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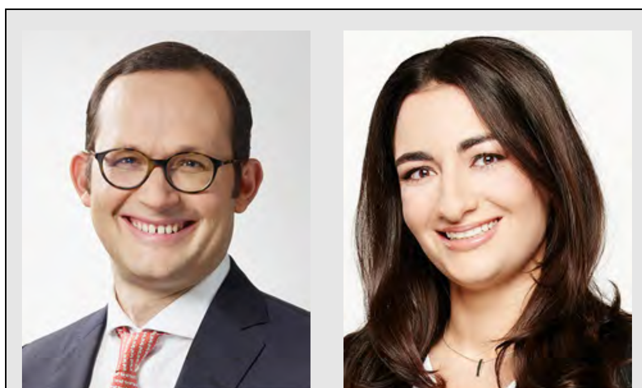

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In this article, the authors examine Montréal's generous provincial tax incentives for video game industry developers and investors, as well as some of the principal tax issues related to mergers and acquisitions in the video game industry.

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Montréal, the largest city in Canada's province of Québec, is the world's fifth-largest video game center.[1] Video gaming studios are choosing Montréal as their preferred location for North American operations because of, among other things, its specialized talent pool fostered by top-notch universities and technical schools with programs that cater to the industry's needs, as well as the presence of major players in related industries such as visual effects, virtual reality, and artificial intelligence. They are also attracted by generous tax incentives, and with the increased concentration of video gaming businesses in Montréal, cross-border investment and mergers and acquisitions activity has intensified.

This article will first discuss the principal tax incentives intended to develop Québec's video game industry and then provide an overview of tax and structuring considerations that frequently arise in transactions in the video game context.

Although the focus of this article is on Québec provincial tax incentives, it should be noted that Québec video gaming studios can benefit from various Canadian federal incentives as well.

Background

Since Ubisoft's arrival in 1997, some of the world's largest video game producers have chosen Montréal for its vibrant creative and artistic energy. Major players in the industry with significant operations in Montréal include Electronic Arts and WB Games. The diverse ecosystem that has developed includes innovative start-ups that have given rise to financing and M&A activity. For example, in the past couple of years, Montréal-based video game studio Hypixel Studios was sold to Riot Games, a game developer and publisher best known for League of Legends.[2] Also, Hasbro, through its subsidiary Wizards of the Coast, bought Montréal-based Tuque Games, which makes a Dungeons and Dragons triple-A game.[3]

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[1] Investissement Québec, "The Video Game Explosion" (accessed Oct. 18, 2020).

[2] Jacob Wolf, "Riot Games Grows With Addition of Hypixel Studios," ESPN, Apr. 16, 2020.

[3] "Wizards of the Coast Acquires Tuque Games," Cision, Oct. 29, 2019.

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Tax Incentives for the Video Game Industry

Multimedia Tax Credits

There are two tax credits available in Québec that are specifically intended, among other things, to foster the development of its video game industry. Both are refundable.[4] As such, they are of particular interest to corporations that are not earning taxable income, which is often the case for start-ups in the design or development phase before game launch.

Both credits are calculated based on the video game company's salary expenditures, and the rate generally depends on whether the video games in question are to be commercialized and whether they are available in French (see table).

Québec 'Multimedia' Tax Credit Rates

Category of Video Game	Base Rate	Enhanced Rate if Available in French
To be commercialized	30 percent	37.5 percent
In any other case	26.25 percent	N/A

For a multimedia title to be considered intended for commercialization, it must be available to the public (not restricted to a limited clientele), and genuine commercialization efforts (for example, marketing activities) must be made. According to the provincial investment promotion agency, Investissement Québec (Investment Québec), merely making a title available on a website is generally not considered sufficient. For a title to be considered to be available in French, the French version of the title must be at least equivalent to the versions produced in another language, and the consumer must be able to obtain the French version through the usual marketing channels from the first day it is marketed.

General Tax Credit

The first tax credit is the Tax Credit for the Production of Multimedia Titles. This is a refundable tax credit related to the production of individual multimedia titles. It can be claimed by a "qualified corporation," which is essentially a corporation that:

- has an establishment in Québec;
- carries on a "qualified business" in Québec; and
- has obtained an initial qualification certificate issued by Investment Québec.

