Continuing the Advantage: INNOVATION EQUITY TAX CREDITS and Stimulating Innovative Companies

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Introduction

On January 17, 2019, Nova Scotia introduced the Innovation Equity Tax Credit (IETC) to encourage equity investment in small and innovative businesses to fund R&D or the commercialization of new technologies, products or processes. The program boasts significant improvements over the previous Equity Tax Credit (ETC) program such as increased maximum investment limits ($250,000 for individuals), allowing corporate investors to participate, and an enhanced 45% credit for investments by individuals in selected ocean technology and life science priority sectors. A summary of recent changes can be found in Appendix A.

A number of recommendations that were put forth in a recent white paper: Modernizing EQUITY TAX CREDITS in Atlantic Canada and Stimulating Innovative Companies, were used as the basis for the IETC. This has led to welcomed changes for many companies in Nova Scotia, as the attraction of capital has been a long-standing issue for emerging businesses, a situation that has improved considerably over the past few months and will have long-term positive impact on our economic improvement.

Great strides have been made and we believe there are still opportunities available to further improve and refine the IETC, so that it may better serve the interests of our local businesses, investment community, and Nova Scotia's economic development objectives. It is our hope that this article will act as a resource for government to further develop and define Nova Scotia's IETC.

This publication is a collaboration developed by active members of Nova Scotia's innovation ecosystem. For the purpose of this article, we are operating under a collective impact framework and would welcome the opportunity to discuss our recommendations in-person.

Immediate Impact
"The Innovation Equity Tax Credit (IETC) changes that were announced in January of 2019 and referenced again in the provincial budget for 2019/20 made a significant impact on the amount of local funds raised in our most recent offering. We were encouraged to see local investors benefit from the new changes. We truly believe that these are the types of significant improvements that are needed to ensure the success of technology-based businesses like ours, so we look forward to this trend continuing." Peter Hickey, Co-founder and Executive Director, IR Scientific

Opportunity

With a number of months' experience with the new program, we have identified a number of changes that we strongly believe will make the IETC even more effective at helping achieve the provincial government's economic development objectives:

1. **Allow directors and specified shareholders to invest through convertible debentures.** Convertible instruments such as debentures have become a common investment vehicle for start-ups as they're often faster, simpler, and less costly than standard share issues. The current rules exclude "Angel Capital", a primary form of "Smart Money", from accessing credits when they are both a significant investor and advisor. Similarly founders are denied credits when investing alongside other investors in convertible debentures which is often a requirement, i.e. "skin in the game"

2. **Expand eligible investments to include other convertible instruments such as Simple Agreements for Future Equity (SAFE)**. The legislation permits investment by way of "convertible debentures", which seemingly fails to acknowledge the possibility of other convertible instruments, most notably promissory notes and SAFE's. Definitions of this nature may limit investors who will qualify for credits, it would likely be more prudent to provide a list of exclusions.

3. **Allow companies to 'pivot'**. The early-stage, innovative companies to be supported by the IETC are inherently risky ventures and in some cases their early experiences may reveal that the originally conceived business plan is not ideal, and that a revised plan or direction is required if success is to be achieved. Making this change, or "pivoting" as it's commonly known, is not uncommon, and when required is critical to the success of the company. The IETC regulations could be updated to stipulate that as long as the pivoted business plan still meets IETC eligibility criteria, companies will still qualify.

4. **Ease restrictions on accessing other funding programs / tax credits**. The current IETC rules exclude companies that have ever received any of Film Industry, Digital Media, Digital Animation, and Capital Investment Tax Credits, or Payroll or Innovation Rebates from Nova Scotia Business Inc. Additionally, they must repay the credits should the company access the same programs within 4 years of the certificate expiration date. To be more fair and consistent with how other programs restrict "double dipping", the IETC should apply these exclusions / restrictions at the business plan level – i.e. on the activities funded by the IETC only. The previous credit provided no such restriction and given the APEC report on the positive growth on the Digital Technology companies this is very restrictive. It especially for existing companies who have previously claimed where this new restriction has denied access to this credit based upon modest credits from DMTC.

