PROVINCIAL & TERRITORIAL TAX NEWS

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INTRODUCTION

This newsletter covers provincial and territorial updates and developments from December 2015 to January 2016.

ASTOUNDING DIFFERENCES IN PROVINCIAL R&D TAX CREDITS

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Cuts to Canada's federal SR&ED tax credits make provincial credits more vital than ever In Canada, R&D tax credits are offered by both federal and provincial governments. However, it's all too easy to lose sight of what comes from where. That's because in most cases provincial credits are automatically triggered by eligibility for the federal Scientific Research & Experimental Development (SR&ED) tax credit which in turn is determined by the Canada Revenue Agency (CRA). The distinction is further blurred because (except for Québec and BC) the refund payments for Canada and the provinces are both made on the same cheque, which is issued by CRA.

Given these links between federal and provincial tax credits, it is now more important than ever to understand the considerable differences in the R&D tax credit regimes of the various Canadian provinces.

For public or foreign-owned companies operating in Canada, the provinces offer the only R&D tax credit that can be immediately "monetized" into a cash refund if the company has no tax payable. Saskatchewan is the only province with a tax credit which (as of April 2015) is entirely non-refundable.

The provincial tax credit regimes offered by Québec, Manitoba, Newfoundland and Labrador, Nova Scotia, and New Brunswick are particularly advantageous for private corporations with high R&D spends, corporations with profits over $500,000, and any corporation that is public or foreign-owned. Saskatchewan's tax credit is actually counter-productive and negative for CCPCs (Canadian controlled private corporations) because although it is not itself refundable, it reduces the amount of cash refundable ITCs available from Canada through the federal level SR&ED.

To be entitled to claim any provincial R&D tax credit there are certain prerequisite conditions: First, you must file a tax return in the province. Second, in most cases you must have a permanent establishment (PE) in the province; the definition of permanent establishment varies but generally it means a physical location "space" (owned or leased) at which is located a person empowered with authority to make decisions on behalf of the business. Finally, provincial tax credits can only be claimed on R&D expenditures for work performed in the province.

Canada's 2012 federal budget inflicted significant cuts to the amount of money available through these tax credits. However, because the 2012 legislation was phased in from 2013 to 2014, many companies are only now (2015) seeing those 2012 cuts hit their bottom lines. These 2012 cuts eliminated capital outlays altogether, allowed only 80% of eligible contract payments, and reduced the proxy overhead from 65% to 55% of R&D salaries.

Except for Québec, all of the 2012 federal cuts flow straight through to the provincial level and trigger an immediate knock-on reduction in the amount of R&D tax credit benefit received from the province as compared to historic norms. The fact that those made-in-Ottawa cuts have a knock-on reduction on the provincial credits often goes unnoticed – provincial treasuries save money while Ottawa takes the heat for the changes.

Manitoba is so far the only province to have proactively taken any measure to reverse the ill effects of the 2012 federal budget cuts by restoring 100% provincial eligibility on contracts payments to certain research institutions, which otherwise would have suffered the cut to 80%.

Even though Québec companies didn't see any immediate reduction in their provincial R&D credits as a result of 2012 federal cuts, in December 2014 Québec's newly elected Liberal government introduced two legislative changes to its R&D tax credits: The first was the introduction of a minimum claim threshold requiring a minimum spend on R&D ($50,000 for small companies, $225,000 for large). The second was a standardization of benefit rates for certain types of transactions. For small firms, the benefit rate on all R&D labour wherever sourced increased from 28% to 30%. For large corporations the benefit rate on R&D out-sourced from universities, consortiums or partnerships fell from 28% to 14%.

While the 2012 federal budget cuts are generally viewed as net-negative and detrimental to the pool of R&D funding available to the private sector in Canada, many economists view the 2014 Québec changes positively. Québec's changes reduce the government's administrative burden in processing large numbers of small claims, curtail potentially abusive small claims and more effectively contain the disbursed funds within the provincial economy.

Canada has 13 "provinces" (technically 10 provinces and 3 territories). All but three provinces (Prince Edward Island, Northwest Territories and Nunavut) offer a provincial level R&D tax credit. Unlike the federal SR&ED which is the same Canada wide, the provincial benefit rates vary ranging from 10% to 30% of eligible R&D expenditures.

10.0%	British Columbia (BC), Alberta (AB), Saskatchewan (SK),
14.5%	Ontario (ON)
14.0%	Québec (QC) large corporations
15.0%	New Brunswick (NB), Nova Scotia (NS), Newfoundland (NL), Yukon Territory (YT)
20.0%	Manitoba (MB)
30.0%	Québec (QC) small corporations

But the benefit rate is only part of the story: In order to make a valid comparison in the R&D tax credits offered by Canadian provinces, three other parameters must be considered:

One, what R&D expenses attract the provincial tax credit? These are not always the same as for federal SR&ED. For example the Québec credit applies only to labour (T4 wages or contracted) whereas all other provinces cover the same categories of expenditures as Canada's federal SR&ED (i.e. wages, materials, contracts and overhead).

Two, is the benefit available in the form of a cash refund in the event the corporation has no taxable income? If so, is all or only some portion of the total benefit refundable? Cash refund means that even if there is no tax payable (i.e. no taxable income), the taxpayer receives a cheque for the benefit amount. Québec Newfoundland and Labrador, Nova Scotia, and New Brunswick offer a tax credit that is 100% fully refundable to all types of corporations. Ontario is mostly refundable to all corporations (10% OITC and 20% OBRI are, 4.5% ORDTC is not). Manitoba is up to 50% for all corporations. Saskatchewan is not refundable at all.

