada can re-examine a transaction involving a TSI to determine whether there was an LRA. For example, situations may arise in future years to indicate that arrangements existed at the time loans were made to qualify them as LRAs. Similarly, interest payments may be missed in future years, resulting in a potentially retroactive impact on deductions taken in prior years. These future events could allow reassessment back to the initial year of investment, no matter when the determination was made.

Compliance

The LRD rules have also empowered Revenue Canada to deal with situations where information is situated outside Canada that is relevant in determining whether amounts are LRAs or whether parties are dealing at arm's length for the purposes of the LRD rules.[57] In these cases, if the information required is not provided to the minister upon request, the minister can deem the amounts to be LRAs or the parties to have not been

[55] For mutual fund trusts and corporations other than Canadian-controlled private corporations, the usual reassessment period is four years after the first assessment.

[56] Proposed subsection 143.2(12).

[57] Proposed subsections 143.2(10) and (11).

dealing at arm's length. As a result, the onus is shifted to the taxpayer to provide the information. Failure to provide the information will result in a loss of the deductions otherwise claimed. The only exception to this rule arises in situations where the information is located in a country with which Canada has a tax treaty and the tax treaty gives Canada the right to access information directly from the foreign government.

Transitional Provisions

As mentioned above, the final version of the LRD rules is much broader than the proposals announced in the press release. Therefore, both the date of the press release (December 1, 1994) and the date of the draft legislation containing the LRD rules (April 26, 1995) are significant for the purposes of the substantial transitional relief or "grandfathering" provided by the LRD rules. For example, the rules do not apply at all to property acquired and to outlays made or incurred by a taxpayer before the date of the press release. They also do not apply where:

1) the property was acquired, or the outlay or expense was made or incurred, before 1995 pursuant to an agreement in writing entered into by the taxpayer before the date of the press release, or

2) the property acquired was a certified production (or an interest in a partnership, substantially all the property of which is a certified production) if principal photography of the production commenced in 1994 and was completed by March 2, 1995.

These latter exemptions are available only if (1) there are no agreements or other arrangements under which the taxpayer's obligations with respect to the property, outlay, or expense could be changed, reduced, or waived in the event of a change to the Act or an adverse assessment under the Act, and (2) if the property, outlay, or expense constitutes a "tax shelter,"[58] a tax shelter identification number was obtained before December 1994.

Although the press release stated that indebtedness would be deemed to be an LRA if interest at the rate prescribed under the Act was not paid annually and bona fide arrangements were not made at the time the debt arose for its repayment (with interest) within a reasonable time, the press release did not contain a requirement that the repayment be within 10 years. This requirement was added by the April 26, 1995 draft legislation, presumably to limit the length of certain tax-deferral structures by requiring that sufficient income be generated in the structure within the first 10 years to repay the indebtedness. Consequently, the final version of the LRD rules contains transitional relief for indebtedness that is to be outstanding for more than 10 years. Specifically, the 10-year limitation does not apply to indebtedness that arises:

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[58] Under subsection 237.1(1).

1) pursuant to the terms of a written agreement entered into by the taxpayer before April 27, 1995;[59]

2) before 1996 in respect of the acquisition of a certified production or an interest in one or more partnerships, all or substantially all of the property of which is a certified production, the principal photography of which commences before 1996 (or, in the case of a television series, the principal photography of one episode begins before 1996) and is completed before March 1996;[60]

3) before July 1995 pursuant to the terms of a document that is a prospectus, a preliminary prospectus, an offering memorandum, or a registration statement that was filed before April 27, 1995 with a public authority in Canada pursuant to federal or provincial securities legislation, if the funds so raised are expended before 1996 on expenditures contemplated by the document; or

4) before July 1995, pursuant to the terms of an offering memorandum distributed as part of an offering of securities where:

> a) the memorandum contained a complete or substantially complete description of the securities contemplated in the offering as well as the terms of the offering;
>
> b) the memorandum was distributed before April 27, 1995;
>
> c) solicitations in respect of the sale of securities contemplated by the memorandum were made before April 27, 1995;
>
> d) the sale of the securities was substantially in accordance with the memorandum; and
>
> e) the funds are expended in accordance with the memorandum before 1995.

These exemptions from the 10-year requirement will apply only if (1) there were no agreements or other arrangements under which the taxpayer's obligations with respect to the property, outlay, or expense could be changed, reduced, or waived in the event of a change to the Act or an adverse assessment under the Act, and (2) if the property, outlay, or expense constituted a tax shelter, a tax shelter identification number was obtained before April 27, 1995. The requirement to obtain a tax shelter identification number does not apply to the exemption in respect of the acquisition of an interest in a certified production.

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[59] The reference to April 27, 1995 in all of the transitional provisions contained in the December 14, 1995 draft legislation comes as something of a surprise. The draft legislation was originally dated April 26, 1995, and it has been customary in recent years to make new provisions effective as of midnight at the commencement of the day in question. This avoids the possibility that taxpayers will, in response to new proposals, modify their arrangements on the day the proposals are announced.

[60] Finance officials are considering expanding this exemption to include direct acquisitions of interests in certified productions.

The concept of the "at-risk adjustment" was not mentioned in the press release. Accordingly, the LRD rules contain grandfathering provisions in respect of arrangements that would otherwise have led to an at-risk adjustment. Specifically, the at-risk adjustment will not reduce the amount of any expenditure or the cost of any property if the property was acquired or the outlay or expense was made before April 27, 1995. The at-risk adjustment also will not apply to property acquired or outlays or expenses made before 1996 pursuant to an agreement in writing entered into before April 27, 1995 if the conditions described above regarding tax shelter identification numbers and agreements or arrangements in the event of changes to the Act are met.

Finally, proposed subsection 143.2(8) provides that any loan to a partnership is deemed to be an LRA if recourse against any member of the partnership is limited in any respect. Even though the press release made no mention of such a deeming rule, the April 26, 1995 draft legislation stated that the rule was effective as of December 1, 1994. Subsequent to the release of the draft legislation, the Department of Finance received numerous submissions that this deeming rule amounted to retroactive legislation. Consequently, additional transitional relief has been provided in the December 14, 1995 draft legislation where (1) the indebtedness arose and is related to property acquired or to outlays or expenses made or incurred by the taxpayer before April 27, 1995, and where (2) the indebtedness arose and is related to property acquired or to outlays or expenses made or incurred by the taxpayer before 1996 pursuant to a written agreement entered into before April 27, 1995 where there is no agreement or other arrangement under which the taxpayer's obligation may be changed, reduced, or waived if there is a change to the Act or an adverse assessment under the Act.

