Felesky Flynn LLP
TAX COUNSEL

Insights Series: Tech Sector Income Tax Issues

This Felesky Flynn Insights Series focuses on tax issues relevant and specific to start-up businesses operating in the technology sector in Canada.

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TAXATION OF GOVERNMENT SUBSIDIES AND GRANTS

In the process of transforming your innovative idea into a profitable commercial venture every dollar matters. As part of that process, accessing non-dilutive capital from governments can be extremely beneficial and there are numerous subsidies, grants and capital access programs that technology and innovation companies are able to apply for and potentially access. One key component to be aware of in applying for and accessing these government subsidies and grants is how the funds received will be taxed and to consider if receiving such funds could impact or reduce your other entitlements.

This article outlines how government grants are taxed generally and identifies a few specific tax issues to watch for when receiving the grants and subsidies. Our comments are far from exhaustive but provide some useful guidance on how the funds from many of these programs could be taxed. The tax treatment depends on the legal characterization of the payment regardless of what the subsidy, grant or other amount may be called.

I. TAXATION OF GOVERNMENT GRANTS GENERALLY

1. General Rule – Taxable Business Income

In a for-profit business scenario, amounts received, other than repayable loans, from governments and other public authorities as financial assistance are generally taxable to the recipient as income from business or property. Like everything with tax, there are a number of exceptions to this general rule, a few of which we will discuss, but a fair assumption to make when receiving government funds in this context is that the amounts received will be taxable in some fashion and will not be a non-taxable nothing.

2. Exception – Co-Investment

An exception to the general rule relates to government funds that are received in exchange for the government or public authority receiving something in return. Amounts that are received by a public authority in exchange for the public authority receiving an interest in the taxpayer, its business or its property, are generally not taxable as business income. The tax treatment of those amounts depends on what exactly the government or public authority is acquiring in exchange.

If the government or public authority is acquiring an equity interest in your business, those amounts are generally not taxable. For example, if a corporation ("**TechCo**") received $50,000 from a public authority and issued preferred shares in exchange, that $50,000 would represent the public authority's investment in TechCo and would not be taxable to TechCo.

On the other hand, if TechCo received $50,000 from a public authority in exchange for the corporation granting the public authority an interest in its property, that could give rise to a capital gain or business income to TechCo depending on the type of property. The takeaway here is that the tax treatment of funds received from a government or public authority will depend on whether the government or public authority is acquiring something in return for the funds contributed to the business.

3. Exception – Reduced Cost of Property

Another exception to the general rule is if the government assistance is received to reduce the out-of-pocket cost of acquiring capital property. In that case, the assistance received generally is not included in business income, but instead reduces the cost of the property to the taxpayer. There are specific rules for reducing cost that apply to both depreciable capital property (*e.g.,* buildings, equipment, IP) and non-depreciable capital property (*e.g.*, land).

If TechCo were to, for example, receive $50,000 from a public authority to assist with the cost of obtaining the copyright of its software code, the $50,000 should not be taxable to TechCo as business income, but instead would reduce the cost of the copyright for tax purposes (assuming TechCo has at least $50,000 of cost in that type of property). This results in TechCo having no up-front tax to pay on the receipt of the $50,000, but will reduce the amount of future deductions it can claim relating to the cost of the copyright and could increase the tax payable on a sale of the copyright in the future.

Another important point is that in situations where an amount is received from a government or public authority that would be taxable as business income, the taxpayer has the option in certain circumstances to elect to reduce the cost of certain capital property instead of having the assistance taxed as business income. This could be a useful option to consider if a government grant that was not required to be used for a specific purpose is in fact used to acquire capital property in the business.

4. Exception – Reduction of Expenses

Another way to avoid the business income inclusion for amounts received as assistance from a government or public authority is to elect to reduce the amount of an outlay or expense (other than an outlay or expense in respect of the cost of property of the taxpayer). This could be a useful option in situations where a taxpayer has incurred expenses that are not deductible for tax purposes, either in the year or in previous years, as the income inclusion could be avoided by reducing those expenses that were of no use from a tax perspective. This election is only available in

certain specified circumstances but it is another option to consider and keep in mind. Of course, avoiding the business income inclusion on the receipt of government assistance is less of a concern for businesses that have losses available (possibly from the start-up phase of their business) to offset the income inclusion.

II. SPECIFIC ISSUES TO WATCH

1. Forgivable Loans

A potential trap to watch when receiving loans from public authorities is that "forgivable loans" are included in business or property income, just like other forms of government grants and subsidies. Even though it may not be intuitive to treat the receipt of loan proceeds as business income, if the loan is received from a government or other public authority and the requirement to repay the loan may be renounced or forgiven by the lender, then the loan will likely need to be included in income when it is received.

If the forgivable loan is ultimately repaid there is a deduction that is available to the borrower to offset the original income inclusion. However, that future deduction would be of no immediate assistance from a cashflow perspective to a corporation that received what was perceived to be a tax-free loan that ended up being taxable. Note that similar adverse tax consequences can apply to "regular" loans that would not qualify as forgivable loans when the loan is initially made but the lender subsequently forgives the loan or cancels the obligation of the borrower to repay.

2. Reduction of Qualified SR&ED Expenditures

Another income tax consideration when receiving government assistance is to consider how the receipt of that assistance will impact access to other government incentives and programs. For example, scientific research and experimental development ("**SR&ED**") expenses that are "qualified expenditures" for income tax purposes entitle taxpayers to investment tax credits ("**ITCs**") which can be applied against income tax owing to reduce tax otherwise payable.

One specific item that reduces the SR&ED expenses that are "qualified expenditures" is the receipt of "government assistance". Government assistance for these purposes is defined broadly as assistance from a government body, municipality, or other public authority whether as a grant, subsidy, forgivable loan, deduction from tax, investment allowance or as any other form of assistance. So, for example, if TechCo were to receive $50,000 from a public authority and the amount could be considered in respect of SR&ED, then TechCo's qualified expenditures would be reduced by $50,000 and the amount of ITCs that could be claimed would also be reduced.

The takeaway here is that the receipt of government assistance can have income tax implications beyond just an income inclusion of the amount received. Technology companies considering applying for government subsidies or grants should consider whether such government assistance could impact their ability to access other tax

related government incentive programs, such as ITCs for qualified expenditures in respect of SR&ED.

In summary, the receipt of most government grants and subsidies by a business are generally taxable as business income. However, there are a number of exceptions and alternative tax treatments that could potentially apply to avoid an income inclusion or defer the taxation of the amounts received. Understanding the tax implications of receiving government assistance is key to understanding the true net benefit of the amounts to be received and to avoiding cash flow issues that could arise from unexpected income taxes owing.