



CATAAlliance Action Report:

(for consultation only, not for release)

Improving Access to Refundable Scientific Research & Experimental Development Investment Tax Credits

The CATAAlliance and Our Position on Current SR&ED Policy

The Canadian Advanced Technology Alliance (“CATAAlliance”) is the trade association that represents the Canadian high-tech industry. We have over 500 member companies, and a further 1,500 companies belong to associations that are affiliated with CATAAlliance. The majority of our members are in the information and communications technology industries. Members also include businesses in the aerospace, biotech and advanced manufacturing industries. Although the vast majority of our members are small and medium-sized enterprises our membership also includes foreign multinationals like IBM, Cisco, Ericsson, Alcatel, and the very largest companies including Nortel, Cognos and BCE Emergis. Most of the members are Canadian controlled companies.

Our members are the leaders of, breeders of, and the next generation of, the Knowledge Economy.

Our Philosophy:

The CATAAlliance believes in making investments tax credits (“ITCs”) for scientific research and experimental development (“SR&ED”) universally accessible to all Canadian entities, regardless of corporate status (i.e. equal access and equal treatment under tax legislation, at least for companies at similar stages). By increasing universal access to refundable SR&ED credits, the additional funding injected into the Canadian economy will ultimately result in increased and sustainable employment levels of knowledge workers in Canada. This in turn will lead to an increase in tax revenue from both the salaries earned by additional knowledge workers employed and from the profits that will result from the new SR&ED based products.

We believe that in order for SR&ED policy to be most effective in achieving its targets, the system for obtaining ITCs must be structured in a simple and predictable manner. Companies should not lose out on the ITCs merely due to the capricious nature of the rules for obtaining them. They should be able to understand them. Simplification of the system will not only help claimants, but will also save considerable time for CCRA by reducing confusion, eliminating regional disparity and decreasing the number of disputes to be addressed.

We also believe that it is essential that the success of SR&ED ITCs be evaluated not only in terms of the immediate creation of technology, but also in terms of their ability to help Canadian-based companies maintain that technology and the jobs of the knowledge workers they employ. Investments in SR&ED are long-term in nature, and it is important that programs that support these activities are effective throughout the entire economic cycle.

Finally, we believe that Canada's SR&ED policy should focus on providing the most effective tax regime and system of SR&ED ITCs. The tax regime should be the preferred method of administering government funding for innovation. We should strive for our system to be the best in the world from both a policy perspective and in respect to simplicity.

Background

ITCs for qualifying SR&ED come in two forms:

- non-refundable credits that are accessible to all entities; and
- refundable credits that are currently only available to a small subset of corporations.

This second category of ITCs provides a critical source of alternate financing to Canadian-controlled Private Corporations ("CCPCs") that meet all the rules for making those ITCs refundable. Refundable ITCs are especially effective in severe economic downturns, where SR&ED spending is relatively stagnant. Most assuredly, when available, they protect the jobs of knowledge-workers, protect Canadian-developed Intellectual Property, and protect the government's investment in the Knowledge Economy.

On the other hand, today's SR&ED ITC system is only marginally effective for those corporations in similar situations who do not qualify for refundable ITCs. Companies in this category include:

- publicly-controlled corporations;
- non-resident controlled corporations;
- a combination of the above; and
- certain CCPCs who are not eligible for full refundability due to restrictions on taxable income and taxable capital for the prior year, or by virtue of certain association rules.

Specifically, when ITCs are not fully refundable, they do not provide the critical assistance that these firms need to help them weather a sustained downturn like we are experiencing today. Instead, they are only available to these companies if they are taxable (i.e. the ITCs can only be applied to taxes owing). Although they can be carried forward for up to ten years, this often results in a pool of credits with no practical or immediate value for many stressed players in today's environment. We are continually

seeing public firms at the brink with significant unutilized ITCs due to their non-refundability. What is worse, these pools do become useful to prospective take-over corporations who operate in a similar line of business.

Non-refundable credits are also often of limited use to many foreign-owned, and particularly U.S.-owned, Canadian corporations, even when the Canadian entity is in profitable position. The investor is generally able to claim back the Canadian corporate income tax, payable by the Canadian company, in the form of a foreign tax credit against tax otherwise payable on the distributed earnings of the Canadian company. Because the SR&ED Investment Tax Credit reduces the Canadian corporate income taxes payable, this in turn reduces the foreign tax credits that are available to the investor, thereby increasing their local income tax liability. Consequently, the Investment Tax Credit provides no net benefit to the investor in determining total income taxes payable for all jurisdictions. We are aware of a number of instances where the value of the SR&ED Credits is ignored by a foreign parent company in making decisions relating to R&D investments in Canada. The introduction of a refundable program, or the offset of credits against a pre-income tax levy would resolve this issue.

