

ITAC

INFORMATION TECHNOLOGY
ASSOCIATION OF CANADA

ACTI

ASSOCIATION CANADIENNE
DE LA TECHNOLOGIE DE L'INFORMATION

November 2007

The Issue: *Reforming SR&ED*

The Scientific Research and Experimental Development (SR&ED) program is a federal tax incentive program designed to encourage Canadian businesses of all sizes and in all sectors to conduct research and development in Canada that will lead to new, improved, or technologically advanced products or processes. The SR&ED program is the largest single source of federal government support for industrial research and development.¹ The Federal Government reports that in 2006 the program provided over \$3 billion in tax assistance.² The program has been designed by Finance Canada and is administered by the Canada Revenue Agency (CRA) through ten tax services offices across the country. Some provinces add a credit of their own based on the SR&ED.

The SR&ED program has been an instrument of Canadian public policy since the mid-eighties. At the time of its creation, it was an innovation itself in terms of government incentives to encourage Research and Development (R&D) investment. But in the past two decades many other nations have created or improved their own programs to stimulate R&D. Some of these programs are specifically targeted to industrial R&D like the SR&ED program, but some take other forms of support such as property tax relief, targeted government procurement programs or other indirect means of support for R&D. This is an indication of the extent to which R&D activity and the ancillary economic benefits accruing from it, such as high value jobs, innovation, productivity and spin-offs, are prized by governments around the world. Another factor that fuels the global competition for R&D investment is the mobile nature of this investment. R&D can occur virtually anywhere in the world with the right pool of highly skilled knowledge workers. This reality has helped to fuel the economic transformation occurring in relatively

low cost jurisdictions in Asia and Eastern Europe. The combination of lower wage rates, mass production of engineers, scientists with advanced degrees, *and* government support (direct or indirect) place Canada's position as an R&D active nation under strong competitive pressure. Like any other economic activity, companies will locate their R&D operations wherever it makes the most economic sense. Those responsible for managing Canada's R&D facilities live and breathe this reality daily. They face pressure not only from their business rivals but internally with their own companies as well. They must regularly justify, based on the quality and cost of outputs, why research and development operations should remain in Canada.



The Federal Government contends that the SR&ED program is “one of the most advantageous systems in the industrialized world for promoting business investment in R&D.” Without question, SR&ED has helped to fuel Canada's growth as a technology creating nation. But logically we should expect that a country with the most advantageous incentive program should expect to be among the top performers in business research and development investment. This is not the case. Canada ranks 14th among Organisation for Economic Co-Operation and Development (OECD) member countries for business expenditures on R&D — a middle-of-the-road position at best. Clearly what is considered the most advantageous incentive program is not achieving the results intended. This has puzzled Canadian policy-makers. ITAC, the Information

¹ “What is the SR&ED Program,” Canada Revenue Agency, www.cra-arc.gc.ca/taxcredit/sred.

² “Mobilizing Science and Technology to Canada's Advantage” Government of Canada 2007, page 37.

Technology Association of Canada, believes there are two key reasons for this disconnect between intent and results that are significant enough to prompt a review of the program. First, the program design precludes many of Canada's R&D investors from achieving any benefit from SR&ED credits. And second, ownership structures of many international R&D investors negate the ability of SR&ED credits to reduce the cost of the investment. Paradoxically, they serve to increase taxes payable in the jurisdiction of global headquarters, so they form a significant cost of the Canadian program, do not really affect R&D investment and actually transfer significant sums from the Canadian Treasury to a foreign government. We have attempted to draw the attention of Government to these problems since 2002. In view of the current intense pressure on the cost-attractiveness of locating R&D jobs in Canada, the Government's expressed commitment to "identify opportunities to improve SR&ED," is therefore particularly timely.

