

Tax Court Rules Government Loans Will Reduce R&D Tax Credits

- Any form of financial contribution from government – even repayable interest-bearing loans – will reduce SR&ED ITCs if the terms are not purely commercial
- Government loans with unusually “patient” repayment terms may be assessed as taxable income
- Tech companies must be aware that using any government loans can undermine SR&ED ITCs
- Remember to re-claim lost SR&ED ITCs in future when loans are repaid

On 14-Sep-2021 the Tax Court of Canada ruled that \$81.6M provided to CAE Inc. by the Canadian Federal Government in the form of an interest-bearing, un-secured, non-forgivable loan under the Strategic Aerospace and Defense Initiative (SADI) program, constitutes “government assistance” and therefore reduces CAE's SR&ED claims per (ITA) subsection 127(18). (The decision was issued in French; a link and translation are provided below.)

This ruling has significant implications for technology companies that have historically made high use of SR&ED tax credits and are now increasingly supported by non-tax incentive funding (SIF, SADI, SDTC, NRC, IRAP etc.) from other areas of the Canadian Federal Government. These companies may be caught unaware of the extent to which these types of direct funding can not only undermine their SR&ED investment tax credits (ITCs), but can also have more far-reaching negative implications on their tax situation (as “patient” government loans can be assessed by the CRA as taxable income).

This latest ruling, and the Federal Court of Appeal's similar decision back in 2014 in *Immunovaccine*, are likely to take on increased significance as the federal and provincial governments emphasize non-tax “direct” incentives (grants and loans) as the preferred method of delivering funding to Canada's technology business community. Companies using such incentives will need to account for the fact that their SR&ED tax credits may well be reduced by loans they receive from any level of government, even if the loans are repayable and interest-bearing.

Companies receiving such loans will need to monitor repayments – which could span many future years – to ensure that opportunities to re-claim lost ITCs are fully exploited.

Background and Facts

The SADI loan provided CAE with a total of \$250M to partially fund a technology development project dubbed “Falcon” that had a total R&D budget of \$700M. The loan was made over a five-year period, from 2009 to 2014. It was repayable over 15 years at an effective interest rate of 2.7% (substantially lower than the 7.15% CAE was paying to its private lenders).

Although the SADI agreement entitled CAE to receive up to \$116M of the loan in 2012 and 2013, the company actually only used \$82M of that amount to pay for R&D work, for which the company claimed SR&ED ITCs in its 2012 and 2013 taxation years. CAE appealed to the Tax Court after the CRA reduced the SR&ED-eligible expenditures (and hence the ITCs) allowed to CAE for project Falcon in 2012 and 2013 by \$82M on the ground that this amount was “government assistance”. The CRA also assessed the \$14M difference between the \$55M that CAE was entitled to receive from SADI in 2012 and the \$41M that it spent on SR&ED, as taxable income per ITA subparagraphs 12(1)(x)(iv) and (v).

Highlights of The Tax Court's Decision

At paras. 104-108 of the ruling, the court notes that SR&ED-reducing “government assistance” is not limited to just the methods explicitly listed in ITA subsection 127(9) (“grant, subsidy, forgivable loan, deduction from tax, investment allowance”), but applies to “any other form of assistance”, encompassing essentially any method that might be used to provide funding, including the SADI repayable loan.

At paras. 137 and 143, the court concludes that the SADI loan was not an “ordinary commercial agreement” and thus it fell within the definition of “government assistance”. As a result, the Court agreed with the CRA that the loan advances reduced CAE's SR&ED claims. Para. 113 cites the Federal Court of Appeal's 2014 decision in *Immunovaccine*, which had ruled that a loan constitutes “government assistance” if it is not made in exactly the same way and for exactly the same reasons as a loan by a private company. At para. 54 the Tax Court notes that the loan terms featured an unusual 5-year deferral of both interest and principal, and at para. 38 that the SADI program did not operate according to a “for profit” doctrine (i.e., no target rate of return). Paras. 78-79 describe several other unusual covenants (e.g., little protection for the lender, restrictions on sale of IP, prohibition of work outside Canada) that would be unlikely in an ordinary private commercial loan agreement.

At para. 145, the court concludes that the \$14M difference between the \$55M that CAE was entitled to receive from SADI in 2012 and the \$41M that it spent on SR&ED, is taxable income as was assessed by the CRA.

Tax Court Decision Appealed

On 8-Oct-2021, CAE filed an appeal of the Tax Court decision in the Federal Court of Appeal. CAE's Notice of Appeal (see link in Learn More below) first argues that since CAE was well capable of repaying the SADI loan, there was no question of the loan either being or ever becoming a grant. The appeal goes on to argue that what CAE "received" from Industry Canada was \$250 million in capital, which will be repaid; and that the interest benefit (due to lower-than-market interest rate, and delayed repayment obligation) was not an amount that was either "received" or "receivable" by CAE.

However, even if the Federal Court of Appeal agrees with CAE on those two points, the Court may still agree with the CRA (and the Tax Court) that the interest terms made the agreement "non-commercial", and as such the capital so advanced was still "government assistance".

