Modernizing EQUITY TAX CREDITS in Atlantic Canada and Stimulating Innovative Companies

DRAFT FOR DISCUSSION June, 2018

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Introduction

Equity tax credit (ETC) programs in Atlantic Canada is an area of emerging focus in policy discussions related to financing innovation (Savoie, 2010; Ivany, 2014; Broten, 2014; Durufle, 2014; Decourcey, 2017). This advocacy is gaining traction, for example, in Nova Scotia, the Premier, the Honourable Stephen McNeil, recently mandated the Minister of Finance to make amendments to the Nova Scotia program and the Minister of Business to support the creation of enabling tax policy to promote innovation driven startups and providing supports for innovative businesses with the potential to create jobs and enhance export growth. There is also growing discussion around a regional approach (Savoie, 2010; Ivany, 2014; Broten, 2014; Durufle, 2014) to increase the uptake of the program and, in turn, increase the amount of investment in innovative small companies in Atlantic Canada.

Excerpt from Nova Scotia Finance Minister's Mandate Letter
(September 2017)

[…] amend the Equity Tax Credit with the aim of promoting more investment in innovation driven entrepreneurship in our province.

Equity tax credits (ETCs) provide individuals or groups of individuals with incentive to make a financial investment in potentially risky and typically innovative small firms. The intention behind ETCs is to help companies with high potential to contribute to economic growth receive the financing they need to grow.

Each Atlantic province currently has its own ETC program – there are some differences but some overlap too, as will be explored later in this paper. Investors, financial experts and policy wonks alike have argued publicly for fine tuning of these programs as well as for more of an Atlantic approach.

This paper will argue for an Atlantic-wide approach to equity tax credits as a means for stimulating innovation in the Region. The Paper will also address structuring of an equity investment to match the current manner in which Angel or Seed capital is invested into business.

The paper will first review the need for policy intervention with respect to financing innovations in Atlantic Canada. Second, the paper will review the literature around ETCs including objectives and risks, as well as economic impact. Third, we will review how angel and seed capital is typically invested so we can design programs to match up to current financing structures. Fourth, the paper will provide an overview of the ETC programming in Atlantic Canada. The fourth and fifth sections of the paper will, respectively, provide an analysis of the situation with respect to ETCs in Atlantic Canada and regionalization options. In conclusion, the paper will recognize the need for implicated parties (Atlantic Provinces and the federal government) to bring additional insight (e.g., data) to the discussion to aide with negotiation of a regional approach to ETCs.

Financing Innovation in Atlantic Canada

Innovation

Innovation and the transition to a knowledge-based economy are crucial to the future Nova Scotia (Savoie, 2010) and Atlantic Canada (ACOA, 2010). Innovation, though, is a risky and expensive undertaking. The Region is well positioned to make the transition to this new economy and is already on the way (ACOA, 2010). There is a strong foundation for innovation (universities and other research institutions, highly skilled graduates, easy access to global markets and a great quality of life for attracting and retaining employees). As a result, Atlantic Canada has growing capacity and growing specialization in the areas of information and communication technology, advanced manufacturing, ocean technology, life sciences, and others. However, without investors who are willing to take part in the risk-sharing, innovation is often unaffordable and/or too risky for companies.

Financing

It is widely agreed that policy interventions are required to push the Region into an investment-friendly state (Savoie, 2010; Broten, 2014; Decourcey, 2017) at all stages of the financing continuum (Decourcey, 2017) but this paper will focus on the pre-seed stage. Currently, this stage is typically financed by friends and family members and government programming at the federal (National Research Council, ACOA) and provincial levels (varies by province).

