

# INNOVATIVE FINANCE NEWS

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Welcome to the first edition of the Innovative Finance News. This bi-monthly publication will address various topics that may be of interest to you and your business. Please feel free to contact any member of the Innovative Finance Group at Gardiner Roberts LLP to discuss this publication and how we can help with your business needs.

**WILLIAM P. LAMBERT** CHAIRMAN, INNOVATIVE FINANCE GROUP

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## SR&ED TAX CREDITS – OPPORTUNITY KNOCKING

**BY WILLIAM P. LAMBERT**

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The Scientific Research and Experimental Development Initiative (“SR&ED”) is a refundable tax credit offered by the federal government to encourage research and development in Canada. Tax credits are provided to businesses after expenditures for eligible work have first been verified by the Canada Revenue Agency (“CRA”).

Despite the fact that the CRA processes 18,000 SR&ED claims representing \$4 billion of tax credits each year, many eligible taxpayers do not take advantage of the SR&ED tax credits, missing a significant opportunity to fund these costs. SR&ED tax credits are effectively an important source of financing, especially in today’s challenging economic environment. This point is not lost on private equity funders, who increasingly regard SR&ED tax credits as a vital component of any technology start-up’s business plan. The availability of refundable SR&ED credits can be a critical factor in obtaining approval of a proposed financing.

### WHO IS ELIGIBLE?

There are three categories of potential claimants: Canadian controlled private corporations (“CCPC”), which can qualify for refundable or non-refundable tax credits; “other Canadian

**CONT.**

corporations", which can qualify for non-refundable tax credits; and proprietorships, partnerships and trusts, which can qualify for refundable or nonrefundable tax credits. (Partnerships do not actually claim SR&ED tax credits, but rather must allocate them to their members on the basis of each member's proportionate share in the partnership.)

## WHAT KIND OF EXPENDITURES CAN BE CLAIMED?

Eligible expenditures include salaries and wages of employees performing SR&ED work, materials (consumed or transformed), machinery, equipment rental and purchase, overhead and SR&ED contracts and third party payments.

## WHAT TYPE OF WORK IS ELIGIBLE?

Eligible work is divided into four categories:

1. "Experimental development" or work done to achieve technological advancements to create or improve new materials, devices, products or processes;
2. "Applied research" or research that advances scientific knowledge with a specific practical application in view;
3. "Basic research" or work done to advance scientific knowledge without a specific practical application in view; and
4. "Support work" or work that directly supports and is commensurate with the needs of experimental development, applied research and basic research.

In order for the work to be considered SR&ED it must:

- (a) attempt to achieve scientific or technical advancement through resolution of scientific or technological uncertainties; and
- (b) use systematic investigation.

Another requirement is that the SR&ED must generally occur in Canada. Canadian subsidiaries of foreign parent companies carrying out qualifying SR&ED activities in Canada are also eligible. Furthermore, the SR&ED deduction now includes

permissible salaries or wages incurred by a taxpayer in respect of SR&ED carried on outside of Canada after February 25, 2008. Payments to an approved association, university, college, or other research institute that are to be used for scientific research and development related to the business and carried on outside of Canada are also eligible.

It should be noted that not all work is covered under the SR&ED program. A list of exceptions can be found in the CRA T4052(E) publication.

## HOW MUCH IS THE ELIGIBLE TAX CREDIT?

The tax credit rate will vary depending on the type of business engaged in SR&ED. Generally, a qualifying CCPC can earn a refundable tax credit of 35% on current and capital SR&ED expenditures up to the expenditure limit of \$3 million. Any amount in excess of the expenditure limit is eligible for an investment tax credit rate of 20%. After applying the credits against taxes payable, a cash refund is available on the balance depending on the type of expenditure. There is a full cash refund on qualified current SR&ED expenditures and a 40% cash refund on qualified capital SR&ED expenditures.

Other Canadian corporations can earn an investment tax credit of 20% on both capital and current qualified expenditures. These are non-refundable credits, but can be carried forward 20 years or back 3 years.

Proprietorships, partnerships and trusts can earn an investment tax credit of 20% on both capital and current qualified expenditures. After applying these credits against taxes payable, these types of entities are entitled to obtain a cash refund of 40% of the outstanding balance of the tax credits.

## OTHER BENEFITS OF THE SR&ED TAX CREDIT PROGRAM

The CRA offers extensive services to SR&ED claimants, including public information and industry-specific seminars. The public information seminars offered give a broad overview or can be tailored to a specific industry. The CRA is also willing to visit a claimant's office to present a seminar, which includes an in-depth power-point presentation on both financial and technical aspects of the SR&ED program.

First-time claimants have the option of having a CRA representative assist them through all steps involved in filing an initial claim. The representative provides advice and information and can also visit the claimant's office to explain the program and its requirements in more detail.

Another service that the CRA offers is a preclaim project review that provides an informal opinion (oral or written) on the suitability of the claim before submitting it to the CRA. This process can be helpful in the beginning stages of a SR&ED project in order to set up the type of documentation system needed to support a claim.

The SR&ED program also offers an account executive service, which can connect a business with a designated contact person from the SR&ED program after the first claim has been filed and reviewed. This person remains the claimant's contact at the CRA each year and can meet regularly in order to help prepare claims. Although CRA officials cannot complete the claim, they can assist in the preparation of the claim and monitor the status of the claim after it has been filed.

The CRA is legally bound under s. 241 of the *Income Tax Act* to uphold the strictest confidentiality regarding claims.


### HOW TO TAKE ADVANTAGE OF THE SR&ED TAX CREDIT

In order to obtain an SR&ED tax credit, claimants must submit an application outlining the nature of their work and the relevant expenditures. The prescribed forms must be submitted with a T2 (for corporations) or T1 (for individuals) by the reporting deadline. Completed forms must be sent to the taxpayer's applicable Taxation Centre.

The forms require prescribed information about the claimant company and descriptions of the projects for which expenses are being claimed. Project descriptions are submitted as a separate attachment to the application and must focus on the scientific or technological aspects of the project.

The complete SR&ED claim must be submitted every year before the reporting deadline even if the project continues. If the prescribed forms are reviewed by the CRA before the reporting deadline, the CRA will advise the claimant of any deficiencies. Once the claim has been submitted it is subject

to both technical and financial review. Due to time constraints, the CRA does not submit every claim through the technical verification process each year and designates some claims as "accepted as filed". This does not mean that the work was eligible, but merely that there is no comment on eligibility. It also does not guarantee that subsequent similar applications will be accepted. Review times range from four months to a year once the complete claim has been received, depending on the type of claim submitted.

If there are questions about whether work is eligible or whether financial expenditures were in fact for the purposes of SR&ED, the claim will need verification. It is important to maintain the relevant technical and financial supporting documents. A review can also involve an on-site visit from CRA officials and by a contractor who is independent from the CRA to ensure fairness and objectivity. 

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