Bulletin

Scitax
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R&D Features in 2008 Quebec and Ontario Budgets

Both with significant changes of interest to technology business

> Higher cash refunds as Provinces match increase in federal SR&ED expenditure limits
> Multi-Media and e-business get increased tax credits
> Ontario Tax Holiday for companies that commercialize University R&D

Ontario and Quebec tabled their 2008 budgets in March. Both offered up important tax credit benefits for technology business. While only Ontario – with its "Tax Holiday" concept - had something truly new, there were significant "tweaks" to boost existing tax credit benefits.

While at first glance some of these changes may appear minor, both Ontario and Quebec have tabled measures that could well boost your next provincial SR&ED refund cheque by as much as $100K. This is particularly significant because many small- and medium-sized companies that are non-CCPCs; and hence not eligible for a federal refund; can still receive a cash refund from their province. Furthermore, companies that pay for R&D done in Quebec, may qualify for a refundable benefit from that province, even if they do not have a permanent establishment there.

While these budget speeches represent the intentions of the government at the time presented, the measures proposed are subject to a parliamentary vote. Generally, this occurs within a few weeks of the budget speech. This bulletin is reporting on the budget speech.

You will see the term "refundable" used throughout this text. Refundable refers to a benefit that is paid in cash, i.e. you get a cheque, even if you have no taxable income. This is distinct from a "deduction" or a "tax credit" which is only useful to the extent that you have taxable income or taxes payable, against which to apply it. This "refundable" benefit, distinguishes the Canadian taxation system from those in most other countries. Refundable benefits are an important source of growth money for early stage companies. We will look at Ontario first, with Quebec following.

PART 1

Ontario

Ontario Innovation Tax Credit (OITC)

OITC is Ontario's "add-on" to the federal government's SR&ED tax credit. In almost all cases, an R&D expenditure that attracts the SR&ED benefit will also automatically attract an additional 10% OITC benefit. While the OITC pays a lower rate than the federal SR&ED, its benefits are refundable to a far broader range of companies. So while many larger companies cannot monetize their federal SR&ED benefits and get ITC's only, they can get up to $200K, soon to be $300K, in cash from Ontario.

This budget proposes to adjust the OITC rules to maintain alignment with changes implemented in the 2008 Canadian Federal Budget (see our Bulletin #34 for details). Essentially this means increasing the maximum amount of cash refund a company can get by increasing the maximum amount that can be claimed. This will be done by increasing the expenditure limit from the current $2 million to $3 million and thus increasing the maximum OITC benefit from $200K to $300K.

Furthermore, the expenditure limit discussed above is reduced, "ground down", as a function of the taxable income in the prior fiscal year. This means that the maximum OITC is subjected to a graduated phase-out where taxable income exceeds $400,000 and is fully eliminated at $600,000 of taxable income. The budget proposes to increase the upper threshold to $700,000 of taxable income. It is intended that the effective date of these changes parallel that of the Federal amendments, which are proposed to come into effect for taxation years ending on or after February 26, 2008 with pro-rations for taxation years that straddle that date.

Ontario Interactive Digital Media Tax Credit (OIDMTC)

The OIDMTC tax credit applies to companies producing interactive multi-media products such as computer games or information kiosks. It generally applies to expenditures incurred in the creation of multi-media content; (i.e. art costs) which are not SR&ED eligible, versus development of foundation technology (i.e. computer science, software engineering) which are more typically covered by SR&ED.

The OIDMTC credit has three "categories" of benefit:

> 30% of qualifying expenditures for smaller corporations that develop their own eligible multi-media products and market them to end users either directly or through retail distribution.

> 20% of qualifying expenditures for corporations as above, but that is too large to qualify for the 30% category.

> 20% of qualifying expenditures for smaller corporations who develop complete multi-media works for others on a fee-for-service basis.

"Qualifying expenditures" are T4 paid labour (100% eligible), sub-contracted labour (50% eligible) and up to $100K marketing costs. Presently, eligible labour expenditures must be incurred within a two-year period ending with completion of product development. The Budget proposes to extend this to a three-year period for products completed after March 25, 2008. The 30% rate for smaller corporations was to end on December 31, 2009. The Budget proposes to extend the smaller corporation 30% rate to qualifying expenditures incurred before January 1, 2012. For larger corporations, the credit rate will be increased to 25% for fee-for-service work qualifying expenditures incurred after March 25, 2008 and before January 1, 2012.

Ontario Tax Exemption for Commercialization (OTEC)

Ontario has a lengthy legacy of highly targeted, specialized tax credit programs. Many of these have been aimed at fostering increased cooperation between universities and private industry. The Ontario Business-Research Institute Tax Credit (OBRI) – first introduced in 1999 – is a good example.

This Budget has introduced another highly novel incentive for private industry to work with universities and other public research institutes: the Ontario Tax Exemption for Commercialization (OTEC).

Under OTEC, any new company formed between March 24, 2008 and March 25, 2012 to commercialize the results of research done at qualifying Canadian universities, colleges or research institutes, would be exempt from paying Ontario Corporate Income Tax and Corporate Minimum Tax for its first ten taxation years. To qualify for OTEC, the corporation must be incorporated in Canada and derive all or substantially all of its income from eligible commercialization activities carried on in Ontario.

