

SR & ED

R&D Program

- Sponsored by the government of Canada
- Provinces offer complementary incentive programs
- By some measures, after-tax cost of performing research and development in Canada is lower than in any other country
- Encourages the growth of start-up companies
- \$1.5 billion paid to > 11,000 claimants



Benefits

- Reduce income tax payable through:
 - Current deductions from income
 - Investment tax credits (ITCs)
- Enhanced ITC rate is 35% for qualifying Canadian controlled private corporations (CCPCs)
- General ITC rate is 20%

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Investment Tax Credits

- Available on qualified expenditures on SR&ED in Canada, in addition to usual tax deductions as business expense
- Computed as % of SR&ED qualifying expenditure pool including:
 - Current expenditures
 - Capital expenditures
 - Overhead (Proxy amount)
 - Shared-use equipment
- Enhanced 35% benefit on initial \$2 million of R&D
 - Refundable in cash
- Treated as income in the next year



R&D in Ontario

- Ontario Innovation Tax Credits (OITC) essentially piggy-backs the Federal SR&ED program with an additional 10% refundable credit available on the same basis as the enhanced ITC rate
- Approximate net after-tax cost of performing research and development assuming \$1,000 of R&D expenditures:
 - CCPC earning manufacturing and processing income: \$330
 - All other corporations: \$450



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Excluded Activities

- Market research
- Sales promotion
- Quality control
- Routine testing
- Human or social sciences
- Prospecting
- Exploring or drilling for, or producing, minerals
- Petroleum or natural gas
- Commercial production
- Style changes
- Routine data collection



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Qualifying Activities

Three-legged Stool Test

- Scientific or technical advancement
- Technical uncertainty / risk
- Scientific method



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Qualifying Activities

CRA's Approach

Seek an advancement of technology

- Forward advance: on the technology's leading edge
- Sideways advance: solution to a technical problem or difficulty that persists despite many standard or ad hoc fixes
- Risk of project technical failure
- Scientific/technical content in accordance with scientific method
 - Formulation, testing and modification of hypotheses
 - Systematic observation, measurement and experiment
- Supported by documentation



Qualifying Activities A Practical View

- Generally speaking, if the project can be achieved in time solely by the expenditure of money, chances are it's a non-qualifying activity
- If enough money plus original thinking may or may not achieve the project's objective, then the project should be eligible



Eligible expenditures

- Current expenditures:
 - Salary, wages and benefits for SR&ED personnel
 - Cost of materials used in SR&ED projects
 - Certain payments to third parties
 - A share of general and administrative overhead costs
 - Report under the regular method or the proxy method
- Capital expenditures:
 - Outlays to acquire plant and equipment to be entirely or substantially used in SR&ED
 - Shared-use equipment is also eligible



Claiming Benefits

- With the annual tax returns filing
- Can only be claimed after incurring expenses on qualifying SR&ED
- Both technical and financial reports



Claiming Benefits

- File within 18 months after the fiscal year end, but preferably before
- Must contain all necessary information



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Preparing the Claim

- Financial information broken down by project and cost category
- Activities are divided into separate projects; each project requires a separate report
- Provide essential technical information for each claimed project:
 - Technical Submission
 - Form T661



Processing and Evaluation

- CRA is committed to delivering settlement notices to 90% of claimants within 120 days of acceptance of the claim
- Auditors and Science Advisors independently rate the apparent worth of each claim
 - Those with a high composite rating are processed as filed
 - 75% of claims were processed as filed in 2001
 - Every five years or so, the claims of highly-rated regular claimants must undergo the standard review process
 - Claims with a low rating or from first time claimants typically undergo the standard review process

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Definition of SR&ED

as per section 248 of the *Income Tax Act*

248. “scientific research and experimental development” means systematic investigation or search that is carried out in a field of science or technology by means of experiment or analysis and that is

(a) basic research, namely, work undertaken for the advancement of scientific knowledge without a specific practical application in view,

(b) applied research, namely, work undertaken for the advancement of scientific knowledge with a specific practical application in view, or

(c) experimental development, namely, work undertaken for the purpose of achieving technological advancement for the purpose of creating new, or improving existing, materials, devices, products or processes, including incremental improvements thereto, and, in applying this definition in respect of a taxpayer, includes



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Definition of SR&ED (continued)