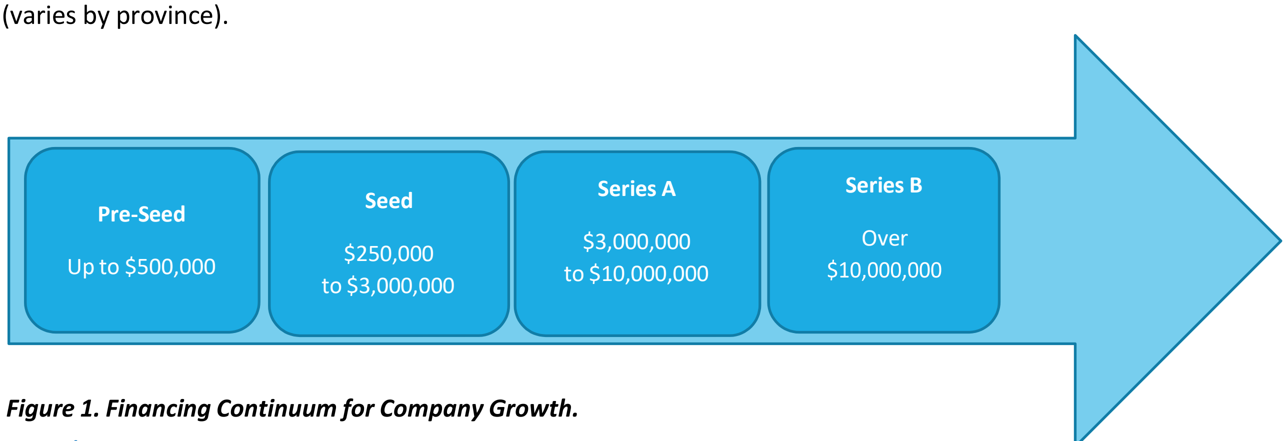

Figure 1. Financing Continuum for Company Growth.

Angel Investment

Angel investment is an informal type of venture capital that addresses financing needs, typically at the pre-seed stage. Angels are individuals with significant business experience who make pre-seed investments of capital and support in early stage companies (Aerndout (2005)). The Angels don't typically invest as individuals, but through their corporate or other investment vehicles. While the capital acquired through these types of investments is extremely important for the companies, almost more important is the time, mentoring, access to networks and active management in the company that invested angels provide. There is a clear advantage to companies accessing angel investment as opposed to only using debt to help with growth (Da Rin *et al.*, 2006). For this reason, investments made by angels are often referred to as *smart money.* It not only provides the capital required for growth but also brings the know-how to facilitate the company's growth. Aerndout (2005) argues that angel investments are *crucial* for emerging companies with the desire to grow and goes on to suggest that where companies have difficulty accessing adequate financing, governments should focus efforts on stimulating angel investment over providing subsidies directly. The Creative Destruction Lab, which established an operation in Halifax for Atlantic Canada earlier this year, is an excellent example of both funding and support, https://www.creativedestructionlab.com/program/.

Angel investment – and venture capital more broadly – has an empirical reputation for yielding positive macro-economic outcomes (EU, 2017). For this reason, Aerndout (2005) is not alone in suggesting a preference for government intervention that supports angel investment; for example, EU (2017) suggests that the economic rationale for incenting angel investment is strong, provided the intervention is properly designed. In addition to incenting private investment, experts indicate that government interventions of this type are also desired for market correction purposes (EU, 2017). Increased angel investment due to government incentive can attract attention to the area through increased discussion in networks and publicized company growth outcomes and, by so-doing, attract additional investment from a further reach.

Tax policy is one way to incent angel investment. The work of the EU's (2017) Capital Markets Union Project investigates the role of tax incentives in venture capital and angel investment and the importance of harmonization of programming across cooperating jurisdictions. This comprehensive project argues that a stronger single market makes for stronger individual markets. The study also outlined five principles for tax policy intervention (Figure 2), which will be used as the frame for analysis of equity tax credits in the Atlantic Provinces later in this paper.

FIGURE 2. POLICY IMPLICATIONS FOR TAX INCENTIVES FOR VENTURE CAPITAL AND BUSINESS ANGELS

1. **INVESTOR RISK AVERSION**: INTERVENTIONS SHOULD LOWER THE RISK OF INVESTMENT
2. **PICKING WINNERS**: RECOGNITION THAT GOVERNMENTS RARELY HAVE THE RESOURCES AND INFORMATION TO SUCCESSFULLY TARGET SPECIFIC FIRMS
3. **QUANTITY AND QUALITY**: CRITERIA SHOULD PROMOTE QUALITY AND FEATURES SHOULD PROMOTE UPTAKE
4. **STABILITY AND AWARENESS**: STABILITY OVER TIME AND AWARENESS-RAISING AMONG TARGET INVESTORS WILL FACILITATE UPTAKE
5. **SYSTEMATIC MONITORING AND EVALUATION**: WILL SUPPORT DESIGN AND REFORM AS WELL AS PROMOTION THE ATTAINMENT OF VALUE FOR MONEY