1995 Federal Budget and Removal of CCA Incentives

The 1995 federal budget[61] provided for the phasing out of the certified production tax shelter system effective January 1, 1996. The method by which the Department of Finance plans to close the system involves the cancellation of incentives previously available for certified productions. Although some of these proposals affect only film tax shelters, others may apply to anyone who owns a certified production, including film producers. Budget proposals that fall into the latter category include:

1) the current exemption for certified productions from the "half-year rule" is to be removed, with the result that the effective CCA rate will be reduced from 30 percent in the first year to 15 percent; and

2) the cancellation of the additional CCA allowance that entitles the owner of a certified production to accelerate the deduction of CCA in order to offset any income earned from the production.[62]

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[61] Canada, Department of Finance, 1995 Budget, February 27, 1995.

[62] By virtue of regulation 1100(1)(l).

The latter budget proposal is more significant because the additional allowance enables the owner of a certified production to match film revenues against film costs, and its elimination may create a serious mismatching problem. For example, assume that a production costs $1,000,000 and is produced in 1995. In 1996, the production generates $800,000 in revenues. Under the current rules, a film producer may write off $300,000 of the costs in the first year and the remaining $700,000 of costs against the $800,000 revenue flow in the second year. Under the new proposals, the producer would be entitled to write off $150,000 in the first year and $255,000 (that is, 30 percent × $850,000 undepreciated capital cost) against the $800,000 revenue flow in the second year, leaving the producer with a huge tax exposure. The impact of such a tax burden would more than outweigh any benefit that a producer might obtain from the production tax credit.

Draft regulations introduced on December 12, 1995 indicate that a new additional allowance will exist for productions that qualify for the new tax credit (described in detail below). The draft regulations also propose to create an additional deduction on account of CCA in respect of property for which a separate class is prescribed by new regulation 1101(5k.1). This additional deduction is to function in the same manner as the current additional deduction in respect of certified productions.[63] New regulation 1101(5k.1) prescribes a separate class for all property of a corporation included in class 10 because of paragraph (x) that is property:

> (a) in respect of which the corporation is deemed under subsection 125.4(3) of the Act to have paid an amount, or
>
> (b) acquired by the corporation from another corporation where
>
> > (i) the other corporation acquired the property in circumstances to which paragraph (a) applied, and
> >
> > (ii) the corporations were related to each other throughout the period that began when the other corporation acquired the property and ended when the other corporation disposed of the property to the corporation.

Where the corporation has produced a Canadian film or video production (class 10(x) of schedule II) that qualifies for the tax credit in subsection 125.4(3), it will fall into the separate class for the purposes of the additional deduction. The additional deduction will follow the property through transfers within a related group of corporations.

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[63] A separate class is created in regulation 1101(5k) in respect of certified productions. The current additional deduction is contained in regulation 1100(1)(l). New regulation 1100(1)(m) provides for deduction of such additional amount as the taxpayer claims in respect of property for which a separate class is prescribed by regulation 1101(5k.1) not exceeding the lesser of:

> (i) the taxpayer's income for the year from the property, determined before making any deduction under this paragraph, and
>
> (ii) the undepreciated capital cost to the taxpayer of the property of that separate class at the end of the year (before making any deduction under this paragraph for the year).

The new proposals do not go all the way toward solving the revenue-mismatching problem for Canadian producers. Because a special class for new Canadian film or video productions is prescribed, revenues received by production corporations and/or their affiliates in 1995 or later from certified productions will not qualify for the additional allowance for new Canadian film or video productions. Consequently, producers who have availed themselves of the tax credit in respect of their 1995 productions will find that revenues received in respect of certified productions from previous years will not be available to accelerate CCA in respect of the productions that they produce in 1995 or later.

Another of the incentives eliminated by the 1995 federal budget is the exemption from the at-risk rules for prescribed revenue guarantees given in connection with a certified production.[64] The budget provided that the exemption would not be available for guarantees granted after 1995. Because revenue guarantees are an integral part of certified production tax shelters, the elimination of this incentive, coupled with the removal of the additional CCA allowance, effectively terminated the viability of these structures as of the end of 1995. The draft legislation released on April 26, 1995 contained additional restrictions on revenue guarantees granted in 1995. According to that draft legislation, to be exempt from the at-risk rules, a prescribed revenue guarantee not only must be granted before 1996, but also must be payable no later than the year 2000 and must not be contingent on any event or condition that occurs or that is to be satisfied after 1995.[65] After several meetings with representatives of the production industry, the Department of Finance agreed to withdraw the additional requirements and issued revised legislation on July 19, 1995, which was updated in the notice of ways and means motion dated December 12, 1995.

THE CANADIAN FILM OR TELEVISION PRODUCTION TAX CREDIT

Overview

On July 19, 1995, the federal minister of finance tabled draft legislation that proposes to create the Canadian film or video production tax credit (PTC). The PTC legislation contained in section 125.4, described in greater detail below, corresponds with the proposals previously contained in the 1995 federal budget and the discussion paper issued jointly by the ministers of finance and Canadian heritage in June 1995.

The PTC will be available in respect of a "Canadian film or video production" and may be claimed only by a "qualified corporation." The term "Canadian film or video production" (now referred to in class 10(x) of schedule II and in the December 12, 1995 draft regulations) has been defined similarly to the current definition of "certified production" contained

[64] The current exemption is set out in subparagraph 96(2.2)(d)(ii).

[65] Clause 37(8) of the April 26, 1995 draft legislation.

in regulation 1104(2). The "point" system and "cost" system, which have been in place since the mid-1970s, continue to be applicable, subject to a few changes, discussed below.[66]

Where the corporation files certain prescribed forms along with its income tax return, it is deemed to have paid on account of income tax payable[67] an amount equal to 25 percent of the corporation's "qualified labour expenditure" for the year in respect of a production.[68] The PTC may be claimed in respect of a production only once principal filming[69] has commenced. Accounts must be kept separately for each production that will qualify independently (rather than on a pooled basis) for the credit. As described in detail below, the qualified labour expenditure in respect of a production cannot exceed 48 percent of its cost (net of assistance). As a result, the maximum credit available in relation to a film production will be 12 percent of the cost of production (net of assistance).

