Are big changes ahead for SR&ED?

This past October, two reports were released that may well lead to some major changes in Canada's incentive programs for scientific research and experimental development. While the extent to which the federal government will implement the recommendations remains to be seen, SR&ED tax credits could be in for a major overhaul. One of the reports wants to see these credits eliminated altogether, at least at the provincial level.

These two reports come from two quite different sources. Canada's Innovation Underperformance: Whose Policy Problem Is It? was published on October 14 by the University of Toronto's Mowat Institute. And Innovation Canada: A Call to Action was released on October 17 by the federal government-appointed Independent Panel on Federal Support to Research and Development, headed by Thomas Jenkins, executive chairman and chief strategy officer of OpenText Corp.

Although the Mowat document is somewhat more severe in its criticism, both reports argue for reduced use of R&D tax credits as an innovation funding mechanism and recommend the use of so-called "direct funding" instead. In this context, direct funding generally means either grants or contingent-repayable loans that are arranged between government and industry for a specific project, before any work has begun on it.

Of the two, the Jenkins panel report is most likely to influence government policy since it was commissioned by Ottawa specifically for this purpose. The Mowat document will more likely be regarded as a supporting piece for any policy changes against tax credits, although federal legislators could counterbalance it with the recommendations in yet a third report called Rewarding Innovation: Improving Federal Tax Support for Business R&D in Canada, published by the C.D. Howe Institute in September 2011. That report concluded that "the SR&ED tax incentive program has generated a narrow net benefit to Canada."

How SR&ED tax credits could change

While SR&ED features in only one of the Jenkins panel's six recommendations, the body of the report contains a number of SR&ED-related corollaries. As written, these should apply only to Canadian-controlled private corporations (CCPC), but it's easy to see at least some of them being extended to corporations of all sizes at some point. Here is a synopsis:

- Reduce spending on SR&ED tax credits and use the savings to pay for direct funding programs focused on the needs of innovative Canadian firms — especially small and medium-sized enterprises. The report argues that the high rate (35%) of refundable benefit currently available to CCPCs is excessive. There is an implication that the 35% CCPC rate should be reduced to the 20% rate available to other corporations.
- For CCPCs, SR&ED benefits should be allowed only for labour expenditures and overhead.
- CCPCs should receive a cash-refundable SR&ED benefit for a limited time; the benefit would then revert entirely or partially to a non-refundable investment tax credit.
- Provide temporary cash-refundable SR&ED tax credits to all small startup companies as well. The funding would be available only for a limited number of years after startup.
- The existing 65% proxy allowance for overhead may be too high. The Canadian government should review this figure in light of actual overhead costs for R&D operations and adjust it to a more realistic figure as necessary. (The provisions of the proxy cap in the existing legislation, i.e., the lesser of 65% or actual, were not noted.)
- Review the government's anti-stacking policy to ensure R&D projects are not "oversubsidized." The existing policy typically limits maximum government contribution to between 75% and 100% of the costs incurred. The panel argues that 75% may be too high.

Both the Mowat and Jenkins reports favour direct SR&ED funding though grants and loans

The nature of the SR&ED changes recommended by the panel caught many by surprise as they seem to be somewhat at odds with a number of the 228 stakeholder submissions published on the panel's website. Almost all these submissions were positive about tax credits. While many criticized the CRA's administration of the SR&ED program, the consensus among the majority was that the program should be fixed, not replaced. The single most-repeated request was that all corporations (not just small private corporations) be eligible for cash-refundable SR&ED benefits.

For those experienced in SR&ED, the report contains a puzzling statement on page E-3: "The current base, which is wider than that used by many other countries, includes non-labour costs, such as materials and capital equipment, the calculation of which can be highly complex. This complexity results in excessive compliance costs for claimants and dissipates a portion of the program's benefit in fees for third-party consultants hired to prepare claims."

For most taxpayers, the central issue is not how to calculate the expenditures, which is usually fairly straightforward, but, rather, what types of work are eligible. The vast majority of disputes between taxpayers and the CRA arise over issues of scientific eligibility and record-keeping, not calculation.

Drawbacks of direct funding

Both the Jenkins and Mowat (but not the C.D. Howe) reports favour direct funding through grants and loans. While tax credits are far from perfect, direct funding has three major drawbacks.

First, there is no legal process for redress of disputes between the administrators and applicants for (or recipients of) the funding. In the tax-credit system, the rules are legislated and any dispute about eligibility or payment can be escalated through to the courts and resolved by an impartial judiciary. This works to everyone's benefit: not only can taxpayers who were denied funding appeal to the courts to get it, but the government can use the courts to recover funding that has been misappropriated. Under a direct-funding model, some or all of the decisions on eligibility and allocation take place outside the legal framework, through somewhat opaque processes that are not always fully accessible to public scrutiny, and there is no independent legal framework to adjudicate eligibility disputes.

Second, a move toward increased direct funding could threaten the global competitiveness of Canadian enterprises. Many international trade agreements (specifically the World Trade Organization Agreement on Subsidies and Countervailing Measures) constrain direct subsidies to business. Article 3 (Prohibited subsidies) has already been applied against Canada's Bombardier by Embraer of Brazil in a 1998 WTO action over funding that Bombardier received from the former Technology Partnerships Canada program.

Third, direct funding models, as the report itself recognizes, generally create a larger administrative burden. As a result, a Canadian firm intent on getting its innovation to market might be deterred from seeking assistance through direct funding because the approval process for an application can delay the start of time-sensitive work. By contrast, tax credit submissions are made retroactively at year-end. They do not have an impact at the start of a project.

More funding for fewer companies?

The recommendations made in the Jenkins report are premised on an assumption that R&D is better fostered by governments than private-sector market forces. It recommends that a minister of innovation be appointed; that direct funding be introduced and administered by the government; and that an external innovation advisory committee be created. If the panel's recommendations are fully adopted, we can expect to see much more targeted — and probably less democratic — payouts of R&D incentive funding to industry. In short, more funding will go to fewer companies.

The SR&ED claim environment has seen considerable changes over the past four years, beginning with the introduction of the new T661 SR&ED expenditures claim form in November 2008. But if these October reports are any indication, we may be due for another round of more severe adjustments. Anyone with a vital interest in SR&ED should keep a sharp lookout in the direction of the next federal budget.

For an expanded version of this article, visit www.camagazine.com/SR&EDJenkins.

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