5. **Increase the maximum age and size limits for Eligible Corporations**. Currently, companies must be less than 10 years old, but this can have the unintended consequence of excluding cases where a serial entrepreneur reuses and 'old' corporation when starting a new venture. Additionally, the employee count of all associated corporations must be less than 100, which appears to be a low threshold given the amount of funding that can be approved under this program. And finally, restricting eligibility to only those companies with less than $15,000,000 in assets (including associated companies) unduly excludes companies with strong IP portfolios but with limited or no sales or infrastructure.

6. **Allow credits for investors outside Nova Scotia Limiting it to NS restricts investors and most importantly limits access to significant pools of capital**. The Province could adopt programs similar to those in Alabama and Arkansas. The Province could also match the investment, rather than provide a credit to an out-of-Province investor (for an $85,000 investment by an out-of-Province investor, the Province would contribute to the issuer $15,000 in the name of the investor). Regardless of the method, expanding the program as suggested in this paper to investors outside of NS would likely be the biggest benefit to NS companies in accessing funds.

7. **Increase the corporate investment limit**. Corporate investors are currently limited to investing $500,000. Given the credit amount for corporate investments is limited to 15% and aggregate of all investments is limited to $5,000,000 it seems overly restrictive to place a limit on the amount a corporate investor can invest. Should this corporate investor limit be applied to a particular capital raise, as opposed to an investor, as companies are often better served by limiting the number of investors?

8. **Limit requiring Review Engagement Reports to the Eligible Corporation.** While requiring financial reviews for companies to benefit from the tax credit is a reasonable requirement, requiring the same for associated corporations may not be practical as such companies may have not have another need for a review engagement and this imposes additional compliance costs.

9. **Allow unrestricted use of the three-year carryback of credits.** The IETC allows a three-year carryback but not for tax years before 2019, reducing the available years to use the credit by up to 3 years which is very significant. This unfortunately penalizes investors in the first three years of this new program. If there is a concern with overlap with old program they can simply net the two credits.

10. **Allow pro-rated payback of credits should the company be sold within the 4-year holding period**. While requiring an investment to be held for 4 years is reasonable, requiring repayment of 100% of the credits should a company be successful and is sold before the 4 year period appears harsh. A merger or acquisition within the 4 year period is expectation likely outcome due to the nature

of the industry. In such instances, basing repayment on the proportion of the 4 years that the investment was held prior to sale of the company would be more reasonable.

11. **Expand the NAICS code listing of eligible oceans technology and life sciences companies.** The NAICS codes provided are insufficient to properly catch relevant and applicable technology companies within the targeted sectors. The eligible NAICS code listing needs to be expanded to reflect those presently used by industry within oceans and life sciences. Otherwise, an allowance should be made for companies not clearly defined nor identified by existing NAICS codes, but can provide reasonable proof of industry inclusion and relevancy based on industry definitions.

12. **Eliminate the requirement for a minimum of three eligible investors.** If a company is able to raise the necessary funds from less than three eligible investors, they should not be delayed or hindered by being required to find additional investors. The current minimum limit serves only to delay progress and present no appreciable barrier.

13. **Clarify the regulations on lapsed applications.** Currently, applications may be considered lapsed if a certificate of registration is not issued within six months. Consideration should be given to revising the regulations to clarify that this would only apply if the delay was caused by the applicant.

Summary

Improving access to capital for innovation and growth is no small task and having effective support programs is a necessity. We are confident that the issues discussed and action on the recommendations in this discussion paper will continue to improve ability of eligible Nova Scotia businesses to attract capital, grow and support general economic growth in Nova Scotia.

The recommendations we've put forward are the next step(s) in the IETC's evolution. It is our hope that other parts of Atlantic Canada will look at Nova Scotia's IETC as a best practice for attracting and retaining investment in Atlantic Canada's innovation ecosystem.

We look forward to contributing to the advancement of our aligned goals.