The PTC will be a refundable tax credit. That is, any corporation that is entitled to the credit will be entitled to a refund of income tax to the extent that no tax is otherwise payable. In such cases, it will be available only once the production corporation's income tax return for the year is filed and assessed by Revenue Canada. No mechanism has been proposed to make the new tax credit assignable.[70]

Only a qualified corporation may claim the credit. A qualified corporation means a corporation that is throughout the year a prescribed taxable Canadian corporation, the activities of which "in the year are primarily the carrying on through a permanent establishment (as defined by regulation) in Canada of a business that is a Canadian film or video production business."[71] A corporation that carries on a Canadian film or video production business through a Canadian permanent establishment while carrying on other businesses would not qualify if such other businesses represent the majority of the corporation's activities.

Consequently, to the extent that the business of a production corporation includes other businesses (including film distribution) or where the corporation carries on business outside Canada, it could possibly be disqualified from the PTC. Producers will have to take great care to ensure

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[66] For an in-depth treatment of the current rules relating to certified productions and criteria for tax shelter financing, see the articles listed in footnote 3, supra.

[67] Under part I of the Act.

[68] Subsection 125.4(3).

[69] The term "principal filming" has not been defined but is used in the technical notes to the draft legislation tabled by the minister of finance on July 19, 1995, supra footnote 12, interchangeably with principal photography. The term "principal photography" is the term currently used in the Regulations in relation to certified productions.

[70] Film industry representatives have expressed concerns that because the credit is not assignable, it cannot be easily banked. As a result, the cost of financing production during the course of filming may become prohibitive.

[71] Defined under subsection 125.4(1).

that the production corporation that applies for the PTC limits other types of business activities carried on.

It is common practice for a producer to form a wholly owned subsidiary for the purposes of producing a particular production. In this manner, the producer is able to isolate the liabilities of the production and restrict the claims, if any, of third parties relating to the property being produced. A newly formed corporation that produced a film through a Canadian permanent establishment would carry on no other business activities and would qualify for the PTC. This option, however, creates additional cash flow problems to the production in situations where the parent corporation is otherwise taxable. In such an instance, if the parent were able to produce directly, it could reduce its monthly income tax instalments based on projected production costs for the fiscal period. By forming a subsidiary, the newly formed corporation would have no income tax payable and the refund of income tax may not be available until its income tax return for the year is filed and assessed.

Prescribed Taxable Canadian Corporation

As mentioned above, a qualified corporation must be a prescribed taxable Canadian corporation. The draft regulations (regulation 1106(2)) define "prescribed taxable Canadian corporation" as a taxable Canadian corporation that is a Canadian, other than a corporation, controlled directly or indirectly in any manner whatever by one or more persons, all or part of whose taxable income is exempt from tax under part I of the Act or a prescribed labour-sponsored venture capital corporation. For these purposes, "Canadian" means a corporation that is Canadian controlled as determined for the purposes of sections 26 to 28 of the Investment Canada Act.[72]

Canadian Film or Video Production

A Canadian film or video production[73] means a film or video production (other than an excluded production) of a prescribed taxable Canadian corporation that is either a treaty coproduction or a film or video production that meets various requirements. Many of these requirements are the same as those under the current system applicable to certified productions. First and foremost, the individual producer must be a Canadian at all times during the production.[74] "Canadian" for these purposes means a Canadian citizen or permanent resident within the meaning of the Immigration Act.[75]

The term "producer" is defined[76] as an individual who:

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[72] RSC 1985, c. 28 (1st Supp.), as amended.

[73] Defined in regulation 1106(3).

[74] Regulation 1106(3)(b)(i).

[75] Definition of "Canadian" in regulation 1106(1).

[76] Definition of "producer" in regulation 1106(1).

1) controls and is the central decision maker in respect of the production;

2) is directly responsible for the acquisition of the production story or screenplay and the development, creative and financial control, and exploitation of the production; and

3) is identified in the production as being the producer.

In addition, a production will not qualify (and will constitute an "excluded production")[77] unless the corporation or a related taxable Canadian corporation retains the following rights[78] in the production:

1) the exclusive worldwide copyright in the production for all commercial exploitation purposes for a minimum of five years commencing when the production is completed and is commercially exploitable; investment by Canadian or provincial government film agencies will be permitted, as will ownership by other prescribed taxable Canadian corporations;

2) control of the initial licensing of commercial exploitation; and

3) retention of a share of revenues that is acceptable to the minister of Canadian heritage from the exploitation of the production in non-Canadian markets.

This last test is subjective and will be entirely at the discretion of Heritage officials.

In addition, there must be an agreement in writing at fair market value consideration with a Canadian distributor or broadcaster that holds a television broadcasting licence issued by the Canadian Radio-television and Telecommunications Commission to have the production shown in Canada within two years that begins at the first time the production has been completed and is commercially exploitable. Finally, distribution of the production by a person who is not a Canadian may not be made within that two-year period.

The following types of production will also be excluded productions:

1) news, current events, or public affairs programming, or a program that includes weather or market reports;

2) a talk show;

3) a production in respect of a game, a questionnaire, or a contest (other than a production directed primarily at minors);

4) a sports event or activity;

5) a gala presentation or an awards show;

6) a production that solicits funds;

7) reality television;

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[77] An "excluded production" is defined in regulation 1106(1).

[78] Subparagraph (a)(ii) of the definition. These three requirements do not apply to official treaty coproductions.

8) pornography;

9) advertising;

10) a production produced primarily for industrial, corporate, or institutional purposes;

11) a production, other than a documentary, all or substantially all of which consists of stock footage; or

12) a production for which public financial support would, in the opinion of the minister of Canadian heritage, be contrary to public policy.

There continues to be a creative points test, which requires that the minister of Canadian heritage allot at least six points in respect of individuals who are Canadians.[79] The cost tests applicable to certified productions will apply in the same way to Canadian film or video productions.[80]

New rules have been proposed for animation. For an animation production, all of the following categories will be worth one point each where services are provided by a Canadian: the director; the lead voice,

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[79] Regulations 1106(3)(b)(ii) and 1106(4). The latter provision includes identical requirements to those under the current rules for certified productions—that is, two points each for the director and the screenwriter and one point each for the highest and second highest remunerated lead performers, the art director, the director of photography, the music composer, and the picture editor. Either the director or the screenwriter must be Canadian, as must at least one of the lead performers who are the highest or the second highest remunerated. For these purposes:

(a) a lead performer in respect of a production is an actor or actress who has a leading role in the production having regard to the performer's remuneration, billing and time on screen;

(b) a lead voice in respect of an animation production is the voice of the individual who has a leading role in the production having regard to the length of time that the individual's voice is heard in the production and the individual's remuneration;

(c) the principal screenwriter of a production is not a Canadian unless

(i) each individual involved in the preparation of the screenplay for the production is otherwise a Canadian, or

(ii) the principal screenwriter is an individual who otherwise is a Canadian and

(A) the screenplay for the production is based upon a work authored by a Canadian, and

(B) the work is published in Canada.