(d) work undertaken by or on behalf of the taxpayer with respect to engineering, design, operations research, mathematical analysis, computer programming, data collection, testing or psychological research, where the work is commensurate with the needs, and directly in support, of work described in paragraph (a), (b), or (c) that is undertaken in Canada by or on behalf of the taxpayer, but does not include work with respect to

(e) market research or sales promotion,

(f) quality control or routine testing of materials, devices, products or processes,

(g) research in the social sciences or the humanities

(h) prospecting, exploring or drilling for, or producing, minerals, petroleum or natural gas,

(i) the commercial production of a new or improved material, device or product or the commercial use of a new or improved process,

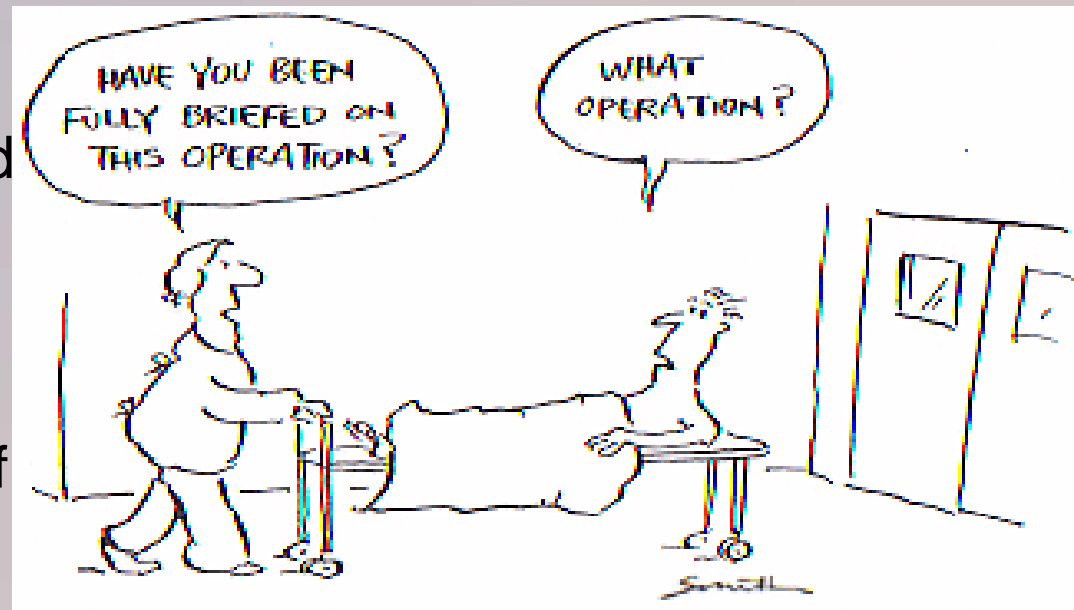
(j) style changes, or

(k) routine data collection.



Optimize the Claim

- Spend the time to set up a system to identify, monitor and capture R&D costs.
- Ensure you identify all eligible R&D projects and related expenditures ie. technical staff must talk to each other, as well as to the financial staff.



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Optimize the Claim

- Without going overboard, document your R&D activities. Just keep a file with notes, e-mails, project plans, status reports, lab reports, patent applications, etc.
- File your claim within 6 months of year-end. If you wait to file after 6 months and before 18 months of year-end, expect delays to the review process. **If you wait longer than 18 months after year-end, the R&D tax credits are lost forever.**



Court Cases

- *Data Kinetics Ltd. v The Queen*, 98 DTC 1877 (TCC, Lamare, J.)
- Tested with communication link to U.S. mainframe as no computer mainframe service bureau in Canada could meet DKL's specific needs
- Allowed however effectively overruled by decisions of the Court of Appeal in *Tigney Technology Limited* and *LGL Limited*



Court Cases

- *R.I.S. Christie Ltd. v The Queen*, 99 DTC 5087 (FCA, Strayer, Robertson and Sexton JJ.A.)
- Taxpayer researched new, on-site concrete-forming medium for use in construction however the documentation didn't establish element of repeatability
- Even without evidence, court may hold that on balance of probabilities, systematic research was performed



Federal ITCs

Type of entity	Nature of expenditure	ITC rate on total expenditures up to expenditure limit	Refund rate	ITC rate on total expenditures in excess of expenditure limit	Refund rate
Qualifying CCPCs	Current	35%	100%	20%	40%
	Capital	35%	40%	20%	40%
Other corporations	Current and capital	20%	-----	20%	-----
Individuals and unincorporated businesses	Current and capital	20%	40%	20%	40%