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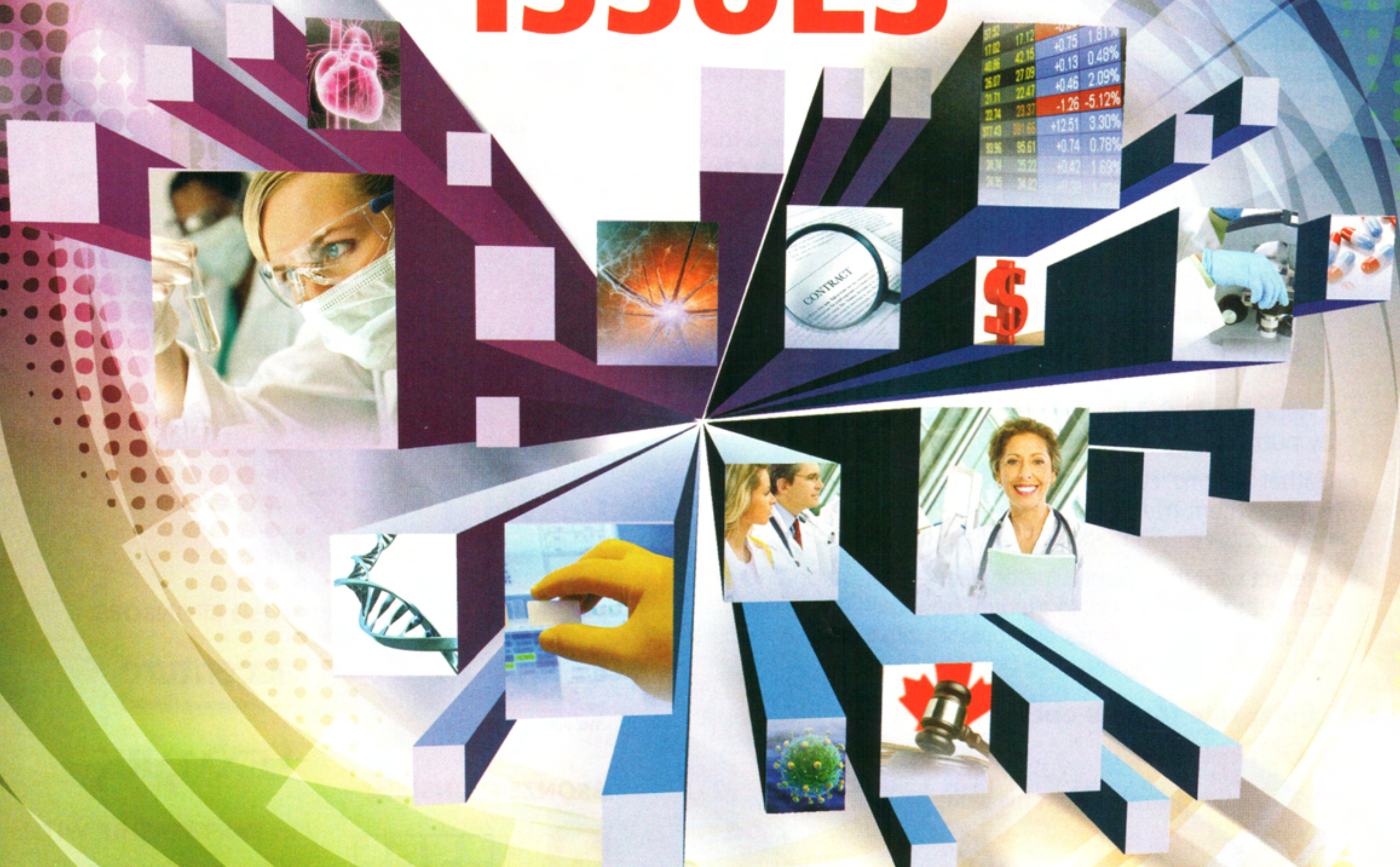