[80] Regulation 1106(3)(b)(iii) provides that not less than 75 percent of the total of all costs for services in respect of producing the production was payable to and in respect of services provided by individuals who are Canadians. Excluded from these costs are costs determined by reference to the amount of income from the production, remuneration payable to or in respect of the producer or creative points persons, amounts payable in respect of insurance, brokerage, legal, and accounting fees and similar amounts and postproduction costs. In addition, at least 75 percent of all postproduction costs incurred, including laboratory work, sound re-recording, sound editing, and picture editing was incurred in respect of services rendered in Canada (other than costs determined by reference to the amount of income from the production or remuneration payable to or in respect of the producer or creative points individuals).

which is the highest or second-highest remuneration; the design supervisor; the camera operator (where the camera operation is done in Canada); the music composer; and the picture editor. In addition, there will be one point allotted where both the principal screenwriter and the storyboard supervisor are individuals who are Canadians. An additional point will be allocated in the following circumstances:

1) layout and background work is done in Canada;

2) key animation is done in Canada; and

3) assistant animation and in-betweening are done in Canada.

Either the director or both the principal screenwriter and the storyboard supervisor must be Canadian, and one point must be allocated in relation to the first or second lead voice. Finally, key animation must be done in Canada.

For documentaries, a new rule deems the documentary to qualify if all creative positions in respect of the production are occupied by individuals who are Canadian (provided that the documentary is not otherwise an "excluded production").

To qualify, any production must be completed within two years after the end of the corporation's taxation year in which principal photography began, and a certificate of completion must be issued by the minister of Canadian heritage within 30 months of the end of the corporation's taxation year in which principal photography began.[81]

Labour Expenditure

To compute the annual PTC available to a qualified corporation in any particular taxation year, the corporation will be required to calculate its qualified labour expenditure, which is based on a calculation of its "labour expenditure." Labour expenditure[82] is to be computed in respect of each individual production of the qualified corporation that is a Canadian film or video production.[83] The labour expenditure for a taxation year must be:

1) included in the cost (or, in the case of depreciable property, the capital cost) of the property;

2) incurred for the stages of production of the property from the final script stage to the end of the postproduction stage;

3) directly attributable to the production of the property; and

4) reasonable in the circumstances.

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[81] Otherwise, the production is considered an excluded production in accordance with subparagraph (a)(i) of the definition in regulation 1106(1).

[82] Defined in subsections 125.4(1) and (2).

[83] The labour expenditure of a corporation that is not a qualified corporation for the year is deemed to be nil under the definition.

The terms "final script stage" and "the end of postproduction stage" are not specifically defined in the Act; consequently, these terms of art within the film industry will be defined in accordance with the ordinary standards of the industry. The Quebec tax credit, which was the model for the PTC, uses a similar test. The term "final script stage" is accepted within the industry to mean the stage at which the screenplay is completed, subject to customary modifications during the course of shooting. Any costs related to the acquisition of story rights and other underlying rights would not be labour expenditures. Expenditures relating to development and completion of the script and/or screenplay would form part of the final script stage and would qualify.[84] All costs incurred from the point of the commencement of the final script stage right through to the end of production will qualify, provided that the costs meet the criteria referred to below.

The following are specific types of expenditures that qualify as labour expenditures:

1) Salary or wages directly attributable to the production that are incurred after 1994 and in the year or the preceding taxation year and are paid by the corporation in the year or within 60 days after the end of the year.[85] Consequently, expenses incurred in a particular year will qualify for the credit for that year if they are paid for in the year or within 60 days of year-end. Expenses that are paid for outside the 60-day period may be carried forward one year, provided that they are paid in the following year or within 60 days of the end of the following year. No double counting of expenses is permitted. "Salary or wages" for these purposes is defined broadly under the definition in section 248 of the Act (excluding any stock option benefits pursuant to section 7 of the Act).[86] Any amount determined by reference to profits or revenues from a production will also be excluded from salary or wages.[87] It is not uncommon for an actor's remuneration to include amounts payable in the future by reference to gross revenues or profits generated from the exploitation of the film. Any of these types of future payments will not qualify as salary or wages for these purposes and, consequently, will not qualify as labour expenditure even when they are actually calculated and paid.

2) That portion of remuneration (other than salary or wages and other than remuneration that relates to services rendered in the preceding taxation year and that was paid within 60 days of the end of that preceding year) that relates to services rendered after 1994 and in the year or that

[84] The original version of the definition of labour expenditure referred to expenses incurred for the stages of production "*from the end of* final script stage" (emphasis added). Under that definition, all script/screenplay-related costs would be excluded. After discussions between Heritage Canada and Finance officials, the legislation was modified. Heritage Canada officials have confirmed this intended change.

[85] Paragraph (a) of the definition of "labour expenditure" in subsection 125.4(1).

[86] See the definition of "salary or wages" in subsection 125.4(1).

[87] Ibid.

preceding year, to the corporation paid to an individual who is not an employee of the corporation will qualify to the extent that the amount paid is attributable to services personally rendered after 1994 by the individual for the production or is attributable to and does not exceed the salary or wages of the individual's employees for personally rendering services for the production.[88] Once again, remuneration excludes any amounts payable by reference to profits or revenues.[89]

It is quite common for producers to pay actors, as part of their remuneration, a "buyout" of their residual rights for a period of years in the property being produced. These amounts are often significant. The issue in relation to these payments is whether they constitute "remuneration determined by reference to profits or revenues." In our view, if the payments are paid up front and in advance, they are no longer "determined by reference" to profits or revenues; rather, they are paid in lieu of or as consideration for the rights to future revenues, and consequently should form part of remuneration for these purposes.

Where payments are made to third-party contractors, a computation must be made of any amount attributable to the services of the contractor and his or her employees. Any amounts related to goods provided by such contractors must be excluded. For example, payments made to makeup artists ordinarily will include not only payment for services but also an attributable portion to makeup kits provided by these contractors. For these persons, a reasonable allocation must be made for the services rendered as opposed to the goods provided. Revenue Canada has adopted a similar test for the purposes of determining deductions at source withholding for non-resident makeup artists under paragraph 153(1)(g) of the Act and regulation 105.

