



- Go to
 - Forms and publications
 - Online services
 - A to Z index
 - Site map
- Information for
 - Individuals
 - Business
 - Other groups
- Search CRA



Application Policy

NUMBER: SR&ED 2000-04R2
DATE: June 18, 2002
SUBJECT: Recapture of Investment Tax Credit

Revision

Example 7 at the end of this document is revised to provide guidance on how to apply the Investment Tax Credit recapture rules in situations where an asset is converted to commercial use and its fair market value (FMV) is less than qualified expenditures claimed in respect of the asset.

Issue

The purpose of this application policy is to outline the position of the Canada Customs and Revenue Agency (the CCRA) with respect to the Investment Tax Credit (ITC) recapture rules when administering the Scientific Research and Experimental Development (SR&ED) legislation under the *Income Tax Act* (Act) and the *Income Tax Regulations* (Regulations).

Legislation

The ITC recapture rules were introduced in the February 23, 1998 federal Budget. Bill C-72, which included the provisions for the recapture of SR&ED ITC, received Royal Assent on June 17, 1999.

The ITC recapture rules are contained in subsections 127(27) to (35) of the Act.

Conditions to apply ITC recapture rules

Paragraphs 127(27)(a) to (d) of the Act describe the conditions in which there will be recapture of ITC in a taxation year. This applies to corporations and individuals. However, in the case of a transfer of qualified expenditures under subsection 127(13), the circumstances are described in paragraphs 127(29)(a) to (d) (see "Recapture of ITC of allocating taxpayer" below).

In the case of partnerships, the circumstances are described in paragraphs 127(28)(a) to (d) (see "Partnerships" below).

The conditions described in paragraphs 127(27)(a) to (d) are:

- (a) the taxpayer acquired a particular property from a person or partnership in a taxation year of the taxpayer or in any of the 10 preceding taxation years,
- (b) the cost of the particular property was a qualified expenditure to the taxpayer,
- (c) the cost of the particular property is included in an amount, a percentage of which can reasonably be considered to be included in computing the taxpayer's ITC at the end of the taxation year, and
- (d) in the year and after February 23, 1998, the taxpayer converts to commercial use or disposes of the particular property or another property that incorporates the particular property.

Note: All four conditions have to be present to create a recapture of ITC.

Analysis

WHEN ARE THE RULES APPLICABLE?

The ITC recaptures rules apply to dispositions and conversions of property that occur after February 23, 1998.

Note that ITCs earned on expenditures incurred before February 24, 1998 are subject to recapture provided that the disposition of the property or its conversion to commercial use takes place after February 23, 1998 and the above conditions are met.

TAX POLICY INTENT

Reflecting the net cost of performing SR&ED

At the outset of an SR&ED project, a claimant may not know whether the materials used in the project will be consumed or will result in a product that has some value. For equipment used in SR&ED a claimant may intend to use the property in SR&ED throughout its useful life, but subsequently changes its use or disposes of it. The recapture rules are intended to reflect the net cost of performing SR&ED. Since this net cost cannot be determined at the outset, the recapture rules will reverse all or a portion of the ITC when the sale of the SR&ED property takes place or when it is converted to commercial use.

No recapture on SR&ED salaries and SR&ED overhead

It is not intended that the rules be applied to recapture ITC in respect of SR&ED labour costs or overhead expenditures. There will be no ITC recapture in respect of any property that is constructed or produced by the claimant, apart from the cost of purchased components or materials (such as a motor in a machine).

The first condition in paragraph 127(27)(a) requires that the property subject to recapture must be acquired from a third party. Further, subsection 127(32) of the Act specifies that for the purposes of subsections (27), (28) and (29), the "cost of the particular property" to a taxpayer shall not exceed the amount paid by the taxpayer to acquire the property from a transferor of the property and does not include amounts paid by the taxpayer to maintain, modify, or transform this property.

It is only where a property was purchased by a claimant and constitutes a SR&ED qualified expenditure and is subsequently disposed of or converted to commercial use, either on its own or as a component of a new property, that an ITC recapture will be triggered.

Example

A corporation develops a new part for a machine in the prosecution of a SR&ED project. The development cost is \$10,000 (SR&ED salaries \$4,000, cost of materials transformed \$5,000 and SR&ED overheads \$1,000). The materials were acquired from an arm's length supplier.

Only the cost of the property acquired by the corporation, i.e. \$5,000 for the material, is subject to the ITC recapture rules at the time of the disposition of the property or its conversion to commercial use.

PURCHASE OF SR&ED COMPONENTS

The impact of the ITC recapture rules is different for a corporation that gives a contract for the manufacture of, or that purchases, SR&ED components, the cost of which is a SR&ED qualified expenditure, than for a corporation that manufactures its own SR&ED components.

In the above example, if the corporation orders the part from an arm's length supplier for \$12,000 (e.g., the \$10,000 development cost plus a profit element), the cost of the property subject to the ITC recapture rules would be \$12,000.

Refer to section "Property acquired through a contract involving SR&ED and other work" for additional comments.