In general, to be eligible, a multimedia title must:

- be produced by the corporation;
- include a substantial volume of three of the following four types of information in digital form: text, sound, still images, and animated images; and
- be published on an electronic medium and controlled by software allowing interactivity.[5]

A video game normally meets these criteria.

The tax credit amount is based on the corporation's qualified labor expenditure. This comprises the salaries or wages attributable to the multimedia title incurred and paid by the corporation to its eligible employees working in an establishment situated in Québec for their eligible production work, which includes:

- activities relating to the writing of the multimedia title's script;
- the development of its interactive structure;
- the acquisition and production of its constituent elements;
- its computer and online development;
- the system architecture;
- the title's community of users;
- the analysis of performance-related quantitative data for the purpose of optimizing the title's performance; and
- technological activities relating to its updating.

Activities relating to the acquisition of copyrights or to the mastering, media duplication, promotion, distribution, or dissemination of a multimedia title may not be recognized as eligible production work.

[4] This means that they not only reduce income taxes payable, but also the amount of the credit minus income taxes payable will be "refunded" or paid to the recipient.

[5] Some types of multimedia titles are not eligible, including titles designed to advertise a for-profit corporation, present its activities, or promote its products or services, as well as titles that "encourage violence, sexism, or discrimination."

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In addition to the initial qualification certificate, to claim the tax credit the corporation also needs to obtain annual "production work certificates" related to its production work and the employees who perform it. Generally, qualified labor expenditure can also include some amounts paid to non-arm's-length contractors for eligible production work and 50 percent of specific amounts paid to arm's-length contractors. Qualified labor expenditure is capped at C $100,000 per employee, with an exception for the top 20 percent highest-paid employees of the corporation (and subject to the availability of an election to exclude a group of up to 20 percent of eligible employees from the application of the cap).

To calculate the tax credit, the corporation's eligible labor expenditure is multiplied by a rate that depends on the title's category:

- 37.5 percent for eligible multimedia titles to be commercialized and available in a French version (excluding vocational training titles);
- 30 percent for eligible multimedia titles to be commercialized and not available in a French version (excluding vocational training titles); and
- 26.25 percent for other titles (including vocational training titles).

Specialized Corporation Tax Credit

The second tax credit is the Refundable Tax Credit for Corporations Specialized in the Production of Multimedia Titles. As its name implies, it is for corporations specializing in the production of multimedia titles, essentially meaning that at least 75 percent of its activities in Québec consist of producing eligible multimedia titles and, if applicable, carrying out scientific research and experimental development (SR&ED) relating to eligible multimedia titles. A "qualified corporation" for this tax credit is a corporation that has an establishment in Québec; carries on a qualified business in Québec; and holds a qualification certificate, known as a "specialized corporation certificate," issued by Investment Québec. The comments above regarding the general tax credit generally also apply to the specialized corporation tax credit.

Like the general tax credit, the amount of the specialized corporation tax credit is a function of the corporation's qualified labor expenditure. However, the tax credit rate is determined by looking at the corporation's eligible multimedia titles collectively. The corporation will be able to access the 37.5 percent rate if at least 75 percent of the eligible multimedia titles produced are commercialized and available in a French version, or at least 75 percent of its gross revenue is derived from those eligible multimedia titles. The rate will be 30 percent if at least 75 percent of the eligible multimedia titles produced by the corporation are to be commercialized but are not available in a French version, and 26.25 percent in all other cases.

SR&ED Tax Credits

In addition to the federal SR&ED regime that permits deductions of eligible SR&ED expenditures and allows taxpayers to earn refundable or nonrefundable investment tax credits at a rate of up to 35 percent,[6] Québec has its own SR&ED regime, known in Québec simply as R&D. It permits deductions of eligible SR&ED expenditures and provides, among other things, for a refundable tax credit for salaries and wages.

The refundable tax credit for salaries and wages is generally available to taxpayers that carry on a business in Canada and carry out SR&ED (or have SR&ED carried out on their behalf) in Québec. It is computed from salaries and wages paid by the taxpayer related to SR&ED undertaken by employees of a Québec establishment and consideration paid to some arm's-length and non-arm's-length contractors.