3) Similarly, remuneration payable to another taxable Canadian corporation for services rendered after 1994 will qualify to the extent that the amount paid is attributable to and does not exceed the salary or wages of the other corporation's employees for personally rendering services for the production. Any payments made to a non-Canadian corporation will not qualify as labour expenditures even if they are attributable to the services of the foreign actor or behind-the-camera personnel on a production. For example, to the extent that a foreign director or actor provides services to a Canadian production through the auspices of a foreign personal services corporation, the Canadian production company will have to accept that any payment made to that personal services corporation will not qualify as a labour expenditure under this definition.

To support the claim of the payer corporation, the recipient taxable Canadian corporation will be required to demonstrate the amount of salary or wages payable to its employees for personally rendering services for the production. To the extent that the recipient corporation is providing

[88] Subparagraph (b)(i) of the definition of "labour expenditure" in subsection 125.4(1).

[89] Subparagraph (b)(ii) of the definition of "labour expenditure" in subsection 125.4(1).

services to a number of productions, it will be required to allocate the value of the services to each particular production. Any markup, premium, or administrative fee charged in excess of attributable salaries or wages will not qualify. It is not clear whether the salary or wages of the employee must be paid within any particular period. Presumably, however, the recipient corporation will be obliged to complete, for the benefit of the production corporation, a prescribed form that indicates the amount received within 60 days of the end of the payer's fiscal year-end and the allocation of that amount to salary or wages of its employees.

This requirement may create some uncomfortable situations for service suppliers because, presumably, it would require disclosure to the corporation of the supplier's markup for overhead and profit. If this requirement is enforced in this manner, suppliers are likely to resist providing this information.

4) Payments made by a corporation to another taxable Canadian corporation, all the issued and outstanding shares of the capital stock of which belong to an individual (where the activities of the recipient corporation consist principally of the provision of the individual's services), will also qualify as labour expenditures to the extent that the amount paid is attributable to services rendered personally by the individual for the production after 1994. Unlike the previous case, it is not necessary to demonstrate a relationship between the payment to the recipient corporation and the salary or wages of its employees. To qualify under this provision, however, the personal services corporation must be 100 percent owned by the individual who renders the services.[90] Thus, to the extent that the shares of a personal services corporation are owned by the individual and his or her family members, this provision will not apply. Consequently, production corporations will have to obtain certificates from any personal services corporation that state that 100 percent of its outstanding shares are held by the individual who is actually rendering the services.

5) A payment made by a production corporation to a partnership that carries on business in Canada will qualify as a labour expenditure to the extent that the amount paid is attributable to services personally rendered after 1994 by an individual who is a member of the partnership or is attributable to and does not exceed the salary or wages of the partnership's employees for personally rendering services for the production.[91]

It is fairly common practice in the film industry for a corporation to form a wholly owned subsidiary for the purposes of producing a production in order to isolate the liability of the parent corporation in respect of any claims that may occur during the production phase. In most of these cases, a portion of the parent corporation's overhead is allocated to the

[90] Subparagraph (b)(iii) of the definition of "labour expenditure" in subsection 125.4(1). Qualifying shares held by directors of the corporation would be permitted by way of exception.

[91] Subparagraph (b)(iv) of the definition of "labour expenditure" in subsection 125.4(1).

production cost and forms an accepted part of the financing of the production. The draft legislation provides a mechanism whereby the labour expenditures of the parent corporation can qualify for credit in the hands of this subsidiary.[92] In such instances, provided that the subsidiary and the parent have agreed, any reimbursement made by the subsidiary in the year or within 60 days of the end of the year of an expenditure that was incurred by the parent in a particular taxation year of the parent in respect of the production and that otherwise would have been included as a labour expenditure of the subsidiary if the expense had been incurred directly by it will be considered a labour expenditure of the subsidiary. For these purposes, it is assumed that the expenditure would qualify as a labour expenditure of the subsidiary if (1) the subsidiary corporation had had the particular taxation year of its parent; (2) the expenditure were incurred by the subsidiary for the same purpose as it was by the parent; and (3) the expenditure were paid at the same time and to the same person or partnership as it was by the parent. If these conditions are met, the expenditure of the parent will qualify as a labour expenditure of the subsidiary.

To illustrate this provision, assume that a parent corporation (Parentco), which has a fiscal year ending December 31, forms a wholly owned subsidiary (Prodco) for the purposes of a particular production with a March 31 fiscal year-end. The corporations agree to allocate all attributable expenditures of Parentco to the production. During the course of the production, Parentco incurs $600,000 of labour expenditures up to December 31 for which it pays within 60 days of the following year. It also incurs an additional $400,000 after December 31. The $600,000 incurred in Parentco's first fiscal year will qualify as a labour expenditure of Prodco for its March 31 fiscal year, provided that reimbursement is made by Prodco on or before May 30 (60 days after March 31). The $400,000 incurred by Parentco after December 31 (even if incurred by March 31) will qualify as a labour expenditure of Prodco for the following year.

The election for parent corporations applies only to wholly owned subsidiaries. No account is taken of common situations of co-ventures between two Canadian producers producing a particular film or television show. In such a case, it would be quite common for the producers to form a corporation to incorporate their joint venture, with each producer holding a percentage interest in the corporation. On the basis of the proposals as drafted, the establishment of a subsidiary that is partially owned by each of the participants in the venture will preclude the application of this election provision.

As an alternative, each producer could form a wholly owned production company that, in turn, enters into a joint venture or partnership to produce the production. Depending on the interpretation of the draft regulations discussed below, an undivided co-ownership may be more appropriate than a partnership, or vice versa. Subject to these constraints,

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[92] Paragraph (c) of the definition of "labour expenditure" in subsection 125.4(1).

there does not appear to be any other restriction that would prevent each Prodco from taking advantage of the election in relation to overhead charges of its particular parent corporation.

Remuneration that qualifies as labour expenditure during the post-production phase includes only remuneration for services rendered by a person who performs the duties of animation cameraman, assistant colourist, assistant mixer, assistant sound effects technician, boom operator, colourist, computer graphics designer, cutter, developing technician, director of postproduction, dubbing technician, encoding technician, inspection technician—cleanup, mixer, optical effects technician, picture editor, printing technician, projectionist, recording technician, senior editor, sound editor, sound effects technician, special effects editor, subtitle technician, timer, video-film recorder operator, videotape operator or by a person who performs a prescribed duty (not yet defined).[93] Surprisingly, the postproduction accountant is not included in this list. The omission may have been an oversight in the drafting. In fact, there does not appear to be any particular logic in having a detailed list of postproduction activities that qualify. These limitations are copied from the Quebec tax credit rules, which have been designed to ensure that broadcasters do not qualify. This restriction does not apply to the proposed federal system.

