

OCTOBER 2011

FEDERAL PANEL RECOMMENDS CHANGES TO SR&ED FOR SMES

Last week, the expert panel leading the Review of Federal Support to R&D in Canada tabled its recommendations to the Government of Canada. While much of the report echoes the concerns and positions of the BCTIA and its members, a few of the recommendations, most notably those around changes to SR&ED tax credits for SME's, and changes to the structure of the National Research Council are more controversial.

Overall, the report is broad-based in its approach and offers a solid, substantive look at innovation in Canada. However, the findings are far from earth shattering and the recommendations are relatively modest in tone and short on specifics.

The report constitutes recommendations of an external panel. They are not specific policies that the government will necessarily implement, but reflect valued opinions that the government may consider in due course.

In all, there were six key recommendations that set out a framework for action:

1. **Simplify the SR&ED program** by narrowing the tax credit to only encompass labour-related costs. Corollary to this recommendation is to potentially increase the tax credit rate and to also apply any program savings towards directed funding initiatives. To start, these changes are only recommended for CCPC SMEs, with a further recommendation to later extend the rules to other segments.

The report also recommends that the CRA strengthen its Pre-Claim Project Review service to provide firms with pre-approval of their SR&ED eligibility.

2. **Innovation as part of Procurement.** Emphasize business innovation as one of the key levers in public procurement with the net effect of supporting innovation from Canadian companies.
3. **Increase the innovation capital pools** available for start-up and growth-stage companies. The report recommended dedicating a portion of BDC's portfolio to start-up stage financing, leveraging where possible angel investment, and increasing BDC's overall funding to support later-stage venture capital funds.
4. **Create an Industrial Research and Innovation Council.** This would seek to consolidate many of the government programs and activities under a common umbrella to make it simpler for SMEs to access and navigate. It would also provide the capacity to extend IRAP's traditional program efforts to include early commercialization activities. This entity would also be responsible for developing a business talent strategy for innovation.

5. **Transform the National Research Council (NRC)** into a group of sectoral, collaborative R&D centres involving universities, businesses and the provinces.
6. **Identify a lead minister responsible for Innovation** and improve the coordination of the innovation agenda across federal and provincial governments.

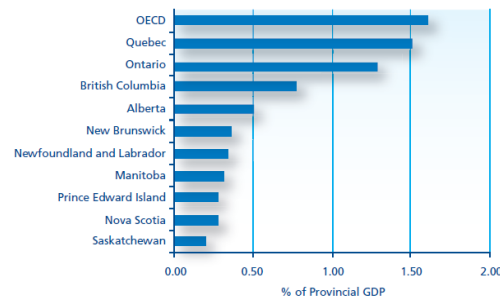
Background

In October 2010, the federal government appointed a private sector panel to conduct a comprehensive review of the support for research and development in Canada. Led by Tom Jenkins, chair of Canadian software leader Open Text, the panel conducted a series of consultations with stakeholder groups across the country and reviewed 228 written submissions from organizations like the BCTIA in its deliberation process.

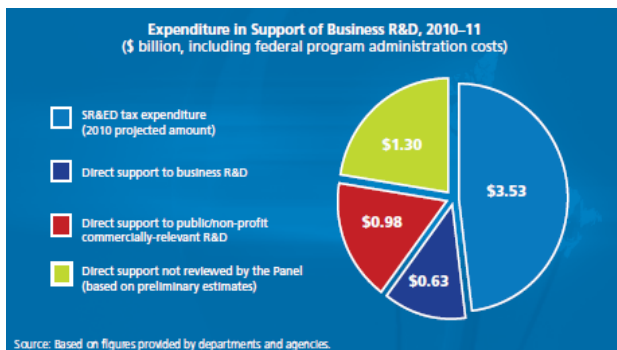
There were two key factors that the panel examined in the context of Canada's R&D performance. The first was Canada's overall productivity growth, which has averaged only 0.6 percent in the period from 2000 – 2009 and is less than half the OECD average of 1.5 percent. Productivity in Canada when compared to the US has declined from 93 percent of the US level in 1984 to just 71 percent in 2009.

The second key factor was Canada's relatively low performance in Business Expenditures in R&D (BERD). At 1 percent of GDP, Canada's BERD intensity was well below the OCED average of 1.6 percent and has declined from \$14B in 2006 to about \$12B in 2009. In British Columbia, our BERD performance is comparatively worse – accounting for approx. 0.8 percent of GDP.

Figure 2.3 Provincial BERD Intensities in Canada, 2008
(business expenditure on R&D as a percentage of provincial GDP)



Source: Statistics Canada (2010b) and OECD (2011).



The panel estimates that federal spending on R&D for the fiscal year 2010-2011 will be \$6.44 billion, which is comprised of over 100 programs and institutes. Of this amount, the SR&ED program accounts for \$3.5 billion.

