

Do Your Research and Development In Canada ... It Pays Off!

Innovation, entrepreneurship and a dynamic economy are on Canada's mind. To prove it, Canada has one of the most favourable tax treatments for scientific research and experimental development (SR&ED) expenditures in the world.

Canada's SR&ED Program

Canada's SR&ED tax incentive program is the largest R&D program aimed at the private sector. The SR&ED program is delivered through the *tax system* and not through budgetary appropriations. Thus there is no pre-determined budget for the SR&ED program because it depends on the value of tax credits earned by the companies in Canada. **All companies based** in Canada that invest in R&D can qualify, irrespective of their size, industry sector or technology area they represent – as long as they perform qualified R&D.

The benefits of doing SR&ED in Canada are numerous. Generally, in addition to tax deductions for SR&ED expenditures, a tax credit is also available based on qualifying SR&ED expenditures carried out in Canada.

For large Canadian corporations and foreign controlled corporations, regardless of size or whether they are public or private, the rate of the tax credit is 20% and the credit is non-refundable. A non-refundable tax credit can be used to offset Canadian federal taxes payable in the current year, in the previous three years, and/or in the next 20 years. There are no limits on R&D expenditures, taxable income or taxable capital for companies claiming the 20% tax credit rate. (See Table 1)

On the other hand, small Canadian-controlled private corporations (CCPCs), with taxable income of up to \$400,000 and taxable capital of up to \$10 million, can receive a refundable tax credit of 35% of qualifying current and capital SR&ED expenditures, to a maximum of \$3 million of expenditures per year. Over the \$3 million SR&ED expenditure threshold, the credit rate is reduced to 20%, of which 40% may be refundable. A refundable tax credit represents a reinjection of cash back into a company, which in turn can be used for sustaining future SR&ED activities. The potential exceeds \$1,050,000 of federal tax refund per year.

To top all of this off, various provinces have their own additional tax incentive programs for SR&ED activities carried out in their respective provinces. (See Table 2)

Two alternatives are available in calculating qualifying SR&ED expenditures. The traditional method allows specific identification of direct and overhead SR&ED expenditures. The proxy method alleviates the burden of identifying actual SR&ED overhead costs by allowing a proxy amount for overhead expenditures to be calculated based on a maximum of 65% of direct SR&ED salaries and wages.

Other benefits of carrying out SR&ED activities in Canada include use access to a world-class infrastructure, including universities and research centres, a superior workforce, easy access to markets, protection and retention of intellectual property, and lower overall business costs.

How can foreign companies qualify for the Canadian SR&ED tax benefits?

(a) Through a Canadian subsidiary of a foreign parent

The Canadian subsidiary can carry out qualifying SR&ED activities in Canada and, through deducting the expenditures and claiming the 20% tax credit, the subsidiary can significantly reduce or even eliminate Canadian taxes payable.

The foreign parent can contract the Canadian subsidiary to carry out the SR&ED activities on their behalf, in which case the foreign parent will own the rights to the SR&ED, and the Canadian subsidiary can still make use of the SR&ED tax incentive program.

(b) Through a Canadian-controlled private corporation

A foreign corporation can set up a CCPC in Canada as long as it owns 50% or less of the company's shares and the shares do not have any special rights attached to them. Traditionally, non-residents set up CCPCs in Canada by having a Canadian investor such as a venture-capital firm or research institution hold the remaining shares.

Eligible criteria and activities

For the purpose of the tax program, SR&ED is defined as “*systematic investigation or search carried out in a field of science or technology by the means of experiment or analysis.*” Claimants can carry out the SR&ED in-house or contract it to a third party to be done on their behalf.

Eligible activities include experimental development, applied research, basic research, and support work. Activities not eligible for benefits under the SR&ED program include research in the social sciences or humanities; commercial production of a new or improved material, device or product; the commercial use of a new or improved process; style changes; market research or sales promotion; quality control or routine testing of materials, devices, products or processes; routine data collection; and prospecting, exploring, or drilling for or producing minerals, petroleum or natural gas.

Up to 10% of R&D wages and salaries of Canadian-resident employees incurred abroad by a Canadian-based company are also eligible. The activities outside Canada must be in support of SR&ED carried on in Canada directly by the company.

For more information on eligible activities, please contact the Canada Revenue Agency (CRA) to ensure that you can qualify for the program. The CRA offers up-front review and preliminary opinion on the eligibility of projects for the SR&ED program.

Table 1: Illustration of the federal SR&ED program on \$5 million of qualified current SR&ED expenditures (all figures in C\$) (Note that doing SR&ED in a province with its own R&D tax incentive program will considerably increase the amounts shown here):

	Small Canadian-controlled Private Corporations				Large Canadian or Foreign-controlled Corporations			
	Credit Rate	% Refund	Refundable Tax Credit (Cash Back)	Non-Refundable Tax Credit (Reduce Taxes)	Credit Rate	% Refund	Refundable Tax Credit (Cash Back)	Non-Refundable Tax Credit (Reduce Taxes)
First \$3 million in SR&ED expenditures	35%	100%	\$1,050,000	–	20%	–	–	\$600,000
Remaining \$2 million in SR&ED expenditures	20%	40%	\$160,000	\$240,000	20%	–	–	\$400,000
Total			\$1,210,000	\$240,000			–	\$1,000,000

Table 2: Combined Provincial and Federal SR&ED tax credits

	Large Canadian or Foreign-controlled Corporations					Combined Credit Rate ¹
	Provincial Credit		Federal Credit			
	Rate	Refund?	Rate	Refund?		
Alberta	10%	Yes	20%	No	28%	
British Columbia	10%	No	20%	No	28%	
Manitoba	20%	No	20%	No	36%	
New Brunswick	15%	Yes	20%	No	32%	
Newfoundland	15%	Yes	20%	No	32%	
Nova Scotia	15%	Yes	20%	No	32%	
Ontario ²	4.5% + 10% for small companies	No	20%	No	23.6% + 8% for small companies	
Prince Edward Island	–	–	20%	No	20%	
Quebec ³	17.5%	Yes	20%	No	34%	
Saskatchewan	15%	No	20%	No	32%	

¹ In calculating the combined credit, the federal tax credit is reduced by the provincial tax credit receivable.

² Ontario R&D Tax Credit of 4.5% is available as of January 1, 2009. Ontario Innovation Tax Credit of 10% is applicable to small public or foreign controlled corporations.

³ In Quebec, only R&D wages are eligible for R&D tax credits, not materials, equipment or overhead.

Additional information on Canada's SR&ED

- Canada Revenue Agency's SR&ED website:
<http://www.cra-arc.gc.ca/txcrdt/sred-rsde/menu-eng.html>
- CRA, *An introduction to the Scientific Research and Experimental Development Program*:
<http://www.cra-arc.gc.ca/E/pub/tg/t4052/t4052-07e.pdf>
- For recent changes to the SR&ED program, see:
www.budget.gc.ca/2008/plan/ann4a-eng.html#business