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### CRA IMPLEMENTS A 10% CAP ON PRODUCERS' FEES FOR TAX CREDITS

**October 2008** — In June, the Canada Revenue Agency (“CRA”) issued draft guidelines for determining the reasonableness of producer fees for the purposes of both the provincial and federal production tax credits co-administered by CRA. In these guidelines (which are still open for industry discussion and input) CRA proposed an aggregate cap on all producer fees (including line producer, executive producer, associate producer, or any other type of producer) of 10% of the B and C portions of the production budget (the “Policy”). CRA’s position is that Policy has, in fact, always been in effect, however, CRA’s auditors are now stringently enforcing it, and in some cases doing so retroactively. The impact of the Policy’s implementation is potentially wide reaching, and will affect not only producers, but also financiers relying on tax credits to repay interim financing.

It appears that producers, in response to the enforcement by CRA of the Policy, are now being cautious in allocating fees to producer categories and keeping within the 10% cap on budgets for current productions. Further, we understand there is some confusion on the issue as CRA is not taking into account whether producer fees that exceed the 10% cap have been paid out to related or third parties, or whether income tax has been paid by these parties on the fees received.

The potential impact of the Policy on lenders who have provided interim financing remains to be seen as productions are audited. Of particular concern will be productions which have been advanced 100% of their tax credits by lenders, and which find

themselves on the wrong side of the Policy. To the extent that producer fees in excess of 10% have formed the basis for any estimated tax credits, such amounts may be excluded from the calculation of the tax credits. The result of this exclusion would be a shortfall in the anticipated tax credits on the production, which could leave the interim financier short of full repayment of its loan.

The application by CRA of the Policy will certainly create issues for some productions which have been completed and are now awaiting their tax credits. Productions that are being audited in this manner and have been hit by CRA’s new practice are being encouraged to appeal. It is too early to comment on the success of appealing the 10% cap and whether the repayment of bank loans will be affected.

Accountants involved in productions are now taking the Policy into consideration when issuing their estimate letter to financiers which routinely request such letters in connection with the interim financing of tax credits. While these estimates are not enforceable, they are relied upon by lenders when providing interim financing.

The fallout of CRA’s implementation of the Policy is also being felt at the provincial level, where the relevant authorities are on the front lines in dealing with producers. British Columbia has expressed to CRA its concern with the proposed Policy and the negative effect of the recent enforcement efforts on producers. British Columbia remains engaged with CRA in further discussions about adoption of the Policy.

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In Ontario, the audit procedures of the Ontario Ministry of Revenue (“OMoR”) did include a review of producer fees, and the 10% B + C threshold was identified in their audit training manuals as an industry practice. However, the OMoR approach differs from the CRA current practices as it uses the 10% more as a benchmark than a cap. To determine whether a producer fee expense met the legislative requirement, OMoR relied on the following criteria for the expenses:

- it was a true expense incurred for the purpose of earning income and was not determined by reference to profits or revenue;
- it was reasonable under the circumstances having regard to the services provided and did not contain overhead costs;
- it was directly related to the production;
- it was in fact payable or paid to the producer; and
- it was supported by appropriate documentation.

As well, OMoR did not lump together all fees paid to anyone with “production or producer” in their title for purposes of determining the 10% threshold. The OMoR approach should be considered by CRA when applying the Policy.

Until a consistent and fair methodology is adopted by CRA, all concerned parties including producers, accountants and financiers should pay particular heed to the issue of producer fees and the potential impact of the Policy.

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