



Overview of the Federal Scientific Research and Experimental Development Investment Tax Credit Program

KPMG ENTERPRISE

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Contents

Overview of the SR&ED program

Categories of SR&ED

SR&ED technical criteria

Qualifying expenditures

In Canada requirement

Changes to the SR&ED program

Provincial R&D tax credits

How to recognize SR&ED

SR&ED contacts



Overview of the SR&ED Program

- **Scientific Research and Experimental Development (“SR&ED”) is the term used by Canada Revenue Agency (CRA) for Research & Development (“R&D”)**
 - Program is delivered through the tax system rather than a direct government grant
 - The program is designed to encourage SR&ED in Canada
 - It is also intended to attract foreign investment in SR&ED in Canada
- **To encourage Research, Development and Innovation in Canada and promote the knowledge economy.**
 - Is one of the world’s most lucrative R&D tax incentives program
 - Single largest Federal innovation funding source with over 18K claimants receiving approximately \$4.0 Billion per year

Overview of the SR&ED Program

▪ **Current Tax Incentives**

- Tax Deductions

- SR&ED is a deductible business expense for tax purposes
- Includes both current and capital expenditures on SR&ED

▪ **Investment tax credits (ITC's)**

- Corporations earn ITC's at either the 20% or 35% rate on qualified expenditures
- ITC's are used to reduce taxes payable
- Can be carried over and applied against other year's taxes payable (3 yrs back and 20 yrs forward)
- Most provinces provide additional incentives – Refundable 10% OITC in Ontario as well as non-refundable ITC of 4.5%

Overview of the SR&ED Program

- **What qualifies**
 - Technology advancement and research, with or without a specific practical application
 - Does not need to be “Rocket Science” and/or result in a “successful” outcome to qualify
- **How to Identify SR&ED eligible projects/activities**
 - Areas where projects hit roadblocks or unexpected challenges

Categories of SR&ED

Basic Research

Advances in scientific knowledge *without* a specific practical application in view

Applied Research

Advances in scientific knowledge with a specific practical application in view

Experimental Development

Work done to achieve technological advancement to create, or improve, new materials, devices, products or processes

Support Work

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Support Work

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Support Work

Categories of SR&ED

Basic Research

Applied Research

Experimental Development

Support Work

- Engineering
- Design
- Operations Research
- Testing
- Mathematical Analysis
- Computer Programming
- Data Collection
- Psychological Research

Categories of SR&ED - Shop Floor SR&ED

- Involves developing new or improved materials, devices, products or processes in a commercial facility or on the “shop floor”
- Employees on the “shop floor” *directly engaged* in resolving or *supporting* the resolution of technological obstacles of the project (Machine / Line operators, Maintenance personnel, Electricians, Test Lab personnel, Millwrights, QA Group, Continuous Improvement / Kaizen Group, etc.)
- Eligible supporting activities related to experimental development
 - Engineering / Design;
 - Computer Programming;
 - Operations Research; and
 - Testing / Data Collection / Analysis

SR&ED technical criteria

Activities/projects generally must exhibit:

1. Technological Uncertainty (Obstacles)

- Whether a given result or objective can be achieved, or how to achieve it, is uncertain or cannot be determined based on current and generally available scientific or technological knowledge and experience
- Taking base-level technology (product/process) to the next level
- Solution not publicly available

