www.mbot.com

Volume Six | Issue 6 | December 2011

MISSISSAUGA BOARD OF TRADE

GOVERNMENT PANEL REPORT CALLS FOR CHANGES TO SR&ED TAX CREDITS

On October 17th, a six-member panel appointed by the Canadian Federal Government released a report recommending significant changes to the allocation of the $6.5 billion that the government spends in an average year on tax credits and other incentives for private sector R&D. The panel is headed by Thomas Jenkins, Executive Chairman and Chief Strategy Officer of OpenText Corporation and, because of this, has come to be known as "the Jenkins Panel" rather than its official title of Panel on Federal Support to Research and Development.

The 150-page report entitled *"Innovation Canada: a Call to Action"* makes six "core" recommendations, amongst which are reductions in SR&ED tax credits and re-direction of the resulting savings towards so-called "direct funding" programs. In this context, 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 that project.

THE REPORTS SIX CORE RECOMMENDATIONS ARE:

1. Creation of a new innovation agency to be called IRIC.
2. "Simplification" of the SR&ED tax credit system and reductions in benefit rates for Canadian Controlled Private Corporations (CCPCs) with the resulting savings redirected to direct funding programs.
3. Encouragement of the Canadian Government to be the early adopters of innovative technologies.
4. Division of the National Research Council into a number of Centres of Excellence linked to universities and industry.
5. Have the Business Development Bank (BDC) become an active early-stage investor in Canadian technology businesses and collaborate with "angel" investors from the private sector.
6. Development of closer links with the Provinces to facilitate alignment of science and technology policies between the two levels of government.

It is important to appreciate that the Panel is not the government, and the government can choose whether and which recommendations to adopt, and how to implement them. However, the easiest recommendations to implement would be those concerning SR&ED tax credits.How SR&ED Tax Credits Could Change

While the Panel's report generally leaves the details of how to implement the strategy to the Government, there are a few specific SR&ED-related corollary recommendation comments found within the report's text that are worth noting. According to the Panel these should apply only to CCPCs, but it's easy to see at least some of these implemented for corporations of all sizes at some point in the future. Following is a synopsis of the report's comments on SR&ED specific changes:

- Decrease spending on SR&ED tax credits and use the savings to pay for direct funding programs focused on the needs of innovative Canadian firms, in particular small- and medium-sized enterprises (SMEs). The report argues that the high rate (35%) of refundable benefit presently available to CCPCs is excessive, especially when combined with provincial benefits. There is implication that the 35% CCPC rate should be reduced to the 20% rate available to other corporations.
- For CCPCs, SR&ED benefits should only be allowed for labour expenditures and overhead.
- CCPCs should receive a fully cash-refundable SR&ED benefit for a limited time, after which the benefit would revert either entirely or partially to a non-refundable investment tax credit.
- Provide temporary cash-refundable SR&ED tax credits to all small start-up companies as well. The temporary funding would only be available for a limited number of years following start-up.
- The existing 65% proxy allowance for overhead may be too high. The Canadian government should review this figure in light of actual overhead costs for R&D operations and adjust it to a more realistic figure as necessary. (The provisions of the "proxy cap" in the existing legislation, i.e. lesser of 65% or actual, were not noted.)

- Review the Government's anti-stacking policy to ensure that R&D projects are not "over-subsidized". The existing anti-stacking policy typically limits maximum government contribution to between 75% and 100% of the costs incurred. The Panel argues that 75% may be too high.

IMPACTS BY INDUSTRY SECTOR

Despite the emphasis on direct funding, total elimination of the SR&ED tax credit program is highly unlikely. There is no benefit for the government in doing so, especially when so many other countries are increasing their R&D credits.

If all of the Panel's SR&ED related recommendations are implemented, the big losers are likely to be secondary manufacturing industries such as plastics, metal forming, printing, packaging and food processing. The beneficiaries would be pharmaceuticals, biotech, aerospace and defence, electronics, semiconductors, optics, forest products, and environmental and alternative energy technology companies.

In the computer industry, companies involved in the development of business-application software would likely suffer. While software-sector companies involved in development of "core" technologies such as operating systems, embedded firmware, graphics technologies, encryption and biometrics could fare somewhat better.

