THE FATE OF R&D Research & Development INNOVATION FUNDING IN BUDGET 2017

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Canadian governments find themselves impaled on a multi-horned dilemma on how to encourage Canadian businesses to do more R&D innovation. Prior to the advent of the Trump administration in the U.S., it was widely expected that the Liberal Government under Justin Trudeau would wind-up (or at least scale back) "special interest" and targeted sector tax credits, many of which were inherited from previous Conservative governments. One potential target for elimination is Canada's Scientific Research and Experimental Development ("SR&ED") tax credit program. However, Mr. Trump's promises of radical changes to the U.S. tax system have made Ottawa pause any significant changes in Canadian tax policy lest we be left non-competitive with whatever emerges in the U.S.

Since its inception in 1986 – to replace the SRTC flow-through mechanism – the present SR&ED tax credit program has provided upwards of $75 billion to fund innovation in a broad spectrum of Canadian businesses. About 25% of this $75 billion has historically gone to companies in Mississauga and Peel Region which has one the country's largest concentrations of technology businesses. It is often overlooked that all but three provinces offer an R&D tax credit automatically triggered by eligibility for the federal SR&ED credit. In many cases, those provincial R&D tax credits are all that matter to foreign- and public-owned corporations.

The future direction of the SR&ED tax credit program (and ultimately of its provincial siblings) came under serious scrutiny in 2011 when the Harper government appointed an "expert panel" to review the efficacy of various economic-stimulus programs intended to incent R&D innovation in the private sector. Dubbed the "Jenkins panel" after its leader Open Text Corp. CEP Thomas Jenkins, it recommended sweeping changes to existing programs, most notably a shift away from R&D tax credits towards "direct funding". Direct funding generally equates to either grants or contingent-repayable loans that are arranged between government and industry for a specific project, before any work has begun on the project.

Past Canadian Governments have made good use of direct-funding programs. A few examples include: the Industrial Research Assistance Program (IRAP), Atlantic Canada Opportunities Agency (ACOA), Federal Economic Development Agency Ontario (FeDev Ontario), Sustainable Development Technology Canada (SDTC), and the now defunct Technology Partnerships Canada (TPC).

In February, Ottawa provided $372.5 million in "direct funding" interest-free loans to Bombardier in what looked a lot like a deal made with the company under TPC back in the 1990s. The similarity was not lost on one of Bombardier's major competitors Embraer SA of Brazil who did exactly what they did the last time – i.e. filed a complaint with the WTO. Embraer won that time and they might well win again. This illustrates one of the major hazards of direct funding initiatives – a company could be granted such funding only to become embroiled in years of costly trade dispute litigation. Indirect funding through tax credits do not carry this risk.

Another drawback of direct funding mechanisms is that there are fewer options for challenging a denied funding decision through the courts. With tax credits, there are readily accessible mechanisms for challenging any CRA assessment through the Tax Court system.

But there are new types of tax credits on the horizon that might supplant or even replace the SR&ED system. Most notable are the so called "patent box" and "flow through share" mechanisms. Patent boxes (adopted by France in the 1970s, British Columbia in 2006, the U.K. in 2012, and Quebec in 2016) allow for a lower than normal tax rate on income arising from intellectual property developed by a company. Flow through shares – which were adopted by Canada for mineral exploration in 1950s and by Alberta for technology venture capitalists in 2016 – allow a company's tax deductions or investment tax credits to be utilized by its investors.

Having applied the brakes to major tax reform in 2017, it will be interesting to see what direction Mr. Trudeau's government takes next when all the cards in the Trump agenda are laid on the table.