

David R. Hearn – Managing Director
Michael Cadesky BSC MBA, FCA

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Canadian Federal Research and Development Review Expert Panel
1200-270 Albert Street
Ottawa, Ontario K1A 5G8

Attention: Consultations

Re: Submission to Review of Federal Support to R&D

Dear Panellists:

This submission comes to you from an independent privately owned partnership of taxation specialists who provide professional services pertaining to SR&ED tax credits. Our firm is comprised of chartered accountants and engineers with an affiliated organization of tax lawyers. Scitax's directors are: Michael Cadesky who is a fellow of the Ontario Institute of Chartered Accountants, a past governor of the Canadian Tax Foundation and also holds a BSc.; David Hearn who is a Certified Engineering Technologist with over 15 years experience in SR&ED and a prior 20 years R&D experience in the electronics and semiconductor industries.

Our submission to you is focused exclusively on questions 9 and 10 of your consultation, i.e. SR&ED. In summary our view is that the existing legislation gives Canada what amounts to the world's best R&D tax incentive for private corporations and certainly near the very top of this list for public corporations as well. We see no reason to change the existing SR&ED benefit mechanisms except perhaps to offer some way for non-CCPCs to more readily monetize their benefits. However – based on our experience – there remains great room for improvement in how the SR&ED program is delivered and administered by CRA. Despite the various initiatives CRA has recently undertaken to improve its delivery of the SR&ED program, we continue to see the efforts of too many of Canada's genuine R&D performers unduly constrained by SR&ED assessment rulings which are badly flawed and inconsistent. At the same time we see too many frivolous SR&ED claims allowed simply because they are too small to justify the allocation of sufficient resources to make an adequate review.

Specific recommendations on improvements to SR&ED follow:

REPLY TO:

77 King Street West
Suite 2401, PO Box 93
Toronto, Ontario
Canada M5K 1G8

V: (416) 350-1214
F: (416) 350-1215

e: info@Scitax.com

www.Scitax.com

Argument for Retention of Tax Credits vs. Alternatives

Scitax publishes a global survey of R&D tax credits which is available free of charge at www.scitax.com. In researching this we have observed that the use of R&D tax credits both at the national and state / province level is increasing throughout the world – more countries are implementing R&D tax credits and those that have them have shown a trend to increasing them. At this time all indications are that the US will shortly implement substantial improvements in its R&D tax credit system which, historically, has offered relatively meagre benefits and has been unreliable – being completely unavailable for several periods of a year or more. Many US states are implementing R&D tax credits, some of which are beginning to approach what is available in Canada. For example in the week of this writing alone, the US state of Louisiana announced its intention to re-commit to its R&D tax credit program that provides cash refund benefits at levels of up to 40%.

One motivation – if not the main one – for a government offering an R&D tax credit, is to induce companies to set up R&D and manufacturing facilities (and high quality, well paying jobs) in their jurisdictions. While the availability of labour is probably the main consideration in the decision processes of these companies, taxation is also a primary consideration. Incentive measures that are not taxation-based often escape this decision process and are therefore inherently ineffective, vis-à-vis differentiating Canada in such decisions.

Therefore, it is our recommendation that in order to sustain its competitive position in global site selection processes, Canada should retain its system of SR&ED tax credits as the primary incentive to inbound industrial immigration. Other types of incentive programs (grants, loans etc.) are simply too complex and unstable to be an effective inducement to commercial interests.

All of this is well discussed in the OECD publication “Tax Incentives for Research and Development: Trends and Issues” available here:
<http://www.oecd.org/dataoecd/12/27/2498389.pdf>.

The Existing SR&ED Tax Credit vis-à-vis Incremental Investment

Canada’s existing system of SR&ED tax credits offers both an investment tax credit (ITC) and a highly flexible “deduction pool” that can be selectively deployed to minimize the taxation burden that a company would otherwise suffer due to the escalation of taxation rates, as profits soar in the “rapid growth” phase of a successful technology product commercialization.

Therefore, we conclude that – due to the complementary nature of the ITC and pool mechanisms – the existing SR&ED structure is effective in encouraging sustained incremental investment in R&D. However, as noted below, we do see possibilities by which this could be made even more effective.

Suggestions For Economic Improvement to Existing SR&ED Tax Credit

Notwithstanding our position set out above that the existing SR&ED tax credit is effective and should be retained, we see some opportunity to enhance its value in certain sectors; most notably vis-à-vis its usefulness as an incremental incentive to non-CCPCs (esp. public corporations and partnerships).

Under the present system only Canadian controlled private corporations have access to refundable benefits. This means that other corporations that endure “sunk R&D costs” at start up have no way of monetizing their SR&ED benefits until they become profitable, which all but defeats the ITC as an incentive to “incremental investment”. The problem is particularly acute for pre-commercial start-up companies who must endure high R&D spending for several years before earning any income from sales. In certain key sectors – notably biotech, pharmaceutical and aerospace – the start-up development costs (clinical trials, test flights, etc.) are so high that adequate capitalization with private funds is highly unlikely.

