

ITAC

INFORMATION TECHNOLOGY
ASSOCIATION OF CANADA

ACTI

ASSOCIATION CANADIENNE
DE LA TECHNOLOGIE DE L'INFORMATION

An Alternative for Extending Refundability of SR&ED Tax Credits



Prepared by:

Karen Wensley
and
Jacek Warda

January 2007

The Information Technology Association of Canada (ITAC) is the voice of the Canadian information and communications technologies (ICT) industry in all sectors including telecommunications and Internet services, ICT consulting services, hardware, microelectronics, software and electronic content. ITAC's network of companies accounts for more than 70 per cent of the 589,000 jobs, \$137.6 billion in revenue, \$5.2 billion in R&D investment, \$22.6 billion in exports and \$11.5 billion in capital expenditures that the industry contributes annually to the Canadian economy.

© 2007 Information Technology Association of Canada

An Alternative for Extending Refundability of SR&ED Tax Credits

An ITAC Discussion Paper

The Canadian tax system for SR&ED is very generous – for those taxpayers who can now or in the foreseeable future (defined as the period during which an anticipated cash benefit can be included in today’s budget decision) make use of the tax credits (“ITCs”). Such taxpayers fall into 4 categories:

1. Small Canadian controlled private corporations (“small CCPCs”), who are entitled to 35% fully refundable credits on up to \$2 million of SR&ED per year.
2. Taxable Canadian corporations, public or private, with sufficient tax payable to make use of the credits. This would include both very profitable companies doing a high level of R&D in proportion to sales, and moderately profitable companies with lower levels of R&D spending.
3. Profitable Canadian subsidiaries of multi-nationals for whom the tax credit does not simply result in higher domestic tax payable by the parent company
4. Canadian corporations anticipating future profitability (the anticipation could be either realistic or optimistic).

For other taxpayers, the tax credits are at best a windfall at some future date when they can make use of them (but too late to have impacted budgeting decisions on R&D spending when the credits were generated) and at worst a compliance exercise with no payback. They also benefit companies with relatively lower levels of R&D spending as a percentage of sales disproportionately to those with high levels of R&D spending because the latter are less likely to be able to use all of the credits they generate.

In technology-based companies, the gap between small CCPC status and sufficient profitability to use tax credits (after using up all tax assets being carried forward) can be a very long one. For companies growing from the start-up stage, the intermediate stages could include loss of CCPC status due to attracting US venture capital or seeking a listing on a public stock exchange, as well as a long period of investment for growth and therefore delayed profitability. In addition, the volatile markets for technology products combined with short product cycles mean that many profitable companies undergo significant downturns which can build up substantial tax assets, again delaying the ability to use ITCs.

The problem is that the structure of the SR&ED tax credit rules is an “all or nothing” structure. Either one can use credits (through refundability for small CCPCs or against taxes payable for profitable companies) or one cannot. This means that for companies outside of the 4 categories above, Canada has no federal tax incentives for SR&ED.

There is no doubt that full refundability of all SR&ED ITCs would significantly increase the tax expenditure on SR&ED. However, it is possible to design partial benefits for companies not now accessing them.

One simple design would be extending the 40% refundability of credits currently available to individuals and CCPCs in excess of their expenditure limit to all taxpayers. This would in effect provide an 8% cash credit with the balance of 12% available against future tax payable.

An alternative design could be allowing companies to choose between a refundable wage credit (similar to that in effect in Quebec today) or 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.

For example, a taxpayer might incur \$100 of SR&ED wages, claim a \$65 proxy amount and \$35 of materials consumed in SR&ED. Under the current system, the ITC would be 20% of \$200 or \$40 of credit available to reduce tax payable. The refundable wage credit could be 20% of wages, or in this case 20% of \$100 or \$20. The \$20 would be immediately refundable (and 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 our R&D centres here. The wage credit level (20% in the example above) could be set at whatever level resulted in an acceptable/affordable level of tax expenditure.

The benefit of this alternative refundable wage credit system is that it would produce some offsetting reductions to the tax expenditures on SR&ED. This would come from taxable multi-nationals who immediately chose the lower refundable credit (on the basis that it would not reduce their foreign taxes paid for purposes of foreign tax credits in their home jurisdiction) as well as future tax expenditure savings from reductions in ITC carryforward pools that could be accessed by taxpayers becoming profitable or in some cases on acquisitions of the company by a profitable purchaser.

