Bulletin

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Plan Now For Upcoming Changes to SR&ED

In this bulletin we provide a timeline for SR&ED cutbacks set to come into effect over the next two years.

On August 14, 2012, the Department of Finance released draft legislative proposals implementing changes to the Scientific Research and Experimental Development (SR&ED) program that were first announced in the March 2012 federal Budget. These were then tabled as amendments to the Income Tax Act (ITA) in Bill C-45, which is now wending its way through Parliament (Second Reading in the House of Commons October 30, 2012) and will almost certainly be enacted in December. Although there has been intense pressure from industry lobby groups to quash these proposals, it is now very unlikely that there will be any changes.

While the majority of these changes are cuts in expenditure eligibility that apply equally to anyone making an SR&ED claim, the good news is that most Canadian-controlled private corporations (CCPCs) will escape the 5-percentage-point cut in the investment tax credit (ITC) benefit rate and remain eligible to receive ITCs of 35% of SR&ED expenditures, which is paid as a cash refund if there are no taxes payable at year end (ITA section 127.1). However, CCPCs whose SR&ED expenditures either exceed the $3M expenditure limit or for whom the expenditure limit is "ground down" to less than $3M (i.e. either by taxable income greater than $500K or taxable capital greater than $10M), will see the existing 20% benefit rate reduced to 15%.

The changes will be implemented on potentially confusing different timelines, and several interrelate with each other. It is important to note that the cutbacks in expenditure eligibility will be accompanied by a massive updating of just about all of CRA’s policy guidance documents on SR&ED. Based on drafts of these documents that have been released for public review over the last year, CRA auditors can be expected to take a much narrower view of the types of R&D work that qualify and to demand substantially more detailed supporting documentation records to corroborate that work. Many taxpayers who have had their SR&ED claims audited by CRA recently have already experienced the effect of these new policies.

Given that the first of the expenditure eligibility cuts come into effect in January 2013, now is the time to start reviewing R&D budgets, and consider accelerating spending before cutbacks take effect.

A. Effective 1-Jan-2013 Regardless of Tax Year-End Date

These changes depend on the calendar date on which the expenditure is incurred.

A.1 Contract Payments: Only 80% of payments for R&D work performed by contractors made after 31-Dec-2012 will attract SR&ED (amendment to ITA 127(9) "qualified expenditure" (a)(ii)). This applies only to arm's length transactions; non-arm's length transactions are not affected.

A.2 Proxy Overhead to 60%: The proxy overhead rate (Income Tax Regulations subsection 2900(4)) is reduced from 65% to 60% on T4 wages paid in calendar year 2013. For a tax year that ends in 2013 but includes days in calendar year 2012, a proxy rate between 60% and 65% will be calculated proportionately, based on the number of days that fall in each calendar year. For example, if the taxation year ends on 30-Apr-2013, the net effective proxy rate will be 63.33%.

B. Effective For Tax Years Ending After 31-Dec-2013

These changes depend on the taxpayer's fiscal year-end and apply to expenditures incurred as of a particular tax year (with pro-rating as noted).

B.1 SR&ED ITC Benefit Rate: The 20% general SR&ED ITC benefit rate (ITA 127(9) "investment tax credit" (a.1)) is reduced from 20% to 15% for non-CCPCs (including partnerships and individuals). There is no change to the high rate (35%) benefit that applies to the first $3 million in expenditures made by a qualifying CCPC (the regular ITC plus the amount in ITA 127(10.1)). However, even for CCPCs the 20% rate for expenses claimed that are greater than the expenditure limit (which is up to a maximum of $3,000,000 depending on taxable income and taxable capital) will be reduced to 15%.

For tax years that include 1-Jan-2014, the 5% cut will be pro-rated based on the number of days in that tax year after 2013, so that on average it takes effect on January 1, 2014.

For example, a net effective ITC benefit rate of 18.33% (instead of 20%) would apply to an SR&ED claim made by a non-CCPC with a taxation year that ends on 30-Apr-2014.

C. Effective 1-Jan-2014 Regardless of Tax Year-End Date

These changes depend on the calendar date on which the expenditure is incurred.

C.1 Capital Expenditures: Expenditures for capital property, such as equipment, made after 31-Dec-2013 are no longer deductible and no longer generates ITC (repeal of ITA 37(1)(b)). This rule will extend into two other categories of SR&ED expenditures, to exclude claims for:

- lease payments, or other payments for the "use" of property that would be capital property if the taxpayer purchased it (ITA paragraph 37(8)(d)); and
- any amounts for capital that are contained in arm's length contract payments or third-party payments (ITA 37(14)). R&D performers will be legally required to inform their customers of the component of their fee that applies to the provision of capital equipment (ITA 37(15)).