However, the computation of salary and wages is subject to an exclusion threshold. It excludes the first dollars spent annually by a

[6] A detailed discussion of the federal SR&ED regime is beyond the scope of this article. *See generally* David Spicer, "Scientific Research and Experimental Development and Investment Tax Credit Incentives," in *Taxation of Private Corporations and Shareholders* 20:1-61 (2020): "Qualifying Canadian-controlled private corporations (CCPCs) can generally claim a higher ITC rate than non-CCPC claimants: 35 percent on their qualifying expenditures up to a specified limit. As well, a qualifying CCPC may be eligible for a refund of all or a portion of its ITCs. The ITC rate on qualifying expenditures that exceed the specified limit is 15 percent. . . . Claimants that are not CCPCs earn ITCs at a rate of 15 percent of qualifying expenditures, and these ITCs are not refundable. ITCs earned in a year can be applied to reduce the current tax payable or can be carried back to reduce income tax paid in the 3 immediately preceding taxation years. ITCs can also be carried forward for a period of 20 years."

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taxpayer on SR&ED-related labor costs.[7] The basic exclusion threshold is C $50,000. It increases on a linear basis if the taxpayer's total assets for the previous tax year (not including assets of associated corporations) are between C $50 million and C $75 million. The exclusion threshold is C $225,000 if the taxpayer's total assets for the previous tax year are C $75 million or more.

The basic tax credit rate is 14 percent. The rate can reach 30 percent for the first C $3 million of qualified expenditures if the taxpayer is a corporation not controlled by nonresidents of Canada and its total assets (including assets of associated corporations) for the previous tax year were less than C $50 million. The 30 percent rate is reduced in accordance with a formula in which the corporation's total assets are between C $50 million and C $75 million.

SR&ED is systematic investigation or research carried out in a field of science or technology through basic or applied research. It must be undertaken for the advancement of scientific knowledge or experimental development that targets achieving technological advancement to create new materials, products, devices, or processes (including incremental improvements), or to improve existing ones. This generally includes work relating to engineering, design, operations research, mathematical analysis, computer programming, data collection, testing, or psychological research. By contrast, work such as market research or sales promotion and quality control, or routine testing of materials, products, devices, or processes, does not qualify as SR&ED.

Proposed Québec Intellectual Property Box

In its 2020 provincial budget,[8] Québec announced that effective in 2021 it will reduce its corporate tax rate from 11.5 percent to 2 percent on patent royalties and on up to 75 percent of profits from other specific forms of specified IP-related income. The taxpayer must have carried out SR&ED in Québec, and the IP being commercialized must result in whole or in part from SR&ED carried out in Québec.[9] This novel tax incentive may be of substantial interest to some mature video gaming studios that carry on SR&ED activities and generate taxable income because it would offer them a combined federal-provincial corporate tax rate as low as 17 percent.[10]

To be eligible for the IP box regime, a corporation must be a qualified innovation corporation. Basically, this means that the corporation carries on business through a permanent establishment in Québec and the business "derived income from the commercialization of a qualified intellectual property asset to which it holds the rights."[11] In this regard, the term "qualified intellectual property asset" refers to a "legally protected incorporeal property that is (1) an invention protected by a patent or a certificate of supplementary protection or by planter's breeder's rights or (2) software protected by copyright. . . . [and] the property must result from SR&ED activities carried out in whole or in part in Québec" (page A21). Obviously, video games could be eligible as a qualified IP asset.

The lower IP box tax rate will be available for income items that fall into one of the following categories:

- a royalty that is a payment for the use or the concession of the use of a qualified IP asset;
- income from the sale or lease of a property incorporating a qualified IP asset;

[7] Note that Québec's 2020 provincial budget proposes to make favorable changes to other SR&ED tax credits that foster collaboration with research entities by eliminating the similar exclusion thresholds. However, this measure will not apply to the salary and wages SR&ED tax credit, so the exclusion threshold will continue to apply.