ITEMS IN INVENTORY

In certain cases a claimant may use for SR&ED purposes a property from its inventory of merchandise purchased for resale or of raw materials acquired for manufacturing. The cost of that property is the laid-down costs if it was purchased from an arm's length supplier and, if the property was manufactured by the claimant, its cost includes the manufacturing salary, the cost of materials and a reasonable portion of overhead. Only the cost of the materials purchased originally could be subject to the ITC recapture rules.

Example

As part of a SR&ED project a corporation is using a batch of cardboard boxes from its inventory to test a new printing process. The corporation manufactures the boxes, which are normally sold to customers. There is no SR&ED labour involved in the manufacturing of the boxes. The manufacturing cost for a batch of boxes is \$10 (labour \$3, material acquired from an arm's length supplier \$5 and overhead \$2). The costs of the boxes used to test the new printing process (assuming there is no excess quantity) are deductible under subsection 37(1). The corporation was able to sell the boxes at \$15 in the subsequent year. The ITC recapture rules will apply and the cost of a "property acquired" by the corporation is \$5 for the purposes of the ITC recapture rules.

In the above situation the onus is on the claimant to break down the costs of items in inventory that are used in SR&ED activities. Reasonable estimates and/or breakdown of standard costs are acceptable.

EXPIRED ITC

The reference to "the 10 preceding taxation years" in paragraph 127(27)(a) ensures that if a property is sold or converted to commercial use and the related ITC has expired, it would not be subject to recapture.

PROPERTY

The word property is defined in subsection 248(1). The word property is broad and reflects the intended scope of the provision. The kind of property that could be subject to the ITC recapture rules include:

- Materials included in a custom product, a commercial asset, or in experimental production
- ASA (all or substantially all) equipment
- Share-used equipment (SUE)
- Animals and growing things used in SR&ED projects
- Property acquired through a contract involving SR&ED and other work

In addition, in certain cases, the ITC recapture rules can apply to incorporeal property (see "Incorporeal Property" below).

Application policy SR&ED 2000-01 gives the meaning of materials for SR&ED purposes.

For the ITC recapture rules to apply, the property must have been acquired by the claimant from a person or partnership. The disposition of a property that was not acquired from a person or partnership will not trigger the ITC recapture rules with respect to that property. For example: animals born on a farm and used for SR&ED purposes before being sold; oil generated during an experimental drilling process and that is subsequently sold.

Since the cost of the particular property must be a qualified expenditure of the claimant, the choice of a method to report SR&ED expenditures will impact on the type of property that could be subject to ITC recapture. See Chart 1.

INCORPOREAL PROPERTY

The legislation does not distinguish between corporeal and incorporeal property. However, in most cases, a SR&ED performer developing and selling an incorporeal property (such as intellectual property) would not be affected by the ITC recapture rules, because normally the property sold could not be said to contain any other property that had been the subject of an SR&ED claim.

An example where the recapture rules will apply to incorporeal property would be the purchase of an existing software application for SR&ED purposes, where the software is directly incorporated into a larger experimental software application (the purchased software is incorporated into the end product), which is eventually perfected and sold (or leased) provided the expenditure was allowable in the first place (i.e., if subsection 37(4) does not apply to disallow the expenditure).

Another situation where the ITC recapture rules will apply to incorporeal property is where a performer acquires an off-the-shelf product (e.g., software) and that subsection 37(4) was not applied because the property was used as a SR&ED tool (the purchased software is not incorporated into the end product). In such a case, the ITC recapture rules will apply when the property is sold or converted to commercial use.

When a payer disposes of the rights to the intellectual property (IP) generated as a result of SR&ED undertaken on its behalf by an arm's length performer, the ITC recapture rules will not apply.

The rationale is:

- Where the IP belongs to the payer as per the contract, the payer is not acquiring the IP. The IP always belonged to the payer. It simply accrues to the payer as it is generated. Accordingly there is no recapture of ITC when the payer disposes of the IP or converts it to commercial use.
- Where the IP belongs to the performer as per the contract (or remains with the performer), subsection 37(4) would usually apply to disallow the expenditure incurred by the payer to acquire the IP from the performer. The payment made under the contract for the SR&ED service, however, is an allowable SR&ED expenditure.

Example

Corporation A (the payer) gives a SR&ED contract to Corporation B, an arm's length corporation, to develop a new process on its behalf. The contract amount is \$100,000. The SR&ED project is SR&ED.

a) Assume that the rights to the IP rest with the payer as per the contract. In that case, Corporation A has not acquired a property from Corporation B (the IP). The IP always belonged to the payer. The IP simply accrues to the payer as it is generated. Therefore, Corporation A will be not subject to ITC recapture when it sells or leases (change of use) the rights to the IP.

b) Assume that the rights to the IP rest with the performer as per the contract but that Corporation A pays \$20,000 at the end of the project to acquire the IP from Corporation B under a separate contract. In that case, subsection 37(4) would apply to deny the deduction for the payment. However, the payment of \$100,000 under the contract for the SR&ED work is deductible under subsection 37(1).