Non-refundable ITCs make up around 70% of all ITCs claimed each year in a dollar sense.

Impact of the Current Legislation

In its current form, the legislation regarding SR&ED and ITCs is extremely complex and structured in a way that creates significant hardship for companies at all stages of evolution (e.g. early-stage/start-up corporations, mid-evolution corporations, and mature corporations).

- The complexity of the rules pertaining to eligibility for refundability even challenge accountants and lawyers who are unable to come to definite conclusions when charged with advising on matters of corporate structuring (e.g. current eligibility status; optimal structuring for future transactions).
- The legislation is out of sync with the business realities these companies face. It does not reflect recent and the most current market conditions as to available sources of funding, nor does it address companies' cash needs in periods of economic stress.
- The present program does little to encourage increased foreign direct investment from certain jurisdictions in R&D activities as the value of the tax credit is washed away on consolidation, and serves to increase the amount of tax payable in the investor's home country.

It is CATAAlliance's belief that the Department of Finance should make it a priority to address the problems of each group in this year's budget.

Early-Stage Corporations:

As capital financing is severely limited in economic downturns, early-stage companies are being forced to look beyond the capital markets for alternative sources of financing, including earmarking refundable ITCs for reinvestment in SR&ED.

One issue faced by some of these corporations is the complexity of the rules requiring associated corporations to share the expenditure limit when determining the amount of ITCs subject to the 35% enhanced rate on qualifying SR&ED (e.g. Canadian-controlled Private Corporations). These association rules severely diminish not only the total SR&ED ITCs earned by these companies, but in particular, the amount of refundable ITCs received. Quite often, a corporation will be caught by surprise and be unaware that what they believe to be an ideal corporate structure in fact causes them to lose a significant portion, if not all, of the refundable ITCs. As a result, the corporation is left with significantly less cash on hand than expected when audited. They do have a pool of non-refundable ITCs but they are only of value when the company is again taxable. Ironically, and most unfortunately, many start-up companies will fail to ever be taxable and the ITCs are only useful to those who take over the corporation.

One particular related concern is the definition of “arm’s length” as it applies to associated corporations. The current tax regime does not distinguish between:

- wholly owned subsidiaries of a single parent corporation that exerts obvious direct influence on those corporations and can manipulate its organizational structure to exploit potential tax laws; and,
- corporations that are associated merely by virtue of a common venture capital financier.

Consequently, corporations who are otherwise dealing at arm’s length from one another – and may not even know the other exists – (i.e. the latter group) are forced to share the expenditure limit and therefore receive a much lower refundable SR&ED ITC than it would otherwise receive.

A second group of early-stage corporations who suffer by not having access to refundable ITCs are those who are primarily Canadian-owned (e.g. can often be > 90%), yet have been required by their U.S. (or other foreign-based) venture capitalists to establish “head offices” outside of Canada (e.g. incorporate in Delaware). For example, this may be because a U.S. financier is a Limited Liability Corporation (therefore not protected under the current tax treaty) or due to the strenuous filing requirements upon the sale of a Canadian corporation by a foreign corporation (s.116 Certificates). Although the R&D work is totally performed, and their workforce totally employed, in Canada, these corporations do not qualify for refundable ITCs on the basis that they are not Canadian corporations. These defacto Canadian Corporations often fall offside only due to a lack of adequate financial support, from Canadian venture capitalists or angel investors, which forces them to seek cross-border financing. This phenomenon has been well documented and is further evidence that the current legislation does not reflect the current business realities faced by Canadian businesses.

A similar group includes CCPCs who have entered into a reverse takeover transaction, whereby the shareholders of a Canadian corporation exchange their shares with those of a foreign public shell corporation. The aim of such a transaction is to provide the Canadian corporation with a public listing. These transactions are typically done on the NASDAQ exchange. Although the shares of the Canadian corporation are now owned entirely by the foreign shell company, ultimate control still rests with the original Canadian shareholders. Although the change in control is merely cosmetic, the current tax legislation causes the Canadian company to lose its status as a CCPC, and consequently its access to refundable ITCs.

A further group consists of young corporations who opted to go public almost from inception, lured by the once overflowing coffers of the equity markets. With further investment dollars not as readily available, many of these firms are being forced to curtail, if not cease, their SR&ED initiatives unless they can secure alternate sources of funding. Unfortunately, they do not qualify for refundable ITCs as a result of being public companies and face extreme difficulties in the current turbulent times, deprived of the assistance that the refundable ITCs could otherwise provide

These corporations are the incubators of our next generation of competitive products.

