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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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SR&ED TAX INCENTIVES IN THE CANADIAN TECH SECTOR: DO YOUR R&D ACTIVITIES ENTITLE YOU TO TAX CREDITS?

For those involved in R&D in the Canadian technology sector, the federal and provincial Scientific Research and Experimental Development tax incentives ("**SR&ED Programs**") can not only reduce current or future tax cost, but also could provide an additional source of cash. SR&ED Programs encourage R&D in Canada by providing significant tax incentives to Canadian businesses, particularly Canadian-controlled private corporations ("**CCPCs**").

For example, a qualifying CCPC that incurs $3 million on expenditures that qualify for SR&ED Programs could be entitled to a $1.05 million refundable tax credit. Since refundable tax credits result in a cash refund once tax payable is reduced to nil, if you or your organization qualifies for SR&ED Programs and is not accessing these benefits - cash is being left on the table.

This article is intended to (1) help Canadian tech businesses determine if their R&D activity qualifies for SR&ED Programs; (2) describe steps a business can take to navigate SR&ED Programs more successfully; and (3) describe, at a high level, the order of magnitude of potential credits.

If you are interested in learning more after this high level overview, we would be pleased to discuss these programs with you or direct you to the numerous other articles and sources of information that provide detail on the SR&ED Programs including how to apply, deadlines for applications and documentation of qualifying R&D required to be created and kept.

I. QUALIFYING ACTIVITIES

Work conducted in Canada that is basic research, applied research or experimental development potentially qualifies for SR&ED Programs. While activity that qualifies as basic research is generally done in universities and research institutes, the for-profit Canadian technology sector carries out much R&D activity that potentially qualifies as applied research or experimental development. Applied research is work carried out to advance scientific knowledge with a specific practical application in view. Experimental development is work carried out to achieve a technological advancement and addresses a technological uncertainty.

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The difference between applied research and experimental development can be illustrated with an example of the transistor. The discovery of the principle of the transistor (*i.e.*, the ability to control the conductivity of a semiconductor) is an example of applied research, whereas the work to develop technology to make devices and products using transistors is an example of experimental development.[1]

To qualify for SR&ED Programs, the work must be (i) conducted as a systematic investigation or search through experiment or analysis; (ii) intended to advance science or technology; and (iii) in respect of a problem that cannot be solved with existing scientific or technological knowledge base. If the activity seems like it may satisfy these requirements, it is critical that the hypotheses, tests and results of the investigation or search be recorded and kept.

Certain work that supports basic research, applied research or experimental development also qualifies for SR&ED Programs. For example, work with respect to engineering, design, operations research, mathematical analysis, computer programming, data collection, testing or psychological research, where such work is commensurate with the needs and directly in support of basic research, applied research or experimental development, also qualifies.

Certain types of work are expressly excluded from SR&ED Programs, including: market research or sales promotion; quality control or routine testing of materials, devices, products or processes; research in social sciences or the humanities; prospecting, exploring or drilling for, or producing minerals, petroleum or natural gas; commercial production of a new or improved material, device or product; commercial use of a new or improved process; style changes; and routine data collection.

Salary and wages, materials, third party contracts and certain overhead expenditures are all expenditures that potentially qualify for SR&ED Programs.

II. SUCCESSFULLY NAVIGATING SR&ED PROGRAMS: BE PREPARED TO TELL YOUR STORY

Successfully navigating the SR&ED Programs requires you to be prepared to tell your story of scientific or technological advancement and to maintain documentary evidence (ideally created contemporaneously with undertaking the scientific or technological advancement) that supports that story.

SR&ED Programs are administered by the Canada Revenue Agency. Disputes with the Canada Revenue Agency regarding SR&ED claims often involve applicants that have not spent sufficient time developing and documenting their story of scientific or technological advancement. Applicants should consider how to clearly articulate key elements of that story in a manner that can be understood by non-technical people. Applicants should also develop and keep contemporaneous documentation showing how specific activities and expenditures further the scientific or technological advancement.

[1] This example of transistors is described in CRA administrative guidance on SR&ED Programs.

Your story should include the following key elements. These items are derived from administrative policies of the Canada Revenue Agency and have been adopted by the courts.

1. A clear articulation of the scientific or technological uncertainty that activities are intended to resolve including an articulation of why existing knowledge or standard procedures are insufficient to address the uncertainty.

2. A clear statement that the purpose of the activities undertaken is to resolve the scientific or technological uncertainty and make scientific or technological advancements.

3. A list of the hypotheses formulated in the process of trying to resolve the scientific or technological uncertainty.

4. A description of the systematic investigation and testing of the hypotheses including experimentation and analysis.

5. A description of the methods for recording the testing of the hypotheses and records showing the results of such tests.

Each of these key elements should be supported by contemporaneous documentation that describes and shows how the activities and expenditures further your story of scientific or technological advancement.

Being able to clearly articulate your story of scientific or technological advancement and supporting that story with contemporaneous documentation will maximize your chances for a successful SR&ED application.

III. POTENTIAL INVESTMENT TAX CREDITS AVAILABLE

The potential investment tax credit ("**ITC**") available to a SR&ED applicant depends on whether the applicant is a corporation, an individual or a trust.

A corporation that is a CCPC is generally entitled to ITCs equal to 35% of the first $3M of qualified expenditures and 15% of additional qualified expenditures. For ITCs earned by CCPCs on the first $3M of qualified expenditures, any ITC balance that is not required to reduce tax owing in the year is a refundable tax credit that should result in a cash refund to the CCPC. For example, a CCPC with $1,000,000 of taxable income that is subject to tax at a rate of 23% would have a tax liability of $230,000 before taking into account any ITCs arising under the SR&ED Programs. If that CCPC had spent $2,000,000 on qualified expenditures, it should be entitled to $700,000 of ITCs. After using $230,000 of those ITCs to reduce its tax liability to nil, the CCPC should be entitled to a cash refund of $470,000. Smaller CCPCs may also be entitled to a refundable ITC for a portion of ITCs related to expenditures in excess of $3M.

Other corporations earn ITCs at the basic rate of 15% on qualified expenditures. These ITCs are not refundable.

Individuals and trusts earn ITCs at the basic rate of 15% and 40% of ITCs not used to reduce tax in the year are refundable.

ITCs that are not applied in a particular year to reduce tax and that are not refunded may be carried back 3 years or forward 20 years to reduce tax owing.

IV. CONCLUSION

Although some effort and resources are required to develop and document the story of scientific or technological advancement, the benefits of qualifying for the SR&ED Programs can be material. Qualifying SR&ED expenditures give rise to material investment tax credits that reduce tax owing and may be refundable in cash. For those undertaking R&D in the Canadian technology sector, it is worth investing some time and resources to determine if you or your organization qualifies for SR&ED Programs and are potentially entitled to investment tax credits.