[8] Québec Budget 2020-2021 (Mar. 10, 2020) (hereinafter, "the budget"). *See* Nathan Boidman and Michael N. Kandev, "Québec Proposes North America's First IP Box," *Tax Notes Int'l*, June 29, 2020, p. 1499.

[9] The government's stated objective in implementing what amounts to North America's first IP box regime is stated at page A20 of the budget's Additional Information: "To encourage the competitiveness of Québec businesses while fostering the retention and valorization of intellectual properties developed in Québec, a new tax measure will be introduced. This measure will take the form of a deduction in calculating the taxable income of a qualifying innovative corporation for a taxation year. The incentive deduction for the commercialization of innovations in Québec will apply as of 2021."

[10] Québec should also be attractive even if the exploitation is by sales of IP-embedded products or rendering of IP-embedded services resulting in a Québec effective rate of 4.37 percent and combined rate of 19.37 percent, as explained below.

[11] Significantly, eligibility for the IP box regime is not limited to Canadian-controlled private corporations.

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- income from the supplying of a service intrinsically related to a qualified IP asset; and
- an amount obtained as damages from judicial remedies relating to a qualified IP asset.

Finally, and importantly, for the IP box regime to be available, the taxpayer must incur qualified SR&ED expenditures in Québec. These are to be calculated "on a cumulative basis, according to a moving average including the particular tax year and the preceding six years. For greater clarity the expenditures preceding that period must not be included in the calculation of the ratio despite the fact that SR&ED activities relating to the creation of the qualifying intellectual property asset may have occurred before the beginning of the period" (page A23).[12]

Qualified expenditures of SR&ED in Québec are set out on page A24 of the budget's Additional Information to include:

- salaries and wages to employees in Québec;
- subcontract Québec SR&ED-related payments to affiliated companies and 50 percent of such payments to unaffiliated companies;
- 80 percent of specific SR&ED-related payments to Québec-based universities; and
- a formula portion of payments to unaffiliated non-Québec subcontractors.

The proposed Québec IP box regime would tax qualified income at a Québec corporate tax rate of as low as 2 percent instead of the provincial corporate tax rate of 11.5 percent. To implement this, the budget provides a formula that takes the corporation's net income otherwise subject to tax in Québec and extracts the portion relating to gross income not related to commercialization of a qualified IP asset. The remainder is then treated in one of two ways.

First, if the gross income from the commercialization of qualified IP assets consists of royalties or an amount obtained as damages from judicial remedies, the qualifying portion is reduced to the extent and by reference to any portion of the company's SR&ED that is not related to Québec. What is left is then multiplied by an 82.6 percent factor to arrive at the incentive deduction for the commercialization of innovations. In this case, the 2 percent tax rate is fully achieved.

The second way in which the remaining qualifying portion is treated arises when the gross revenue from commercialization arises from sales of products or provision of services imbedding Québec-developed IP. In these cases, a routine return factor is applied that seems to be borrowed from the foreign-derived intangible income regime introduced by the U.S. Tax Cuts and Jobs Act. Not unlike the deduction of 10 percent of basis in tangible property in computing FDII, the budget proposes a reduction of the qualifying portion by "an estimate of a routine return." This routine return deduction is the greater of:

- 25 percent of the portion of the net income attributed to gross income from commercialization of a qualified IP asset as compared with the balance of the gross income; and
- 10 percent of the gross income attributable to commercialization of a qualified IP asset, reduced by the portion of the net income (less the amount of SR&ED expenditures of a current nature deducted in the tax year by the taxpayer) determined by reference to the gross income from the commercialization of a qualified IP asset and the gross revenue that is not.

M&A Tax Issues and the Video Game Industry

We next review the principal Canadian income tax issues relevant to inbound investment and M&A activity in Canadian video gaming studios.

Asset Deal vs. Share Deal

A first threshold in most M&A situations is whether a transaction should be carried out by way of a purchase of business assets or the acquisition of shares in the capital of the target.

An asset deal is generally seen as more favorable to the acquirer because it provides a stepped-up tax cost in the underlying assets (and resulting tax shelter availability going forward).

[12] There appears to be nothing in the proposal that would deny the new IP box benefit to a company simply because it did not develop the IP that is commercialized, but instead acquired it, providing, *inter alia*, it did carry on qualified research and development in the year the benefit is claimed or in the prior six years.