Mid-Evolution Corporations:

Although the fundamental issue remains the same among companies at all growth stages, mid-growth corporations that are not eligible for refundable ITCs face their own somewhat unique set of challenges.

Specifically, many of these companies are at risk of “hitting the wall” in terms of SR&ED spending, due primarily to high cash-burn levels and the difficulties in accessing additional capital freely in today’s open markets and economic climate. If these corporations fail to find alternative means to finance their SR&ED budget, they run the risk of permanently hindering their prospects for future evolution (e.g. loss of key talent, delays in performing – and therefore benefiting from – SR&ED). Consequently, these corporations become prime targets for corporate takeovers. This creates a further risk that the non-refundable ITCs could be lost entirely if the company is amalgamated or wound up into the purchaser.

One associated risk is that Intellectual Property developed within Canada can flow outside of the country without any commensurate creation or maintenance of employment within Canada. This can occur in two ways: (1) rights to the IP are transferred outside Canada, and/or (2) the related knowledge workers leave Canada. Furthermore, this second scenario could result in a talent squeeze similar to what was experienced only a few short years ago.

Mature Corporations:

In the wake of investor wariness, even large and/or established corporations are being forced to look elsewhere for secondary sources of financing. For many, having access to refundable ITCs in periods of economic downturn would provide much needed bridge financing to see them through the rough patches in-between periods of profitability.

The federal government's philosophy was to make the ITCs non-refundable in order to encourage larger corporations to push more strongly for sales and profitability. The government's economic strategy is now shifting to a focus on developing and sustaining a highly competitive Knowledge Economy. This recognizes the benefits of SR&ED, which include increased economic activity and knowledge gains and transfers between organizations. Removing the present barriers and allowing companies to effectively utilize the SR&ED program will result in sustained, high value, knowledge employment and increased industrial SR&ED activities by current performers. It will also significantly increase Canada's global competitiveness in terms of encouraging foreign direct investment in SR&ED and Canada's Knowledge Economy. Consequently, the government's philosophy may need to be revisited and possibly revised. Sustaining knowledge employment in good and lean times is simply essential to the advancement of Canada's Innovation Strategy.

These corporations form the backbone of our current generation of competitive prowess. Along with the early-stage and mid-evolution corporations, they set the pace for Canada's future SR&ED competitiveness in the world's knowledge-based economies. Here knowledge and leading edge technologies will provide companies and economies with the edge to compete in world markets.

Our Comments

The federal government has made a strong commitment to the growth of the Knowledge Economy. This is a key platform of "Canada's Innovation Strategy" initiative. As evidenced by the countless surveys produced on the topic, CATAAlliance believes that ITCs are the most desirable and effective medium for fostering such innovation. Certainly, the usefulness and importance of the SR&ED ITCs is being more and more recognized by governments in other nations, who are striving to create more sophisticated and effective instruments for spurring growth via innovation. This alone should motivate the Canadian government to rise to the challenge and ensure that they are not defeated at their own game.

The CATAAlliance argues that the issue around SR&ED ITCs is not just how to promote innovation, but rather how to create a sustainable innovative knowledge economy, protect jobs of knowledge workers, maximize the leverage of locally developed intellectual property, and consequently protect Canada's own investment in the Knowledge Economy.

We have worked with both government and CCRA before on SR&ED-related matters and some great changes have occurred (e.g. the complete turnaround in the way the SR&ED program is being administered). However, we find that too many companies are falling through the cracks in part because of the sheer complexity of today's system. This is further exemplified by the number of eligible companies that simply cease claiming SR&ED tax credits. This problem has to be rectified.

As well, what needs to be acknowledged is these ITCs are not all that they are purported to be, especially in the current economic environment. That is to say that in non-refundable form they provide too limited accessibility. On behalf of its membership, the CATAAlliance strongly encourages the Minister of Finance and his colleagues to reflect on our contention that Canada's SR&ED policies should aim to:

- support companies equally in both good and bad times,
- provide a level playing field for all companies at a similar growth stage, regardless of foreign or public ownership and regardless of association with other Canadian corporations; and
- provide for the sustained employment of Knowledge Workers.

The CATAAlliance cannot stress enough the importance of responding quickly and swiftly to correct the potentially disastrous effects that current SR&ED policy could have on innovation and growth and on Canada's future.

Companies currently engaged in SR&ED form the backbone for which Canada's innovation agenda will be achieved. This is true regardless of ownership and organizational structures.