ICT and R&D

The information and communications technology industry (ICT) is, by a wide margin, the largest investor in private sector R&D in the Canadian economy. Our share of Canada's business research and development investment in 2006 was 39 per cent, about twice as much as any other sector. Of the top ten corporate R&D spenders listed by Research Infosource in 2006, five are ICT companies.³

ICT is a global industry driven by the persistent need to improve and to discover new innovations. It is a mature knowledge-based industry with a long history in Canada. The industry contains a broad variety of companies ranging from start-ups, to global leaders worth billions of dollars. In Canada, our ICT community contains a healthy mix of strong Canadian enterprises as well as multinationals, many of whom operate research and development facilities here. This research and development contributes significantly to our industry's economic performance. Our annual growth rate of four per cent leads the overall economy. ICT companies have used the SR&ED program since its inception. This has given us insight into the efficiency of the program in good times and in bad. Generally, calls for reform have centered around three areas: 1) reduce administration burden; 2) cover activities closer to commercialization, and, most importantly;

3) extend refundable tax credits to all business research and development investors.

Extend refundable tax credits to all business research and development investors

Currently the SR&ED program functions in three ways, depending upon the nature of the claiming company. If that company is a small Canadian-controlled private company, it can earn a refundable tax credit of 35 per cent up to the first \$2 million of R&D expenses. This refund takes the form of a cheque payable annually to the company. For many young technology companies, this is an important, predictable contribution to cashflow and can contribute significantly to the viability of an emerging company. Other Canadian companies – including larger publicly traded Canadian companies – qualify for a non-refundable investment tax credit of 20 per cent. This takes the form of a deduction from corporate income taxes.

This seems like a sound incentive except when taxable income is not large enough to make full use of the credits. In the early part of this decade, the global technology industry experienced a major downturn. The result was that many of Canada's ICT companies, ironically including some of our largest R&D investors, could not access the full value of their credits. Billions of dollars of credits went into "carryforward" pools and it is likely that even with the return to health of the ICT industry, many of these credits will be unused. More important from the perspective of providing incentives for future R&D activity, companies with large carryforwards of SR&ED deductions and credits receive no benefit from credits earned on ongoing SR&ED expenditures even once they return to profitability, until those carryforwards are used up. As a result, companies with some of the largest R&D establishments in the country employing thousands of Canadians and producing world class innovation receive no credit for their R&D activity. This condition will be exacerbated by the otherwise laudable intention to reduce the rate of corporate tax. And many mid-sized companies that go through significant cyclical drops in profits, a not uncommon phenomenon, do not get the benefit of their credits at a time when they need them most. Yet these mid-size companies are often the fastest-growing over time and the source of our future world leaders.

For a third category of companies, profitable Canadian subsidiaries of multinationals, the non-refundable tax credit is available, but, depending on the tax treaty involved, it produces no direct incentive to maintain or expand R&D activity in

³ Canadian Corporate R&D Directory Database 2006, Research Infosource, www.researchinfosource.com/top100

Canada. These credits reduce taxes payable in Canada but increase taxes payable by the parent company in its headquarters' jurisdiction, particularly the United States. This effectively produces a flow of tax credits from the Canadian fiscal system into the U.S. Treasury without producing any incentive at all. This sizeable drain may help to explain why our credit program is not producing the investment results it should.

ITAC believes that an effective R&D incentive program needs to ensure that *all* investors in R&D have meaningful access to the credits they have earned. We have called upon the Government repeatedly to make all tax credits refundable.

We have given considerable thought to overcoming this flaw in the program so that it can generate more industrial R&D for the sums spent on it. The alternative design we would propose would allow companies to choose between a refundable wage credit, similar to that in effect in Quebec today, and a non-refundable SR&ED credit as it now exists. The choice could be made in each taxation year. The taxpayer would be choosing between immediate cash of a lower amount or a higher credit that might be useful in the future.

The refundable wage credit could be a percentage of wages (including an amount in respect of wages of Canadian contractors performing SR&ED for the company). This would be immediately refundable, and possibly included in taxable income the following year, and there would be no additional carryforward. This would focus the refundable credit on companies with significant R&D work forces in Canada, helping to keep and grow our R&D centers here. The wage credit level could be set at whatever level resulted in an acceptable and affordable level of tax expenditure.⁴ To the extent that companies choose the refundable wage credit over the non-refundable SR&ED credit, this would actually lower the tax expenditure while representing a more effective incentive.

