

# GOLDFARB, SHULMAN, PATEL & CO. LLP

## Scientific Research and Experimental Development (“SR&ED”)

### And Your Organization

April 8, 2004

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The federal and Ontario governments provide significant income tax incentives for businesses performing SR&ED. According to the Canada Revenue Agency, approximately 11,000 businesses receive \$1.4 billion of annual SR&ED tax credits, and that number is growing by 13% each year. Nevertheless, many eligible businesses do not benefit from these incentives, because their management is either unaware of the incentives, or incorrectly believes that the particular endeavor does not qualify for the incentives.

Canada provides one of the most generous tax incentive regimes among industrialized countries, which has been summarized on the attached pages. SR&ED tax credits must be claimed no later than one year following the due date of the claimant’s tax return, for the taxation year in which the SR&ED expenditures are incurred. Since retroactive claims for SR&ED tax credits beyond this deadline are not permitted, the timely identification of potential SR&ED within your organization is critical.

In brief, SR&ED is defined in the Income Tax Act as being a systematic investigation or search that is carried out in the field of science or technology, by means of experiment or analysis, and that is either basic research, applied research, or experimental development. In simple terms, an endeavor is considered SR&ED if its objective is an advancement in technology, which incorporates technological uncertainties that are resolved in a systematic manner, by individuals who are skilled in the technologies involved.

The ultimate outcome of the SR&ED process should be the commercial implementation or production of new or improved materials, equipment or processes. Examples of the activities which **would likely** qualify for the SR&ED incentives are as follows:

#### New or improved materials

1. A toy manufacturer develops improved materials to enhance the safety of its toys.
2. A house builder develops a new type of window that will reduce heating costs.
3. A paint manufacturer develops a new chemical for treating wood.

#### New or improved equipment

1. A textile manufacturer desires modifying an advanced weaving machine, to increase the rate of production by 50%. The SR&ED process will include a series of test production runs, which will assist in the resolution of the technological problems involved with these modifications.
2. A manufacturer of steel products employs specialty machines which use hydraulic power. The manufacturer believes that productivity could be enhanced if such machinery were to incorporate electric drive technology, rather than a hydraulic drive. The development of the electric drive technology represents a new technology to the company, and therefore, qualifies as SR&ED.

#### New or improved processes

1. Refer to the previous example. In carrying out the integration of the new electrical drive system, there was uncertainty whether it could be integrated into the current machine structure, without major modifications. In carrying out the integration, it was learned that major modifications would have to be made to the current machine structure, before the integration would meet the technological specifications. These modifications would require significant change to the design and interface of standard components. This endeavor would constitute SR&ED.

The SR&ED benefits are also available in respect of the development of novel computer software applications. Our firm has had success in SR&ED claims related to such endeavors.

Our goal is to provide assistance to our clients who may benefit from SR&ED tax incentives. If you believe that your business may qualify, please contact us so that we may work in tandem with you, in order to maximize and expedite your organization's benefit from these SR&ED tax incentives.

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## A Summary of the Federal and Ontario SR&ED Tax Incentives

April 8, 2004

The following is a brief summary of the incentives:

### Federal income tax incentives

The federal government provides investment tax credits (“ITCs”) for qualifying current and capital expenditures. The general tax credit rate is 20 per cent. An additional 15 per cent credit (that is, 35 per cent in total) is available to smaller<sup>1</sup> Canadian-controlled private corporations (CCPCs).

### Refundable federal ITCs

SR&ED tax credits may be deducted from federal taxes otherwise payable. Should an excess remain, the unused SR&ED tax credits are fully or partially refundable as summarized in the following chart:

Corporation Type	Eligible Current Expenditures		Eligible Capital Expenditures	
	ITC Rate	Refundable Portion of ITC	ITC Rate	Refundable Portion of ITC
Qualifying CCPC <sup>2</sup>	35% <sup>1</sup> 20%	100% 40%	35% <sup>1</sup> 20%	40% 40%
Non-qualifying CCPC	35% <sup>1</sup> 20%	100% None	35% <sup>1</sup> 20%	40% None
Non-qualifying, non-CCPCs	20%	None	20%	None

In any case, the unused tax credits can be carried back three years or carried forward 10 years, to be applied against the federal taxes in those years.