The consequences of failing to act now are clear and, we believe, severe. An exponential increase in the number of corporate failures resulting from their inability to finance future SR&ED, coupled with a mass exodus to more SR&ED-favourable tax jurisdictions will undoubtedly jeopardize the opportunity to improve the standard of living for all people living in Canada.

Treatment of Accessibility in Other Jurisdictions and Their Policy Implementations

One source of guidance on how to improve Canadian SR&ED policy is the treatment of accessibility in other countries that are, or are aiming to be, at the forefront of SR&ED. Two such countries are the United Kingdom and France. Highlights of their treatment are summarized in Appendix A. Appendix B summarizes the treatment of accessibility in other tax jurisdictions.

Recommendations

The CATAAlliance's primary recommendations are:

1. for the government to simplify the legislation so that it provides equitable treatment for all businesses, and to let firms access their ITCs at all times if they are:
 - Canadian public corporations;
 - Foreign-controlled corporations who perform SR&ED through a permanent establishment in Canada and meet certain established criteria (e.g. when both the SR&ED work is performed and the workforce is employed all or substantially all in Canada); or
 - Any combination of the above; and
2. for the government to provide all CCPCs access to their ITCs at all times by:
 - eliminating the rules which deny CCPCs access to refundable credits where such CCPCs have taxable income in their previous taxation year in excess of their business limit;
 - making all ITCs 100% refundable by:
 - increasing the rate of refundability of ITCs earned above the expenditure limit from 40% to 100%; and
 - increasing the rate of refundability for SR&ED capital expenditures from 40% to 100%;
 - eliminating the \$15 million taxable capital limit and the \$400 thousand taxable income limit which reduce CCPCs' access to full ITC refundability on its first \$2 million of qualifying SR&ED expenditures.

Our preference is for the Government to make all ITCs that cannot be applied against taxes owing refundable in the year they are earned and that the legislation be simplified so it works effectively for all.

There are numerous other possible mechanisms for improving access to SR&ED ITCs that are being used or explored in other jurisdictions. The CATAAlliance suggests the following to see that the ITCs are fully accessible, should full refundability not be an acceptable solution (we have ranked these in order of preference):

- Remove the association rules requiring loosely associated corporations to share the expenditure limit for qualifying SR&ED expenditures (i.e. make the enhanced 35% rate available to each associated company on its first \$2 million of qualified expenditures) in order to increase the total refundable ITCs available to these corporations.

This will necessitate developing a more appropriate and clear distinction between:

- companies that have been set up by a parent corporation merely to take advantage of an additional \$2 million expenditure limit; and
- companies that have common VC ownership, but whose mind and management are clearly distinct from one another.

The CATAAlliance believes that the following must be done if universal refundability is unacceptable.

- Permit companies to apply their unused SR&ED ITCs to balances owing to the federal government in respect of:
 - Employment-related source deductions (e.g. CPP and EI remittances)
 - Goods & Services Tax remittances
 - Government loans; and
 - Other federal remittances.

To provide benefits to the broadest audience possible, the application of the credits must not be limited to only one form of tax remittance/obligation. This would skew the benefit to a particular group, which is unfair and unacceptable. The solution would then only be cosmetic.

The CATAAlliance does not recommend that ITCs be offset against federal large corporations tax (capital tax) payable. Likewise, CATAAlliance does not believe that it is appropriate to have taxable capital/capital tax as a criterion in determining a company's SR&ED expenditure limit in a tax year. The reasons for this are twofold:

- 1. the federal capital tax is absolutely not a large enough balance to offset the ITCs against; and**
- 2. the CATAAlliance strongly believes that the federal government should abolish federal capital tax altogether and has already tabled this recommendation.**

- Allow corporations who have not been taxable for a prescribed period of time to receive full cash refund of their unused ITCs. In France, the prescribed period is 3 years.
- As a means of providing partial refundability, allow all corporations to receive a refundable ITC at a prescribed percentage of qualifying SR&ED labour expenditures (e.g. Federal R&D Wage Credit, similar to the Quebec R&D Wage Credit). The net cost of such a program would be minimal given that the provinces might match such an incentive. The additional tax revenue generated from any additional SR&ED employees would also serve to mitigate the costs of the program

Concluding Statements

As part of Canada's Innovation Strategy, the federal government has set a goal to see Canada rank among the top five countries in the world in terms of SR&ED performance by 2010. Canada is currently ranked as 14th in the world.

