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Bulletin

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Canadian Government's "R&D Review Expert Panel" Makes Its Report

Substantial changes to SR&ED tax credits on the horizon . . . . . .

(17-Oct-2011) A six-member panel, appointed by the Canadian Federal Government, released its report on the efficacy of various economic-stimulus programs intended to increase private sector R&D and technological innovation. The Panel is headed by Thomas Jenkins, Executive Chairman and Chief Strategy Officer of Open Text Corporation and, because of this, has come to be known as "the Jenkins Panel".

The report recommends sweeping and significant changes to the incentive programs through which approximately $6.5 billion in Canadian public money is allocated to private-sector researchers each year. Most notably, at a time when many countries are increasing the use of tax credits as their primary R&D incentive mechanism, the report recommends a "rebalancing" away from R&D tax credits – called SR&ED tax credits in Canada – in favour of increased use of "direct funding". Direct funding generally equates to either grants or contingent-repayable loans that are arranged between government and industry for a specific project, before any work has begun on the project.

The Panel's seeming disdain for tax credits – which it calls a "blunt instrument" – is unexpected, considering that the majority of the 228 industry submissions that the Government received, were positive about tax credits as an economically beneficial funding mechanism with few making any significant mention of direct-funding programs as a preferred alternative. While many of the submissions criticized the operation and administration of Canada's SR&ED Tax-Credit Program, the consensus among the majority of the submissions was that the program should be "fixed" rather than "replaced". In fact, the single most repeated request in these submissions was that all corporations be eligible for cash-refundable SR&ED benefits, instead of only small private corporations.

To persons experienced in SR&ED the report contains a puzzling statement on page E-3 (PDF – page 17):

> *The current base, which is wider than that used by many other countries, includes non-labour costs, such as materials and capital equipment, the calculation of which can be highly complex. This complexity results in excessive compliance costs for claimants and dissipates a portion of the program's benefit in fees for third-party consultants hired to prepare claims.*

For most taxpayers, the central issue is not how to calculate the expenditures – which in most cases is relatively straight forward – but rather what types work of work are eligible. Furthermore, the vast majority of disputes between taxpayers and the CRA arise over issues of scientific eligibility and record keeping, not calculations. It is, therefore, surprising and unfortunate that the Panel's recommendations did not embrace clarification / expansion of the definition of SR&ED set out in paragraphs a through c of subsection 248(1) of the Income Tax Act. See the Learn More section at the end of this bulletin for a URL link to this paragraph of the Act.

The Panel's recommendations for changes to the SR&ED tax credit program are covered in detail below, but their common message is that small- and mid-sized Canadian Controlled Private Corporations (CCPCs), which have historically received higher benefits than foreign or public corporations, are likely to suffer cutbacks in their eligibility for benefits over the next 12 to 24 months. Large public- and foreign-owned corporations will generally remain unaffected – at least with respect to SR&ED tax credits.

Drawbacks of Direct Funding

There are three substantial drawbacks to the direct-funding models advocated by the panel:

First, under a direct-funding model, there is no legal process for redress of disputes between the administrators and either applicants for, or recipients of, the funding. In the tax credit system, the rules are legislated and any dispute on eligibility or payment can be escalated through to the courts and resolved by an impartial judiciary. Under a direct-funding model, some, or all, of the decisions on eligibility and allocation, take place outside of the legal framework through somewhat opaque processes that are not always fully accessible to public scrutiny and there is no independent legal framework for adjudication of disputes on eligibility.

Second, various international trade agreements – specifically the World Trade Organization (WTO) Agreement on Subsidies and Countervailing Measures – constrain direct subsidies to business. Article 3 (Prohibited Subsidies) has already been applied against Canada's Bombardier by Embraer of Brazil in a 1998 WTO action over funding Bombardier received from the former Technology Partnerships Canada (TPC) program. This is a significant issue in Canada, which does not have a large enough domestic market to support the commercialization of technology. Any Canadian Government assistance program that does not require the applicant to be export-capable would be folly.

