

MONTHLY NEWSLETTER

Scientific Research and Experimental Development



JACOB MILOSEK, CPA, CA
JENNIFER DAWE, CPA, CA

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This document represents the first of what will be a series of monthly newsletters. Our goal is to provide updates on topical tax issues. Information contained in the newsletters is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

The Scientific Research & Experimental Development (“SRED”) tax incentive system provides significant tax savings to qualifying businesses. Benefits of the SRED program include:

- Investment tax credits (“ITCs”) of up to 35% of eligible SRED expenditures
- Fully deductible tax pool of qualifying expenditures with an indefinite carry forward period
- 10% Ontario Innovation Tax Credit for eligible SRED expenditures
- Tax credits are refundable for Canadian-Controlled Private Corporations (“CCPCs”)

In order for expenditures to qualify for the program, SRED must seek a scientific or technological advancement, must have scientific or technological uncertainty, and must use scientific methodology in attempting to resolve the uncertainty.

For years, Canada’s SRED has been one of the most lucrative in the world. A recent trend appears to be detracting some of incentives previously offered. Specifically, the 2012 federal budget contained four significant changes which negatively impact SRED businesses. A number of these changes were effective January 1, 2014 and will therefore have a significant impact on the 2014 tax results for SRED businesses.

CAPITAL EXPENDITURES

Capital expenditures are assets with an extended useful life. Rather than expensing what is often a large amount immediately in the year of acquisition, taxpayers are required to deduct a percentage each year over the life of the asset as capital cost allowance (“CCA”). The amount of CCA that can be claimed in a given year varies depending on the type of asset.

Capital expenditures were previously fully deductible in the year of purchase if the property would be used all or substantially all (90% or more) of its operating time in its expected useful life for the prosecution of SRED in Canada, or all or substantially all of its value would be consumed in such activities. Eligible capital expenditures included buildings in Canada or equipment. These rules in effect permitted an accelerated deduction of capital expenditure costs. Both new and used assets qualified for the deductible treatment, but assets had to be new to qualify for ITCs.

Effective January 1, 2014, capital expenditures can no longer be claimed for SRED purposes. An immediate deduction is no longer available and SRED assets are subject to the CCA system. ITCs will also no longer be available on capital asset additions.

PRESCRIBED PROXY AMOUNT

To report overhead expenses related to SRED, claimants have the option of reporting under the *traditional method* or the *proxy method*. Actual overhead expenses are used under the traditional method, so it is necessary to apportion overhead used in SRED activities under this method. As the expenses may be difficult to track, the proxy method simplifies this process by allowing an estimate of what the overhead costs related to SRED are based on a fixed percentage. The proxy method facilitates both record keeping of overhead expenses for the taxpayer and simplifies the SRED audit process.

The proxy method previously approximated overhead expenses as 65% of qualifying SRED salaries, subject to actual costs incurred. Effective for the 2013 calendar year, the proxy amount was reduced from 65% to 60%. The 2014 calendar year will see a further reduction to 55%. These reductions will be pro-rated for non-calendar fiscal year ends. The reduction of the proxy amount will reduce the ITCs that a claimant is entitled to. Claimants who have historically used the proxy method may wish to compare the results of using the traditional method to determine if a change in methods is beneficial. The reduced proxy rate may still yield a higher benefit. In evaluating the merits of the traditional method, it is important to consider the added complexity of trying to track overhead expenses and the added administrative costs that may result.

CONTRACT EXPENDITURES

In situations where a taxpayer contracts out its SRED to a non-arm's length party, the qualified expenditures on which ITCs may be claimed are restricted to the allowable SRED incurred by the performer. The payer's expenditure will not qualify. The parties may elect to have the performer's qualifying expenditures transferred to the payer. This treatment of non-arm's length contract SRED is intended to prevent ITCs from being claimed on certain amounts that would not be eligible for ITCs if the payer performed the SRED in-house, such as a profit element and certain costs such as rent and interest.

There were previously no restrictions on contract payments to arm's length parties. Effective January 1, 2013, the ITC claim for arm's length contract expenditures is restricted to 80% of the cost to the payer for expenditures incurred after 2012. The rationale for this change is to eliminate the opportunity for the payer to claim ITCs related to the profit portion of such contracts.

GENERAL ITC RATE

The general ITC rate for CCPCs with eligible SRED expenditures in excess of \$3,000,000, non-CCPCs, and unincorporated businesses was previously 20%. Effective January 1, 2014, the general ITC rate was decreased from 20% to 15%. The reduction will be pro-rated for fiscal years that straddle January 1, 2014. The enhanced ITC rate available to CCPCs on their first \$3,000,000 of eligible expenditures will remain unchanged. Unincorporated businesses conducting SRED should consider incorporation to take advantage of the enhanced ITC rate.

CONCLUSION

The SRED program has the simple goal of providing incentives to businesses in Canada to perform SRED. However, the rules related to SRED are complex. Annual policy decisions and budget changes add to this complexity and create uncertainty for SRED claimants. The four changes discussed above will negatively impact businesses with qualifying SRED and should be considered in budgeting considerations for 2014. Should you have any questions about the changes outlined above or general questions about the SRED program, please do not hesitate our tax group at Hendry Warren LLP.

About the Authors:

Jacob Milosek, CPA, CA and Jennifer Dawe, CPA, CA have each worked for Hendry Warren LLP for over 6 years. Both have completed the CICA's In-Depth Tax Course and work exclusively in the firm's tax department. They provide a wide variety of taxation related services across of a breadth of tax topics.