PROPERTY ACQUIRED THROUGH A CONTRACT INVOLVING SR&ED AND OTHER WORK

In certain cases a payer acquires under contract a component part to be used for SR&ED. In other cases the contract involves the performance of SR&ED and other work and results in the acquisition of a property by the payer that can reasonably be expected to be used in its business or that will be sold. As stated in paragraph 16 of Interpretation Bulletin IT-151R5: "Projects, such as the development of a custom product, that may involve SR&ED work may also involve commercial production work that does not constitute SR&ED under paragraph (i) of the definition SR&ED in subsection 248(1). To determine the eligible expenditures on SR&ED for such projects, the SR&ED work and the non-SR&ED work should be identified and the project costs allocated between these activities."

Application of the rules

- When a payer gives a contract to an arm's length performer for SR&ED, or SR&ED and other work, to be performed on its behalf which results in the acquisition of property (other than intellectual property) that will be used in the payer's SR&ED, or that will be used in its business, or that will be sold, the ITC recapture rules apply when the payer disposes of the property or converts it to commercial use.
- The payer should claim the SR&ED portion of the contract under line 340 (expenditures for SR&ED contracts) of form T661 or T665, if the contract involves the acquisition of a property that will be used in its business or that will be sold, or record the full amount of the contract as cost of materials (either on line 320 "cost of materials consumed" or 325 "cost of materials transformed" as the case may be) if the contract involves the acquisition of a SR&ED component part from a taxable supplier.

The cost of the finished product includes the SR&ED expenditures incurred by the performer to develop the product. The cost of the finished product (or a portion of the cost) has generated ITC. The allowable SR&ED expenditures incurred by the payer in respect of the property will be one of the limits to consider when applying the ITC recapture rules. See example 7.

Amount of ITC recapture

Pursuant to subsection 127(27), the amount of ITC recapture is added to the taxpayer's tax otherwise payable under Part I for the taxation year. A claimant who has a balance of unused ITC can use it to reduce or eliminate that amount of tax payable for the year, including any amount added due to the recapture rules in subsections 127(27), (29) or (34).

The amount of tax generated by this recapture mechanism is not subject to the surtax under section 123.2.

All amounts added to tax payable under this provision for a taxation year will increase the amount of the claimant's subsection 37(1) pool of deductible SR&ED expenditure for the following year.

There shall be added to the claimant's Part I tax otherwise payable for the year the lesser of two amounts:

The first amount is the amount that can reasonably be considered to be included in computing the claimant's ITC in respect of the particular property that was acquired by the claimant.

The second amount is determined by multiplying either the proceeds of disposition or the fair market value of the property, as the case may be, by the historical ITC rate on which the ITC was earned:

- Where the property, or another property that incorporates the property, is disposed of to a person dealing at arm's length with the claimant, the second amount is the same percentage (for example, 20 per cent) that the claimant applied in calculating the original ITC claim in respect of the particular property multiplied by the proceeds of disposition of that property [paragraph 127(27)(e)]. See Example 1.
- In any other case (i.e., where the property, or another property that incorporates the property, is converted to commercial use or sold to a non-arm's length party*), the second amount is the same percentage (for example, 20 per cent) that the claimant applied in calculating the original ITC claim in respect of the particular property multiplied by the fair market value of the particular property or the other property that contains the property) [paragraph 127(27)(f)]. See Example 2.
- The current version of Interpretation Bulletin IT-419 "Meaning of arm's length", expresses in general terms, criteria which the CRA will consider in determining whether or not persons deal with each other at arm's length.

The fact that the ITC recapture takes place in a different year from the original claim may occasionally create a liability for tax in a loss year.

ITC Rate

Subsection 127(27) allows for the recapture of an amount that can reasonably be considered to be included in computing the taxpayer's ITC. In certain cases a Canadian-controlled private corporation (CCPC) has earned a portion of its ITCs at a rate of 35%, and another portion at 20%. The amount of the ITC is determined according to the enhanced rate (35%) for the amount that is within the expenditure limit and the base rate (20%) for the amount exceeding this expenditure limit. The claimant will first compute the ITC on current expenditures, as they are 100% refundable.

Generally, the recapture amount will be computed according to the nature of the expenditure (current or capital) and the rate used in the past. For example:

- When the total allowable expenditures does not exceed the expenditure limit, the recapture amount will be computed at the rate of 35%.
- When the total allowable expenditures exceeds the expenditure limit, but the amount of current expenditures is less than this limit and the amount recaptured is related to current expenditures, the recapture amount will be computed at the rate of 35%. If however, the amount of current expenditures exceeds the limit and the amount recaptured is related to a current expenditure, a rate of 20% will be used on the portion of the amount exceeding the expenditure limit and a rate of 35% will be used on the

of the amount exceeding the expenditure limit and a rate of 35% will be used on the portion of the amount that is within the expenditure limit.

- If the total allowable expenditures exceeds the expenditure limit and the property sold or converted to commercial use is related to a capital expenditure, a rate of 20% will be used on the portion of the capital expenditure that exceeds the expenditure limit and a rate of 35% will be used on the portion that falls within the expenditure limit. For example, if the total allowable expenditures is \$2,500,000 and the capital expenditures \$600,000, \$500,000 will be computed at the rate of 20% and \$100,000 at the rate of 35%.