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In the video game industry context, if a target is desirable mainly because of its existing game portfolio, an asset deal may be attractive to allow for the extraction from Canada and, potentially, the offshoring of the target's IP.[13]

In our experience, however, share deals are more common in the video game industry than asset deals. First, minority share subscriptions and secondary acquisitions can only be carried out as share deals. Share deals are also popular in PE or strategic acquisitions because they more readily ensure the retention of the video gaming studio's workforce, which is most often the target's most significant asset. Also, sellers of start-ups are often motivated to sell shares to use their lifetime capital gains exemption.[14]

To combine the benefits of asset and share deals alike, hybrid deals have become very popular in cross-border situations, including video gaming studio deals. For example, an increasingly popular structure in relation to the acquisition of a Canadian-owned target by a foreign buyer has the target elect to "step-up" the basis of its assets under section 111(4)(e) of the Income Tax Act (Canada). This includes internally generated IP,[15] on a taxable basis, followed by a cashless distribution of the after-tax surplus generated on this notional inside disposition immediately before the buyer's purchase of the target's shares. When the target is under contract for its acquisition by a foreign purchaser, the capital gain realized on the target's goodwill and internally developed IP is subject to a lower rate of taxation[16] as compared with that applicable to a Canadian resident individual[17] or Canadian-controlled private corporation.[18] The buyer is also favored in a hybrid deal because it acquires the operating entity with assets that have stepped-up basis and that can be extracted if desirable.

Basic Share Deal Tax Considerations

If an M&A transaction is to be carried out by way of an acquisition of shares, a threshold issue is whether to use a Canadian acquisition corporation. Almost invariably, PEs or strategic acquirers use this kind of corporation. This is because a direct acquisition of the target's shares, while providing the buyer with high basis in the shares, does not step up the shares' paid-up capital (PUC). PUC is an important tax account that tracks the amount invested in the corporation. PUC is valuable because it can be returned tax-free to the investor at any time, irrespective of whether the corporation has any distributable earnings and profits (subject to corporate insolvency tests),[19] which if paid as dividends would be subject to withholding tax of at least 5 percent. Also, PUC can effectively be converted into interest-bearing debt without adverse Canadian tax consequences.[20] Importantly, PUC cannot be created after the fact by interposing an acquisition corporation after the target has been bought.[21] Therefore, a foreign acquirer normally sets up a Canadian acquisition corporation funded by way of a loan or high-PUC shares. The acquisition corporation then buys the shares of the target and merges (or "amalgamates") with it.

Minority-interest acquisitions raise questions with less clear-cut answers on the use of an acquisition corporation. If the investment is not a stepping stone to a future takeover, it may be preferable to forgo the use of an acquisition

[13] While historically, offshoring was made attractive by non-nexus-based IP box regimes (mainly based in Europe), the OECD's base erosion and profit-shifting project's action 5 has made this structuring less popular. Québec's proposed IP box should further incite studios to retain valuable IP there.

[14] This exemption shelters about C $900,000 per person.

[15] *See* Canada Revenue Agency Doc. 2020-0841791I7, which considered a situation of acquisition of control of a Canadian corporation, in which it used a section 111(4)(c) and (d) write-down of debt owing by a controlled foreign affiliate to designate a section 111(4)(e) write-up of the capital cost of goodwill (class 14.1), customer relationships (class 14.1), and IP (class 12 — for example, software copyright). CRA indicated that this could be done even though, before the acquisition of control, these assets had no cost.

[16] The general combined federal-provincial corporate rate is 26.5 percent in Québec. The effective rate of taxation of capital gain is 13.25 percent, considering that only one-half of a capital gain is taxable.

[17] An individual resident in Québec is subject to a combined federal-provincial top marginal rate of 53.31 percent.

[18] A CCPC with an establishment in Québec is taxable at a combined federal-provincial rate of 50.2 percent on its investment income (for an effective rate of 25.1 percent on capital gains), which includes an anti-deferral refundable tax on aggregate investment income, including taxable capital gains.

[19] This is unlike the corresponding treatment in the United States.