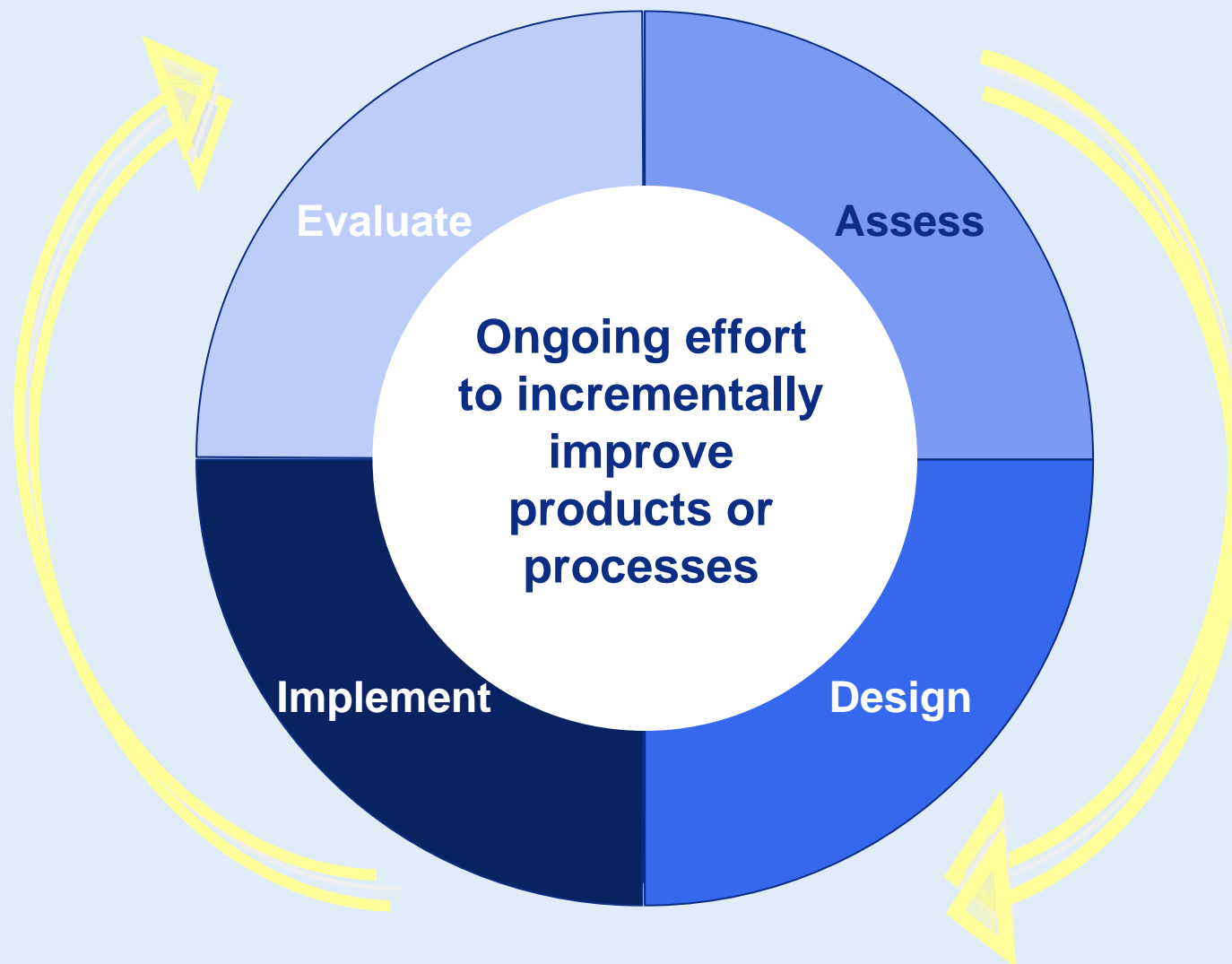
2. Technological Advancement

- Advances the understanding of scientific relations or technologies

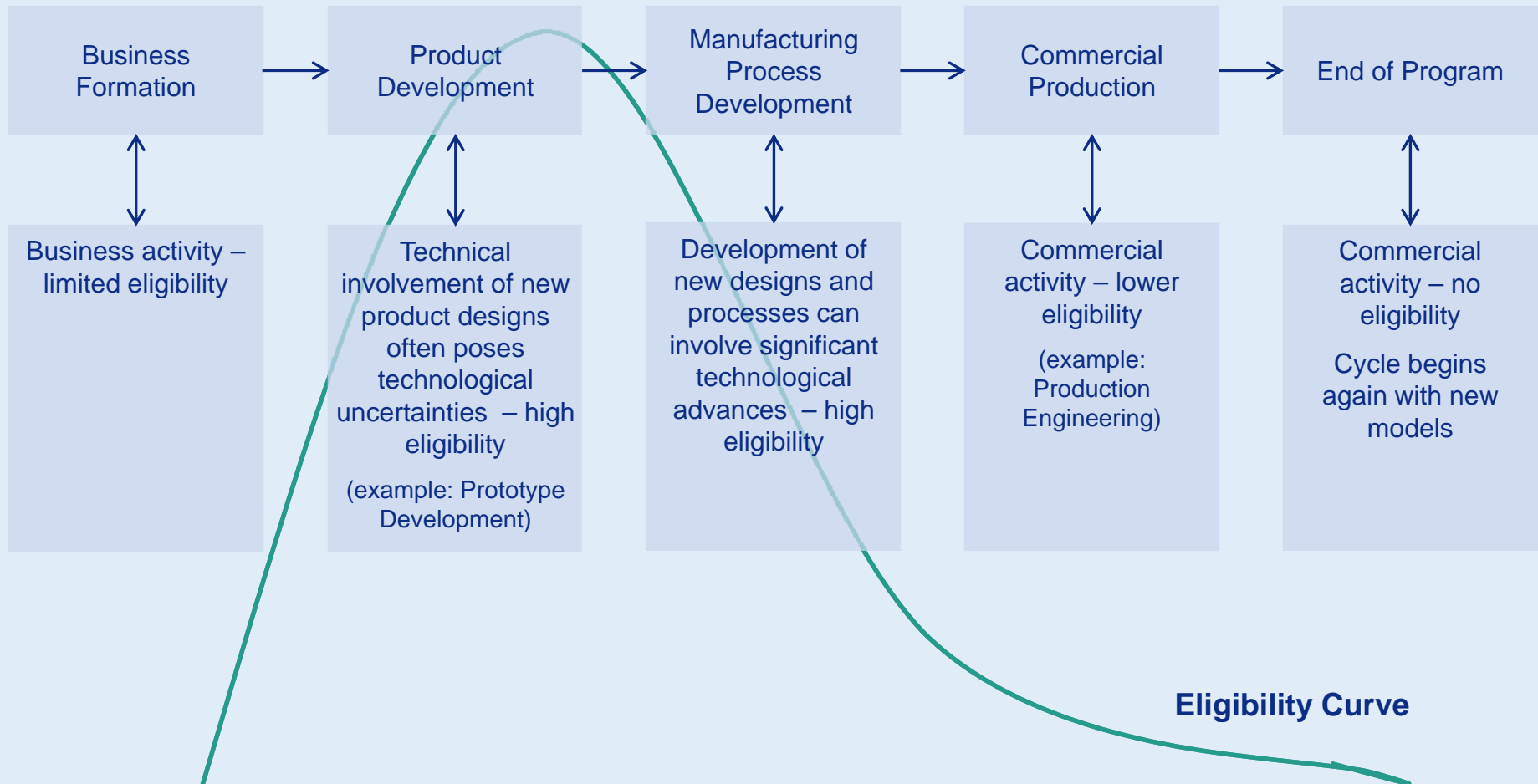
3. Scientific and Technical Content

- Systematic investigation through experiment or analysis
- Includes “Shop Floor” SR&ED
- Supporting Documentation

R&D – Four Phase Process



R&D Life Cycle



Qualifying expenditures

Labor Directly engaged in experimentation/testing to develop technological knowledge.	Contracts Testing, engineering, programming contracts by outside companies (within your country) supporting the resolution of technological obstacles.	Overhead Incremental and directly related expenditures such as supplies, heat, water, training etc. (Traditional vs. Proxy)
Materials Materials needed to conduct testing for a particular project.	Capital Equipment purchased for sole use in R&D projects.	Third Party Payments Payments to universities, colleges, research labs and other consortia

Qualifying expenditures – overhead costing methods

- **Proxy Method vs. Non-Proxy (Traditional) Method For Overhead calculation**
 - Elective but cannot be changed within a single year
 - Proxy calculates overhead as 65% of qualifying salaries and wages
 - Overhead (office supplies, utilities, travel and training, property taxes, support staff and indirect management, ...etc.)
 - Traditional overhead computation requires detailed tracking of incremental overhead expenditures which may be difficult to track especially in a manufacturing environment

“In Canada” requirement

- **“In Canada” Requirement**

- To qualify for ITC's, expenditures must be incurred in respect of SR&ED carried on “in Canada”
- In some cases qualifying activities carried on outside of Canada qualify for program benefits where those activities are an essential part of a Canadian-based project and could not have been performed in Canada.
- Federal 2008 Budget introduced some legislative changes that provide for these exceptions

Changes to the SR&ED program

Rebalancing of R&D funding from tax incentives to direct support:

\$1.3 billion redirected from Flagship SR&ED program, mainly to direct support programs, over the next 5 years

\$1.1B for direct R&D support for various new or existing programs such as:

- \$110M increase to IRAP in each of the next five years
- \$67M National Research Council
- \$500M for venture capital initiatives

Changes to the SR&ED program

Reduction of general tax credit rate:

- The general SR&ED investment tax credit rate will be reduced from 20% to 15%.
- Effective January 1, 2014
- Rate unchanged for CCPC's eligible for 35% refundable ITC rate (for now)