Other situations may arise and will be handled on a "case-by-case" basis. The onus is on the claimant to match SR&ED expenditures with the costs incurred in such a way as to identify the ITC rate used and the recapture amount, where appropriate.

Disposition of property, proceeds of disposition, conversion to commercial use

DISPOSITION

The expression "disposition" is defined in subsection 248(1) of the Act. A disposition of any property includes any transaction or event entitling a taxpayer to proceeds of disposition of the property.

PROCEEDS OF DISPOSITION

There is no specific definition in the Act of the term "proceeds of disposition" that would apply for the purpose of the ITC recapture rules. The meaning of the term includes its common commercial meaning, that being the "sale price of a property that has been sold".

It could also include compensation for property destroyed and any amount payable under a policy of insurance in respect of loss or destruction of property (this is consistent with the definition of "proceeds of disposition" in subsection 13(21) and section 54 of the Act). Compensation under an insurance policy could be seen as an event entitling the taxpayer to proceeds of disposition. Thus, for example, there would be a disposition of property in a situation where a claimant is entitled to a compensation under an insurance policy for materials consumed in SR&ED because of a fire during testing.

In the case of a custom product or an experimental production, the invoice or contract should normally be available and the proceeds of disposition could be determined without difficulty.

The proceeds of disposition should not be allocated to the different expenditure elements that form part of the total cost of the property. For example, a corporation acquires materials for \$75,000 and incurs SR&ED salaries of \$120,000 to develop a custom product. The custom product is sold to an arm's length person for \$100,000. The proceeds of disposition to calculate the ITC recapture are \$100,000. The proceeds should not be allocated to the cost of materials and the SR&ED salaries (for which there would be no ITC recapture).

Disposition or conversion to commercial use of "another property that incorporates the property"

A claimant may sell a particular property or convert it to commercial use, the cost of which was claimed as a qualified expenditure, and the particular property cannot be physically distinguished or separated from the property that contains it. In such a case, the total proceeds of disposition or the FMV for the entire property, as the case may be, will be used to determine the amount in subsections 127(27)(e) or (f).

For example, a corporation develops a new nylon monofilament on an experimental basis. The cost of materials included in this experimental production is \$10,000. The new nylon produced was just of average quality but it was incorporated into an existing fabric and sold to an arm's length party for \$8,000. The entire property once finished, cannot easily be broken down into its separate components. The proceeds of disposition for the purposes of subsection 127(27)(e) are \$8,000.

In certain cases, the particular property contained in another property could be sold as part of a whole property. We are of the view that a prorated portion of the proceeds of disposition of the property sold would be acceptable where it is possible to physically identify the particular property, the cost of which was claimed as a qualified expenditure, as a separate property.

For example, a corporation develops an experimental engine for a machine with the objective of increasing the performance of the existing models. The cost of materials transformed into the experimental product was \$100,000. The SR&ED project did not result in a better engine and at the end of the project the new engine was incorporated into a machine, which was sold to an arm's length party for \$200,000. However, it would have been possible to sell the engine separately for \$50,000. In this case, the proceeds of disposition for the purposes of subsection 127(27)(e) are \$50,000.

CONVERSION TO COMMERCIAL USE

Under paragraph 127(27)(d), the ITC recapture rules apply where the taxpayer disposes of a property or converts it to commercial use. It is a question of fact whether a property has been converted to commercial use.

"Commercial" generally suggests an association with a revenue generating activity.

In the case of a commercial asset as defined in application policy SR&ED 96-07, the fact that the SR&ED project is complete on a particular date does not necessarily mean that the asset is being converted to commercial use on that date. The commercial asset will be considered to be converted to commercial use when it becomes available for use. For the purposes of determining when the conversion to commercial use occurs, the available-for-use rules contained in subsection 13(27) should apply. Paragraph 13(27)(a) specifies that one date to consider is the time the property is first used by the taxpayer for the purposes of earning income.

When determining if a SUE was converted to commercial use it is the CCRA's position that a conversion will not occur for SUE unless the usage of the equipment for SR&ED becomes only incidental. That is, there will only be recapture in respect of SUE when the property has been all or substantially all converted to commercial use.

When a property that was developed by the claimant is converted to commercial use or sold to a non-arm's length party, it is necessary to establish the FMV of the property. Since the FMV of the property would reflect the costs of materials transformed into the property, the SR&ED labour costs and a portion of the SR&ED overhead expenditures, the FMV will usually be greater than the other limit to calculate (i.e., the amount that can reasonably be considered to be included in computing the taxpayer's ITC in respect of the particular property that was acquired by the taxpayer). The onus is on the claimant to substantiate any FMV that would be a lesser amount than the costs of materials transformed in the property and claimed as qualified expenditures.

De minimis rule

By administrative policy, the ITC recapture rules will not be applied in the case of scrap sales. Scrap sales are considered to take place when the proceeds from the sale of an experimental product are less than 10% of the total cost of the property.

For example, in developing an experimental product, a corporation incurs the following SR&ED expenditures: salaries \$100,000 overhead \$65,000 and materials incorporated in the product \$25,000. The product was sold at the end of the project for \$10,000. Since the proceeds from the sale represent only 5% of the total cost of the experimental product, it is considered to be scrap sales and the ITC recapture rules will not be applied.