This extension of SR&ED tax credit refundability would require no new definitions and very small changes to tax legislation. Provinces that do not currently have a refundable SR&ED tax credit might be willing to align. Overall, it would achieve the objective that the tax expenditure on SR&ED would be a motivating factor in R&D spending and location decisions by Canadian taxpayers.

To explore this idea further, ITAC commissioned JPWInnovation Associates to determine if the practice of offering optional discounted credits occurs in other jurisdictions. Their report follows.

Discounting R&D Tax Credits: An International Scan

Question: Does ITAC know of any jurisdiction with an SR&ED-like program that offers participants the option of accepting discounted refundable credits in the short term or long term refundable credits. And if it does what has been the impact of this option?

Introduction

To extend accessibility to the SR&ED program, without incurring excessive additional tax expenditures, ITAC has explored a possibility of designing additional but partial benefits for companies not now accessing them. In other words, a “discounted” or reduced refundable tax credit is contemplated.

ITAC identifies two relatively simple designs to administer such a tax credit without incurring hefty legal and administration costs:

1. Extending the 40 per cent refundability of SR&ED tax credits currently available to individuals and CCPCs in excess of their expenditure limit to all taxpayers. An estimated effect is to provide the 8 per cent cash credit with the balance of 12 per cent available against future tax payable.
2. Allowing companies to choose between a refundable wage tax credit 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.

Key Points

Several countries have “discount” mechanisms in place, which are similar to the suggested in a sense that they employ the concept of “discount.” Three countries have been identified as having discount-like programs: Australia, Austria and United Kingdom: A common feature of these countries programs is that they all employ enhanced allowances from taxable income not direct tax credits. Yet another country - Norway - offers a tax offset from withholding taxes and social security contributions for firms unable to fully utilize earned tax credits. These programs are discussed below.

Australia – R&D Tax Offset

All small firms, public or private, foreign or domestic, can claim a *refundable* tax offset (credit), which is net of any other tax owing before it is refunded. The maximum tax offset is equivalent to tax savings from R&D tax concession – in such case the tax offset is 7.5 per cent. The offset supports small innovative companies, particularly – but *not* restricted to - those in tax loss who cannot gain immediate benefit from the concession.

Empirical Evidence: Australia consistently measures the impact of the R&D tax measures. According to Australian Department of Industry, Tourism and Resources, in 2003-04, business uptake of the R&D Tax Offset for small business increased by 19 per cent over the previous year with more than 2350 small businesses investing around \$663 million in R&D. During 2003-04 more than 5600 companies registered under the R&D Tax Concession, a record level,

almost 600 more than the previous year.¹ The efficiency and effectiveness of the new elements of the program, including spillovers and broader national benefits generated by the tax offset were to be evaluated in the second half of 2005.² To date, no specific results have been released.

Austria – Alternative R&D Tax Credit

All companies, small and large, public or private, foreign or domestic, have an option to claim an alternative refundable tax credit of 8 per cent instead of an enhanced allowance. Until 2005, the credit represented a discount as its value was lower than the tax saving from the R&D tax allowance (i.e., a 25 per cent level allowance multiplied by corporate tax rate of 34 per cent yielded a tax saving of 8.5 per cent, slightly higher than the alternative R&D tax credit itself). At the present time, Austria's alternative R&D tax credit is not a discount but represents more of a "premium" for the companies opting for it. At the current corporate income tax rate of 25 per cent, the tax saving from the R&D tax allowance is only 6.25 per cent. This makes the alternative R&D tax credit more beneficial than the R&D tax allowance.

Empirical Evidence: There has not been a formal evaluation of the R&D allowance and the alternative tax credit. Austria is planning an evaluation within next year. It is interesting to note that Austria has not adjusted its alternative tax credit to match the reduction in the corporate tax rate, which indicates that the credit is quite popular as an option to R&D allowance.