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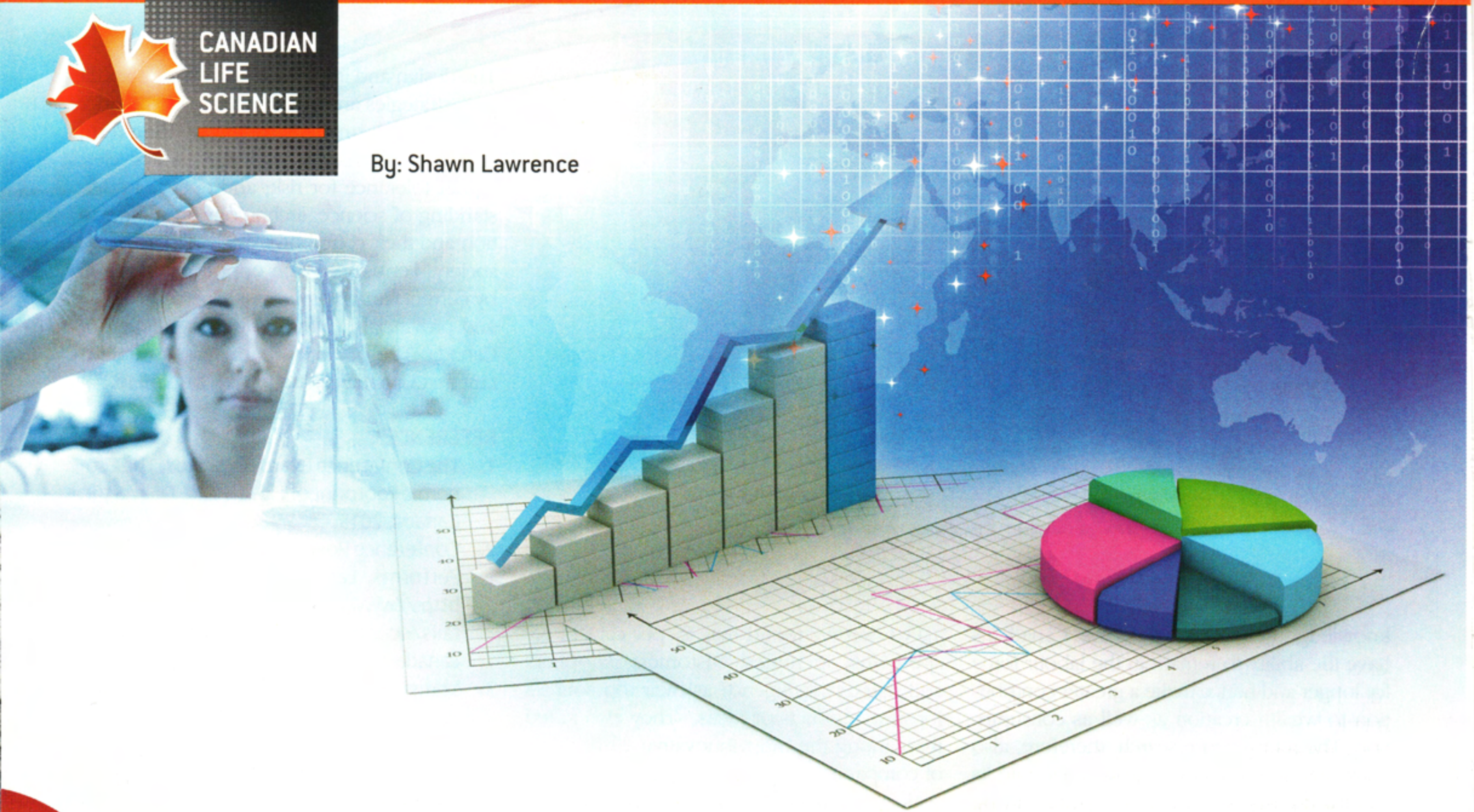

HOW IMMINENT CHANGES IN R&D TAX CREDITS WILL CHANGE YOUR BUSINESS

In 2013, changes to Canada's Scientific Research and Experimental Development (SR&ED) tax program announced in last year's federal budget will start to hit your bottom line. Bio-tech companies will likely feel more pain than most. Historically the program has delivered about $3 billion of federal money to fund private sector R&D in Canada. An additional $1 billion per year or so of provincial tax credits are tied to SR&ED eligibility. This system of tax credits has been effective both in retaining high quality jobs in Canada and incenting foreign companies to set-up in Canada thereby creating new jobs.

