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R&D Tax Update

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Will Canada keep pace?
Key changes to global R&D tax regimes

As Canada considers possible changes to our Scientific Research & Experimental Development (SR&ED) tax credit system, it is important to consider what impact these changes may have on Canadian investment in research and development (R&D), particularly with increased global competition for research investment. In 2008, the Organisation for Economic Co-operation and Development (OECD) ranked Canada's R&D tax incentive regime third behind that of France and Ireland. However, many countries are making significant improvements to their programs, thereby lowering their effective cost of doing research. The most recent changes have come from countries that Canada competes against for global investment: the United Kingdom, the Netherlands and Russia. Each of these countries recently announced improvements to encourage R&D within their borders in an effort to attract innovative companies and top talent, following similar developments in Australia, Austria, Portugal, and other countries.

The United Kingdom

The United Kingdom recently announced that large companies will become eligible for refundable tax credits beginning in 2013. This proposal will extend the availability of cash credits that are currently limited to loss-making small and medium enterprises. This new "above the line" R&D tax credit regime will provide a significant benefit for larger companies that invest in R&D. As outlined in a Deloitte survey in 2010, many large companies believe that a move to an "above the line" tax credit for R&D would not only increase cash flow, but would increase the visibility of the benefit to key decision makers, leading to more R&D being undertaken in the United Kingdom.

This proposed change was originally discussed as part of the consultation process carried out in 2011 in the United Kingdom. Draft legislation was released on December 6, 2011. Further consultation on the details of the "above the line" credit will be part of Budget 2012. Companies with foreign parents who have found that the U.K. R&D tax benefit is diminished by the group's overall tax position may particularly benefit from this change.

The Netherlands

Currently, the Netherlands offers two tax incentives for taxpayers engaged in qualified research:

- WBSO (a Dutch acronym) is an incentive that reduces wage tax and social security contributions for employees engaged in research. The reduction is 50% for the first 220,000 euros in R&D wage costs (60% for start-up companies) and 18% of the remaining wage costs, with a maximum reduction of 14 million euros per taxpayer.
- Innovation Box (formerly Patent Box): this incentive allows companies to deduct eligible development costs and losses related to the exploitation of intellectual property from corporate taxes. In addition, the corporate tax rate on income attributed to qualifying inventions is eligible for a reduced rate of tax (5% rather than the standard 25%).

As of January 1, 2012, the Netherlands also allows companies to claim a Research & Development Allowance (RDA). The RDA is an additional deduction against taxable income. This deduction applies to costs and expenditures directly related to R&D activities performed by the taxpayer, other than wages which are already covered by the WBSO. The RDA rate for 2012 is set at 40%. This means that the net benefit, assuming a marginal tax rate of 25%, is 10% of the R&D expenditure. The implementation of the RDA is closely linked to the implementation of the WBSO.

Russia

Over the past few years, in an effort to attract foreign investors, Russia has been introducing various tax incentives and innovation-friendly legislation, including a profits tax incentive equal to a current deduction for R&D expenditures and a 150% super deduction for companies conducting R&D activities in prioritized industries. In addition, Russia has recently announced a change in the profit tax rules for Special Economic Zones (SEZs) beginning in 2012.

Russia currently has four categories of SEZs: technology and innovation, industrial, tourist, and port and logistics industries. A total of 24 SEZs exist and more are planned. Companies established within the boundaries of an SEZ benefit from reduced “red tape”, a free customs zone, and limited tax benefits.

Beginning in 2012, the regional authority where an SEZ is located may reduce the regional portion of profit tax from 13.5% down to 0%. Thus, companies located in the zone may only be required to pay the 2% federal portion of the profit tax. Companies in technology (and tourist) zones are further exempted from the 2% federal portion. At this time, the extent to which regional authorities will reduce the profit tax below 13.5%, and on what criteria the reduction will be based, remains unclear.

What is Canada’s next step?

With these positive changes to R&D tax regimes around the world, Canada must continue to improve its current SR&ED regime to maintain its competitiveness. As outlined in Deloitte’s **pre-budget letter to Minister Flaherty**, Canada can improve its R&D regime by extending refundability to all businesses and not just small Canadian-controlled private corporations (CCPCs). Companies other than CCPCs only receive the benefit of the credit when they have taxes payable, which makes the benefit, at best, “nice to have”. Long-term planning can be difficult for these organizations since many operate in cyclical industries and cannot predict when they will have sufficient corporate tax liability to benefit from the SR&ED tax credit. Extending the refundable credit to all corporations would appropriately reward the risks inherent in carrying out R&D in Canada, sending a strong message to foreign companies seeking new investment opportunities. In addition, for many Canadian R&D performers with U.S. parents, refundability means the difference between the incentive being a permanent tax saving as opposed to a tax deferral, which can be a powerful distinction.

Canada must take positive steps to maintain our position in the global market as a favourable jurisdiction in which to perform R&D. Any changes to tax legislation on this matter must therefore be carefully crafted to ensure the economic policies reflect the trends on the international front. Otherwise, Canada's attractiveness as an investment destination may be impacted.

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