Three, is there a "ceiling" on the maximum amount of benefit that can be claimed? Unlike Canada's federal SR&ED tax credit which has no maximum, some provincial credits are limited either to the maximum dollar amount that can be claimed or the maximum amount that will be paid as a cash refund. Where such ceiling limits exist they are generally (except Alberta) tied to the federal SR&ED expenditure limit (presently $3M) such that the maximum amount of R&D tax credit benefit never exceeds $300,000 regardless of the R&D expenditures incurred.

BC and Ontario subscribe to the federal SR&ED expenditure limit model whereby the maximum provincial level benefit is capped at $300,000. But if the corporation has taxable income over $800,000 or taxable capital exceeding $50M, the expenditure limit is "ground" to $nil (i.e. $0) and NO provincial level tax credit is available.

Québec, Manitoba, Newfoundland and Labrador, Nova Scotia, New Brunswick, and Yukon do not subscribe to the federal expenditure limit which means that the taxable income and taxable capital grinds that act to reduce SR&ED benefits federally and provincial benefits in other provinces have no adverse impact. This is a significant point of comparison.

Alberta sets its own maximum expenditure limit ($4M vs. Canada's $3M) and has its own "grind" formulae by which the maximum benefit in that province is $400,000.

CASE OF ACUTE DIFFERENCES: ONTARIO VS QUEBEC

Comparing Ontario and Québec makes a good case by which to illustrate the extent to which R&D tax credits can differ between provinces. These two neighbouring provinces are Canada's largest by population, share a common border, and have historically rated top in economic activity. While both provinces can claim large communities of science and technology business, Québec has always had a disproportionately large number of R&D facilities. The differences in the provincial R&D tax credit regimes between these two provinces is acute and telling.

One thing that Ontario and Québec have in common is that they both offer a cash refundable credit to all corporations. However, Québec extends this to partnerships which are not eligible for the Ontario credit.

In Ontario, the provincial R&D tax credit benefit rate is 14.5% (10% OITC + 4.5% ORDTC) for all corporations plus an additional 20% for the Ontario Business Research Institute Tax Credit (OBRI) for R&D services purchased from qualifying institutions. While the OITC and ORDTC are widely used (primarily because they are automatically tied to federal SR&ED claims made by Ontario companies), the OBRI is more obscure and less frequently utilised because it applies only to R&D services purchased from universities and research institutions.

The maximum cash refund available from Ontario is $4 million (OBRI) but only if $20 million of R&D services were purchased from a qualifying research institution; otherwise the maximum is $300,000 (OITC as 10% of $3M) for other R&D expenditures. The 4.5% ORDTC is non-refundable – it is an ITC applicable only to Ontario corporate taxes.

But even more worrisome is that the $300,000 Ontario cash refund is ground down to zero if the corporation's taxable income exceeds $800,000 or taxable capital exceeds $50M; both of which are assessed on a worldwide basis. For large profitable corporations, this typically obliterates entitlement to any Ontario tax credits except the non-refundable 4.5% ORDTC and the 20% OBRI, which as noted above, only applies to institutional contracts.

The bottom line is that, the maximum amount of Ontario R&D tax credit that most Ontario corporations are ever likely to receive is $300,000. Québec has no such limit and the amount of Québec R&D tax credit that a corporation can receive is determined only by how much it spends on R&D labour. The only possible edge Ontario has in this comparison is that its credit applies to overhead and materials as well as labour, which may be advantageous for smaller corporations with lower labour rates whose R&D activities entail building experimental prototype machinery.

Québec also offers the highest benefit rate (30% for small corporations, 14% for large corporations) and unlike Ontario, has no expenditure limit grind that obliterates the eligibility for larger corporations.

The only ceiling or limitation applicable to the Québec credit are the new minimum claim thresholds discussed above and a benefit that drops from 30% to 14% as the company's assets exceed $50M.

The Québec provincial tax credits apply only to R&D salaries or the labour component of contracted R&D services. Interestingly, Ontario tax credits exclude payments to non-arm's length contractors, while Québec allows 100% of non-arm's length but only 50% of arm's length (80% if the arm's length party is a university or other institution).

It is often (wrongly) assumed that Québec's richer R&D tax credits are offset by higher corporate and personal tax rates that repel profitable corporations and high-earning individuals. In fact, in 2015 the top blended federal / provincial tax rates in Québec are

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26.9% for corporations and 49.97% for individuals, which compares favourably to Ontario where the top rates are 26.5% and 49.53% respectively.

SCIENTIFIC ELIGIBILITY CONCERNS, ISSUES AND DISPUTES

Rate percentages and ceilings aside, the one factor that most dramatically effects the availability of R&D tax credits across the board at both federal and provincial levels is how the Canada Revenue Agency (CRA) assesses the technical / scientific eligibility of the work for which expenditures are claimed.

All provinces rely on the CRA's determination as to whether the R&D work for which the expenditures were incurred qualifies as eligible to attract the tax credit or not. Regrettably, denial of claims by CRA for lack of "scientific merit" seems to be at an all-time high.

Companies with long histories of eligibility have found themselves suddenly cut-off on grounds that their R&D is either not sufficiently scientific to qualify as SR&ED or they don't have the records to prove it.

According to CRA's own statistics, the number of SR&ED-related notice of objection filings increased 25 fold between 2007 and 2014. Many of the these objections have now escalated into Tax Court Canada actions. A total of 43 SR&ED actions were raised in the TCC in 2014 which was more than 2.5 times the average annual number for the previous five years. As of this writing, there are just over 70 SR&ED cases pending resolution in the Tax Court of Canada.