However, at a time when many countries – and many U.S. states – are expanding their R&D tax credits, Canada is cutting back. And as those cutbacks are about to start; most companies will feel their effect for the first time in 2013. The effect will be progressively more severe as the different types of cuts come into effect in subsequent years. Since for many Canadian companies the tax credits provide a cash benefit beyond whatever tax is payable, these cuts will go straight to the bottom line.

Count David Hearn managing director of Scitax Advisory Partners among those who feel the SR&ED changes are going to be an especially tough pill to swallow for the biotech sector. He foresees the changes having a lasting impact on R&D in Canada.

In a recent interview with *Biotechnology Focus*, Hearn noted "On the surface it might seem that the cuts apply primarily to large corporations that are foreign- or public-owned. However, the majority of the changes are cuts in expenditure eligibility that apply to anyone making a SR&ED claim. The biotechnology and pharmaceutical industries are going to be particularly hard-hit by these changes for a couple of reasons. Firstly, an unusual portion of start-up companies in this sector are publically funded which means they'll see a five per cent cut in their SR&ED benefit rate in tax years ended after December 31, 2013. Secondly, because of the immediate 20 per cent cut in eligibility of contract research which is so prevalent in this sector. And thirdly – perhaps worst of all for biotech – is the total elimination of SR&ED on any capital equipment whether purchased or leased. Biotech can be a very capital intensive sector of industry."

According to Hearn, any changes to SR&ED implemented by Canada's Federal Government will end up altering science and technology policies of the various provincial governments, some of whom could

> "If I'm a biotech company and I hire you as a subcontractor, and you charge me $100 for the research, previously 100 per cent of what you paid me attracted SR&ED. As a result of budget 2012, as of January 1st 2013, only $80 of the $100 is going attract SR&ED. That's bad news for any company that buys R&D services, buts its really bad news for contract research companies selling those services…" — David Hearn

have priorities somewhat different than those of Ottawa.

"For example Ontario offers the OITC which provides s a 10 per cent cash refund to all corporations and the ORDTC, that provides a 4.5 per cent non-refundable ITC. Other provinces offer similar and in some cases much greater benefits than above. Both of these credits are calculated on whatever expenditures Ottawa allows at the federal level. As such, when the federal government reduces the expenditures that attract SR&ED, for example Ottawa reducing contractors by 20 per cent, this is also reflected in the Ontario benefit. So in effect the federal government has reduced the amount of tax credit benefit that Ontario has to pay. So far, only one province has moved to address this; in November 2012 Québec introduced a boosted tax credit aimed specifically at the bio-pharma sector."

As for the bigger picture, the feeling in the industry is that most Canadian-controlled private corporations (CCPCs) escaped the five percentage point cut in the investment tax credit (ITC) benefit rate and remain eligible to receive ITCs of 35 per cent of SR&ED expenditures, paid as a cash refund if there are no taxes payable at year end. Yet according to Hearn, that's not entirely true.

"It's generally well known that for non-CCPCs that Budget 2012 changed the benefit rate from 20 per cent to 15 per cent. What's less well communicated is that high spending CCPCs will also suffer that same cut on expenditures above $3 million."

Hearn went on to say that *Biotechnology Focus* readers in particular need to pay attention to this wrinkle for two reasons: "First because bio-tech is one the sector likely to have CCPCs spending more than $3 million per year, second because this $3 million limit is changed by factors of taxable income and taxable capital. For example, a company with taxable income of $600,000 in the prior year would see the reduction in benefits from 20 per cent to 15 per cent at only $2 million instead of $3 million."

Another significant change arising from Budget 2012 is the reduction in the "proxy" overhead which is a notional amount calculated as a percentage of the claimed SR&ED wages that is allowed for overhead and "supplies." Regardless of tax year end, effective Jan. 2013 the percentage changes from 65 per cent to 60 per cent, and then in Jan. 2014 changes again down to 55 per cent. Hearn noted that companies still have the option to elect the 'traditional' overhead method wherein the actual overheads are claimed instead the proxy percentage. However, Hearn went on to say that unfortunately claims made using the traditional method seem more likely to be audited than those made using proxy.