BCTIA's Assessment

Overall, the report is broad-based in its approach, but short on specifics. We were encouraged that the panel took into account several of the recommendations that BCTIA had raised including the need for deeper capital pools, the expansion of programs to support early commercialization, the encouragement of innovation in public procurement and the streamlining of programs and processes to make them easier to access.

Below is our view of the positives and negatives of the recommendations set forth:

Consolidation of Programs - We agree with the concept of establishing a national Industrial Research and Innovation Council that would clearly amplify the focus on innovation in Canada as well as providing a long overdue vehicle for consolidating the myriad of more than 100 federally supported programs. It would allow for increased support for IRAP, extend support towards more commercialization activities and champion the development of a talent strategy on a national basis.

While the report touches on the importance of improving the commercialization outcomes from R&D efforts, the BCTIA believes that the direct support programs can and should take a more active role in funding commercialization efforts.

Increased Access to Capital - The report recognizes the gaps in risk capital at both the start-up stage and the growth stage of a company's lifecycle. Increasing the capital available at BDC, especially to leverage angel investment and support more venture funds would represent a positive step. The one glaring omission in the report, however, is the opportunity to adopt successful early stage capital programs such as the BC Small Business Venture Capital programs on a national level.

Recommendations on Streamlining SR&ED - On the positive side, we agree with the report's broad objective of simplifying the SR&ED program and providing more predictability in the eligibility of claims. The challenge remains, however, that the complexity and administration associated with SR&ED filings has more to do with the burden of contemporaneous documentation and evidence, which alone cannot be resolved by narrowing the tax credit calculations to only labour-related costs¹. Moreover, any such change in eligibility to solely labour costs has the unintended consequence of favouring labour-oriented R&D (such as software firms) at the expense of capital-intensive R&D firms (such as aerospace, Cleantech and manufacturing) which has a profound effect on early stage SMEs.

The report also overlooks one of the key attributes of SR&ED – that being the program's role in mitigating the access to capital issue for SMEs. It enables SMEs to compensate for their comparatively lower levels of investment as well as providing capital leverage to attract foreign investment. We have long advocated the need to extend the refundability attributes of SR&ED to non-CCPC SMEs, eliminating ownership structure as a criterion, and thereby increasing the flow of foreign direct investment into Canadian tech companies. We believe that any proposed changes to SR&ED need to be reviewed more

¹ PwC Tax Bulletin

http://www.pwc.com/en_CA/ca/sred/developments/publications/contemporaneous-documentation-2011-07-en.pdf

holistically in the context of early stage capital in addition to setting relative levels of indirect versus direct funding of federal R&D.

Finally, the report's recommendation to reduce the amount of SR&ED refundability over time based on the growth and profitability of a business is contrary to the direction of other OECD countries, most of whom are increasing their rates of refundability². It also risks oversimplifying lifecycle realities of different technology sectors such as life sciences, Cleantech, nanotechnology and quantum computing which may require substantially longer timeframes to achieve growth and profitability.

Next Steps

In response to this R&D review, and as part of our Member Consultations, the BCTIA will undertake the follow actions in response to the panel's recommendations:

1. Forward a formal response to The Honourable Gary Goodyear, Minister of State (Science and Technology) (Federal Economic Development Agency for Southern Ontario);
2. Coordinate a series of discussions with our technology association colleagues across Canada to share insights and where possible, provide coordinated feedback to the federal government;
3. Brief the Provincial government and Opposition on the panels' recommendations for SR&ED and the potential impacts for the Provincial SR&ED program.

Review of Federal Support to Research and Development – Expert Panel Report can be downloaded from the following links:

Executive Summary:

[http://rd-review.ca/eic/site/033.nsf/vwapj/EecutiveSum-sommaireExe-eng.pdf/\\$FILE/EecutiveSum-sommaireExe-eng.pdf](http://rd-review.ca/eic/site/033.nsf/vwapj/EecutiveSum-sommaireExe-eng.pdf/$FILE/EecutiveSum-sommaireExe-eng.pdf)

Full Report:

[http://rd-review.ca/eic/site/033.nsf/vwapj/R-D_InnovationCanada_Final-eng.pdf/\\$FILE/R-D_InnovationCanada_Final-eng.pdf](http://rd-review.ca/eic/site/033.nsf/vwapj/R-D_InnovationCanada_Final-eng.pdf/$FILE/R-D_InnovationCanada_Final-eng.pdf)

² Deloitte Global Survey of R&D Tax Incentives http://www.deloitte.com/assets/Dcom-Canada/Local%20Assets/Documents/Tax/EN/2011/ca_en_tax_RD_Global_RD_Survey_TaxIncentives_111011.pdf