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R&D Tax Update

August 27, 2012 (12-5)

Draft legislation to implement controversial changes to SR&ED program

The Department of Finance has released for consultation draft legislative proposals that implement a number of important tax measures from Budget 2012, including the changes announced to the Scientific Research and Experimental Development (SR&ED) tax incentive program. Interested parties are invited to comment on the draft legislation by September 13, 2012. Deloitte will be preparing a submission and readers are welcome to **propose comments** to us for our consideration. The SR&ED measures contained in the draft legislation are summarized below.

Reduced ITC rate

The draft legislative proposals reduce the basic investment tax credit (ITC) for qualified SR&ED expenditures incurred by taxpayers other than eligible Canadian-controlled private corporations (CCPCs) from 20% to 15%, starting in 2014. The enhanced 35% credit rate for eligible CCPCs remains unchanged.

Prescribed proxy amount

The draft legislation implements the proposed reduction in the prescribed proxy amount for overhead expenditures from the current rate of 65% to 60% for 2013 and to 55% after 2013. The rate reductions will be prorated for each taxation year by the number of days in each calendar year.

Third-party arm’s length payments

Third-party arm’s length payments for SR&ED eligible for ITCs are limited to 80% of such payments for expenditures incurred after December 31, 2012. This change applies to payments for SR&ED performed on behalf of the taxpayer (i.e., subcontractors) and payments for SR&ED carried on by third-parties which include corporations resident in Canada, approved associations, universities and colleges, research institutes and non-profit R&D corporations.

Capital expenditures

Capital expenditures will no longer qualify as eligible expenditures for both SR&ED deductions and ITCs, starting in 2014. This includes the capital portion of arm’s length contract payments and third-party payments. The performer is henceforth obligated to inform the payer of the amount of capital equipment that is to be excluded.

Capital expenditures include expenditures of a capital nature in respect of property acquired that would be depreciable property to the taxpayer. Therefore, it appears that

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costs for developing capital property - such as salaries paid to develop SR&ED property - will generally be considered to be current expenditures and, thereby, eligible for SR&ED incentives. This also implies that costs which may be capitalized for accounting purposes would still qualify as eligible SR&ED expenditures. Despite the release of the draft legislation and related explanatory notes, we believe that questions still remain on what costs will fall into the definition of capital expenditures and how the draft legislation will be administered.

Leases

Payments for the lease of premises, facilities and equipment will no longer qualify for SR&ED deductions and ITCs. The provisions that currently allow taxpayers to claim all or a portion of lease costs for the right to use such properties are being repealed.

Shared-use equipment

As part of the proposals to exclude capital expenditures from the calculation of eligible SR&ED expenditures after 2013, the rules surrounding the shared-use equipment (SUE) will be phased out starting in 2014 and eliminated by February 1, 2017. A portion of the cost of equipment that is acquired and available for use before the end of 2013 will continue to qualify for ITCs under the SUE rules. Thus, the first term SUE can be claimed in 2014 and the second term SUE can be claimed in 2015.

Industry view and opportunity assessment

As discussed in our **July 11, 2012 R&D Tax Update**, a recent post-budget survey of Canadian companies indicates that reactions to the proposed SR&ED changes have generally not been positive. The proposals reduce government support for SR&ED, making Canada's incentive regime less attractive than those of competing countries who are improving their incentive programs. In addition, although Budget 2012 proposes more direct funding that is applauded by industry, the details for these supposedly compensatory measures are, for the most part, not yet available. The federal government's support of innovation through the SR&ED program has been cited as an important incentive in attracting more innovation investment to Canada. Large and small, global and national companies have all considered the program to be a positive factor in increasing their innovation investment. The survey shows that industry is looking for universal incentives and for more certainty so that the related funding can more readily be taken into consideration in investment decisions.

It is critical that R&D projects be reviewed in order to ensure that particular elements are not excluded from the SR&ED incentive regime by virtue of the new legislation. For example, understanding whether a cost item is a capital versus a current expenditure is essential. Similarly, contractual relationships must be reviewed to ensure that the related agreements optimize the underlying SR&ED tax credits. Additional ideas that could help to mitigate the impact of the proposed changes are included in our **July 11, 2012 R&D Tax Update**.

As previously mentioned, readers are invited to provide their **comments** for consideration in our upcoming submission to the Department of Finance.

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