By administrative policy, the ITC recapture rules will not be applied when the FMV of an experimental product at the time of its conversion to commercial use or disposition to a non-arm's length party, is less than 10% of the total cost of the property.

Where a SR&ED expenditure was allowed as "cost of materials consumed", i.e., in a case where it was not incorporated into a SR&ED product, there will be no ITC recapture unless the proceeds received are greater than 10% of the cost of the materials (e.g., proceeds of insurance policy).

In applying the ITC recapture rules the CCRA will take into account the materiality of the amount.

ASA Equipment

Subclause 37(8)(a)(ii)(A)(III) of the Act contains an intent test for the deductibility of capital expenditures for SR&ED purposes (acquisition of ASA equipment). The fact that there will be ITC recapture on the sale of ASA equipment, or on its conversion to commercial use, does not mean that the rules for the deductibility of capital expenditures under paragraph 37(1)(b) have been relaxed. Only the cost of equipment meeting the intent test for capital expenditures for SR&ED will be allowed as expenditures.

Note: there could also be recapture of capital cost allowance (CCA) when the equipment is sold. Subsection 37(6) provides that, for the purposes of section 13, an amount claimed under subsection 37(1) that may reasonably be considered to be in respect of property described in paragraph 37(1)(b) will be deemed to be an amount that has been allowed to the taxpayer as capital cost allowance. The Guide to Form T661 (line 440) provides more explanations and an example on how to calculate the amount of CCA recapture.

In the case of ASA equipment, the SR&ED rules in subsection 37(6) deem each capital SR&ED property to be depreciable property of a separate prescribed class. Therefore, all the ordinary and on-going record keeping associated with the depreciable property has been required for SR&ED property for many years.

It is the claimant's responsibility to substantiate the composition of the opening balance of his ITC account. In this regard, the ITC recapture rules in subsection 127(27) do not impose any additional burden on the taxpayer. When the Act provides for an account (for example, undepreciated capital cost (UCC), ITC, SR&ED expenditures), the taxpayer must be able to substantiate all the amounts composing the balance of that account at the start and end of any given taxation year.

However, there may be cases where some claimants have been unable to comply with this level of record keeping. Where ITC recapture is necessary in respect of assets for which no historical records exist, the CCRA will take a reasonable approach based on estimates and approximations.

Where ASA equipment is sold to a non-arm's length person or converted to commercial use, one of the limits to determine the amount of ITC recapture is the FMV. For this purpose, a notional UCC for the ASA equipment, calculated using the CCA rate that would have applied had the equipment not been a SR&ED capital expenditure would be used as an estimate of the FMV. The onus is on the claimant to support any value that is substantially less than the notional UCC. See Example 3.

Recapture of ITC of allocating taxpayer (the performer)

Subsection 127(29) of the Act provides for the recapture of ITC in the hands of a SR&E performer in certain circumstances where the performer has transferred qualified expenditures incurred in the performance of a SR&E contract to a non-arm's length taxpayer under subsection 127(13).

Subsection 127(29) applies where the circumstances described in paragraphs 127(29)(a) to (d) occur. These circumstances are similar to those described in subsection 127(27) except that under paragraph 127(29)(c), all or part of the qualified expenditures can reasonably be considered to have been the subject of an agreement made under subsection 127(13) by the performer and the transferee.

The ITC recapture in the hands of the performer is the lesser of the two amounts described in paragraphs 127(29)(e) and (f). The first amount is the amount that can reasonably be considered to have been included in the transferee's ITC in respect of the qualified expenditures that were transferred by the performer. The second amount is the amount determined by the formula " $A \times B \div C$ ". A is the percentage used by the transferee to calculate its ITC. B is one of two amounts. Where the property (or another property that incorporates the property) is disposed of to a person dealing at arm's length with the taxpayer, B is the proceeds of disposition of that property. In any other case, B is the FMV of the property or the other property that incorporates the property at the time of its conversion to commercial use or its disposition to a non-arm's length party. C reduces the amount of ITC recapture under subsection 127(29) by any amount of ITC recapture under subsection 127(27) in respect of the particular property. C will apply where a SR&E performer has transferred a portion of the qualified expenditure associated with a property, and has retained the remainder of the qualified expenditures. See Examples 4, 5 and 6.

Timing considerations

Where the performer and the payer have different taxation year-ends timing problems may arise for the purposes of the ITC recapture rules. There will be a timing problem in circumstances where:

- the performer disposes of a property for which it incurred a qualified expenditure
- all or part of the qualified expenditure is transferred to a non-arm's length payer under subsection 127(13)
- the taxation year-end of the payer ends before the performer's taxation year-end.

Example

Company A (the payer) gives a SR&E contract to Company B, a non-arm's length SR&E performer to perform SR&E on its behalf. Company A's taxation year-end is 30/11/99 and Company B's is 31/12/99. Company B incurs expenditures of \$100,000 for SR&E labour, \$65,000 for SR&E overheads, and \$135,000 for materials transformed into an experimental product. Company B transfers in its taxation year-end 31/12/99 the qualified expenditures of \$300,000 to company A. The FMV of the experimental product at the time of its transfer to company A is \$500,000.

