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Budget 2012's impact on innovation investment: Survey results and opportunities

July 11, 2012 (12-4)

To promote business innovation, the Canadian government proposed in its 2012 federal budget a number of changes to the government's support for research and development (R&D). The budget announced a number of positive initiatives to improve the administration of the program. In addition, the government has proposed to shift some of the support from the Scientific Research & Experimental Development (SR&ED) tax credit program to direct support mainly through targeted grant programs, such as the Industrial Research Assistance Program (IRAP). Specifically, the funds for more direct funding come partly from the following reductions to the SR&ED incentives:

- The federal non-refundable SR&ED tax credit will be reduced from 20% to 15% starting in 2014. However, the budget does not change the enhanced 35% credit rate for eligible Canadian Controlled Private Corporations (CCPCs)
- The prescribed proxy amount will be reduced from 65% to 55% by 2014
- Qualifying expenditures from arm's length SR&ED contractors will be limited to 80% of the contract payment for expenditures incurred after December 31, 2012
- Capital expenditures will no longer qualify as eligible expenditures for SR&ED deductions and investment tax credits (ITCs), starting in 2014. This includes the capital portion of arm's length contract payments

To capture the private sector's perspective related to the budget changes, Deloitte, in cooperation with several industry associations, conducted an online survey in May 2012 of companies from across Canada, with a particular focus on innovation investment. Although the scope of the 2012 federal budget covers a number of tax policy aspects, this survey focused solely on how industrial innovation may be effected and more generally, industry's view of innovation policy and its influence on Canadian industry.

What we learned

The survey results revealed considerable disappointment and uncertainty by Canadian companies in response to the proposed changes in the 2012 federal budget.

- The reduction in expenditures eligible for SR&ED ITCs will significantly impact companies – particularly large companies
- More than 80% of respondents believe that the changes will reduce their SR&ED claims going forward

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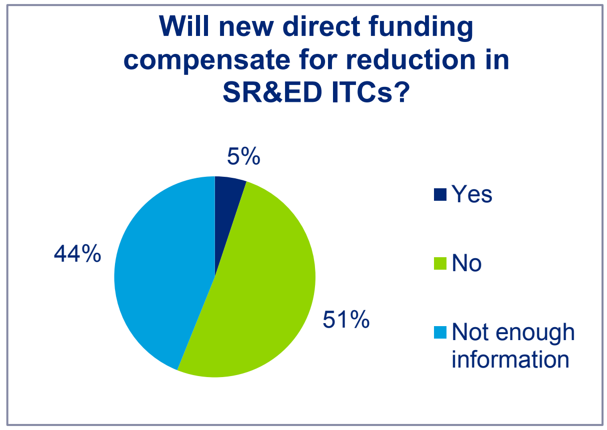
- The changes do not seem to be well understood by respondents, as both large and small companies appear to underestimate the impact

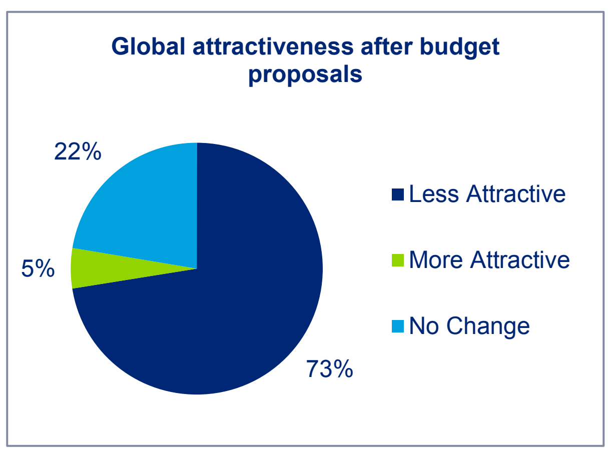
The proposed shift to more direct government support through grants was generally not viewed as compensating for the reduction in SR&ED ITCs.

- In fact, only 5% of survey participants felt that direct funding announced in the budget would offset the reduction in SR&ED ITCs
- A significant portion of companies indicated uncertainty on the impact of the changes, as much of the budget was not clear on how the direct funding will be allocated



In addition, the global attractiveness of Canada's R&D incentive regime was viewed to be at risk with the proposed changes.

- More than 70% of the survey respondents believe that Canada will be less globally attractive once the 2012 budget is implemented with the following as the main reasons cited by respondents:
  - Increased cost of R&D in Canada
  - Better incentives available in other parts of the world
  - Increased complexity with shift to direct funding



Post-budget opportunities

Now is the time to determine the next steps to mitigate the impact of the proposed changes. The list below describes some opportunities to consider.

Opportunity	Details
Other incentives	Take advantage of federal and provincial incentives outside of R&D that can be used for research or allow funds to be freed up for research
Maintain eligibility status	For CCPCs, staying under the taxable income/taxable capital limits will give access to the enhanced ITC rate of 35%. This involves tax planning and R&D spending analysis.
SR&ED contractors versus third party payments or attributable services	Thoroughly determine whether the type of work being performed by contractors is truly SR&ED-contractor work as opposed to third party payments or other services in support of SR&ED
International planning	Examine corporate structures to maximize global R&D expenditure return and review optimization opportunities
Proactive claiming	Document and claim concurrently to provide larger, more robust claims. Good tools for this include Deloitte's Innovation Strategy™ and Experimental Planning™.
Proxy versus traditional	Thoroughly analyze both methods as the post-budget choice may be less obvious. If the traditional method is chosen, implement systems to substantiate eligible overhead expenditures.
Capital purchases	Plan capital purchases for SR&ED before the reduction comes into effect and assess whether the item in question is a capital or a current expenditure
Provincial planning	Understand provincial regimes and determine the best federal/provincial mix to maximize SR&ED benefits.
Global investment	Analyze global R&D spending to optimize the total incentives received per R&D dollar spent. Review activities in comparison to R&D incentive regimes in the relevant countries.

Deloitte R&D professionals (listed on the left) can assist you in navigating through the Budget 2012 proposed changes to the SR&ED program and in identifying the opportunities that can lessen the impact of the changes.

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