The effect of the wage credit approach would be to focus the value of the credit on research and development wages. It would have several ancillary benefits. It would simplify the audit process for both the claimant and for CRA. It would also focus refundable credits on wages of SR&ED personnel, which would attract and retain knowledge workers in Canada. Unlike SR&ED credits for material and equipment, which can be sourced from anywhere in

the world, a wage credit would contribute towards salaries which in turn contribute to personal tax, EI, and CPP payments back to the Government.

This focus on the wage portion of R&D costs also works to address the most frequently cited objection to full refundability – affordability. Our recommendation limits the refundability to the labour component of the tax credit and applies only to the current year and in future years. The current legislation which allows the use of carry forwards to offset taxes payable and allows a refund of current year credits should continue.

Extending refundability in this fashion will require no new definitions and minimal changes to tax legislation. Overall it would achieve the objective of ensuring that SR&ED does serve as an incentive for any and all investors in business research and development in Canada. We also believe that it would significantly reduce the cost of refundability to the Canadian fiscal system to a level considerably lower than current estimates.

Many ICT companies also feel that the investment tax credit should be non-taxable to further improve its incentive value.

Dollar Parity Places Additional Pressure on R&D Investors

R&D jobs in Canadian business operations are exceptionally valuable. We know we need to do more business R&D to drive innovation and commercialization of innovations in Canada. Moreover, R&D operations are often the source of innovative spin-off technology enterprises.

Canada has an excellent reputation for its talented researchers and, as a result, we have a strong foundation of research and development activity. But this activity is highly mobile. And the marketplace for attracting R&D investment is highly competitive. Many emerging nations can already beat Canada's R&D capacity in terms of both the size and the cost of their R&D labour pools.

Canada has maintained a qualitative edge over these competitors and our low dollar worked to give Canadian-based labs a cost position that kept them "in the game" in the spectrum between the United States and developing nations. Dollar parity with the United States has eroded that position. Canada now finds itself among the very highest cost destinations for R&D activity.

In theory, the SR&ED program should improve Canada's attractiveness as an R&D investment

⁴ "An Alternative for Extending Refundability of SR&ED Tax Credits," by Karen Wensley and Jacek Warda, ITAC, January 2007.

destination, but if the incentive value of the program is non-existent because of an investors' tax status, the credits are meaningless and Canada remains one of the highest cost locations to perform R&D. Globally competitive Canadian or foreign-based companies must continually evaluate all their business costs. If Canada persists as an expensive place to perform R&D, that activity and investment will go elsewhere and it will be very difficult to get back.

Cover Activities Closer to Commercialization

The life of a new product innovation never begins in the laboratory. There are a number of significant costs that companies incur bringing their innovation to the attention of a global marketplace. These may include the cost of meeting and recruiting beta customers and distributors, market research costs and the costs of international collaboration. The commercialization phase in the life of an innovation is arguably one of highest risk. For emerging companies, it frequently arrives at a point when funding is most strained. Many ICT companies believe the expansion of the SR&ED program to assist in this vital phase of development would help ensure a stronger success rate for Canadian innovations.

The Administration of SR&ED

While issues with program design render the SR&ED program useless to many large investors in Canadian R&D, problems with the administration of the program have a similar effect for many investors who are entitled to refundable credits or can use them to offset taxes payable.

The process of making an SR&ED claim is immensely complex. Many innovation intensive companies, working hard in the lab to ready their product for market and working equally hard in the market to find customers, see the CRA reporting requirements as onerous. SMEs may find that applications require expertise not available within their workforce. Seeking that expertise imposes costs in a context when every dollar spent can make the difference between success and insolvency. As a result, many R&D intensive companies simply do not apply. This condition is not restricted to start-ups.

At times in the history of the SR&ED program, CRA has recognized this difficulty and attempted to remedy the problem. For example, it instituted various programs to reach out to SMEs to help them claim the credits to which they were entitled. This was consistent with a philosophy that believed

that SR&ED is an incentive program and should be operated as such.

Large corporations as well as SMEs are also finding widespread discrepancies in administration between regional taxation centres and even between auditors. This variability in execution used to be addressed in CRA head offices measures for quality control. But these measures appear to have been abandoned along with any notion that head office might provide a channel for appeal of a regional decision.

There is a disconnect between the federal policies governing the program and the rigid interpretation of those policies in the CRA's field offices where claims are reviewed and processed. If the government is serious about the innovation and job creation advantages of the program, it needs to instill a progressive attitude to interpretation in the field offices.