Third, industry is generally less receptive to direct-funding models on the grounds that the approval process for an application can delay the start of time-sensitive work. Tax Credit submissions are made retroactively at year-end based on what was actually done and therefore do not impact the start of a project.

Impacts on Industry Sector

Both the Panel and the Government have made it clear that incentive funding for industrial R&D is a priority. The objective of this exercise is to make it more efficient, not eliminate it.

Despite the emphasis on direct funding, total elimination of the SR&ED tax credit program is highly unlikely. There is no benefit for the government in doing so, especially when so many other countries are increasing their R&D credits. However, if the Panel's recommendations are fully adopted by the Government, we can expect to see much more targeted and less democratic payout of R&D incentives. This would potentially lead to substantially larger funding for a much smaller number of companies. Companies undertaking "genuine" applied research and innovation projects could enjoy much richer funding, while others could be denied funding entirely.

The targeted and less democratic approach to funding might well mean the end for many, if not all, of the many thousands of small SR&ED claims that are made each year for routine product-improvement projects. Should this happen, the big losers are likely to be secondary manufacturing industries such as plastics, metal forming, printing, packaging and food processing. The beneficiaries would be pharmaceutical, bio-tech, aerospace, defence, electronics, semiconductors, optics, forest product and environmental/alternative energy technology companies.

In the computer industry, companies involved in the development of business-application software would likely suffer. While software-sector companies involved in development of "core" technologies such as operating systems, embedded firmware, graphics technologies, encryption and biometrics could fare somewhat better.

Analysis of Recommendations specific to SR&ED

As mentioned earlier, it is important to emphasize that the Panel is not the Government. The Panel can only make high-level recommendations. It is the Government that chooses which recommendations to adopt, and how to implement them. Moreover, changes cannot happen overnight. The easiest recommendations to implement would be those concerning SR&ED tax credits. However, even these relatively simple changes would not likely happen until the next federal budget is tabled in March 2012.

The report – which is 150 pages – contains extensive suggestions about how the Government can become more effective in enabling R&D innovation in the Canadian economy. The core recommendations are:

1) Creation of a new innovation agency to be called IRIC.
2) "Simplification" of the SR&ED tax credit system.
3) Encouragement of the Canadian Government to be the early adopters of innovative technologies.
4) Division of the National Research Council into a number of Centres of Excellence linked to universities and industry.
5) Have the Business Development Bank (BDC) become an active early-stage investor in Canadian technology businesses and collaborate with "angel" investors from the private sector.
6) Development of closer links with the Provinces to facilitate alignment of science and technology policies between the two levels of government.

The focus of this bulletin is the "Simplification" of the SR&ED tax credit system".

Although the Panel's report generally leaves the details of how to implement the strategy to the Government, there are a few specific SR&ED-related recommendation comments found within the report's text that are worth noting. These apply almost exclusively to Canadian Controlled Private Corporations (CCPCs) but may in the future have knock-on effects to all corporations. Following is a synopsis of the issues that the Panel indentified and its recommendations to the Government for action on those issues:

Issue #1: Government spending on SR&ED is not effectively targeted.

At present too much of SR&ED benefits is given to subsidizing routine business R&D.

Recommendation: Decrease spending on SR&ED tax credits and use the savings to pay for direct-funding programs focused on the needs of innovative Canadian firms; in particular small- and medium-sized enterprises (SMEs).

Reference: Document page 6-3, PDF page 93.

Issue #2: The Canadian Government pays SR&ED tax-credit benefits on a wider range of expenditures (i.e. labour, materials, contracts, equipment and overhead) compared to most other countries.

Covering this broad range of expenditures results in the Canadian Government expending more on tax credits than is really necessary to be competitive with other countries. In addition, the calculation of these diverse expenditures makes the application process overly complex and causes taxpayers to rely on consultants to prepare their claims.