The Innovation Strategy also targets the following goals:

- by 2010, at least double the Government of Canada's current investments in R&D;
- by 2010 rank among world leaders in the share of private sector sales attributable to new innovations;
- by 2010, develop at least 10 internationally recognized technology clusters;
- by 2010, significantly improve the innovation performance of communities across Canada;
- ensure the business regime continues to be competitive with those of other G-7 countries; and
- by 2005, substantially improve Canada's ranking in international investment intention surveys.

The CATAAlliance fully supports this initiative, and firmly believes that only by addressing the issues above will the federal government achieve its targets.

Explicitly, the CATAAlliance believes that improving the accessibility of the refundable SR&ED ITCs will be critical to achieving the technology leadership that the government is anticipating to result in Canadian jobs under the goals of Canada's Innovation Agenda. The **Kyoto** accord will result in further environmental spending which would also be eligible for SR&ED and any improvements to the SR&ED ITCs would improve funding for environmental technologies.

Finally, it is important to note that the full community supports the need for improvement in the SR&ED system. Organizations such as the Ottawa-Carlton Research Institute ("OCRI") and the Information Technology Association of Canada ("ITAC") are equally supportive of extending the base of refundable tax credits to all Canadian corporations and recognize the need for this issue to be immediately addressed.

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Appendix A

Summary of SR&ED Policy in Other Nations in Respect of Refundable Credits

United Kingdom:

Qualifying small and medium-sized enterprises (SME) in the United Kingdom can increase the amount that they deduct for qualifying current R&D expenditures by a further 50%. This credit is referred to as R&D Tax Relief. Recent legislation has served to provide this relief to large corporations as well, but only on 25% of qualifying R&D expenditures.

The R&D tax credit scheme in the UK also allows SMEs that are not profitable to surrender their qualifying R&D losses to the Exchequer in exchange for a cash refund, worth up to 24% of their actual spending on qualifying R&D, subject to limits on the maximum "surrenderable loss". In addition, the refund cannot exceed the total amount payable in the tax year in respect of certain employment-related source deductions.

It should be noted that the United Kingdom is not at the forefront of R&D spending. Similar to Canada, it continually lags other countries such as the United States, France, Germany and Japan in terms of GDP devoted to R&D expenditures.

France:

Companies eligible for R&D credits in France may use the credits to offset their corporation tax liability in the year the expenditures were occurred, or in the following three years. If a company is unable to use any part of the credit (i.e. is not taxable) by the end of the three-year period, the Treasury refunds all unused credits. In the alternative, during the three-year period, a company may transfer the credit to a bank, enabling them a refund of the credit, subject to an administration fee from the bank.

The current tax regime in effect until 2003, but is expected to continue (as per past history). It should also be noted that the credits are calculated based on incremental R&D (e.g. the increase in R&D expenditures in a given year over the average of the R&D expenditures from the prior 2 years) and is capped at 6.1 million Euros.

Please note that the French system clearly has its limitations, and there are aspects of it that CATAAlliance does not want to emulate. Specifically, a very strong disadvantage of the France System is that it is based on incremental R&D spending. The CATAAlliance is not recommending a shift to a system based on incremental R&D spending (e.g. most companies are reducing, not increasing, their SR&ED spending in the current economic environment), nor are we recommending a cap on qualifying SR&ED expenditures.

Appendix B

Summary of SR&ED Policy in Other Jurisdictions in Respect of Refundable Credits

New Brunswick:

In its 2003-2004 budget, the province of New Brunswick proposes to increase its R&D tax credit from 10% to 15% of eligible expenditures incurred on or after January 1st, 2003 and to make the credit fully refundable. The amount of the refund is calculated as the credit in excess of tax otherwise payable.

The New Brunswick government recognizes that “many businesses, including smaller businesses involved in SR&ED do not have taxable income and therefore cannot take full advantage of a non-refundable tax credit. These businesses sometimes have cash flow challenges and often do not earn taxable income in the first few years of operation. The new refundable tax credit will help fund their research activity”.

Quebec:

The province of Quebec offers a refundable R&D Wage Tax Credit to companies for wages paid to employees of companies with a permanent establishment in that jurisdiction. The credit is available to both Canadian Controlled Private Corporations (40%) and other Canadian corporations (20%) on a maximum of \$2 million in qualifying expenditures.

Quebec also offers a refundable tax credit (32%) for contract and other payments to certain eligible entities, including prescribed universities, public research centers and private research consortiums. The credit also applies in respect of pre-competitive research projects and environmental technology innovation projects.

Other Jurisdictions:

In other jurisdictions, such as New Jersey, companies have the option to sell their unused non-refundable credits to other corporations within that jurisdiction. It is possible that such a program could work in Canada (e.g. subject to an ordering of use of the credits – must apply to taxes payable first).