Finally remember that TCC ruled against CAE on TWO distinct issues, both of which are in dispute here: 1) The SADI loan, to the extent it was for use in projects that qualified for SR&ED, constitutes "government assistance" and hence acts to reduce SR&ED ITCs; and 2) the balance of the loan was included in income as government assistance under paragraph 12(1)(x).

Assessing the Impact – How Might This Affect You?

Going forward, the Canadian Government and some provinces are likely to make increased use of direct funding methods (grants and loans) to incentivize technology business; much of this will be directed at companies which – like CAE – have historically filed substantial SR&ED claims. At first glance it might appear that this approach could mean a big net increase in the funding available to these companies (i.e. grants or loans in addition to SR&ED ITCs); however, no government wants to pay twice for the same thing.

There are an increasing number of court rulings on this "government assistance" issue – including the Federal Court of Appeal's 2014 ruling in *Immunovaccine*, cited at para. 104 of CAE – that are going to be very difficult to get around. (In November 2014 the Supreme Court of Canada declined to hear an appeal of the *Immunovaccine* decision.)

Some examples of existing government incentive programs that are now more likely to be assessed as reducing SR&ED include: loans from BDC and EDC; the Strategic Innovation Fund (SIF); Sustainable Development Technology Canada (SDTC); and the Canada Emergency Wage Subsidy (CEWS).

There are four basic factors to consider in assessing the potential impact of these direct funding measures on your SR&ED claims:

1. Is the funding "government assistance"?
2. If it is, does it act to reduce SR&ED ITCs?
3. When were the funds available?
4. SR&ED notwithstanding, does the assistance need to be taken into income and attract income tax? (loans are not normally considered income).

Issue #1 has been well worked out in other earlier jurisprudence not specifically related to SR&ED; see, for example, the *Consumers Gas*, *Ottawa Valley Power* and *CCLC* cases discussed at paras. 108-116 of the CAE decision.

Issue #2 boils down to how and when the loaned funds were used to pay for R&D claimed as SR&ED.

Issue #3 arises due to ITA subsection 127(18) using the words “has received, is entitled to receive or can reasonably be expected to receive”; which means that funds that are *available* from a funding source can reduce SR&ED even if they were not actually received and used.

Issue #4 turns on the exact terms of the specific loan agreement. If there is generous re-payment deferral, or forgiveness is likely then the loan can be considered as income.

As well, if the terms of the funding agreement contain covenants that would not normally be found in an “ordinary commercial agreement” (e.g., job creation/retention, IP restrictions, work required to be performed in Canada) – and potentially even if the lender is not operating under a purely “for-profit” doctrine – the CAE decision makes SR&ED reduction increasingly likely.

How Should Government Loans Be Treated in SR&ED Claims?

The Tax Court ruling will almost certainly be appealed to the Federal Court of Appeal. However, given the 2014 *Immunovaccine* decision, it's entirely possible that the Court of Appeal will uphold the Tax Court's decision.

On the surface, it might seem that a solution would be to simply forgo filing a SR&ED claim for any work that is (or may be) paid for with funds from a government loan. However, any company taking this approach may shortchange itself (and its shareholders) by missing the opportunity to “recapture” the lost SR&ED ITCs (ITA subsection 127(10.7); see Form T661, line 445) in the future when any portion of the loan is repaid, or if funds that were available but not received are no longer available (ITA subsection 127(10.8)). Note that even this opportunity might be lost if – as is sometimes the case – the direct funding agreement includes an “anti-stacking” provision that explicitly bars claiming SR&ED ITCs on any work paid for with the loan.

Learn More

CAE's Notice of Appeal to the FCA filed 8-Oct-2021

https://scitax.com/pdf/A-264-21_Notice_of_Appeal-EN.pdf

Full text of the Tax Court Canada decision on CAE (14-Sep-2021)

http://www.scitax.com/pdf/Dckt_2016-4984-IT-G_14-Sep-2021.pdf

Scitax Bulletin #59 Supreme Court Declines Immunovaccine SR&ED Case (27-Mar-2015)

<http://www.scitax.com/pdf/Bulletin.59.Supreme.Court.Declines.Immunovaccine.SRED.Case.27-Mar-2015.pdf>

Full text of the Federal Court of Appeal decision on Immunovaccine (11-Sep-2014)

http://www.scitax.com/pdf/Dckt_A-171-13_11-Sep-2014.pdf

Full text of the Tax Court Canada decision on Immunovaccine (10-Apr-2013)

http://www.scitax.com/pdf/Dckt_2011-245-IT-G_10-Apr-2013.pdf

Canadian Government publication "*Strategic Aerospace and Defence Initiative (SADI) – Program Guide*"

https://www.ic.gc.ca/eic/site/ito-oti.nsf/eng/h_00022.html

CRA guidance document "Assistance and Contract Payments Policy"

<https://www.canada.ca/en/revenue-agency/services/scientific-research-experimental-development-tax-incentive-program/assistance-contract-payments-policy.html>

Scitax Bulletin #48 R&D Expert Panel Makes Its Report (recommends increased use of direct funding instead of tax credits)

<http://www.scitax.com/pdf/bul-048.pdf>

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While we normally work in concert with our client's existing accountants, our affiliated tax-dedicated chartered public accounting firm - Cadesky Tax - 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.

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