Company B's SR&E qualified expenditure pool is reduced by \$300,000 in its taxation year ending on 31/12/99. However, Company A's SR&E qualified expenditure pool is increased by \$300,000 in its taxation year ending on 30/11/00, i.e. its first taxation year that end at the same time or after the end of the particular taxation year of the performer.

There is a recapture of ITC for company B in its taxation year ending 31/12/99. The recapture amount of ITC is calculated using the ITC rate for company A (which is not known until 30/11/2000). Assuming an ITC rate of 35%, the amount of the recapture would be \$47,250 (35% of \$135,000).

Company A will claim ITC of \$105,000 (35% of \$300,000) in its taxation year ending 30/11/00.

In a situation like the one described in the example, CCRA will accept that the performer reports the ITC recapture in its subsequent taxation year. In the example, Company B could report the ITC recapture only in its taxation year ending on 31/12/2000.

If the performer only transfers a portion of the qualified expenditures to the payer then only the amount of ITC recapture that exceeds the amount of ITC earned by the performer in the year in respect of the property can be reported to the subsequent taxation year.

Non-arm's length disposition of equipment

Subsections 127(33) and (34) apply in circumstances where a non-arm's length transfer of SR&E property to another taxpayer would otherwise trigger the SR&E ITC recapture provisions.

One of the reasons for introducing them was to settle the question of the disposal of a SR&E capital property to a new corporation with a non-arm's length relationship in the context of reorganization, when the use to which the property is put does not change. Without these rules, the ITC would have been recaptured when the property was disposed of at the time of the reorganization.

Subsection 127(33) provides that the SR&E ITC recapture provisions do not apply to a taxpayer who disposes of SR&E property to a non-arm's length purchaser in circumstances where the cost of the particular property to the purchaser would have been a SR&E capital expenditure for an equipment that would meet the all or substantially all (ASA) test described in subclause 37(8)(a)(ii)(A)(III) of the Act.

Subsection 127(34) creates a recapture mechanism where the non-arm's length purchaser subsequently sells the property or converts it to commercial use. Subsection 127(34) requires the non-arm's length purchaser to apply a recapture rule similar to the recapture rule in subsection 127(27) based on the rate at which the original ITC was generated on the property.

Technically subsection 127(33) is not applicable to the transfer of SUE to a non-arm's length person. However, administratively, recapture will not occur for shared-use equipment (SUE) that is transferred to a non-arm's length person unless the usage of the equipment for SR&E becomes only incidental. That is, there will only be recapture in respect of SUE when the property is sold by the non-arm's length person or has been all or substantially all converted to commercial use.

Partnerships

The ITC recapture rules for partnerships are contained in subsections 127(8), (28), (30), (31), (34) and (35) of the Act.

Per subsection 127(28), a partnership will have a recapture of ITC in a year when all of the following conditions are met:

- a particular property is acquired by the partnership from a person or partnership in the current fiscal period or in any of the 10 preceding fiscal periods of the partnership,
- the cost of the particular property was a qualified expenditure,
- the cost of the property was included in computing the ITC of the partnership at the end of a fiscal period of the partnership, and
- in the year and after February 23, 1998 the property (or another property that contains it) was disposed of or converted to commercial use.

The recapture will be calculated for the fiscal period of the partnership in which the property was disposed of or converted to commercial use. The recapture will be deducted from the ITC of the partnership otherwise available. Each member of the partnership will report his or her share of the ITC of the partnership, reduced by the amount of the recapture, as required in subsection 127(8). If the partnership does not have sufficient ITC otherwise available to offset the recapture, then the amount by which reductions to ITC exceed additions (the excess) will be determined. A member should report the amount that is his or her share of the excess as an addition to Part I tax payable (subsection 127(30)).

The amount of the recapture will be determined as the lesser of:

- (i) the ITC earned in respect of the particular property that was acquired by the partnership, and
- (ii) the amount determined by applying the percentage which was used in calculating the ITC earned on the property to the proceeds of disposition of the property if it was disposed to an arm's length person, or in any other case, the fair market value of the property.

Any amounts payable under this provision for a taxation year by members of the partnership will increase the amount of the partnership's subsection 37(1) SR&E pool for the following year. In addition, under paragraph 53(1)(e), the adjusted cost base of the member's partnership interest will be increased by the amount added to the member's tax under subsection 127(30).

Subsection 127(35) provides a rule applicable in respect of non-arm's length disposition of equipment where the purchaser is a partnership. The comments made under "Non-arm's length disposition of equipment" also apply in these circumstances.

Forms

The amount of ITC recapture is calculated using form T25CH(31) for corporations (or T2038 for individuals and partnerships) and is included on line 602 of the T2 return as an addition to Part I tax payable.

All amounts added to tax payable by a claimant under this provision for a taxation year will increase the amount of the claimant's subsection 37(1) SR&E pool for the following year. Refer to line 453 of Form T661 or T665, or Schedule T25CH(32).

