

Does Your Business Involve Research of Any Kind? SR&ED Tax Refunds May Be Possible

How would you like the Government to pay sixty-eight percent of your salary costs?

If your company qualifies under the Scientific Research and Experimental Development (SR&ED) program, this is possible. The Government will refund a company up to sixty-eight percent of the salary it has incurred to develop or improve a product or process that qualifies under the SR&ED program.

This article discusses the basics of the SR&ED program, the technological requirements to qualify for the program, the documentation required for the tax filing, as well as Ontario and Quebec SR&ED tax credits.

The Basics

The SR&ED program is a federal initiative to promote innovation and development within Canada. This initiative is managed by the Canada Revenue Agency (CRA) and can result in a significant refundable or non-refundable tax credit to eligible corporations for eligible projects.

A Canadian Controlled Private Corporation (CCPC) with taxable income less than five hundred thousand dollars and taxable capital less than ten million dollars in the prior year is eligible for a thirty-five percent refundable tax credit on the first three million dollars of eligible expenditures. Amounts in excess of three million dollars are eligible for a twenty percent non-refundable tax credit that can be applied against taxes payable in the current year, three prior years or twenty future years. If the thresholds of \$500,000 and/or \$10 million (noted above) are exceeded, the \$3 million expenditure limit is reduced.



Companies that are not CCPC's are eligible for a twenty percent non-refundable tax credit on eligible expenditures. These credits can be used in the current year or carried back to the three previous years or carried forward for the next twenty years to be utilized against taxes payable in those years.

Eligible projects can include new products or processes and improved products or processes. These projects can be run on a standalone basis; for example the development of a new product line would be a stand alone project. These can also be done as part of a larger project; for example the development of a new component to be inserted into an existing or new device can be a project on its own.

Eligible expenditures for SR&ED projects can include the following:

- Salaries and wages
- Materials
- Contractor costs
- Lease costs
- Certain capital Assets
- Overhead

Salaries and wages, materials, contractor costs and lease costs are self explanatory, any amount paid for these costs that are applicable to an eligible SR&ED project are eligible for the tax credit.

Capital expenditures are a little more complicated, these types of expenditures fall into two categories:

- capital assets used all or substantially all in SR&ED
- capital assets used primarily for SR&ED

For expenditures that are used all or substantially all (meaning more than ninety percent of the useful life of the asset will be used for SR&ED eligible purposes), the whole expenditure is eligible for the tax credit.

For expenditures that are not used ninety percent of the time in SR&ED but are used primarily (more than fifty percent) of the time in SR&ED, a maximum of fifty percent of the expenditure is eligible for the tax credit over a two year span.

Overhead is also more complicated with respect to SR&ED. There are two methods that can be used to allocate overhead to an eligible project. The first method is the traditional method where a company allocates overhead to the SR&ED project on a similar basis as it would allocate overhead to a product line or service. This method can be quite burdensome if overhead information is not normally tracked or if the method of overhead allocation used cannot be easily applied to a SR&ED project.

As a result of the difficulties in allocating overhead to a specific project, the CRA permits the use of the second type of allocation; commonly known as the proxy method. This method allocates sixty-five percent of SR&ED salaries and wages to the project as overhead. This represents a significant advantage in my opinion as there are very few companies that actually operate at an overhead rate of sixty-five percent of labour costs.

Technological Requirements

In order to qualify for SR&ED tax credits a project must meet all three of the following technical requirements:

- Have at least one technological advancement
- Overcome at least one technological obstacle
- Work done in a systematic manner

Items one and two generally go hand in hand, if you have a technological advancement you are seeking you will generally have to overcome a technological obstacle and if you have overcome a technological obstacle a technological advancement has normally occurred.

A technological advancement will occur when you push the boundaries of your knowledge base to the next level. You need to remember that technological advancements are company specific; you do not need to be creating a product that is better than all other products in the market. What you need to be creating is a product that is better than all of your products in the market.

The next item is a technological obstacle. This is exactly as it sounds; some obstacle that prevents you from obtaining your goal. A decision you need to make to attempt to better your product or process.

The final item, work completed in a systematic manner,

requires you to approach the problem in a logical manner rather than simply using trial and error. Using your knowledge level you would develop a hypothesis and determine what you believe to be the best method to overcome your technological obstacle to achieve your technological advancement.