Labour expenditures are reduced by the amounts of the assistance in respect of the expenditure that the corporation or any other person or partnership has received, is entitled to receive, or can reasonably be expected to receive. This determination is made each year at the time the corporation files its income tax return for the year.[94]

The types of assistance that will reduce labour expenditures are defined by paragraph 12(1)(x) of the Act and include inducements by way of grant, subsidy, forgivable loan, deduction from tax, allowance, or any other form of inducement from a government, municipality, or other public authority. As a result, allowances that reduce labour expenditures include Quebec refundable tax credits, Ontario film investment program (OFIP) rebates, Nova Scotia tax credits, and other grants to the extent that they are attributable to salary or wages. Because Quebec's tax credit is entirely calculable by reference to salary, wages, and remuneration, the entire Quebec tax credit will be considered assistance.[95] In the case of the OFIP rebate, however, a calculation will have to be made in which the rebate is divided between the portion applicable to salary, wages, and remuneration and that relating to other budgetary costs. To a certain degree, therefore, Ontario producers who qualify for OFIP will have a slight

[93] Paragraph 125.4(2)(b).

[94] Paragraph 125.4(2)(c) of the Act. The definition of "assistance" is contained in subsection 125.4(1).

[95] At the time this article went to press, discussions were under way with various federal and Quebec officials with respect to the possibility of exempting the Quebec tax credit from the definition of assistance in computing labour expenditures.

advantage over their counterparts in Quebec who qualify for the Quebec tax credit.

Assistance does not include the acquisition of an interest in the production by any person. Telefilm or other agency investments are not considered assistance for these purposes. Such investments, however, will otherwise reduce the cost of the film available for the credit.[96]

Cable Production Fund[97] assistance to broadcasters, which is directed at producers, constitutes assistance to the broadcaster rather than to the producer. Paragraph 125.4(2)(c) refers to assistance "in respect of an expenditure" being received by the corporation or by any other person or partnership. It is arguable that this assistance is not in respect of the expenditure. Rather, in accordance with the Cable Production Fund guidelines, the assistance is in respect of the broadcaster's licence commitment. Consequently, it should not qualify as assistance that reduces labour expenditure.

Qualified Labour Expenditure

The qualified labour expenditure (QLE) of a corporation for a taxation year in respect of a property of the corporation that is a Canadian film or video production is computed as the lesser of two formulas. The second formula[98] starts with 48 percent of the cost[99] of the property (or, in the case of depreciable property, its capital cost), net of any assistance. The assistance, determined at the time of the filing of its return of income for the year, is assistance the corporation or any other person or partnership has received, is entitled to receive, or can reasonably be expected to receive that has not been repaid before that time pursuant to a legal obligation to do so. Excluded for these purposes are any other amounts of assistance that would otherwise reduce the cost.

After netting assistance from the cost and multiplying by 48 percent, it is necessary to reduce the result by QLEs in respect of the production for a preceding taxation year before the end of which principal filming or taping began. Since the calculation of QLE is made on a year-by-year basis with regard to the fact that productions may overlap fiscal years, labour expenditures of the corporation continue to add to the costs; as a result, QLEs that qualified for the credit in previous years will adjust the cost in the current year. This adjustment ensures that the PTC is claimed only once in relation to the QLE of a particular year.

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[96] See subsection 125.4(1) in the definition of "qualified labour expenditure" in paragraph (b).

[97] Established by the Canadian Radio-television and Telecommunications Commission (CRTC).

[98] Paragraph (b) of the definition of QLE in subsection 125.4(1).

[99] Note that the cost, for CCA purposes, is reduced by the amount of the PTC for the year. See subsection 125.4(5).

As mentioned above, QLE for a particular year is the lesser of two formulas. The first formula used to calculate QLE is the amount by which

1) the total of

a) the labour expenditure of the corporation for the year in respect of the production;

b) repayments of assistance in respect of the production;[100] and

c) the amount by which the labour expenditure for a preceding taxation year and repaid assistance of the corporation for a preceding taxation year in respect of the production exceeds the corporation's QLE in respect of the production for a preceding taxation year before the end of which the principal filming or taping of the production began

exceeds the total of all amounts, each of which is

2) assistance that, in a prior year, did not reduce the labour expenditure (because it was not anticipated at that time) and that, at the time of the filing of its return of income for the year, the corporation or any other person or partnership has received, is entitled to receive, or can reasonably be expected to receive that is in respect of the labour expenditure of the corporation for a preceding taxation year; or

3) where the corporation is a parent, any amount of labour expenditure that a parent corporation agrees to transfer to its wholly owned subsidiary.

The following example illustrates the application of these provisions. Prodco is a qualified corporation with a December 31 fiscal year-end. Principal photography of a motion picture commenced in 1995. The overall cost of production will be $5,000,000, of which $3,000,000 will be incurred in 1995 and $2,000,000 in 1996. Telefilm will invest $1,000,000 in the production, advancing $500,000 in 1995 and $500,000 in 1996. An OFIP rebate of $600,000 is projected. Two-thirds of the OFIP rebate is reasonably allocable to salary or wages and remuneration. Labour expenditures incurred in the particular years and paid within 60 days of the end of the year, before assistance, will be $1,400,000 in 1995 and $1,300,000 in 1996.

On the basis of these facts, the project will qualify for a *maximum* PTC equal to $408,000:

25% × 48% of [cost ($4,000,000) − assistance ($600,000)] = $408,000.

The actual combined PTCs for 1995 and 1996 will be $408,000, calculated as follows. In 1995, labour expenditure will be $1,192,600. This calculation is based on the assumption that overall labour costs will be reduced by assistance applicable to labour costs of $400,000 (2⁄3 × $600,000). The $400,000 will be allocated to 1995 costs based on 1995 labour expenditures divided by total labour expenditures:

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[100] Provided that the repayment is made in the year pursuant to a legal obligation to do so in respect of a taxation year for which the corporation is a qualified corporation.

$$\$1{,}400{,}000 - \$400{,}000 \times \frac{\$1{,}400{,}000}{\$2{,}700{,}000} = \$1{,}192{,}600.$$

The 1995 QLE will be the lesser of:

1)	$1,192,600	(labour expenditure for the year)
	nil	(repayment of assistance)
	nil	(excess labour expenditures and assistance repayments of previous years over QLE of the previous year)
	$1,192,600	

and

2)	$1,027,200	calculated as
a)	48% of	
i)	$2,500,000	($3,000,000 cost in 1995 less $500,000 Telefilm investment)
less		
ii)	$ 360,000	(assistance in respect of cost, calculated as $\frac{\$3{,}000{,}000}{\$5{,}000{,}000} \times \$600{,}000$)
	$2,140,000	
less		
b)	nil	(QLE of previous year)

48% × $2,140,000 = $1,027,200

The 1995 PTC will be 25 percent of $1,027,200, or $256,800.