In the case of materials transformed into a product such as a custom product, a commercial asset or an experimental product, the expenditures for the costs of materials transformed is to be recorded on line 325 of Form T661 or T25CH(32). An amount recorded on this line is an indication that there could be ITC recapture in the year the property is sold or converted to commercial use.

Original signed by /
Mel Machado
Manager
Financial Legislative Application Section
SR&E Directorate
Issued by: Financial Legislative Application Section

Chart 1

Expenditures	PROXY METHOD	TRADITIONAL METHOD
--------------	--------------	--------------------

	Deductibility	ITC recapture *	Deductibility	ITC recapture *
Materials consumed	Deductible SR&ED expenditure	NO	Deductible SR&ED expenditure	NO
Materials transformed	Not a deductible SR&ED expenditure	-	deductible SR&ED expenditure	YES
ASA equipment	Deductible SR&ED capital expenditure	YES	Deductible SR&ED capital expenditure	YES
SUE	Not a deductible SR&ED capital expenditure (but is a qualified expenditure)	YES	Not a deductible SR&ED capital expenditure (but is a qualified expenditure)	YES
Arm's length contract involving SR&ED and acquisition of property	SR&ED portion of contract is a deductible SR&ED expenditure	YES	SR&ED portion of contract is a deductible SR&ED expenditure	YES
SR&ED Contract generating intellectual property (IP)	Contract amount is usually deductible	NO recapture when the IP is sold or converted to commercial use	Contract amount is usually deductible	NO recapture when the IP is sold or converted to commercial use

* Subject to the comments in this application policy

Examples

Example 1

A corporation, a manufacturer of paper products, performs SR&ED related to the development of fine papers with special finishes. Experimental production is required to test whether a product with the necessary qualities can be produced. Expenditures are incurred as follows for the experimental production:

Materials (pulp @ \$40 per ton) - \$ 400
Salaries - 5,000
Overhead - 3,000
Total expenditures - \$8,400

The corporation earned ITC of \$1,680 on the SR&ED expenditures above (i.e., ITC at the 20% rate). The paper produced in this trial run is subsequently sold in an arm's length transaction for \$4,500.

The recapture amount is determined by the formula in subsection 127(27). The recapture amount is the lesser of:

(i) the ITC earned in respect of the particular property (the property acquired from a third party)
\$80 (i.e., \$400 X 20%)

and

(ii) the amount determined by applying the percentage which was used in calculating the ITC on the property to the proceeds of disposition of the property (since it was disposed to an arm's length person):
\$900 (i.e., \$4,500 X 20%)

The ITC recapture will be \$80, the lesser of \$80 and \$900.

Example 2

A corporation purchases a piece of equipment for \$300,000. The expenditure qualifies as a SR&ED capital expenditure (ASA equipment). The corporation earns ITC of \$105,000 (i.e., ITC is earned at the 35% rate). Three years later the corporation ceases to use the equipment for SR&ED and moves it into the manufacturing division. The fair market value of the equipment at that time is estimated to be \$180,000 (see example 3). The recapture is the lesser of:

61 the ITC earned in respect of the particular property i.e., \$105,000 and

(ii) the amount determined by applying the percentage used in calculating the ITC earned on the particular property to, in this case, the fair market value of the particular property:

\$63,000 (i.e., \$180,000 X 35%)

The recapture will be \$63,000, the lesser of \$105,000 and \$63,000.

Example 3

In 1997, a corporation bought a machine for \$100,000 to be used for SR&ED. It was determined that the machine qualified as SR&ED ASA equipment. In fiscal year 2000, the corporation decided to use the machine for manufacturing purposes because the SR&ED project failed.

The machine would have qualified as a class 43 asset if it had been used for manufacturing in 1997. As class 43 has a 30% declining balance rate, the UCC of the machine is \$41,650 at the time of its conversion to commercial use (the CCA is calculated as follows:

1997 - \$15,000, 50% of 30% of \$100,000, the half year rule applies, 1998 - \$25,500, 30% of \$85,000, and 1999 - \$17,850, 30% of \$59,500, total CCA is \$58,350). It is that notional UCC of \$41,650 that should be used to estimate the FMV of the machine for the purposes of the ITC recaptures rules.

Example 4

A Co, a corporation, has no pre-existing SR&ED qualified expenditure pool. In year 1, in the performance of a SR&ED contract for B Co, a non-arm's length company, A Co purchases a \$2 million microscope as a qualified expenditure. A Co has \$3 million of other qualified expenditures of a current nature in year 1. A Co transfers to B Co \$2 million of qualified expenditures, of which \$800,000 is with respect to capital expenditures, as identified on form T1146. In year 2, A Co sells the microscope to an arm's length third party for \$1.5 million.

In this situation, in respect of the microscope, A Co transferred \$800,000 and kept \$1.2 million. Assuming an ITC rate of 20 per cent for both A Co and B Co, the ITC recapture for A Co will be \$240,000 pursuant to section 127(27) for the qualified expenditure amount it kept (\$1.2 million). By applying the formula "(A x B) - C", A Co will also have an ITC recapture of 20% x \$1.5 million - \$240,000 = \$60,000 pursuant to subsection 127(29). A Co's total ITC recapture is \$300,000.