DRAWBACKS OF "DIRECT FUNDING"

The Jenkins Report reveals a marked dislike for tax credits, which are called a "blunt instrument". In lieu of tax credits, the report favours "direct funding" delivered through grants and loans. While tax credits are far from perfect, we suggest that the report ignores three major drawbacks to direct funding.

First and most importantly, under a direct funding model there is no legal process for redress of disputes between the administrators and either applicants for, or recipients of, the funding. In the tax credit system, the rules are legislated and any dispute on eligibility or payment can be escalated through to the courts and resolved by an impartial judiciary. This works to everyone's benefit: not only can taxpayers who were denied funding appeal to the courts to get it, but the government can use the courts to recover funding that has been misappropriated. Under a direct funding model, some or all of the decisions on eligibility and allocation take place outside of the legal framework, through somewhat opaque processes that are not always fully accessible to public scrutiny, and there is no independent legal framework for adjudication of disputes on eligibility.

Second, a recommendation for a rebalancing toward increased direct funding may threaten the global competitiveness of Canadian enterprises. Various international trade agreements – specifically the World Trade Organization (WTO) Agreement on Subsidies and Countervailing Measures – constrain direct subsidies to business. Article 3 (Prohibited Subsidies) has already been applied against Canada's Bombardier by Embraer of Brazil in a 1998 WTO action over funding Bombardier received from the former Technology Partnerships Canada (TPC) program.

Third, direct funding models, as the report itself recognizes, generally add an increased administrative burden. This can deter a Canadian firm intent on getting its innovation to market, from seeking assistance through direct funding on the grounds that the approval process for an application can delay the start of time-sensitive work. By contrast, tax credit submissions are made retroactively at year-end based on what was actually done and therefore do not impact the start of a project.

Conclusion

The recommendations made in the Jenkins Report are premised on an assumption that R&D is better fostered by governments rather than by private sector market forces. This is demonstrated through the recommendation for the identification of a new minister of innovation, the recommendations for direct funding administered by the government and through which the government will decide the industry winners, and the recommendation of the creation of an "External Innovation Advisory Committee" (IAC) – a body with a "whole-of-government focus", which would oversee the implementation of the Jenkins Report recommendations and serve as a "permanent mechanism" to advise on the future of innovation in Canada.

If the Panel's recommendations are fully adopted, we can expect to see much more targeted (and probably less democratic) payout of R&D incentive funding to industry. This could potentially lead to substantially larger funding for a much smaller number of companies. Companies undertaking genuine applied research and core technology innovation projects would likely enjoy much richer funding via the new direct funding initiatives, while those who rely on SR&ED tax credits for more routine commercial product development could suffer. The Jenkins Report was only released last week. A full response by industry should be issued in the next few months. The exchange of ideas should be innovative.

Scitax™
Advisory Partners
R&D Tax Credit Specialists

ABOUT THE AUTHORS

A. Christina Tari LLB LLM is a tax litigation lawyer. In her role as legal counsel to Scitax clients, she obtains settlement of SR&ED claims that have been wholly or partially denied by CRA through Notice of Objection and/or Tax Court of Canada processes. Before entering private practice in 1989, Christina served for nine years as a tax litigation counsel for the Canadian Department of Justice. She is a past chair of the Canadian Bar Association, Ontario Tax Section and the author of Federal Income Tax Litigation in Canada.

David R. Hearn CET is an engineering technologist and Managing Director of Scitax Advisory Partners LP. He entered the SR&ED field at a "big four" multinational accounting firm in 1993, prior to which he held engineering and R&D positions in the electronics industry.

Michael C. Cadesky BSc MBA FCA has practiced full-time and exclusively in the field of taxation since he became a Chartered Accountant in 1980. The FCA designation, which he was awarded in 1994, distinguishes Michael as a Fellow of the Ontario Institute of Chartered Accountants. Michael is a director of Scitax and the managing partner of Scitax's affiliated firm of chartered accountants, Cadesky and Associates LLP, who provide expert-level support on any taxation-related matters that arise either during preparation of the claim or in dealing with CRA auditors afterwards.