Government funding for R&D

Need money to finance research and development? Don't overlook government assistance. You may be eligible for funding under the federal Scientific Research and Experimental Development program.

by Rudy Morrone, P.Eng

Your company is trying to develop and commercialize a new technology, but money has dried up and you haven't been able to attract the attention of investors. What are your options? Government research and development ("R&D") programs should not be overlooked as an option for financial assistance. The federal government's Scientific Research & Experimental Development (SR&ED) program may allow individuals or businesses in need of funds to recover the necessary cash flow to continue R&D. As new technologies develop further, financiers and investors may show an interest in them, thus enabling commercialization.

The SR&ED program

The SR&ED program is administered by the Canada Customs and Revenue Agency (CCRA)—formerly Revenue Canada. It is primarily governed through the Income Tax Act (Canada) and its corresponding regulations (collectively referred to as the "Act"). It operates through a scheme of tax credits for R&D activities carried out in Canada, which provide scientific or technical advances.

The impetus for the program is to stimulate R&D in Canada and attract foreign investment to Canada. It allows a taxpayer (as defined in the Act), who has carried out R&D in Canada in the course of his or her business activities and incurred related expenditures, to process a claim for tax credits on such expenditures. There are an unlimited number of R&D projects that may be claimed, but all claims must be supported by technical and financial evidence.

The credits that may be obtained may either be refunded to the taxpayer ("claimant") or applied against federal taxes paid or payable by the taxpayer.

Who's eligible?

Any taxpayer may make claims. Claimants include individuals, corporations of any size and unincorporated businesses in all types of industries. A Canadian-controlled private corporation (CCPC), which is not controlled, directly or indirectly, by non-resident individuals or public corporations (other than a prescribed venture capital corporation) may make claims, as can a corporation whose shares are listed on prescribed exchanges. However, partnerships may not make claims, because they are not recognized as taxpayers under the Act (the taxpayer is the individual partner in the partnership).

As shown in Table 1, there are three types of tax credits available, depending on the type of claimant. One of the most beneficial tax credits is the 35 per cent refundable tax credit for small CCPCs, defined as those CCPCs that have a taxable income no greater than $200,000 or taxable capital no greater than $10 million in Canada.

Only a small CCPC may obtain the enriched benefit of obtaining a refundable credit. The enriched benefit is subject to an expenditure limit of $2 million in the taxation year, which means that the refundable tax credit cannot be greater than $700,000. This refundability limit is gradually phased out when, in the previous year, the claimant's taxable income is greater than $200,000, or the taxable capital the claimant employs in Canada is greater than $10 million.

All other businesses and individuals may obtain non-refundable tax credits of up to 20 per cent of eligible expenses, which can be carried back three years and forward 10 years to be applied against federal taxes paid or payable by the claimant.

As already noted, claims comprise a technical and a financial component. The technical component includes the qualifying activities and criteria that must be met. The financial component addresses the expenses included in the claim.

Technical component

To be eligible for the program, R&D must be in keeping with a claimant's business activities. Qualifying activities for claims can involve basic research and applied research and experimental development. Technical support work may be eligible, provided that it is directly related and essential to the qualifying activities. Eligible work may include engineering, design, operations, research, mathematical analysis, computer programming, data collection and testing, and psychological research. Ineligible activities include work related to the social sciences or humanities, market research, sales promotion, style changes, commercial production or use and prospecting, exploring, drilling or producing minerals, petroleum or natural gas. Since work that involves commercial production or use is ineligible, it is possible for experimental development projects with a commercial focus to include both eligible and ineligible work.

In order for claimed activities to qualify, the following three criteria must also be met:

- There must be scientific or technical advancement. The focus here is not on the technology itself, but rather on the process of developing, or attempting to develop, the technology. The process must go beyond accepted or known

Table 1. Tax Credits by Claimant

Claimants	Expenditures	Refundable Credit on SR&ED	Nonrefundable Credit on SR&ED	Refundability on Expenditures (Current)	Refundability on Expenditures (Capital)
Canadian controlled private corporations (CCPCs)	≤$2 million	35%	–	100% ($700,000)	40% ($280,000)
CCPCs	>$2 million	–	20%	100% (against taxable income)	40% (against taxable income)
Non-CCPC corporations, individuals and unincorporated business entities	–	–	20%	–	–

practice to further knowledge of the science or technology. An activity that is new to the world is more likely to be perceived as a scientific or technical advancement than one that is simply new to a company.

- There must be scientific or technological uncertainty. The uncertainty cannot be something that can readily be resolved through existing information.
- There must be an experimental process, which includes some basic systematic investigation undertaken by qualified personnel (they must have relevant scientific or technical experience), who are responsible for directing or performing the qualifying R&D to arrive at the advancement. This entails providing evidence demonstrating that an experimental approach was used.

Financial component

Of course, actual R&D expenses must be incurred in order to be claimed. Typically, to determine "qualified" or eligible expenditures, the claim would:

- include current expenses, which comprise expenses related to salaries and wages of technically qualified personnel, arm's-length contract payments for work done and expenses for materials consumed or transformed that are directly related to the R&D;
- include capital equipment expenses. The general rule is that, to be eligible for a capital expense claim, equipment must be new and used at least 90 per cent of the time for the R&D. But there is a shared-use allowance in limited circumstances provided that, over a two-year period, the new equipment is primarily used for the R&D; and
- deduct contract revenues, government and non-government assistance, and prescribed general and administrative expenses that are not related to R&D and are therefore not claimable. Prescribed expenditures include administrative salaries (unless attributed to the R&D), legal and accounting fees, membership fees, interest type fees, advertising and selling expenses, expenses incurred to acquire intellectual property rights and patent prosecution expenses.

Claims must be filed within 12 months of the filing date for the taxation year during which expenses were incurred. There is both an audit and an appeal process for each claim.

Benefits and limitations

Benefits of the SR&ED program include providing the taxpayer with the opportunity to recover cash flow, which can provide him or her with money to continue the R&D. The program may be used to complement or supplement other government-sponsored R&D assistance programs.

In addition, the technical audits/reviews under the program provide the new technology with an additional level of credibility related to its technical soundness, which may help companies attract additional funding. However, financiers and investors will consider not only the technical soundness of the technology, but also such other factors as:

- the business plan and vision of the taxpayer;
- the relationship and participation of the key members involved with the technology and how committed they are to the ongoing process;
- whether the technology has a sustainable competitive advantage;
- the stage of the R&D and the resources required to reach commercialization;
- the market acceptance for the technology;
- whether there has been an adequate level of confidentiality concerning the technology; and
- the degree of protection provided by intellectual property rights obtained for the technology.

On the downside, the SR&ED program appears to be an administrative maze, which may be overwhelming to claimants. Claimants must pay close attention to the Act and the changing legal and administrative landscape. But by using the right services, these challenges can be readily addressed. ◆

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