Appendix A: Summary of changes

Summary comparison between the ETC and IETC programs:

Program Detail	Before: Equity Tax Credit	Current: Innovation Equity Tax Credit	
		Individual	*Corporation
Nova Scotia Provincial Tax Credit	35%	35% (45% if life science or ocean technology industry (refer to appendix A)	15%
Maximum Investment	$50,000	$250,000	$500,000
Maximum Tax Credit	$17,500	$87,500 ($112,500 if life science or ocean technology industry)	$75,000
Investor Eligibility Requirements	Individual resident of Nova Scotia 19 years of age or older	Resident of Nova Scotia 19 years of age or older	Resident of Nova Scotia
Investment holding period	5 years	4 years	
Investment Types	Non-redeemable, non-convertible, fully-paid voting common shares	Voting Common Shares; Convertible debentures; and Preferred shares. (Note: at least one investor must invest in shares, and there are restrictions on who can invest in convertible debentures.)	
Tax Period to Absorb Credit	3 year carry back and 7 year carry forward	Carried back 3 tax years that end after April 1, 2019, or carried forward 7 seven subsequent taxation years.	
Corporation Eligibility Requirements			
Incorporated	In Canada and registered to carry on business in Nova Scotia	In Canada and registered to carry on business in Nova Scotia	
Headquartered	Nova Scotia	Nova Scotia	
Lifetime maximum raise	NA	$5,000,000	
Percentage of wages paid in Nova Scotia	25%	50%	
Revenue Maximum	$25,000,000	NA	
Asset Maximum	$25,000,000	$15,000,000	
Employee Maximum	500 employees	100 employees	
Investor Minimum	3 eligible investors	3 eligible investors	
Incorporated Within	NA	10 years of application	

Program Detail	Before: Equity Tax Credit	Current: Innovation Equity Tax Credit	
		Individual	*Corporation
Operations	Active Business	Is developing or implementing new technologies or applying existing technologies in a new way to create new products, services or processes	
Excluded Operations	Personal services business, and investment businesses	Refer to Appendix B	

*These proposals were announced in the 2019 April budget but have not been enacted into legislation to date.

Amendments to original legislation:

In April of this year, as part of the 2019-2020 provincial budget, additional amendments were made to the legislation to allow corporate investors to qualify for the IETC credit, and to add a Venture Capital Personal and Corporate Tax Credit, however the regulations have yet to be revised.

Corporate IETC Investors:

- Governing legislation enacted April 12, 2019, and is retroactive to April 1, 2019 but associated changes to the regulations and claim forms not yet.
- Per provincial budget documents, the corporate credit is 15% on a maximum investment of $500,000
- Can be carried forward 7 years or back 3 (but not any earlier than to a fiscal year ending after April 1, 2019).

Venture Capital Personal and Corporate Tax Credit:

- Governing legislation enacted April 12, 2019, and is retroactive to April 1, 2019 but associated regulations governing specific eligibility requirements as well as other key criteria (such as instances that would require paying back tax credits) and claim forms have not yet been put in place.
- **Per the legislation:**
  - Tax credit rate is 15% for both corporations and individuals.
  - Process:
    - Venture capital funds (corporations or limited partnerships) must first apply to become registered as a “qualifying venture capital fund” (QVCF).
    - Once registered, the QVCF can then apply for approval for an equity capital raise in order for it to be eligible for tax credits.

        - Once approved, the QVCF may then proceed with the raise, after which it may apply for tax credit certificates on behalf of and for each of its “eligible investors” who made an “eligible investment”
        - Once the tax credit certificate is received the eligible investor may then apply the amount to provincial income taxes in the current year, or any of the 3 previous years ending after 1 April 2019, or carry forward for future use up to 7 years.
    - The regulations will set an annual maximum for all venture capital tax credit certificates to be issued. The legislation includes provisions for the province to suspend the approval of additional venture capital funds or equity raises by previously qualified venture capital funds in a given year, if additional approvals would result in the maximum amount being exceeded.
- **Per the budget:**
    - For 2019-2020 the provincial government anticipates issuing venture capital tax credits totaling $3 million dollars which equates to $20 million in eligible investments.