These "eligible commercialization activities" would encompass the development of prototypes and the marketing and manufacturing of products related to the intellectual property.

The exemption would generally apply to corporations that commercialize intellectual property in priority areas such as, but not limited to, bio-economy/clean technologies, advanced health technologies, and telecommunications, computer and digital technologies.

The one caveat here is that forming a "new" company may not be as straight forward as it seems. Although the legislative definitions and regulations are not yet fully formed, extrapolating from definitions and principles in other areas of taxation, suggest that it would require new and unrelated shareholders. This could pose a significant practical barrier for a private corporation that is already in some aligned business e.g. a biotech company seeking to commercialize a gene –based diagnostic.

Another uncertainty is the relationship; if any; between OTEC, OBRI, OITC and SR&ED. In theory all of these could be combined; i.e. "stacked-up"; to substantially reduce the tax burden of a new company purposefully established to undertake commercialization of university generated intellectual property on an ongoing basis. However, in this scenario, would the OTEC and OBRI act to reduce the federal SR&ED, as would OITC?

If correctly administered OTEC might well prompt the release of some interesting intellectual property not only from universities but also from places like the National Research Council.

PART 2

Quebec

Quebec R&D Wage Tax Credit (QRDWTC) – Increased Expenditure Limit

Quebec has two "add-ons" to the federal government's SR&ED tax credit. One is the Quebec R&D Wage Tax Credit -- which applies to T4 wages paid by Canadian companies to R&D performing workers in Quebec. The other is the Quebec Credit for ContractPayments – which applies to R&D services purchased on a sub-contracted basis from certain specified qualifying entities located in Quebec.

The QRDWTC has two rates 37.5% for Canadian Controlled Private Corporations (CCPCs) and 17.5% for others. At present, eligibility for the 37.5% rate is subject to a ceiling limit of $2 million.

This budget proposes to increase that limit to $3 million which essentially means increasing the maximum amount of cash refund a company can get under QRDWTC from $750K to $1.125M.

Although not specifically mentioned in Quebec's budget documents, this measure was most likely taken to maintain alignment with changes implemented in the 2008 Canadian Federal Budget (see our Bulletin #34 for details).

Tax Credits for Pre-Competitive R&D Undertaken in Public / Private Partnerships

At present, a refundable tax credit for private partnership pre-competitive research is offered to partnerships consisting solely of private partners. However, a favourable advance ruling must be obtained from Revenue Québec before all or part of any expense that would be eligible for this credit is incurred.

The Budget proposes that businesses in a pre-competitive research partnership in which at least one of the partner entities is a public organization and the others are private corporations, will now have access to the 37.5% QRDWTC on wage amounts paid to researchers.

Additional related proposals would further amend existing rules such that: the portion of the R&D expenditure contributed or borne by the public entity would no longer act to reduce the tax credit eligible expenditures of the private partners – see details below under the topic *R&D Subcontracted to Universities*. In addition, the requirement to obtain a favourable advance ruling from Revenue Québec would be abolished for purposes of this credit. Instead, taxpayers who claim this tax credit would be required to attach to their tax returns, the information prescribed by Revenue Québec; and an eligibility certificate issued by the Quebec Department of Economic Development, Innovation and Export (MDEIE); which will replace the MDEIE opinion.

This Budget measure is intended to foster pre-competitive R&D partnerships between private enterprise and public research organizations; e.g. universities, government labs, etc

R&D Subcontracted to Universities and Other Public Institutions

At present, private entities that purchase R&D services from a university or other public research institute suffer reduced tax credit eligibility on any portion of the total expenditures that is contributed or borne by the public entity.

The Budget proposes to change this such that the expenditure contributed or borne by the university or other public research institute, does not act to reduce the tax credit eligible expenditures of the private sector entity. This change will apply to R&D expenditures so incurred after March 13, 2008.

New Refundable Tax Credit for e-Business

The Budget proposes a temporary new refundable 30% tax credit for eligible corporations that undertake certain defined "information technology" activities in Quebec.

To be eligible to apply for the credit, the corporation must have a permanent establishment in Quebec where it carries on a business relating to information technology where at least 75% of its activities constitute "eligible activities" involving at minimum six full-time employees.

"Eligible activities" are described to include, IT consulting services, the development, integration, maintenance and evolution of information systems, the design and development of e-commerce solutions, and the development of security and identification services.

This credit applies to salaries paid from March 14, 2008 to December 31, 2015 and is subject to maximum cap of $20,000 per full-time employee per year.

Learn More...

> Full text of the 2008 Ontario Budget http://ontariobudget.ca/english/papers_all.html

> Full text of the 2008 Quebec Budget
http://www.budget.finances.gouv.qc.ca/budget/2007-2008/index_en.asp#documents

> Scitax Bulletin #34 SR&ED Features in the 2008 Canadian Federal Budget
http://www.scitax.com/pdf/scitax/bul-034.pdf

> Ontario Interactive Digital Media Tax Credit (Ontario Media Development Corporation)
http://www.omdc.on.ca/PageFactory.aspx?PageID=3640

> Ontario Business-Research Institute Tax Credit
http://www.rev.gov.on.ca/english/bulletins/ct/obitc_frost_0002.html]

For more information on this topic, contact:
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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.

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