C.2 Proxy Overhead to 55%: The proxy overhead rate (Reg. 2900(4)) is further reduced from 60% to 55% on T4 wages paid in calendar year 2014. For a tax year that ends in 2014 but includes days in 2013, a proxy rate between 55% and 60% will be calculated proportionately based on the number of days that fall in each calendar year. For example, if a taxation year ends on 30-Apr-2014, the net effective proxy rate will be 58.33%.

D. Impact on Provincial Tax Credits

While all of the above noted changes are implemented by Canada at the federal level through amendments to the *Income Tax Act*, most of them will flow through automatically to the R&D tax credits provided by the provinces. This occurs because provincial tax credits generally apply to the same expenditures that Canada allows for SR&ED purposes. As a result, the cuts to expenditures in the categories of proxy overhead, capital and contract payments will be proportionately "amplified" by the resulting loss of provincial benefits.

It is interesting to note that in its 2013 budget tabled on November 20, 2012, the Province of Quebec introduced a "temporary" increase to that province's R&D tax credits that boosts that province's refundable tax credit on T4 wages from 17.5% to 27.5%. However this increase applies only to R&D employees of designated "biopharmaceutical" companies, and in order to qualify the company must apply for an advance ruling certificate.

It will be interesting to see whether other provinces follow Quebec's lead in dulling the pain of the federal cuts in sectors they view as strategic to their economies.

E. New SR&ED Policy Documents Expected

Over the last two years, the CRA has been actively engaged in a "Policy Review Project" through which it aims to revise all of its Application Policies and other documents that provide guidance on various aspects of the SR&ED rules to both CRA staff and taxpayers.

Although these documents do not carry the force of law, they are a very reliable guide with respect to the criteria CRA auditors will use to assess your claim. A total of 19 new policy documents are set for release early in 2013, after which all of the existing policy documents (including Information Circular 86-4R3) will be deleted. See "Learn More" below for details on how to obtain an archive of ***draft*** versions of all of these policy documents.

While most of these new policy documents are much-improved clarifications or consolidations of earlier versions, a few contain policy positions that significantly narrow the definition of what qualifies as work eligible for SR&ED treatment. Some of these narrowed definitions are not well supported by either legislation or court precedents. Taken together with the expenditure cuts, this narrowing of eligibility will mean substantial changes in the SR&ED benefits for some taxpayers relative to past years. Unfortunately, the full impact of this may not become apparent until taxpayers are audited in the future.

Of particular concern in this regard are the new Application Policies entitled *Eligibility of Work for SR&ED* (replaces Information Circular 86-4R3) and *Development of an Asset* (replaces Application Policy 2004-03).

LEARN MORE

New CRA SR&ED Policy Documents
Although CRA has not yet released the final versions of its 19 new policy documents, an archive of the draft versions as released for public comment is available from upon request.
Email bulletins@scitax.com for access.

2012 Canadian Federal Budget. See pages Annex 4 – Tax Measures (pages 410 to 413) for detailed description of proposed SR&ED changes.
http://www.budget.gc.ca/2012/plan/toc-tdm-eng.html

Bill C-45 Oct 2012 Ways and Means Motion to implement changes announced in budget 2012.
http://www.fin.gc.ca/drleg-apl/bia-leb-1012-eng.asp

Province of Quebec provincial budget 2013
http://www.budget.finances.gouv.qc.ca/budget/2013-2014/index_en.asp

CRA publication T4088 Guide to T661
http://www.cra-arc.gc.ca/E/pub/tg/t4088/README.html

CRA publication Application Policy 96-06 Application Policy 96-06 Directly Undertaking, Supervising or Supporting v "Directly Engaged" SR&ED Salary and Wages
http://www.cra-arc.gc.ca/txcrdt/sred-rsde/pblctns/sr9606-eng.html

Scitax publication Introduction to R&D Tax Credits in Canada
http://www.scitax.com/pdf/Introduction.to.R&D.Tax.Credits.in.Canada.SCITAX.pdf

About Scitax

Scitax Advisory Partners LP is a Canadian professional services firm with specialist expertise in all aspects of planning, preparing and defending Scientific Research and Experimental Development (SR&ED) tax credit claims.

We offer a multi-discipline team of engineers, chartered accountants and tax lawyers to ensure that your SR&ED issues are covered from every angle.

While we normally work in concert with our client's existing accountants, our affiliated tax-dedicated chartered accounting firm – Cadesky and Associates LLP – is an expert resource for advice on any taxation matter such as may arise either during the planning and preparation of your claim or while dealing with CRA afterwards.

In addition to planning and preparing new claims, we also engage on claims that have been challenged by CRA auditors or that have received negative assessments for either scientific or expenditure eligibility. If a satisfactory settlement cannot be achieved with CRA at the local office level, we will appeal your assessment through either Notice of Objection or Tax Court of Canada procedures with the assistance of our affiliated firm of tax lawyers.

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