(EU, 2017)

Equity Tax Credits (ETCs)

Source of & Form of Funds for Angel

Given tax efficiency, creditor protection, and financial reporting, angel investment is typically made through a corporation. The Angel investor, to invest personally would need to withdraw funds from a corporation, and the tax depletion would reduce the available funds to invest. In NS a dividend rate of 47% outweighs the equity tax credit rate of 35%. If made personally, it is not reported on financial statements and could cause exposure in different circumstances.

Investors are not bound by geography in terms of investing, but their taxation will be tied to geography. Therefore, an investor from outside the region investing into the region does not benefit from any tax incentive, and restricts the source of funding.

Investors very often will look to structure their investment through instruments other than common shares. They will look at convertible debt and/or convertible preferred shares, and straight loans. It is important to note this debt is typically subordinated and is viewed as equity by knowledgeable investors and banks. Their motivations will be protecting downside risk, minimum returns etc. These funds can then be converted to common shares at different trigger points. Current equity tax credits would not cover these investments (except NB) and if they did their conversion or other changes in corporate structures would trigger repayment when the investment has not changed.

Therefore, an ETC that is designed to comprehend investors other than personal individuals, not bound by geography (in terms of investors not investment, i.e. funds still to be invested in the region) and expands beyond common shares to recognize the various nature and form of investments would reach a larger and more investor friendly market.

Description

Equity tax credits (ETCs) are a way for governments to incent private equity investment in eligible businesses through a personal income tax credit. As noted in Broten (2014), advantages of equity tax programs over traditional government investment in businesses include: active pursuit of equity capital by firms as a preferred alternative to reliance on debt and traditional government financing; provision of mentoring, advice and networking by the investors (smart money); and, increased focus on optimization of returns through efficient use of capital given the presence of savvy investors. Furthermore, Pittman (2012) points out that ETCs may help address a major market failure: the ability of small Atlantic-based companies to access outside capital to finance expansion and argues that ETCs are "inherently fairer" as governments are not burdened with the responsibility of picking winners. Pittman also points out that evidence shows that ETC programs are efficient interventions as they do not require a lot of overhead to operate and the value for cost is high.

Impact

In the context of the basket of available tools for stimulating investment in innovation, equity tax credits are seen as desirable and having relatively high economic value for cost. However, existing literature around both the theory and empirical evidence related to ETCs is scarce. As explained in EU (2017), this is in part because such interventions are relatively new and not present in many countries. In addition, the impact of such incentives (and all economic development interventions) is hard to asses due to the lack of a true control case. Finally, government data related to tax measures is not often publicly available. Although globally there is a lack of data on the impact of ETC programs (Hellman, 2010) all studies and experts in the field of innovation financing agree that they are worthwhile if designed properly (EU, 2017; Pittman, 2012) because they are inherently fair and not expensive (Pittman, 2012; Savoie, 2010).

The Province of British Columbia (BC) is one of the only jurisdictions with recent and public quantification of outcomes. Hellman (2010) did a review of the 517 companies that received investment through BC ETC program between the years of 2001 and 2008. The study found that, on average, the companies generated 2.43 jobs per year (broad control group generated almost zero jobs), grew revenues by an average of $572,000 per year and, per dollar leveraged, an additional $3.76 of equity and $1.15 of debt outside of the program. In total, the credits paid amounted to $256M, which leveraged at least $2.3B in equity investment for the companies. The study also spoke qualitatively to significant economy-wide spillover benefits of the strong companies. It is important to note that the BC program allows for angel investments as well as investments from venture capital funds; both types of investment are included in the averages above but the information is broken down below. The companies receiving only angel investments (206 of the 517) grew revenues by an average of $235,000 per year and raised $810,000 of the total $2,300,000 in equity.