Recommendation: For CCPCs, SR&ED benefits should only be allowed for labour expenditures and overhead. Going forward, this approach might also be extended to companies that are not CCPCs.

NB: It is not known whether or not the Provinces that offer R&D tax credits linked to SR&ED, would also limit their SR&ED benefits. If the Provinces do not follow the lead of the Federal Government in only funding labour and overhead expenditures, the objective of simplifying the claim process would not likely succeed.

Reference: Document page 6-10, PDF page 100.

Issue #3: The high rate (35%) of refundable benefit presently available to CCPCs is excessive, especially when combined with provincial benefits.

Recommendation: Nothing specific, but there is an implication that the 35% CCPC rate should be reduced to the 20% rate available to other corporations.

This would appear to conflict with the recommendation for boosting the 35% rate described in Issue #4.

Reference: Document page 6-8, PDF page 98.

Issue #4: Two overlapping issues here: The first issue is that the existing SR&ED tax credit is not sufficiently "targeted" to companies that are truly innovative versus those that are engaged in routine product development. The second is that the 35% benefit rate might have to be increased to compensate CCPCs for claiming only labour and overhead expenditures.

Recommendation: CCPCs should receive a fully cash-refundable SR&ED benefit for a limited time, after which, the benefit would revert either entirely or partially to a non-refundable investment tax credit.

Reference: Document page 6-13, PDF page 102.

Issue #5: Due to restrictions on refundability, some start-up companies that are not CCPCs are unable to monetize their SR&ED benefits. As a result, they effectively have reduced access to government assistance.

Recommendation: Provide cash incentives to all corporations through the proposed new "direct-funding" incentive programs. Provide temporary cash-refundable SR&ED tax credits to all small start-up companies as well. The temporary funding would only be available for a limited number of years following start-up.

Reference: Document page 6-14, PDF page 104.

Issue #6: Current legislation permits overhead expenditures, calculated at 65% of the wages paid to labour, to be claimed under the "Proxy Method" used in submitting SR&ED claims.

Even though the Proxy Method already a "caps" the amount that can be claimed as overhead to either 65% of labour costs or the actual overhead expenditures, whichever is less, the Panel believes that the Overhead Method results in the allocation of excessive SR&ED benefits.

Recommendation: The government should undertake a study of the actual true R&D-specific overhead costs and determine if the 65% should be decreased to a more realistic figure.

Reference: Document page 6-13, PDF page 102.

Issue #7: "Stacking" of benefits from multiple funding programs with the result that the "skin in the game" cost to the private corporation is unrealistically low.

Recommendation: Review the Government's anti-stacking policy to ensure that R&D projects are not "over-subsidized". The existing anti-stacking policy typically limits maximum Government contribution to between 75% and 100% of the costs incurred. The Panel believes that 75% may be too high.

Reference: Document page 6-9, PDF page 99.

Examples of Direct-Funding Programs

The Canadian Government has made good use of direct-funding programs in the past. Most of these direct-funding programs were initiated during Liberal mandates and then subsequently cancelled when Conservative governments came to power. Examples include: the Industrial Research Assistance Program (IRAP), Technology Partnerships Canada (TPC), Atlantic Canada Opportunities Agency (ACOA), Federal Economic Development Agency Ontario (FeDev Ontario) and Sustainable Development Technology Canada (SDTC). All the direct-funding programs required companies seeking funding to apply in advance before work started or any expenditures were incurred. The differences between the programs were in the unique funding regulations for each program. For example, the funding ratio, the requirements for repayment, the interaction with tax credits and the requirement that the work be undertaken by "consortiums" of either multiple companies or in collaboration with a university.

