Canadian Tax Highlights

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SR & ED Report Calls for Change

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On October 17, 2011, a six-member government-appointed panel released a report, *Innovation Canada: A Call to Action* (the Jenkins report), recommending six changes to government spending on incentives for private sector R & D and technological innovation. Recommendations include substantial changes to rebalance government spending away from tax credits, which the report calls a "blunt instrument," and toward direct funding. Direct funding generally means grants and contingent repayable government loans for a specific project before its commencement. The common message of the recommended SR & ED changes is that small and medium-sized CCPCs, which historically have received higher benefits than foreign or public corporations, will likely suffer decreased eligibility over the next 12 to 24 months.

On average, the federal government spends $6.5 billion annually to stimulate R & D innovation in Canada's private sector, including $3.5 billion through the federal SR & ED program, which automatically triggers about another $1 billion of provincial R & D tax credits. Of the remaining federal expenditure of $3 billion, half is disbursed through about 60 other non-taxation-based funding mechanisms—a mix of non-repayable grants (such as the Industrial Research Assistance Program), contingent repayable loans (the Atlantic Canada Opportunities Agency), procurements, and schemes in which government researchers provide specialized assistance to private sector groups—and half is used to administer all federal assistance. Over the past five years, the federal government has become increasingly concerned about this spending, particularly on SR & ED tax credits, and through various means has surveyed satisfaction with the SR & ED program. Most recently, the press has reported that the CRA is concerned about a proliferation of fraudulent claims. A few days before the Jenkins report was released, the University of Toronto's Mowat report (*Canada's Innovation Underperformance: Whose Policy Problem Is It?*) concluded that money spent on R & D tax credits "would be better used for direct supports to the innovation process and would produce more value-added, world-leading, commercialized products and services."

In October 2010, the federal government created the Jenkins panel to review ways to better deploy funds spent on R & D incentives, including the SR & ED tax credit program, with a view to reallocation and not reduction. The panel received input from federal and provincial government ministry personnel; from a survey by a market research firm of R & D-performing companies that included a Web-based questionnaire sent to about 1,000 companies and detailed in-person meetings with a smaller number; from OECD consultations and data; from meetings with government officials in Australia, Germany, Singapore, the United Kingdom, and the United States; and from 228 businesses, industry groups, academic institutions, and private citizens. The 150-page Jenkins report makes extensive suggestions about how to increase government effectiveness in enabling R & D innovation in the Canadian economy. The core recommendations include the following:

1) a new innovation agency, the Industrial Research and Innovation Council, should be created;
2) the SR & ED tax credit system should be simplified, CCPC benefit rates reduced, and savings redirected to direct funding programs;
3) the federal government should be the early adopter of innovative technologies;
4) the National Research Council should be divided into centres of excellence linked to universities and industry;
5) the Business Development Bank should become an active early-stage investor in Canadian technology businesses and collaborate with angel investors from the private sector; and
6) the federal government should develop closer links with the provinces to align science and technology policies.

The report's recommendation for a shift away from tax credits was unexpected: the majority of the 228 industry

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respondents were generally positive about the SR & ED program—except for criticisms of its operation and administration—and very few preferred direct funding. The most common suggestion for improvement was to extend eligibility for cash-refundable SR & ED benefits to all corporations, not just small private companies. The report also seems to focus on the third-party compliance costs associated with the complex calculations caused by the inclusion of non-labour costs in the current SR & ED expenditure base. In our view, however, the calculations are generally relatively straightforward; it is the determination of the nature of eligible work that is complex. The vast majority of disputes between taxpayers and the CRA arise over scientific eligibility and record keeping, not over calculations. It is thus surprising that the panel did not recommend clarification and expansion of paragraphs (a) to (c) of the SR & ED definition in subsection 248(1). The report mentions problems with the CRA's pre-claim review service, but it does not mention the agency's recent excellent efforts to improve its SR & ED policy guidance documents through consolidation and simplification.

