Shifting R&D Support in Canada

For Immediate Release
June 25, 2012

Markham, ON – The Federal government has delivered its much-anticipated budget, and its proposed changes to the $3.6 Billion SR&ED ("Scientific Research & Experimental Development") program. These changes are strongly aligned with the broad recommendations of the Jenkins Report issued October 2011.

"It is unanimous among Government, Industry and Academia that the global economy is increasingly more competitive, and those that focus on innovation and technological changes will succeed and thrive. Many SR&ED ONE (formerly R&D ONE) clients have developed new products and technology, and created a substantial number of high-value jobs thanks to the SR&ED program. Therefore it is surprising to see that the Canadian government's answer to increasing innovation in Canada is to actually reduce indirect funding through the SR&ED program, which leaves investment decisions in the hands of the private sector, in favor of direct funding determined by government. Only time will tell if this approach will work or be detrimental to our country's growth and competitiveness." Danny Ladouceur, Principal & Co-Founder of Ideacia ONE Inc.

Reduction in the SR&ED Program

1. Reduction of the **general investment tax credit rate from 20% to 15%** starting January 1, 2014. This will have a direct impact on publicly traded, foreign controlled, and large private companies only. **The enhanced 35% tax credit rate for small businesses** (*that have taxable income less than $500,000*) **remains unchanged**.
2. **Capital expenditures will no longer be an eligible expenditure** starting January 1, 2014. Payments for use of capital property will now also no longer be an allowable SR&ED expenditure.
3. The prescribed **overhead Proxy**, which is calculated on eligible Salary costs, will be reduced from the 65% rate to 60% (in 2013) and 55% (from January 1, 2014).

4. **Arms Length Contract expenditures will be limited to 80%** of payments effective January 1, 2013. This is to remove the profit portion in a contractor's rate. Consistent with Capital expenditure elimination, any amount paid to an arm's length contractor relating to a capital expenditure will also now be excluded from the eligible SR&ED expenditure pool.

5. The government will spend $6 Million in the next two years to implement changes to the administration of the program, as follows:

    - Conduct a pilot study on a pre-approval process feasibility;
    - Enhance CRA's existing online self-assessment eligibility tool;
    - Work collaboratively with industry representatives to address emerging issues;
    - Improve the Notice of Objection process to allow for a second review of scientific eligibility determinations; and
    - Study why companies choose to hire consultants on a contingency-fee basis.

Financial Impact Illustrations

To understand the financial impact that these changes will have on different companies let's review the four scenarios in the illustration below. In each case, the company spent $250,000 in eligible SR&ED expenditures. You will note that the impact the announced budget changes on SR&ED tax credits vary depending of the nature of the expenses, and the type of company.

SR&ED Tax Credits
2012 Federal Budget Impact

	CCPC - A	CCPC - B	CCPC - C	Non-CCPC
Labour	$250,000	$0	$85,000	$85,000
Sub-Contracts	$0	$250,000	$100,000	$100,000
Materials	$0	$0	$15,000	$15,000
Proxy	$162,500	$0	$55,250	$55,250
Proxy After January 1, 2014	$137,500	$0	$46,750	$46,750
Total Expenses Today	$412,500	$250,000	$255,250	$255,250
Total Expenses After Jan. 1, 2014	$387,500	$200,000	$226,750	$226,750
Capital Expenditures	$0	$0	$50,000	$50,000
SR&ED Credits:				
Current	$182,046	$110,331	$132,853	$93,068
After Changes	$171,014	$88,265	$101,533	$63,004
Impact - $	**$11,033**	**$22,066**	**$31,319**	**$30,063**
Impact	***-6.1%***	***-20.0%***	***-23.6%***	***-32.3%***

In scenario A, the company only has Salary expenses, and the impact between the SR&ED tax credit under the current rules and the new provisions is only $11,033 or 6.1%. Scenario B shows that impact is much greater when the company's expenses are arms-length contractors. In this case, the difference between the current SR&ED tax credit and the amount under the new rules is $22,066 or 20% since arms length contractor expenses attract no overhead Proxy but also, under the new rules, is limited to only 80% of amount spent. Whenever the $250,000 in expenditures is spread across all expenses categories, the impact increases to 23.6% given that assets are no longer eligible.