There is also the possibility of "hybrid" models that combine direct-funding and tax-credits. Recommendation 1.2 on page E-9 of the Panel's report makes reference to a "voucher" approach. Although this is not described in any detail, it might refer to a model in which eligibility for SR&ED tax credits at the end of the year is dependent on the outcome of an advance pre-approval process to be applied at or before the start of the fiscal year. Another variation would have an independent agency assessing the work and then issuing an "eligibility" certificate. The certificate would be attached to the corporate tax return leaving the Canadian Revenue Agency (CRA) in charge of handling the financial details.

In the "Learn More" section below there is a URL link at which you will find a conference paper written by David Hearn in 2000 that gives a detailed analysis of the now-defunct Technology Partnerships Canada Program – Canada's largest direct funding program.

What happened to the Ombudsman's Systemic Enquiry Into SR&ED?

The R&D Expert Review Panel, formed in October 2010, seems to have eclipsed the Taxpayers' Ombudsman Systemic Enquiry into SR&ED, which it overlaps. Although the Ombudsman's Inquiry started before the Panel, in September 2009, the only findings from the Inquiry came in the fall of 2010, when the Globe & Mail newspaper quoted Ombudsman chief Paul Dubé as having heard "a lot of industry complaints" about the operation of the SR&ED program. Despite starting later, the R&D Expert Review Panel report has come out ahead of the Taxpayers' Ombudsman Systemic Enquiry into SR&ED which has not yet issued a public report on its findings.

It is important to note that the Taxpayers' Ombudsman and the R&D Review Expert Panel have two very different functions. The R&D Review Expert Panel had two tasks:

First, to investigate "efficacy" in terms of the economic benefits that accrue to the Canadian economy from the money that the Canadian Government spends on a variety of R&D incentives, which include the SR&ED tax credit program.

Second, to recommend changes to improve that efficacy.

The Ombudsman's job was to review the CRA's administration of the SR&ED program and to determine whether there was a need for changes to ensure that the Agency's operational doctrines are correctly aligned with the existing legislation.

Learn More….

Definition of SR&ED set out in paragraphs a through c of subsection 248(1) of the Income Tax Act.
http://www.scitax.com/pdf/Definition.of.SR&ED.Sec_248_1.pdf

Full text of the R&D Expert Review Panel Report as released 17-Oct-2011
http://rd-review.ca/eic/site/033.nsf/vwapj/R-D_InnovationCanada_Final-eng.pdf/$FILE/R-D_InnovationCanada_Final-eng.pdf

The official announcement of the panel's formation (Industry Canada)
http://www.ic.gc.ca/eic/site/ic1.nsf/eng/05946.html

Biographies of panellists
http://rd-review.ca/eic/site/033.nsf/eng/h_00010.html

Survey Questionnaire
http://rd-review.ca/eic/site/033.nsf/vwapj/Consultation-Paper.pdf/$file/Consultation-Paper.pdf

Archive of all respondent submissions indexed by organization and author name
http://rd-review.ca/eic/site/033.nsf/eng/h_00006.html

World Trade Organization Agreement on Subsidies and Countervailing Measures
http://www.wto.org/english/docs_e/legal_e/24-scm_01_e.htm

Conference Paper: Technology Partnerships Canada Bridges the Venture Capital Gap in Canadian High-Tech, D. Hearn, Federated Press April 2000
(describes an example "direct funding" program and the 1998 WTO action between Bombardier and Embrear)
http://www.scitax.com/pdf/2000.TECHNOLOGY.PARTNERSHIPS.CANADA.FP.D.Hearn.2000.pdf

OECD, 2010 "Investing in Innovation – Firms Investing in R&D"
(ranks business expenditures on R&D and government incentives for R&D by country, 2008 data)
http://www.oecd.org/dataoecd/29/31/45188215.pdf

Scitax Advisory Partners 3-Aug-2011 "Overview of R&D Tax Incentives in Selected Global Knowledge Economies"
http://www.scitax.com/pdf/Scitax.International.RD.Tax.Credit.Survey.Table.pdf

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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