[20] This is unlike the corresponding situation under IRC section 385. Note that cross-border interest deductibility is subject to Canadian thin capitalization rules.

[21] Section 212.1 of the ITA.

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corporation, assuming that distributions are not expected and the exit strategy contemplates a sale. If, however, an acquisition corporation is still used, the controlling shareholder of the target may resist a merger of the acquisition corporation with the target, in which case the investor may face difficulties at the time of an exit when a buyer may not be willing to buy the acquisition corporation's shares. This traps any gain in the Canadian tax net. These issues should be addressed at the time of investment, rather than being put off until the time of exit.

Earnouts

Video game industry deals, especially concerning start-ups, often see earnouts as a key feature of the consideration package. This is easily explained by the uncertainty of the future success of any particular game product under development. The concern with earnouts relates to a tax rule — section 12(1)(g) of the ITA — that may convert what would otherwise be a favorably taxed capital gain on the sale of shares into fully taxable income. The rule applies when an amount received by the seller is dependent on the use of, or production from, property, whether or not the amount is an installment of the property's sale price. While it may be questioned whether the rule was ever intended to apply to share sales, the CRA's positions have been unhelpful, and there is a long history of structuring experience to avoid this rule.[22]

One approach typically used is to rely on the CRA's administrative position relating to the cost recovery method.[23] If this position can be invoked, the gain on the sale of shares can retain its capital gains treatment. The concern with the CRA's position is that it is restrictive in its application. These are the conditions imposed by the CRA in Interpretation Bulletin IT-426R:

> 2. Taxpayers may use the cost recovery method if the following conditions are met:
>
> (a) The vendor and purchaser are dealing with each other at arm's length.
>
> (b) The gain or loss on the sale of shares of the capital stock of a corporation is clearly of a capital nature.
>
> (c) It is reasonable to assume that the earnout feature relates to underlying goodwill the value of which cannot reasonably be expected to be agreed upon by the vendor and purchaser at the date of the sale.
>
> (d) The earnout feature in the sale agreement must end no later than five years after the date of the end of the tax year of the corporation (whose shares are sold) in which the shares are sold. For the purposes of this condition, the CRA considers that an earnout feature in a sale agreement ends at the time the last contingent amount may become payable under the sale agreement.
>
> (e) The vendor submits, with its return of income for the year in which the shares were disposed of, a copy of the sale agreement. It also submits with that return a letter requesting the application of the cost recovery method to the sale, and an undertaking to follow the procedure of reporting the gain or loss on the sale under the cost recovery method as outlined below.
>
> (f) The vendor is a person resident in Canada for the purpose of the ITA.

Considering the above, the commercial objectives of the parties may sometimes need to be adapted to CRA requirements.

Another way to structure an earnout that does not invoke section 12(1)(g) is to use a reverse earnout.[24] This approach is often less desirable because the upfront gain is based on the full price. Subsequent reductions of the price can result in a capital loss that, while available to be carried forward indefinitely, may be carried back only three years.

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[22] For the CRA's views, see generally Interpretation Bulletin IT-426R, "Shares Sold Subject to an Earnout Agreement" (Sept. 28, 2004).

[23] If a taxpayer chooses not to use the cost recovery method, paragraph 12(1)(g) will generally apply (CRA docs. 2000-0051115 and 2013-0505391E5).

[24] *See, e.g.*, CRA Ruling 2009-0337651R3.

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Finally, a way to completely sidestep these issues is to package the earnout as convertible share consideration.[25] The downside of this approach, however, is that share consideration is not cash, and therefore may not be desirable for the buyer and/or the seller.

Conclusion

In this article we reviewed the generous provincial tax incentives that attract video game industry developers and investors to Montréal. These are the Tax Credit for the Production of Multimedia Titles and the Tax Credit for Corporations Specialized in the Production of Multimedia Titles. Other examples are the more general SR&ED regime and the recently announced Québec IP box that is expected to launch in 2021. We then outlined the principal M&A tax issues relevant to video game industry participants, including strategic and financial acquirers and investors. ■

[25] This typically sees preferred shares that are convertible to common shares if specific earnings thresholds are met.

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