R&D Tax Credits Under Review

> U.S. Congress debates a new formula and could add another $5B
> Canada renews commitment and promises better administration

R&D tax credits are one of the few “good news” topics when comparing business taxation in Canada and the U.S.

In fact our Canadian SR&ED benefits are so much better; we often forget that the U.S. even has an R&D tax credit program at all. But they do.

In this bulletin we report on some recent R&D tax credit initiatives by Canada and the United States.

In Washington, congress is presently considering significant changes to legislation that could start to close the gap with Canada.

Meanwhile, at home Canadian Prime Minister Stephen Harper recently unveiled Ottawa's latest Science and Technology policy platform; *Mobilizing Science and Technology to Canada’s Advantage.*

While the rising profile of R&D tax credits in national economic policy highlights private sector scientific innovation as a key economic growth strategy for both countries, the tactics used by Washington and Ottawa are almost polar opposites.

The Canadian offering is skewed towards small to medium-sized companies, which receive a higher benefit rate and can receive their credit in cash even if they pay no tax. Furthermore, since the credit is calculated as a percentage of actual expenditures in each tax year, the cash refund enables small companies to “bootstrap” their way through early stage growth.

The situation in the U.S. is almost the opposite. Washington’s tax credit is based on a change in R&D spending over time as compared to a historic datum; an approach that favours very large corporations. For example, in 2004, 54% of the $5.5 billion tax benefit paid out went to about 100 companies; the remaining 46% was shared amongst more than 10,000 companies.
Another significant difference in the Canadian and U.S. R&D tax credit regimes is that while Canada’s is a permanent fixture within the income tax act, the US credit must be renewed annually. In addition, its re-instatement is subject to so called “pay-as-you-go budget rules”. Although it was allowed to lapse last year; hence no credits; Congress has extended the credit twelve times since it was started in 1981. Surprisingly the difference in R&D tax credit pay-outs by Washington and Ottawa does not mirror the population ratio: Canadian R&D tax credits average out to about $3.5 billion per year while most recent figures put the U.S. the figure at about $10 billion per year.

**Proposed U.S. Changes**

In the U.S. the “proper” name for R&D tax credit used by the IRS is “§41 - Credit for Increasing Research Activities”. The U.S. Congress is now debating two separate bills dealing with R&D tax credits.

According to a recent Wall Street Journal article, depending on which bill is passed, the net result would be a significant increase in R&D tax credit benefits; up to as high as $15 billion per year. However, depending on which bill is accepted, this additional funding could flow either primarily to the 100 large companies that now get more than half the credits or to the 10,000 other companies that have been getting the other half.

Historically, the method of U.S. R&D tax credit calculation has been to compare the change in the ratio of R&D spending to gross income over the past four years with the same ratio for the company at a retrograde datum set in the mid-1980’s. If the ratio has increased, then a tax credit is applied for a set portion of the difference. This approach tends to favour larger more established companies i.e. the same 100 or so that typically get 54% of total pay out.

After allowing the tax credit to lapse in the prior year, a new formula was introduced in December of 2006. Under this formula a company compares the most recent year’s domestic research spending to half of the average of the previous three years. Twelve percent of the difference qualifies as a tax credit against the company’s U.S. corporate tax bill. This elimination of the 1980 retrograde datum tends to favor younger companies and recent start-ups, which generally tend to be smaller enterprises.

As mentioned above, there are now two alternatives to this December 2006 approach now under consideration:

- One alternative; being put forward by S. Levin, Dem. Mich.; would use the 1980’s retrograde datum approach, but would see an increase in the benefit rate from twelve percent to twenty percent. Not surprisingly it is primarily those 100 large companies who are most pleased with Levin’s plan.
- The other alternative bill, being put forward by M. Baucus, Dem. Mont., would maintain the December 2006 approach; i.e. three year retrograde formula, but increase the percentage to twenty percent. The Baucus plan has been applauded by almost everyone in the technology sector, but it worries fiscal conservatives in government who view it as an unwelcome drain on federal coffers. Even many of those 100 large companies concede that this might be better approach in the long run.
And in Canada…

Ottawa has just re-stated its commitment to R&D tax credits as a key plank in the government’s science and technology platform. Unfortunately, none of the SR&ED changes so anticipated in the spring 2007 federal budget have yet materialized. The Canadian government’s latest science and technology policy announcement was made by Prime Minister Stephen Harper on May 17th, in Waterloo Ontario. In his speech he said that “more private research and development is the key to strengthening the country's economy” and that “the government’s new strategy is designed to reverse years of declining private-sector involvement in R&D”. The Prime Minister’s announcement contained several key policy commitments to be implemented over the next two years. The following policy commitments are drawn from the briefing release document “Mobilizing Science and Technology to Canada’s Advantage” that Ottawa released to accompany the Prime Minister’s speech.

> Identifying opportunities to improve the Scientific Research and Experimental Development (SR&ED) program, including its administration, to further encourage R&D within the business sector in Canada.
> $500 million over seven years to Sustainable Development Technology Canada to invest with the private sector in establishing large-scale facilities for the production of next-generation renewable fuels.
> $120 million in 2006-07 to CANARIE Inc. to manage and improve Canada’s research broadband network over the next five years.
> Replacing Technology Partnerships Canada with a new program, the Strategic Aerospace and Defense Initiative. This program will support excellence in aerospace and defense R&D.
> Considering new or different approaches to stimulate the supply of venture capital in Canada, including working to attract institutional investments in Canadian funds.

Learn More...

About US Tax Credits:
> Cornell University’s Legal Information Institute website has a nice summary of the legislation behind §41 Credit for Increasing Research Activities at:
http://www.law.cornell.edu/uscode/26/usc_sec_26_00000041----000-.html

Full Text of Canada’s Most Recent Policy Release:
> The full text of Mobilizing Science and Technology to Canada’s Advantage – including the specific go-forward policy commitments – is available on line at:
http://ic.gc.ca/cmb/welcomeic.nsf/ICPages/CorporatePublications#s-t

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About Scitax...

Scitax Advisory Partners is a professional services firm with specialist expertise in Scientific Research and Experimental Development (SR&ED) tax credits.

We offer a team of senior technical consultants all of whom have ten or more years experience in the SR&ED field. All Scitax technical consultants have engineering or science backgrounds and at least twenty years industry experience in their particular field prior to consulting.

Our primary function is to produce a technical submission package that most effectively communicates your SR&ED claim to CRA in a way that highlights eligibility and expedites processing. We assist you in identifying and preparing all required documentation including project technical descriptions, cost schedules, and everything else your tax preparer needs to file the claim. Once your claim is filed, Scitax will advocate for you with CRA and help you negotiate fair settlement of your claim.

While we normally work with our client’s existing tax advisors, our affiliated firm Cadesky and Associates can provide a full package of tax services if required.