Also seemingly abandoned in large part is the account manager program, whereby large corporations could get continuity of contact with CRA and undergo real time audits to avoid future disagreements about interpretation and documentation. Finally, ITAC regrets the dissolution of the Partnership Committee which provided CRA with input from claimants that we believe contributed to the effectiveness of the programs. These attempts at "client service" have proven to be cyclical, disappearing when political pressures raise concerns about abuse and accountability.

ITAC recommends that at minimum CRA must clearly redefine the purpose for the SR&ED tax credits as a vital measure to incent economic behaviour beneficial to the Canadian economy. And the administration of the program must be executed with this philosophy clearly in the minds of all auditors. Auditors must see their primary objective as the encouragement of R&D investment while maintaining appropriate standards of compliance. Today the emphasis appears to be only upon compliance which frequently discourages participation in the program and as a result undermines the intended incentive for R&D investment. ITAC would like to see an immediate refocus on client service, reinstatement of the Partnership Committee, and a clear line of CRA headquarters control over regional administrative quality.

ITAC is encouraged by the current indications that this valuable program will be examined and improved. We strongly encourage the Federal

Government to undertake this process as quickly as possible (dollar parity makes the situation critical) in order to ensure that Canada occupies its rightful place in the global knowledge-based economy.

Consultation Document Questions

- A. How do SR&ED tax incentives affect the performance of R&D in Canada and how can they contribute to increasing private sector investment in Canada?

Investing in research and development to produce the next generation of innovations is a costly but necessary activity for the technology companies. By reducing the cost of this investment SR&ED tax incentives support R&D investment in Canada and encourage more. But for many of Canada's largest R&D investors, this support is only theoretical because for a variety of reasons described above, the current structure of the program prohibits their access to credits or renders them valueless. The effect on these investors is that Canada's premier R&D incentive program provides them no incentive at all.

In addition to being costly R&D activity is also highly mobile. Jurisdictions all around the world compete aggressively through a broad array of direct and indirect incentives to attract labs and research mandates into their territories. Managers of competitive, global R&D-intensive businesses continually assess the qualitative and quantitative benefits of performing R&D in one jurisdiction versus another. The neutral to negative impact of Canada's current program weakens the argument for maintaining R&D activity in Canada. By making the SR&ED tax credits refundable, by extending the coverage of the program to include expenses more closely related to commercialization and by reducing the cost of compliance, we can ensure that Canada truly does have one of the finest R&D incentive programs on earth.

- B. Are there features of the SR&ED tax incentives that impede the growth of small and medium sized innovative Canadian companies, and how?

The limitation of refundable credits to small CCPCs is clearly an impediment to SMEs that begin to grow and that need access to funding that puts them over the size limits or lose their CCPC status. Some expansion of entitlement to the 35 per cent refundable credit is worthwhile. As a general principal, SR&ED should be designed to help keep as many R&D investors as possible in business and in Canada.

And while a focus on the impact of SR&ED on small businesses is a worthy consideration, we should not overlook the importance of large R&D investors in the Canadian innovation ecosystem. These companies anchor clusters. Their supply chains spawn new R&D intensive start-ups and provide a ready market for smaller companies. Their management know-how provides a vital and scarce resource for the growth of technology start-ups. And they are, by a very wide margin the largest contributors to Canada's private sector business investment. If we lose sight of the importance of the role played by our R&D leaders, many of who currently derive no benefit from SR&ED, we will seriously disrupt our innovation ecosystem.

- C. How could more private sector R&D be leveraged?

Making SR&ED tax credits accessible to all investors R&D would provide a truly competitive incentive for maintaining private sector investment R&D in Canada and encouraging more.

- D. Given the improvements already implemented or under study, how could the administration of the SR&ED tax incentives be further improved and their complexity reduced?

Our recommendations are detailed above. In summary, we suggest a philosophical restatement of the purpose of the program in design and execution, as a policy instrument whose purpose is to incent R&D investment and activity. Consistency in administration and disposition of claims in a time frame consistent with the pace of global innovation-driven business should be basic principles.



Bernard A. Courtois
President and CEO
Information Technology Association of Canada