CANADIAN TAX Highlights

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SR & ED and the 2012 Federal Budget

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Although the March 29, 2012 federal budget proposed no personal or business tax rate increases, it did contain some 30 tax measures, over half of which were aimed exclusively at business. Six measures are projected to reduce SR & ED federal tax credits by $1.33 billion over the next four years. (Provincial R & D tax credits will also fall proportionately in provinces, such as Ontario, that rely on the same definitions.)

The federal government spends on average $6.5 billion annually to stimulate R & D: $3.5 billion is distributed via the SR & ED program, which in turn triggers $1 billion of provincial R & D tax credits. Over the last five years, Ottawa has commissioned several studies to assess the SR & ED program's administration, delivery, and economic efficacy. The recently published Jenkins report (*Innovation Canada: A Call to Action*) called the program a "blunt instrument" and recommended more economically efficient direct measures such as grants and loans, and seven measures to reallocate savings from reduced SR & ED credits into direct funding programs. Pre-budget reports from other public policy think tanks had similar themes, and press reports suggested that the program was subject to abuse, was plagued by fraud, and produced questionable economic benefits. However, industry submissions to the Jenkins panel showed that the majority supported the SR & ED program and wanted it fixed rather than replaced.

In the 2012 budget, the government did not fully embrace the Jenkins report recommendations; instead, it chose a path of moderation. The government maintains that the budget's SR & ED cuts will be offset by bolstered direct grant and loan programs. Budget proposals increase funding for the NRC's IRAP grant program of $110 million per year and deliver $400 million in venture capital through an unspecified technology investment program (probably through forgivable or interest-free loans).

The budget incorporates only two of the Jenkins report's SR & ED reduction recommendations. The report recommended that SR & ED benefits be calculated on labour and overhead; the budget reduces by 20 percentage points the benefit allowed for R & D services purchased from contractors and excludes capital altogether. The report recommended a cut to an overly generous 65 percent proxy overhead allowance; the budget cut the rate to 55 percent. And the report's recommendation to reduce the 35 percent SR & ED rate for CCPCs became the budget's 5-percentage-point reduction in the 20 percent rate for non-CCPCs.

- Only 80 percent of the payments made after 2012 for services by arm's-length contractors attract SR & ED benefits. If a contract payment made after 2012 includes an amount for a capital expenditure, the eligible amount is first reduced by the capital expenditure; the 80 percent restriction is then applied. An R & D service provider must inform its SR & ED-claiming customers of any capital component of its fee.
- Expenditures for capital items or lease payments made after 2013 are no longer eligible for SR & ED benefits.
- The proxy overhead reduction from 65 to 55 percent of T4 wages is phased in: the rate is 60 percent in calendar year 2013 and 55 percent thereafter. Prorating applies for straddle taxation years. A company with high overheads can still elect the traditional method, which uses actual expenditures; although that method is more complex to calculate and more likely to trigger an audit, it may result in a greater SR & ED benefit because a broader range of expenditures is allowed. The proxy rate cuts enhance that advantage.

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■ The reduction from 20 to 15 percent in the general SR & ED ITC benefit rate for non-CCPC corporations, individuals, and partnerships takes effect for taxation years ending after 2013 (prorated for straddle years). The high 35 percent rate and the cash refundable benefit for qualifying CCPCs are unchanged.

Little detail was provided on two budget measures to improve the SR & ED program's operation. Funding of $6 million was slated for administrative measures, including a new second review of scientific eligibility in the notice-of-objection process. The government also proposed to study the practice of tax consultants who charge contingent fees of a percentage of the SR & ED benefit for claim preparation services; the approach developed because most clients were unwilling to pay per diem rates. Regulation of the practice may prove problematic, if only from a definitional viewpoint—for example, one must distinguish between a money-back guarantee, a deferred billing arrangement, and a success fee.

The 2012 budget did not touch on several areas that might benefit from change. A legislative amendment to "equalize" the SR & ED definition has been pending since 2002; the French version gives a less restrictive definition of "work undertaken" (paragraph (d)) and the CRA administers eligibility by reference to the English version. Also, the filing deadline for SR & ED claims still lags normal business tax-filing deadlines by 12 months; consistency would encourage bringing SR & ED claims into the regular annual tax-filing process and thus improve record keeping and discourage "found money" catch-up claims. The Jenkins report and other reports identified an urgent need to recruit risk capital into the technology sector; the budget missed the opportunity to mirror the success enjoyed by flowthrough shares in encouraging high-risk investment in the Canadian resources industry.

The renewed federal emphasis on direct funding through grants and loans instead of tax credits creates concerns. International trade agreements constrain direct subsidies, and an affected corporation may find itself unwittingly embroiled in a trade dispute. For example, Bombardier's funding from the former Technology Partnerships Canada program conflicted with the WTO Agreement on Subsidies and Countervailing Measures. In an attempt to conform to the WTO rules, Canada has made several large-scale (contributions exceeding $1 million) direct innovation-funding programs available only to consortiums of multiple companies or of one or more companies and a university or a public research institution.

Government funding—a grant or a loan that is forgivable, contingent, or at no or less-than-market interest—is assistance that reduces SR & ED benefits. The reduction occurs in the tax year for which the assistance is received or is receivable; thus, a loan for R & D expenditures to be incurred in a subsequent year may eliminate a company's entire SR & ED for the earlier year. Repayment may trigger recovery of the benefit, but even an eliminated cash refund benefit is recovered only as an ITC.

Moreover, some or all decisions on direct funding eligibility and allocation occur in relatively opaque processes that are not always fully accessible to public scrutiny and that lack an independent legal framework for dispute adjudication. Tax credit disputes—for both a taxpayer who was denied funding and the government that seeks to recover misappropriated funding—can be resolved by an impartial judiciary.

Given the relatively moderate tightening of the eligibility rules in the budget, it is hoped that the CRA will not impose further restrictions through increasingly narrow administrative interpretations. It is also hoped that enhanced administrative efficiencies will be achieved in any direct funding grant and loan programs paid for via the budget's SR & ED cuts and that the funding will be fully distributed back to industry.

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