<sup>1</sup> The 35% credit applies to the annual qualifying expenditures, not exceeding \$2 million (pro-rated for a short taxation year). The \$2 million limit is shared by an associated group of companies. The \$2 million limit is reduced where the associated group of companies' taxable income of the preceding year or taxable capital (as determined for the purposes of the large corporations tax) of the current year exceeds the threshold amounts. The threshold amount for the taxable income is \$300,000 (\$200,000 for 2003 and prior years). The \$2 million expenditure limit is phased out for incomes between \$300,000 and \$500,000, and is completely eliminated at \$500,000. The threshold amount for the taxable capital is \$10 million. In this case, the \$2 million expenditure limit is phased out for taxable capital between \$10 million and \$15 million, and is completely eliminated at \$15 million.

<sup>2</sup> A qualifying CCPC is one that has been a CCPC throughout the particular year, which together with associated corporations, had taxable income for its immediately preceding taxation year not in excess of the business limit. The business limit is \$ 250,000 for the 2004 calendar year (increasing to \$300,000 for calendar 2005 and thereafter), but which may be reduced if the corporation and its associated corporations has taxable capital in excess of \$10 million. In determining whether a corporation's taxable income exceeds the business limit, one does not take into account the “specified future tax consequences” (such as loss carry-backs from subsequent years) for that preceding taxation year.

**Federal income tax incentives – continued**

In addition to the tax credits, the qualifying current and capital expenditures are fully deductible in the year incurred, or they can be carried forward indefinitely. The qualifying expenditures are reduced by provincial and any other incentives for performing SR&ED.

**Ontario income tax incentives**

Ontario provides four provincial income tax incentives for SR&ED: a discretionary deduction for the federal investment tax credit claimed in respect of the SR&ED expenditures carried out in Ontario, the Ontario Innovation Tax Credit, the Business-Research Institute Tax Credit, and the Ontario Research Employee Stock Option credit.

The Ontario Innovation Tax Credit (OITC) is a refundable 10 per cent tax credit for annual qualifying expenditures, not exceeding \$2,000,000, performed in Ontario. The OITC must be shared by an associated group of corporations. The OITC reduces, in the year that it is earned, the amount of qualifying expenditures for SR&ED incurred for the year, which will ultimately impact on the federal SR&ED tax credits. The OITC may be used to reduce Ontario corporate income tax otherwise payable, or it may be refunded.

The Business-Research Institute Tax Credit (BRITC) is a fully refundable 20 per cent investment tax credit available to corporations, in respect of qualifying expenditures incurred on SR&ED under approved contracts with eligible research institutes. To be eligible for the BRITC, the SR&ED must be performed in Ontario and related to a business the corporation carries on in Canada. An annual \$20 million limit exists for qualifying expenditures shared among an associated group of corporations. Eligible research institutes are provincially assisted post-secondary institutions, such as universities and colleges of applied arts and technology, hospital research institutes, and prescribed Ontario non-profit research organizations. An institute may perform SR&ED either directly on behalf of the corporation, or under an arrangement whereby the corporation must be entitled to exploit the results of the institute's work. In the latter case, the institute must also be approved for purposes of the federal SR&ED legislation.

The Ontario Research Employee Stock Option credit is available to eligible employees of eligible companies that directly undertake SR&ED in Ontario. The credit reduces Ontario personal income tax arising in respect of the taxable amount of stock option benefits and capital gains arising from the sale of shares acquired through the exercise of eligible employee stock options. The credit that is available to an individual in any year is the product of \$ 100,000 multiplied by the individual's applicable Ontario marginal tax rate. An eligible employee must, amongst other criteria, spend at least 30% of his or her time undertaking directly, supervising or supporting the performance of SR & ED in Ontario, in the year in which the eligible stock option agreement is entered into.