ETC Programs in Atlantic Canada

All four Atlantic Provinces currently have some form of ETC program. Some elements are similar and some are different. Key considerations related to each program will be explored below and the specific program design elements will be outlined in Table 1. Of note, Nova Scotia's program appears to have had the highest uptake although longitudinal data was not available for any of the provinces. Specifically, Pittman (2012) found that according to the provincial budgets for the 2011-12 and 2012-13 fiscal years, Nova Scotia accounted for 96% of combined spending on ETCs across the four provinces, a lot of which can be attributed to one particular type of investee, Community Economic Development Investment Funds (CEDIF). The focus of the CEDIF component is community development rather than economic growth and therefore is outside the scope of this paper.

Nova Scotia (NS)

Nova Scotia's *Equity Tax Credit Program* provides support for access to equity financing with no sector restrictions. In Nova Scotia's 2012 Budget, the cost of the ETC program was identified to be $7.53M (cited in Pittman, 2012). In November of 2014 an arms-length review of the NS tax system was released (Broten, 2014) and, with respect to the ETC program, concluded that, overall, the program has succeeded in achieving its objective although there are some issues with the CEDIF component. The report recommended that the annual eligible investment be increased to $100,000, that high-growth sectors be targeted, and that eligibility requirements be reviewed to ensure best value. Savoie (2010) recommended an increase to $250,000.

New Brunswick (NB)

The *Small Business Investor Tax Credit Program* was instituted with a dual objective of increasing access to equity financing for small businesses and other eligible investees and encouraging investment within NB by NB residents. Similar to in NS, the NB program does not restrict eligibility to activity in certain sectors. It is important to note that uptake of the NB program had been minimal (Pittman, 2014) and in 2014-15 the government enhanced their program to drive more adoption. Today, the program provides the highest eligible investment amounts ($250,000 individuals & $500,000 for corporations and Trusts) and the highest credit rate (50% individual and 15% corporations) in the region. In addition, the NB ETC program points out it takes a considerable amount of time to build a new investment market. As Pittman points out, despite this program having the highest investment cap, in 2011-12 there were no subscribers to the program.

Prince Edward Island (PE)

In Prince Edward Island, the *Equity Investors Incentive Program* is intended to help new and expanding businesses move away from conventional term debt and working capital financing as well as to incent residents of the province to make local investments. Unlike NS and NB, PE does limit eligibility to specific sectors, which aligns with the province's existing economic specializations such as food and biosciences.

Newfoundland and Labrador (NL)

In Newfoundland and Labrador, the *Direct Equity Tax Credit Program* is positioned as a reward for local investment in startup, modernization, expansion or growth of small businesses. A significant difference between this program and those of the other provinces is that there are two credit rates: essentially, one for the capital city and surrounding area and one for rural areas. Like PE, this program restricts investments to designated growth sectors.

Table 1: Provincial Equity Tax Credit Programs in Atlantic Canada – Key Design Features

	Maximum Credit	**Form of Investment**	**Eligible Investors**	**Eligible Sectors**
NS *Equity Tax Credit Program*	Maximum 35% of $50,000 ($17,500)	Common Shares	Individual Residents of NS	No restriction
NB *Small Business Investor Tax Credit Program*	Maximum 50% of $250,000 ($125,000) Corporation 15% of $500,000 ($75,000)	Common Shares	Individual and Corporations Residents of NB	No restriction
PEI *Equity Investors Incentive Program*	Max is 20% $57, 142 ($20,000)	Common Shares	Individuals Residents of PEI	• Export-focused manufacturing and processing • Interactive, information and communication technology • Aerospace • Life sciences
NL *Direct Equity Tax Credit*	Max 35% of $142,858 ($50,000) outside the North East Avalon Max 20% of $250,000 ($50,000) within the North East Avalon	Common Shares	Individuals Tax payers in NL	• Technology • Research and development • Aquaculture • Forestry and agri-food • Manufacturing and processing • Export / import replacement businesses • Tourism • Cultural industries
Regional *(proposed)*	Maximum Individuals 40% of $250,000 ($100,000) Corporation Partnerships, outside NS individuals etc. 20% of $500,000	Common shares Convertible preferred and debentures	Individual and corporations, partnerships, etc., fully refundable	• Innovation Technology, with greater than 50% of wages in Atlantic;

Analysis

After a review of lessons learned in other jurisdictions (BC, EU), reviewing available literature on ETCs in Atlantic Canada (e.g., Savoie, 2010; Pittman, 2012; Broten, 2014) and, finally, through a limited number of informal expert interviews, analysis is provided below on the ETC programs in Atlantic Canada using a frame of reference provided by the conclusions of EU, 2017.