Moreover, the report's preference for direct funding does not consider that model's three major drawbacks:

1) Most importantly, a direct-funding model lacks a legal process for resolving disputes between administrators and funding applicants or recipients. The tax legislation is detailed and prescribes a procedure for the adjudication of disputes over eligibility or payment by an impartial judiciary. Judicial recourse is available both to a taxpayer who is denied funding and to the government to recover misappropriated funding. In the case of direct funding, at least some final decisions on eligibility and allocation occur outside the independent courts and in processes that are not always fully open to public scrutiny.
2) International trade agreements—specifically, the WTO's Agreement on Subsidies and Countervailing Measures—constrain direct subsidies to business. In 1998, article 3 (prohibited subsidies) of the agreement was applied against Bombardier with respect to its funding from the former Technology Partnerships Canada (TPC) program. Canada does not have a sufficiently large domestic market to fully support the commercialization of technology, and thus participants must be able to export their products without invoking international sanctions associated with the receipt of direct subsidies at home.
3) Direct-funding models require upfront applications and approval that can delay the start of time-sensitive work. Tax credit claims are made after the year-end and are based on work done, and thus do not delay the project's start.

It is unlikely that the SR & ED tax credit program will be eliminated at a time when so many other countries are increasing their R & D credits. However, if the report's recommendations are fully adopted, there may be substantially more funding for many fewer companies. The requirement for "genuine" applied research and innovation projects—not just routine product improvement—may signal an end to many or all of the thousands of small SR & ED claims made each year. The big losers would likely be secondary manufacturing industries such as plastics, metal forming, printing, packaging, and food processing; others—such as companies in pharmaceuticals, biotech, aerospace and defence, electronics, semiconductors, optics, forest products, and environmental and alternative energy technology—would benefit. In the computer industry, the development of business application software would likely suffer, but the development of core technologies such as operating systems, embedded firmware, graphics technologies, encryption, and biometrics might fare somewhat better.

Although the government is not compelled to follow the report's recommendations, direct funding is unfortunately the easiest change to implement and promises the most tangible immediate results. The report offers some corollary comments that are related to the SR & ED recommendation and directed to CCPCs, but they potentially apply to any corporation:

- Spending on SR & ED tax credits should be decreased and the savings used to pay for direct funding that focuses on innovative Canadian firms, particularly small and medium-sized enterprises. The current high rate (35 percent) of the refundable benefit for CCPCs is excessive, especially when combined with provincial benefits; it is implied that the 20 percent rate should apply to all corporations.
- A CCPC's SR & ED base should include only labour expenditures and overhead, to simplify the application process and thus reduce related costs. This is in keeping with the practice of most other countries.
- A CCPC's right to a fully cash-refundable SR & ED benefit should extend for a limited time and then be converted wholly or partially to a non-refundable investment tax credit.
- Temporary cash-refundable SR & ED tax credits should be made available to all small startup companies.
- The existing 65 percent proxy allowance for overhead should be reviewed in light of actual overhead costs for R & D operations and reduced if necessary. (The legislated proxy cap—the allowance is the lesser of 65 percent and the actual rate—was not noted.)
- The federal policy against stacking—the receipt of benefits from multiple funding programs—should be reviewed to ensure that R & D projects are not oversubsidized.

The existing policy typically limits the maximum federal contribution to 75 to 100 percent of costs incurred; the panel concluded that the lower threshold may be too high.

The report alludes to a hybrid model that combines direct funding and tax credits, and it refers to a "vouchers approach," which may mean a pre-approval process at or before the start of a fiscal year to establish eligibility for SR & ED tax credits at year-end.

Although the report suggests various means to access an "increased supply of risk capital" for innovative, growing firms, it does not mention the use of flowthrough shares that pass to others a company's deductions for eligible expenditures. For many years, flowthrough shares have successfully encouraged high-risk activity in the Canadian resources industry. The legislative concept is well understood by investors and represents an effective opportunity to recruit risk capital into the technology sector.

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