The difference between labour expenditure in 1995 ($1,192,600) and 1995 QLE ($1,027,200) will be carried forward under one of the formulas in the 1996 QLE computation.

For CCA purposes, the cost of the film will be reduced by $256,800 in 1995.

In 1996, the labour expenditure will be $1,107,400. This calculation is based on 1996 expenditures of $1,300,000 less allocated assistance of $192,600 (calculated as 2⁄3 × $600,000 × 1996 labour expenditures ($1,300,000) over total labour expenditures ($2,700,000)).

The 1996 QLE will be the lesser of:

1)	$1,107,400	(labour expenditure for the year)
	nil	(repayment of assistance)
	$ 165,400	(excess labour expenditure in 1995: $1,192,600 − $1,027,200)
	$1,272,800	

and

2) the amount by which

$1,632,000	(48% of cost at end of 1996 of $4,000,000 net of assistance of $600,000, or $3,400,000)

exceeds

$1,027,200	(1995 QLE)
$ 604,800	

The PTC for 1996 will be 25 percent of $604,800, or $151,200.

The combined PTCs will be $408,000 ($256,800 + $151,200).

Restrictions on Credit

To qualify for the PTC, no deduction for tax purposes may be available to anyone other than the production corporation (with certain limited exceptions). No credit will be available where an "investor," or a partnership in which an investor has an interest, directly or indirectly, may deduct an amount in respect of the production in computing its income for any taxation year.[101] An investor is defined as a person (other than a prescribed person) who is not actively engaged on a regular, continuous, and substantial basis in a business carried on through a permanent establishment in Canada that is primarily a Canadian film or video production business.[102] Consequently, no tax shelters are permitted in respect of any production costs. Although draft regulations have been introduced, there is no definition of prescribed person as yet; however, the technical notes indicate that prescribed persons would generally include a broadcaster.

To disqualify the production, it is necessary that an investor "may" claim a deduction in computing income for Canadian tax purposes in "any" taxation year. It is irrelevant whether the deduction is actually claimed. As a result, technically speaking, an investor might be able to claim a deduction for Canadian purposes even though it has no intention of making such a claim. However, given the proposed elimination of the exemption from the leasing property rules, no deduction on account of CCA may be claimed by any investor except to the extent of income from Canadian film or video productions. Although no deduction is likely in the year of acquisition, an investor may be entitled to a deduction in computing income eventually to the extent that income from the production is generated. A foreign investor who has no permanent establishment in Canada, however, will be subject only to income tax in Canada on film royalties to the extent that part XIII of the Act applies (that is, subsection 212(5)). Consequently, no deduction may be claimed from the gross film royalties subject to withholding tax. Foreign copyright participation,

[101] Subsection 125.4(4).

[102] Definition in subsection 125.4(1).

however, currently causes a production to qualify as an excluded production, which would not qualify for the credit.[103]

The case of Canadian investors is clearer. To the extent that a Canadian (other than a Canadian broadcaster) purchases a portion of the copyright, the possibility of obtaining the credit will be eliminated except where the investor is engaged on a regular, continuous, and substantial basis in the Canadian film or video production business in Canada.

Mechanics of Obtaining the Credit

In order to obtain the PTC,[104] the production corporation must file, along with its income tax return, prescribed income tax forms (which have not yet been created), as well as a Canadian film or video production certificate from the minister of Canadian heritage, together with such additional documents as will be announced in the next few months. It is likely, at this time, that the Heritage Canada certificate will be obtainable before the completion and final audit of a particular production. As at the date of writing, Heritage Canada officials have indicated that no certificates will be issued before entry into force of the legislation. The certificate will certify that the production is a Canadian film or video production and will estimate amounts relevant for the purposes of determining the PTC.[105] These estimates are subject to verification by Heritage Canada and by Revenue Canada.[106]

A certificate issued by Heritage Canada may be revoked subsequently where an incorrect statement was made for the purposes of obtaining the certificate or the production turns out not to be a Canadian film or video production.[107] In the case of revocation, the certificate is null and void and is treated as never having been issued. Consequently, any tax credit received before revocation will be repayable with interest. Penalty provisions have not yet been drafted.

Income Tax Considerations Relating to the Credit

In the absence of regulations, it is somewhat premature to speculate on *all* of the income tax considerations associated with the new credit system as far as Canadian producers are concerned, but there are a number of them that are likely to exist under the new system.

For example, any portion of the film cost represented by deferrals will not be available for credit. Consequently, to obtain the PTC, third-party costs (including producers' fees and overhead) must actually be paid rather

[103] See supra footnote 76.

[104] Subsection 125.4(3).

[105] Definition of "Canadian film or video production certificate" in subsection 125.4(1).

[106] According to the technical notes to the July 19, 1995 draft legislation, supra footnote 12.

[107] Subsection 125.4(6).

than merely payable out of future revenues from the production. Therefore, to obtain the maximum credit, it is in the producer's interest not to have deferrals. A common mechanism of dealing with deferrals from a cash flow perspective is to pay the amount that would otherwise have been the deferral and have it loaned back to the production.[108] This enables the production company to access the credit without causing any cash shortfall to the production. Although this strategy tends to maximize the tax credit available, there are some significant income tax considerations that should be borne in mind. In most instances, where the deferral is paid and the cash loaned back, the recipient of the deferral will be obliged to include the amount received in computing income without a corresponding deduction for the loanback, and as a result the fee received will be taxable.

An examination of a particular case outlines the problem. Assume that a production has a budget of $1,000,000, including $100,000 of deferred producers' fees and overhead that would otherwise qualify as labour expenditure. In the first alternative, the deferred producers' fee is treated as a deferral and, as a result, the project qualifies for a maximum 12 percent credit on only $900,000, or $108,000. If the deferral were actually paid and loaned back, the available credit would be increased to $120,000 (an increase of $12,000). The producer, however, would have an additional $100,000 of taxable income, which could result in additional federal and provincial tax payable, depending on the producer's other income levels and general income tax position. As a result, in the quest to obtain an additional credit, tax liability arises that is greater than the credit sought. Therefore, the producer should be wary about falling into this trap and should fully understand the risks involved.