Policy Implications

The frame for analysis will be the five policy implications/principles for tax incentives for venture capital and business angels that were identified in the EU's Capital Markets Project (2017); these principles are also presented above in Figure 2.

Investor Risk Aversion

All of the Atlantic ETCs lower the risk of investment through the tax credit provided. Some jurisdictions outside Atlantic Canada (see EU, 2017) also provide investors with loss relief but with such measures there is a risk of weaker due diligence by the investor around the expected return on investment, which in turn means that there is a higher risk of the investee not making as high of an economic contribution as would be desired by government.

Another factor to consider in this category is the rate of tax credit. As shown above, provincial ETC programs in Atlantic Canada offer varying tax credit rates, ranging from 20% to 50%. One could argue that a higher rate would lower the investor risk but with higher rates come a higher risk of tax planning schemes; in effect, investors may make an investment just for the tax credit and not necessarily because they see the potential for a high return on investment or a have a desire to participate in the active management of the firm and thereby contribute *smart money*. Provincial governments would have to determine the rate that would provide the best balance between incentive and guarding against tax planning schemes. Personal communications during the development of this paper suggest that 35% – 40% might be appropriate.

Picking Winners

While provincial governments in Atlantic Canada all recognize to varying degrees that "picking winners" is not the most fair or effective approach to economic development, they do have capacity – individually and as members of the Atlantic Growth Strategy – to identify high potential sectors or clusters. Prince Edward Island and Newfoundland have exercised this capacity in the design of their ETC programs, restricting eligibility of investments to selected sectors. Nova Scotia and New Brunswick have not exercised this capacity but it has been recommended as a best practice and consideration for re-design, at least in Nova Scotia (Broten, 2014).

Quality and Quantity

Ensuring that ETC programs are designed in such a way that ensures quality investment is of the utmost importance for Atlantic Canada given the dire need for economic growth and the case for innovation.

There have been some criticisms of ETCs incenting low quality investments (e.g., condos, golf courses) and misuse of the program whereby investees offer investors rewards that would otherwise have a cost in return for their equity investment (e.g., golf course memberships) (Savoie, 2010). Again, this speaks to the need for a well-designed program with significant consideration given to eligibility requirements such as sector.

In terms of quantity of investment, data is required for an in-depth assessment of the ETC programs in Atlantic Canada, but the available information suggests that uptake has been low. Although an in-depth review of the detailed features of each program was not undertaken for this paper, any re-design should ensure that features such as administrative requirements for investor and investee alike as well as eligibility criteria do not unnecessarily or unintentionally restrict uptake.

Stability and Awareness

Stability in program design helps to limit confusion for investors and ensure that accessing the program is as straightforward as possible. Some of the Atlantic Provinces have made changes to ETC programs and this may be a contributing factor to the apparent limited uptake. Harmonized provincial programs could result in more positive outcomes. This is believed to be true in the EU where the European Commission is undertaking a substantial project to promote harmonized tax incentives across member governments, arguing that a stronger single market makes for stronger individual markets (EU, 2017). Should a regionalized approach be pursued in Atlantic Canada, longevity of the program design should be an important consideration.

Awareness of the ETC programs in Atlantic Canada can be assumed to be low given the apparent limited uptake of the program. In addition, because of the small market size in each individual province, investment opportunities are limited. A regionalized approach to ETCs in Atlantic Canada could help to broaden the pool of investment opportunities as well as of investors. Regionalizing the approach would create buzz in the investment community and thus help with awareness going forward.

Systematic Monitoring and Evaluation

Public literature on the outcomes of the ETC programs in Atlantic Canada is extremely limited. Nova Scotia published a review of program data from several years in the 1990s, shortly after the program was established, but, because the data is so out of date, it was not considered relevant for this paper. Understanding the economic and social impact of the individual programs to date as well as ensuring the programs are monitored regularly into the future should be prioritized to ensure maximal value for the use of government resources.