United Kingdom – Payable Tax Credit

Small companies, public or private, foreign or domestic, are granted a 150 per cent allowance for current R&D expenditures.³ Companies not in profit can sacrifice their R&D losses in return for payment of a tax credit of *up to* 24 per cent of the cash cost of the qualifying R&D. Ninety per cent of support for SMEs is claimed through this mechanism.⁴ The "24 per cent" is an upper limit, as the size of refund will depend on individual circumstances of the company such as the magnitude of surrenderable losses, the amount of qualifying R&D expenditures, and company obligations under payroll and national insurance taxes. The 24 per cent refund represents a discounted tax credit – in "profitable" situations SMEs can claim a 28.5 per cent tax credit. Thus by sacrificing R&D tax allowance-created losses, companies can receive a refund but always at a discount of 4.5 percentage points (see Table 1).

¹ The Hon Ian Macfarlane, MP, *R&D Tax Concession – a Winner for Business*, Media Release, May 9, 2006, <http://minister.industry.gov.au/index.cfm?event=object.showContent&objectID=17FEEB1D-F0A5-ED8E-8583A9AF5759A968>

² *Australia's R&D Tax Concession Program: Discussion Paper*, Prepared for the Workshop of TIP Delegates on Fiscal Incentives for R&D, OECD, Paris, Wednesday 8 June 2005

³ In 2002, the United Kingdom extended the allowance to large companies. The rate is 125 per cent.

⁴ HM Treasury, *Supporting Growth in Innovation: Enhancing the R&D Tax Credit*, July 2005, p. 18

Table 1: United Kingdom: The Cost of Tax Incentives for R&D and the Size of “Discount”⁵

Cost arising from £100 of R&D spending		
	Pre-tax-incentive support	Current support
SME deductions	$£100 * 19\% = £19$	$£100 * 150\% * 19\% = £28.5$
SME payable credit	0	$£100 * 150\% * 16\% = £24$
Discount	0	$£28.5 - £24 = £4.5$

Notes

- R&D tax credits allow SMEs to deduct an additional 50 per cent (and large companies an additional 25 per cent) of R&D spending when calculating taxable profits.
- R&D tax credits allow loss-making SMEs to claim a payable credit worth **16 per cent** of enhanced R&D spending (i.e. 16 per cent of 150 per cent of actual R&D spending).
- SMEs are assumed to pay tax at 19 per cent.

Empirical Evidence: To date, over 17,000 claims have been made for R&D tax credits since they were introduced and over £1.3 billion of support has been claimed through the scheme. In 2003-04, the last year in which data is broadly complete, over 5,500 companies claimed the credit – approximately 4,500 SME companies and almost 1,000 large companies. In 2003-04, just under £550 million of support was claimed through R&D tax credits.⁶ An in-depth evaluation of the R&D tax allowance is underway in the United Kingdom. The approach includes a survey and an econometric study to estimate the early effects of the tax credit on R&D spending. There is a plan to repeat the study in a few years to pick up longer term and wider effects on innovation, productivity and growth.⁷

Norway – Withholding Tax Offset

Norway has established an R&D tax credit in 2002. The credit is given at 20 per cent of qualified R&D expenditures for small companies and 18 per cent for large companies. If a Norwegian company, of any size, public or private, foreign or domestic, cannot make full use of the credit against corporate income tax in one fiscal year, it may offset the credit directly against employers’ social security contributions or against the tax withheld on the employees’ salaries. (This works somewhat similar to R&D wage tax credits in the Netherlands and Belgium.)

Empirical evidence: A Statistics Norway evaluation started in April 2004 and the final results are expected toward the end of 2007. It includes economy-wide impacts such as increased business financed R&D, increased innovation and increased value added.⁸ Recent experience in Norway shows that the take-up of direct refund option is quite widespread and can make-up a significant part of the expenses of a scheme.⁹

⁵ Robert Betts, HM Revenue & Customs, KAI Analysis, London, UK, corroborated by e-mail

⁶ HM Treasury, as above, p. 13

⁷ Tristan Slinger, HM Revenue & Customs - Analysis Directorate, *Evaluating R&D Tax Credits in the UK*, Presentation to the Workshop of TIP Delegates on Fiscal Incentives for R&D, OECD, Paris, June 8, 2005

⁸ Sissel Øverlie, *The Norwegian tax refund scheme*, Research Council of Norway (presentation)

⁹ Jan Nill, *Design and use of fiscal incentives to promote business RDI in CREST countries – an overview*, Contribution for the CREST OMC 3% 2nd cycle expert group on fiscal measures, European Commission Joint Research Centre - Institute for Prospective Technological Studies (IPTS), 2005