Example of technological requirements:

i. Information

XYZ Company is a manufacturer of hand held devices. Recently they have received complaints from customers regarding their newest handheld device, the XYZ1000. Customers have been complaining about the short battery life even when the device is not in use. (Note – this does make this a business issue - an issue does not need to be a business issue in order to be a SR&ED eligible project)

XYZ does some research and determines that the issue is not with the battery supplier as the same battery is used in other hand held devices and has a much longer life than it does in the XYZ1000. Further research indicates that it is the components within the hand held device causing the issues as some are running regardless of necessity, specifically the antenna and LCD screen.

In the end XYZ solves the problem and introduces the XYZ2000 that will have a battery life that lasts a similar amount of time as the competitors hand held devices.

ii. Technological Documentation

The SR&ED claim would be documented as follows:

Technological Advancement:

To improve the XYZ1000's existing battery life from the current average of twenty hours to the industry average of forty hours. (Note – the numbers are not necessary here but I strongly recommend the use of numbers as they set a specific technological goal rather than a general “increased battery life”. The numbers will also stand up to CRA audit better than the general statement.) You will note that the indicated base level of twenty hours indicates the current technological capability of the company, what is commonly know as the current knowledge base, this knowledge base needs to be included in the submission to the CRA in order for the claim to qualify.

Technological Obstacles:

It is quite often best to write these in the form of a question, in this case:

Can XYZ develop an antenna that will not draw as much power in standby mode and still function properly within the XYZ1000?

Can XYZ enhance the LCD screens operating efficiency reducing the battery consumption while in standby mode?

Systematic Manner:

The systematic manner occurred here when XYZ started its research and then determined that the problem was with the components. From here they would have developed a logical hypothesis as to which components were operating when the hand held was not in use. From here they would experiment with some known production process to improve the antenna and LCD screen.

Documentation Required for the Tax Filing

When preparing a SR&ED tax filing you should be sure to retain all documentation relating to the technological advancement, this includes meetings, discussions, emails, planning documents, photographs, versions of software, algorithms, tests, etc.

You should also keep timesheets or other time tracking logs to quantify your hours spent on SR&ED projects, without these you must estimate your numbers (while this method is accepted by the CRA in the initial claims by a company they strongly recommend time sheets or other tracking methods). Without appropriate documentation regarding time worked on an SR&ED project the company leaves room for the CRA to come in and deny or reduce certain labour expenditures resulting in a reduced refund.

Provincial Incentives

Along with the Federal ITC on SR&ED expenditures, the majority of the provinces also provide some form of tax credit. The Ontario and Quebec tax credits are outlined in this document. For information on the credits provided by other provinces please contact me and I will discuss the credits with you.

Ontario

The Ontario tax credit, known as the Ontario Innovation Tax Credit (OITC), essentially piggybacks on the SR&ED ITC provided by the Federal government. The OITC is a ten percent refundable tax credit on the first three million of eligible expenditures incurred in Ontario.

As a result of the harmonization of Ontario and Federal taxes in 2009, Ontario created a new tax credit related to SR&ED. This tax credit known as the Ontario Research and Development Tax Credit (ORDTC) is non-refundable at a rate of four and a half percent. This credit is received on eligible expenditures less the OITC received in the year. This tax credit can be renounced in order to increase the refundable portion of the Federal SR&ED tax credit.

Quebec

The Quebec credit is a thirty-seven and a half percent refundable tax credit on the first three million of eligible expenditures incurred in Quebec. Eligible expenditures in Quebec include salary and wages incurred in Quebec

for qualifying R&D and one-half of the eligible contractor costs incurred in Quebec for eligible R&D.

The Sixty-eight Percent Refund

At the start of the article I stated that the government would pay up to sixty-eight percent of salary costs to eligible companies. The actual numerical calculation is complex however a simple example will illustrate this figure.

Example Details:

- Company is a CCPC with taxable income less than \$500,000 and taxable capital less than \$10 million in the prior year
- The company operates in Ontario and all SR&ED was performed there
- SR&ED eligible salary and wages are \$100,000
- The company is electing to use the proxy method of overhead allocation

Example Solution:

Calculate the eligible expenditures:

Salary	\$100,000
Overhead (65% proxy)	<u>65,000</u>
Total eligible expenditures	165,000
Less the OITC	<u>(16,500)</u>
Eligible expenditures for the ITC	\$148,500
Federal ITC (35%)	\$51,975
OITC (10%) of Federal pool	<u>16,500</u>
Total refundable credits	\$68,475

The company spent \$100,000 in eligible labour expenditures and received \$68,475 in refundable ITC's. In other words, a refund of sixty-eight percent of the amount spent.

For more information about SR&ED tax refund please contact a professional at Welch LLP or visit us at: www.welchllp.com

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