Regionalizing the Approach to ETCs in Atlantic Canada

A regional approach to ETCs would undoubtedly help to address some of the existing issues identified in the analysis above. A regional approach would create consistency across the provinces and result in easier program promotion resulting in a bigger pool of investment opportunities and investors. It could also indirectly increase attention on the Region from outside investors, whether or not those investors are eligible for an ETC.

Options for Regionalization

An evaluation of the available mechanics for regionalizing the approach to ETCs is beyond the scope of this paper and would need to be discussed among the provincial departments of finance along with the Canada Revenue Agency (collects taxes on behalf of provinces). The following options are mentioned, however, as initial input for such discussions.

(1) **Federal ETC for Atlantic Region**. Under this approach, the federal government would provide a credit on personal income taxes for investments made in Atlantic Canada by Atlantic Canadians. This approach may make sense on the surface given the federal government's commitment to economic growth in the Region as evidenced by the creation of the Atlantic Growth Strategy. However, realizing changes to the federal tax system may require significant time and resources and risk a loss of interest / commitment / momentum at the federal level should it be overtaken by other priorities.

(2) **Harmonized and Reciprocal Provincial Programs**. This approach may be the most expedient of all the options and the best approach for safeguarding one of the principle objectives of ETCs, which is to support the important objectives of *smart money* and investors with experience in and knowledge of the jurisdiction to a local growth company (EU, 2017). While some might argue that "local" should be restricted on a provincial basis, there is growing momentum towards a regional outlook given the small combined market size of the Atlantic Provinces. An investor resident in any of the Atlantic Provinces could make an investment in her/his own province or any of the other Atlantic Provinces and claim it on her/his tax return in her/his home province. The home province of the investor would provide the credit but, after the fact, charge the province where the investment was made.

(3) **Harmonized but Independent Programs**. Provincial programs would remain independent and investor eligibility would still be restricted by residency in each province but the design criteria would be harmonized such that the programs are identical. The incremental economic benefit of this approach may not outweigh the administrative costs of operationalization.

(4) **Harmonized but Independent Programs with No Investor Residency Requirements.** Provincial programs would remain independent but design would be harmonized, like in Option 3, and there would be no residency restrictions for the investor. This would most certainly increase the supply of available investment. Before proceeding with such an approach, the Atlantic Provinces would need to carefully consider whether it makes sense to move away from one of the original core principles of ETC programs: local smart money. A case study of other jurisdictions that have utilized this approach would be helpful.

Summary and Recommendation

Improving access to capital for innovation in Atlantic Canada is no small undertaking and having an effective ETC is helpful.

The access to funds for companies can be improved by an ETC that comprehends who the investors are. It can restrict where the funds are invested (rejoin and industries) but not where funds come from and in what format, as long as it is equity. These alterations expand the pool to not only capital but advisors, Smart Money.

A regional approach has merit. ETCs are fair and efficient interventions requiring minimal administrative costs. A regional approach could improve program design elements, lead to more awareness of the programs and set the stage for stability in the programs for years to come. These improvements, in turn, could lead to increased uptake of the programs and therefore increased investment and, depending on the regionalization option chosen, a broader pool of investment opportunities and investors.

A lot of work remains, however, before agreement could be reached on a regional approach to ETCs. In particular, provincial governments would each need to examine the longitudinal data for their respective programs in order to understand strengths and weaknesses. In addition, a detailed analysis of the eligibility criteria for investors and investees would be required to ensure the approach yields maximal value for use of government resources. A comprehensive jurisdictional scan could help in this regard. Stakeholder reactions would also need to be considered and plans developed for mitigating negative reaction.

Our recommendations are

1. Regionalize the Equity Tax Credit for Atlantic Canada;
2. Expand the investment pool to allow Investors from outside the Area;
3. Expand the investment pool beyond individuals, include corporations, partnerships etc.;
4. Expand the format of the investment to include other forms of equity such as convertible debentures and preferred shares;

If the use of the funds is targeted for Atlantic Canada, then the main objective of investing in Innovative Atlantic Canadian companies has been achieved. We will expand the pool from which we draw from to fund these Innovative companies.

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