That said, we do not recommend implementing universal refundability for all corporations. Instead we suggest the following alternatives:

- 1) *Limited Cash Refunds* for companies operating on certain designated small- and micro-cap junior stock exchanges such as TSX Venture Exchange, NASDAQ etc.
- 2) *Flow-Through Shares* as have been used for years as a development incentive in the Canadian mining and resource industries. A flow-through share scheme would provide for the transfer of losses from non-profitable corporations to corporations and individuals that have taxes to pay and allow the holders of these shares to participate in any upside potential of the companies selling them.
- 3) *Discounted / factored ITCs*. Corporations that are not otherwise eligible for refundable SR&ED benefits could be offered the opportunity to convert their ITCs to cash in the current year on a discounted basis, i.e. \$100 in ITC can be redeemed for \$25 of cash refund. This could be administered either directly by the government or on the government’s behalf by financial institutions who might be offered some form of accelerated reduction of their own taxes in proportionate return for undertaking acceptance of the ITCs. Such an approach would benefit government by reducing the long term deficit burden carried with respect to future tax liabilities.

We firmly believe that any of the above three approaches is preferable to any government sponsored venture capital investment funds or vehicles such as the former Technology Partnerships Canada.

Recommendations for Improvements to Existing SR&ED Program Delivery

As noted in our introduction above, our experience together with that of many experienced professionals in our practitioner community, not to mention several prominent technology industry associations, is that the efficacy of the existing SR&ED program has (and continues to be now as of this writing) badly undermined by CRA's operating doctrines.

While it is true that CRA has recently begun attempts to implement reforms, we do not see these attempts to be making much difference on the ground. The one exception to this – which we heartily endorse and applaud – is the policy document consolidation project presently underway within CRA SR&ED directorate. To date CRA has had too many SR&ED related policy and guidance documents, many of which are not synoptic. We urge CRA to persevere with this and produce a single master policy guidance document. All others – including sector specific guides – should be discontinued as they only serve to increase the administrative burden and confound taxpayers.

In addition to the furtherance of the policy document consolidation project, we offer the following recommendations to restore useful operation of the SR&ED program:

- 1) Eschew external certification and review of SR&ED claims: Under no circumstances should any aspect of the certification or review of SR&ED eligibility be removed external to CRA. To do so would pose too great a threat to taxpayer privacy and the security of commercially valuable (and defence sensitive) scientific information. To CRA's credit there have been few (if any) instances where taxpayer's R&D information has gone astray. Rather than shifting the burden elsewhere, government must cause CRA to administer the SR&ED program correctly, even if it means bringing in new talent from outside the government to do it.

- 2) Notice of Objection / Appeals process: At present the CRA units that handle SR&ED appeals seem to operate "open loop" with respect to the RTA units at the local CRA offices that made the disputed decisions in the first place, i.e. there seems to be no formalized mechanism by which the findings of the appeals officers are communicated to the RTA (auditor) organization as a whole, so that flawed assessments are not repeated. Furthermore, there does not seem to be any mechanism by which RTA's are accountable for assessment decisions that are found to be flawed at the appeals stage. Indeed appeals unit managers have been heard to say that local office RTA's deliberately "unload" difficult / complex files into the appeals process by issuing flawed assessment decisions.

3) Adopt standards-based approaches for “bright line” SR&ED guidance and compliance requirements: Many of the malfunctions within the existing SR&ED delivery arise because CRA fails to adequately define and demarcate its eligibility requirements. The fields of science and engineering are full of internationally recognized and thoroughly documented technical communication standards and yet CRA’s communications with taxpayers (both guidance, policy and assessments) consistently fail to draw on these standards.

By way of example: At present, two of the most contentious issues in SR&ED disputes between CRA and taxpayers are: A) The eligibility of software development activity, and B) The requirements for record keeping in respect of claimed labour expenditures, i.e. timesheets.

There are readily available internationally recognized “frameworks” to facilitate communication of information in both of these areas.

To better communicate the eligibility of software development activity, CRA could adopt demarcation based on the internationally recognized 7 layer OSI model (ISO standard 7498-1) or other similar standards. CRA’s primary software guidance document IC97-1, makes no reference to the OSI model.

With respect to telling taxpayers what is required in terms of requirements for time records: industry standard project management methodologies such as work breakdown structures (ANSI PMI-978-1-933890-13-5), embodied in readily available software tools such as Microsoft Project, provide an ideal way to show linkage between expenditures, hours of work effort and R&D activity. This approach is already mandated by many Canadian government agencies for tracking / reporting of project expenditure data.

Please accept our sincere thanks in undertaking work so thoroughly vital to Canada’s continued growth and future prosperity. Should you wish further communication with us in this matter, please call (416) 350-1214.

Yours truly



David Hearn CET

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Michael Cadesky BSc, MBA, FCA

Director

Director