For CCA purposes, the cost of the film property produced by the producer will be reduced by the amount of the credit claimed.[109] As a result, the effect of the credit will be similar to that of other assistance related to the production. Presumably, if the production is successful and recovers its costs, a good portion of the credit previously received will, in fact, become taxable. By way of example, assume that the $1,000,000 production that generates a tax credit of $120,000 was made and financed with $800,000 of presales and other deficit financing equal to $80,000. After receipt of the next $80,000 of revenues, the producer will be taxable on additional production revenue.[110] Some deferral of taxation will be available to the extent that the producer continues to produce year after year; and to the extent that the production increases, a rolling deferral of tax may be available.

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[108] Subject to the possible applicability of subsection 245(2). Given that the recipient of the fee will be required to include the amount in computing income, it becomes difficult to see in most cases how this could be considered a misuse of the provisions of the Act or an abuse of the Act read as a whole.

[109] Subsection 125.4(5).

[110] Assuming that changes are instituted to permit the additional allowance currently available for certified productions to continue for film producers.

Policy Considerations

Worldwide software technology has been developing rapidly in terms of computerized special effects, interactive television, and the possible merger of CD-ROM with television delivery, and Canadian film and television producers have been expanding production capabilities to keep pace with these changes. Canadian tax regulations, however, were drafted in the 1970s to deal with the realities of time—hence the limitation of certified productions to film and videotape. Today, in the 1990s, when the tax system is being overhauled, the government has an ideal opportunity to move along with the industry into the 21st century. Proposals for expanding the tax credit beyond film and videotape should be front and centre on the agenda of the film industry. In the past few years, a growing number of productions have had significant digital components. It is not clear whether the cost of producing the computerized aspects of a production should form part of the cost of producing the film. More bewildering are situations where digitized components of film production are reused for video game or CD-ROM applications. These components are not really part of film or video but are essential elements in the production.

Notwithstanding the urgings of the report prepared in 1994 for the minister of Canadian heritage (and which proposed the creation of the PTC), the current proposals limit themselves to 1970s technology. The failure of the draft legislation to deal with technological advances will place too much discretion in the hands of administrators as to what qualifies as part of film or video production. In our view, this demonstrates a failure on the part of the government to give direction to policy at a time when competitive forces require Canadian producers to keep pace with emerging technologies.

PROVINCIAL TAX INCENTIVES

Quebec

Quebec offers an assortment of incentives to the film and television industry. A refundable production tax credit is available to eligible corporations in the production of a certified Quebec film or television production.[111] The credit covers 40 percent of all eligible labour costs, which are limited to 45 percent of eligible production costs. This tax assistance can provide producers with a maximum credit of 18 percent of the overall budget. The refundable tax credit will be determined separately for each film and may be claimed by the production company in its tax return.

An interim financing assistance program is offered by the cultural branch of the Quebec government, SODEC. Production companies whose income tax and tax on capital are less than the refundable film and television tax credits to which they are entitled will qualify for an interim financing program. Producers who have obtained advance rulings confirming that their production will qualify as a Quebec film are able to obtain a loan

[111] See sections 1029.8.34 to 1029.8.36 of the Taxation Act, RSQ, c. I-3, as amended.

guarantee issued by SODEC. The guarantee will in turn permit producers to obtain an interim loan from a financial institution in order to obtain interim financing for the production of their film or program. Up to 75 percent of the expected tax credit can be loaned to a company, based on a guarantee by SODEC that is given to a bank.

To qualify as a "Quebec film," the position of "producer" must be held by an individual who was domiciled in Quebec for the two years preceding the date on which filming began. In addition:

1) a minimum of six units of production (based on the "point system") must be obtained in respect of input of persons domiciled in Quebec for two years before production;

2) a minimum of 75 percent of production expenses (other than those covered by the point scale) must be paid to natural persons who were domiciled in Quebec for at least two years;

3) a minimum of 75 percent of postproduction expenses must be incurred in Quebec;

4) only fiction films, documentary films, and magazine-type programs and variety shows intended for children may qualify;[112] and

5) there must be a broadcast commitment by the holder of an operating licence issued under the Broadcasting Act or by the holder of a distribution licence so that the production will be broadcast in Quebec or shown in Quebec on premises where films are shown to the public.

An official coproduction between a Quebec-domiciled producer and another country (such as the United Kingdom or France) with which Canada has an official coproduction treaty will also qualify for the credit. For example, a film with an 80 percent Canadian and 20 percent UK participation will also qualify as a Quebec film if 75 percent of the 80 percent of Canadian financing is spent on Quebec goods and services. A coproduction is not required to achieve six units of production from Quebec residents; only the expenditure tests must be met. Therefore, in an official coproduction, one may be able to use one American actor (plus, of course, other actors from the participating countries) and still meet the criteria for a Quebec film if the 75 percent test is met. The 18 percent Quebec tax credit will then be calculated on the 80 percent of Canadian financing.

Nova Scotia

The Nova Scotia Film Development Corporation (NSFDC) provides funding for the development and production of motion pictures and video projects that provide significant economic benefit to Nova Scotia. In the past, the NSFDC has provided funding through the Nova Scotia Labour Rebate Program (NSLRP).

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[112] On December 20, 1995, by *Information Circular* 95-7, this credit was broadened to include certain variety shows and magazine-type programs for adults.

On April 11, 1995, the Nova Scotia government tabled its 1995 provincial budget. The budget contained a proposal to replace the NSLRP with a refundable tax credit similar to the Quebec credit and the PTC. A general framework in respect of the operation of the credit was released on May 19, 1995 in the form of a government bill.[113] The credit is referred to in the bill as the film industry tax credit and is in an amount equal to 30 percent of eligible salaries paid to Nova Scotia residents between 1995 and 1999. The credit for any particular film is capped at 15 percent of the total production budget. Regulations setting out criteria for eligible films, eligible producers, and eligible salaries have yet to be released.

ADDENDUM

A notice of ways and means motion tabled on March 6, 1996 with the 1996 federal budget contained a provision allowing for the assignment of the PTC. This provision is apparently in response to production industry concerns regarding perceived difficulties in obtaining interim financing for the PTC. According to resolution 37 of the notice of ways and means motion, after March 5, 1996, the assignment of an income tax refund attributable to the PTC will be effectual in law, subject to the following limitations:

1) any such assignment will not be binding on Her Majesty and no liability will be created between the assignee and Her Majesty as a result of the assignment; and

2) the rights of the assignee will be subject to all equities and all statutory rights of setoff in favour of Her Majesty that would have had priority if there had been no such assignment.

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[113] See section 8 of An Act Respecting Certain Financial Measures, SNS 1995, c. 2, adding section 13E to the Nova Scotia Income Tax Act, RSNS 1989, c. 217, as amended.