Capital expenditures:

- Remove capital expenditures from the base of eligible expenditures for expenditures incurred in 2014 and subsequent years. All other expenditures such as salary and wages, materials, overhead expenses and contract payments remain eligible;

Proxy Overhead Calculation

- Reduce the prescribed proxy amount from 65% to 60% (2013) to 55% (2014) of direct labour costs

Arm's Length Contract Payments

- Only 80% of the contract payments to be used for purposes of calculating the SR&ED tax credits effective January 1, 2013

Impact of changes on General Tax Rate Calculation

		Current	After 1/1/2014
		General Federal Rate 20% No OITC	General Federal Rate 15% No OITC
Labour	L	\$ 100,000	\$ 100,000
Proxy (overhead allocation)	P	\$ 65,000	\$ 55,000
Contract Payments	CP	\$ 10,000	\$ 8,000
SR&ED Expenditure Pool	A = L + P + CP	\$ 175,000	\$ 163,000
OITC (10%)	B=A* 10%	\$ -	\$ -
Qualified SR&ED expenditures for Federal ITC	C=A-B	\$ 175,000	\$ 163,000
Credit Rate		20%	15%
Federal ITC (35% or 20%)	D=C* Rate	\$ 33,425	\$ 23,350
Ontario research and development credit (4.5%)	E= (A-B)* 4.5%	\$ 7,875	\$ 7,335
Total SR&ED Benefits	F=B+D+E	\$ 41,300	\$ 30,685
			- 26%

Impact of changes on Enhanced Tax Rate Calculation

		Current	After 1/1/2014
		Enhanced Rate 35% OITC 10%	Enhanced Rate 35% OITC 10%
Labour	L	\$ 100,000	\$ 100,000
Proxy (overhead allocation)	P	\$ 65,000	\$ 55,000
Contract Payments	CP	\$ 10,000	\$ 8,000
SR&ED Expenditure Pool	A = L + P + CP	\$ 175,000	\$ 163,000
OITC (10%)	B=A* 10%	\$ 17,500	\$ 16,300
Qualified SR&ED expenditures for Federal ITC	C=A-B	\$ 157,000	\$ 146,700
Credit Rate		35%	35%
Federal ITC (35% or 20%)	D=C* Rate	\$ 52,644	\$ 49,034
Ontario research and development credit (4.5%)	E= (A-B)* 4.5%	\$ 7,088	\$ 6,602
Total SR&ED Benefits	F=B+D+E	\$ 77,232	\$ 71,936
			- 7%

Changes to the SR&ED program

Enhance Predictability – The government will spend \$6M over the next two years to implement changes to the administration of the program through the following measures:

- Have CRA conduct a pilot project to determine the feasibility of a formal pre-approval process;
- Enhance the existing online self-assessment eligibility tool;
- Work collaboratively with industry representatives to address emerging issues;
- Make more frequent and effective use of “tax alerts”
- Improve the Notice of Objection process to allow for a second review of scientific eligibility determination.

The above initiatives complement the SR&ED Policy Review Project currently underway, which will consolidate and clarify the administrative policies that are contained in about 70 documents pertaining to the SR&ED tax incentive program.

Provincial R&D tax credits

- **Provincial R&D tax credits (ROC) - several provinces offer tax credits to eligible entities**
 - British Columbia : 10% Refundable/non-Refundable
 - Saskatchewan : 15% Non Refundable
 - Alberta : 10% Refundable
 - Manitoba : 20% Non Refundable
 - Ontario : 10% Refundable and 4.5% non-refundable
 - New Brunswick : 15% Refundable
 - Nova Scotia : 15% Refundable
 - Newfoundland : 15% Refundable
 - Quebec : 17% to 37.5% fully refundable

How to Recognize SR&ED

SR&ED Tax Credits are possible if the answer is “yes” to one or more of the following:

- Do you employ engineers or scientists?
- Are your products technology-centric or based on emerging or rapidly changing technologies?
- Is time being spent developing new ways of doing things?
- Is time being spent adapting processes before saleable products/services go out?
- Do your products go through rapid, constantly changing development cycles?
- Are there projects that failed for technical reasons?
- Are there projects with significant cost over-runs?
- Are software or technical consultants involved?
- Is money invested to develop better products or faster processes?
- Is shop floor experimentation being performed?
- Are significant amounts of scrap being generated?
- Are there patents involved?
- Has other government funding (e.g. IRAP) been received?



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