Scenario D shows that the impact of these changes is far greater on Non-CCPC's (large private companies, publicly traded or foreign controlled). In this case, the impact is a reduction of more than 32% in our illustration.

TIP

Companies that use contractors to perform their SR&ED activities should consider hiring their own employees. For every dollar spent in employee cost, the recovery rate will be 68% (currently 73%) under the new rules compared to only 35% (currently 44%) in the case of contractor costs.

All in all, government anticipates all of the changes to the SR&ED program will yield more than $500 Million in annual savings by 2014. These savings are to be redeployed to direct support programs, such as grants, which it hopes will improve the commercialization of innovation in Canada.

Increasing Direct Support

The Government believes that it lags behind other countries in the commercialization of R&D so it plans to reinvest the savings from SR&ED as follows:

1. Double the funding for the Industrial Research Assistance Program (IRAP), an increase of $110 Million per year.
2. Invest $400 Million for the creation of a large-scale venture capital fund led by the private sector, which will provide early-stage risk capital for young knowledge based companies. The structure of this fund will be determined in the coming months.
3. Confirm the previously committed additional $100 Million to the Business Development Bank of Canada to support its venture capital activities.
4. Provide $105 Million over the next two years to support Innovation in the forestry sector.
5. Making the Canadian Innovation Commercialization Program permanent and adding a military procurement component, costing $95 Million over three years from 2013-14, and $40 Million per year subsequently.
6. Deliver one-time incremental funding of $67 Million for the National Research Council to refocus on business-led, industry-relevant research.

3100 Steeles Avenue East, Suite 802
Markham ON L3R 8T3
416.485.0005 T 1.877.266.0005 TF 1.866.845.1445 F
www.sredone.ca

7. Double the IRAP internship program for $14 Million over two years to help graduate students to undertake hands-on research in innovative Canadian companies

8. Invest $12 Million annually to make the Business-led Networks of Centres of Excellence program permanent, with the aim to strengthen knowledge transfer and commercialization.

Global Perspective

According to the Organization for Economic Co-operation and Development (OECD), in 2008, Canada ranked third in the world for R&D support for small businesses, and eleventh for large firms. However, based on Deloitte's Global Survey of R&D Tax Incentives, half of the 24 top industrialized countries have increased their R&D incentives during the economic downturn, here are just a few examples:

- Australia, China, Ireland, Italy, Japan, Russia, Singapore, and the Netherlands have all increased their R&D tax credits or deduction percentages.
- France, Australia, Ireland and UK now provide Refundable credits.
- More countries are considering the introduction of R&D tax credits.

As discussed in SR&ED ONE's (formerly R&D ONE) submission to the Toronto Region Research Council's (*Improving the R&D Incentive for Large, Public and Foreign Corporations*), the non-refundability of the SR&ED tax credit for large and foreign controlled corporations was already seen as a deterrent to foreign R&D investments. The changes announced today will only make Canada a less attractive jurisdiction to invest in, given that the net cost of conduction research and development has increased in this country.

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Conclusion

Any reduction in the SR&ED tax credit is negative, and may have adverse long-term impact in high-value employment, competitiveness of Canadian companies and foreign investment in Canada. But all in all, these budget changes will have a much smaller impact on small and medium sized Canadian businesses compared to large and foreign controlled businesses operating in Canada.

Clearly, it is now more important than ever that companies understand the impact of all changes on their R&D investments and SR&ED tax credits, and hire the right advisor to professionally guide them through the ever-changing Canadian tax regime.

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SR&ED ONE, an Ideacia ONE company, is the premier full service SR&ED firm serving clients of all sizes from divers industries. Our team of professional consultants that cover all fields of science and finance, deliver quality results using our proven methodology, which has earned us a solid reputation with CRA. We also provide IRAP and Media Tax Credit claim preparation to our clients as an added value service. We also offer free on-site eligibility assessments. For more information, visit us **www.sredone.ca** or call us at 1.877.266.0005.

Contact:
Danny Ladouceur, CA, Principal & Co-Founder principal@ideaciaone.ca
www.sredone.ca

3100 Steeles Avenue East, Suite 802
Markham, ON L3R 8T3
416.485.0005 / 1.877.266.0005