Had A Co not transferred any qualified expenditures for year 1, its ITC recapture pursuant to 127(27) would still have been \$300,000 (20% x \$1.5 million proceeds as the lesser of the two amounts described in subsection 127(27)).

Example 5

Corporation PAY ("PAY") runs a feedlot operation. PAY contracts with Corporation FRM ("FRM"), a non-arm's length party for FRM to perform SR&ED on behalf of PAY with a view to determining the best diet for steers. FRM purchases 300 head of steers for \$300,000. FRM incurs other expenditures of \$20,000 for feed and \$65,000 for SR&ED salaries. FRM transfers the qualified expenditures of \$385,000 to PAY in an agreement under subsection 127(13). PAY earns ITC at the 20% rate on the expenditures. FRM subsequently sells the steers for \$450,000 (arm's length sale).

Since all the expenditures were transferred to another person under an agreement described in subsection 127(13) the amount of the ITC recapture will be determined by the formula in subsection 127(29).

The recapture is the lesser of:

61 the ITC earned on the qualified expenditures in respect of the property and which were transferred:

\$60,000 (20% of \$300,000) (no recapture on the feed and SR&ED salaries) and

(ii) the amount determined by the formula
(A x B) - C
\$90,000 [i.e., (20% x \$450,000) - 0]

Where

A is the percentage which PAY used in determining ITC, 20%
B is proceeds of disposition, \$450,000, and
C is \$0, since all of the expenditures were transferred.

FRM will have recapture of \$60,000, the lesser of \$60,000 and \$90,000.

Example 6

All of the facts are the same as in Example 5, except that FRM transfers \$200,000 of the total SR&ED expenditures of \$385,000. PAY earns ITC of \$40,000 (20% of \$200,000). FRM earns ITC of \$37,000 (20% of \$185,000). When the steers are sold there will be a recapture of ITC calculated in 2 steps.

First step:

Recapture for FRM under subsection 127(27) will be determined as the lesser of:

(i) the ITC earned in respect of the particular property
\$28,831 [20% x (\$300,000 x \$185,000/\$385,000)] and

(ii) the amount determined by applying the percentage used in calculating the ITC earned on the property to the proceeds of disposition of the property:

\$90,000 (20% X \$450,000)

FRM will have recapture of \$28,831, the lesser of \$28,831 and \$90,000.

Second step :

Recapture for FRM under subsection 127(29) will be determined as the lesser of:

(i) the ITC earned on the qualified expenditures which were transferred in respect of the particular property

\$31,169 [20% X (\$300,000 X \$200,000/\$385,000)]

and

(ii) the amount determined by the formula $(A \times B) - C$

\$61,169 [(20% X \$450,000) - \$28,831]

Where

A is the percentage which PAY used in determining ITC, 20%

B is proceeds of disposition, \$450,000, and

C is \$28,831, the recapture determined under subsection 127(27) in first step.

FRM will have recapture of \$31,169, the lesser of \$31,169 and \$61,169.

Total of first and second steps:

The total ITC recapture in the hands of FRM is \$60,000 (\$28,831 + \$31,169)

Example 7

Corporation A gives a contract to Corporation B (arm's length) for the construction of equipment to meet unique performance criteria. The contract requires that Corporation B perform SR&ED on behalf of Corporation A in the development of the equipment. The total amount of the contract is \$1,000,000. All of the work was completed at the end of year 1, at which point Corporation A started using the new equipment in its operations.

For purposes of claiming the allowable SR&ED expenditures, Corporation A identified the SR&ED and non-SR&ED and allocated the costs accordingly. The SR&ED portion of the contract was estimated at \$800,000. The \$200,000 not claimable is a cost relating to expenditures incurred on the commercial portion of the equipment. The CCRA's Research and Technology Advisor found the allocation to be reasonable.

Corporation A entered \$800,000 on line 340 of form T661 as expenditures for arm's length SR&ED contract. When Corporation A starts using the equipment in its operations, there is a conversion to commercial use and the ITC recapture rules will apply.

The FMV of the equipment at the time of conversion to commercial use is \$500,000. For the purpose of determining the FMV, the claimant has used the cost of producing a second unit if the technology had already existed.

For the purposes of the ITC recapture rules, using a prorated amount (**see Note**) as FMV would be acceptable as it is reasonable to apportion the FMV between the SR&ED costs and other costs. Since the ITC on the particular equipment was claimed using a 20% rate, the ITC recapture will be calculated as follows:

The recapture amount is the lesser of:

(i) the ITC earned in respect of the particular property (the portion of the contract in respect of the SR&ED is part of the cost of acquiring the property)

\$160,000 (i.e., \$800,000 @ 20%) and

(ii) the amount determined by applying the percentage which was used in calculating the ITC on the property to the Fair Market Value of the property at the time of its conversion to commercial use

\$80,000 (i.e. [$\$500,000 \times 800,000/1,000,000$] @ 20%)

The ITC recapture will be \$80,000, the lesser of \$80,000 and \$160,000.

Note: Any other reasonable apportionment of the FMV would be acceptable if it is based on the facts of the case, and is supportable.