"The cuts made to the SR&ED credit tax program through Budget 2012 could be further amplified by a whole series of new policy documents released by CRA in December 2012. While these documents don't have the force of law, they paint an accurate picture of how CRA will assess the claim you file and what their auditors expect to see in terms of compliance record keeping. Many industry observers have pointed out that some of the positions set out in these new policy documents are somewhat more restrictive in terms of the types of R&D work that qualify to attract SR&ED as compared to earlier versions of similar documents produced by the Agency. Dr. Russ Roberts of the Canadian Advanced Technology Association recently wrote on that organization's website that: 'The result of the new, consolidated policies when used in audits has been supported for a much narrower scope of SR&ED, both in terms of what are SR&ED projects and what work can be associated with them.'" [1]

It all adds up to putting Canadian technology firms – especially biotechnology businesses – in a pinch, Hearn concludes.

"Essentially, you get less benefit, less eligible expenditures and less R&D activity that qualifies for the credit. So, as a result of Budget 2012 there is a reduction in expenditures and benefit rate on the quantitative side, and as a result of CRA administrative policy we're seeing a reduction on the qualitative side."

Hearn also has questions regarding the timing of and the purpose behind the cuts. The federal government maintains that the cuts to the SR&ED program will be offset by bolstered direct grants and loan programs. While such initiatives as increasing funding for NRC's IRAP grant program and delivering $400 million in venture capital through its technology investment program are positive measures, Hearn believes they won't offset the crunch CCPCs are facing with the cuts.

"In a time when just about all of the world's knowledge economy countries are increasing, not decreasing the use of tax credits, the Canadian Government's move to curtail them is puzzling. Our system of SR&ED tax credits has given Canada a significant competitive advantage on the global stage; so if the goal is to attract investment, jobs and businesses to Canada , I think any move away from tax credits is a step in the wrong direction," he said.

The renewed federal emphasis on direct funding through grants and loans instead of tax credits also creates some unique concerns he believes.

"For starters, businesses understand the tax credit system much more than they understand the direct funding models based on grants and loans. When company CEOs or CFOs choose a location, they think about availability of labour, they think about cost of real estate, the quality of life, the political stability, and most importantly, from a government policy standpoint, companies look at the tax picture first. They really don't like grants and loans, for the reason that such funding mechanisms are so highly subjective. In most cases the government is picking the winners and losers."

He explains that transparency is the big advantage that funding R&D through the tax system has over any of these "direct funding," grant and loan schemes.

"The tax system operates according to the rule of law. It operates with the support of the same professional chartered accountants and lawyers to whom we entrust all other aspects of commercial oversight.

"In a time when just about all of the world's knowledge economy countries are increasing, not decreasing the use of tax credits, the Canadian Government's move to curtail them is puzzling. Our system of SR&ED tax credits has given Canada a significant competitive advantage on the global stage."

There are well defined redress procedures through the courts by which anyone denied R&D funding can appeal that denial and by which government can recover R&D funding given to anyone not entitled to receive it. But in these grant/loan schemes, there's no process for redress. There are rules but there isn't really legislation per se. There's no professional body that acts as a translating layer between government and business."

Another thing to know about these grants and loans, explains Hearn, is that they often work against the tax system.

"A company that receives government assistance gets less R&D tax credits."

Essentially, direct funding has the potential to affect the SR&ED benefit the company may have been otherwise eligible for.

Hearn also has a suggestion for government to consider as an alternative to direct funding for non-CCPCs, again with transparency being the goal. It's an argument that has been put forth many times before in past Hot Button Issues of *Biotechnology Focus.*

"I don't want to say I'm against direct funding, and I do think the Canadian Government is showing itself to be genuinely interested in supporting the biotech sector. However, I think government needs to re-visit the flow-through share idea. Flow-through shares have worked perfectly to incent development of Canada's petroleum industry. There's a high demand amongst investors for these types of shares, the legislation already exists and our professional communities know how to use them."

REFERENCES

1. see "Comment" at http://www.cata.ca/Media_and_Events/Press_Releases/cata_pr02011302.html

To see this story online visit
www.biotechnologyfocus.ca/how-imminent-changes-in-rd-tax-credits-will-change-your-business/