Scientific research and experimental development: Government of Canada announces consultation on tax incentives

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On January 31, 2024, the Canadian federal government announced a consultation on potential changes to the Scientific Research and Experimental Development (SR&ED) tax incentive program under Canada's *Income Tax Act* (ITA), seeking input from stakeholders.

In conjunction with the announcement, the Department of Finance released a consultation paper providing the relevant background for the initiative (Consultation Paper). Stakeholders have until April 15, 2024, to provide their comments and suggestions.

The SR&ED regime in the ITA

The SR&ED regime in the ITA is the largest element of the federal government's support for businesses to carry out SR&ED in Canada, with over $13.7 billion of SR&ED expenditures claimed and $3.9 billion of tax credits provided in 2021 alone.

The regime provides tax incentives in two ways. First, qualifying SR&ED expenditures are fully deductible against a taxpayer's income (i.e. in the year incurred), even if normally considered capital in nature and thereby not otherwise immediately deductible. Faster deductibility allows these expenses to reduce taxes owing faster than would otherwise be the case.

In addition, a subset of these qualifying SR&ED expenditures are eligible for "investment tax credits" (ITCs), being an actual deduction from taxes owing (not merely a deduction from income in computing taxes owing). A taxpayer that is a "Canadian-controlled private corporation" (CCPC) can claim an ITC of 35% up to $3M of its eligible SR&ED expenditures for the year, and an ITC of 15% of eligible SR&ED expenditures beyond that threshold.

Depending on the CCPC's taxable income and taxable capital, some or all of these ITCs are "refundable," meaning that the government will pay the ITC to the CCPC even if it does not have taxes owing to which the ITC could be applied. Non-CCPCs are

entitled to a non-refundable ITC of 15% of their eligible SR&ED expenditures. See Business Tax Canada's information about Canadian subsidiaries for further details on the SR&ED rules in the ITA.

What is SR&ED?

The laws surrounding the SR&ED program can be very complex. The Canada Revenue Agency (CRA) has published various administrative positions and guidelines for the program. Understanding what constitutes qualifying SR&ED is essential to understanding what types of business activities are eligible for these tax incentives.

Under the ITA, SR&ED means the systematic investigation or search that is carried out in a field of science or technology by means of experiment or analysis and that is:

- **basic research** (work undertaken for the advancement of scientific knowledge without a specific practical application in view);
- **applied research** (work undertaken for the advancement of scientific knowledge with a specific practical application in view);
- **experimental development** (work undertaken for the purpose of achieving technological advancement for the purpose of creating new, or improving existing, materials, devices, products or processes, including incremental improvement); or
- **work undertaken by or on behalf of the taxpayer** with respect to engineering, design, operations research, mathematical analysis, computer programming, data collection, testing or psychological research, where the work is commensurate with the needs, and directly in support, of work described in the above three bullets and undertaken in Canada by or on behalf of the taxpayer.

Work that is not eligible includes:

- market research or sales promotion;
- quality control or routine testing of materials, devices, products or processes;
- research in the 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 or the commercial use of a new or improved process;
- style changes; and
- routine data collection.

It is important to note that it is the attempt to gain scientific knowledge or technological advancement that qualifies as SR&ED. A successful work product does not need to be developed from the SR&ED for one to benefit from the SR&ED program.

Background of the consultation

The SR&ED review came amidst the federal government’s renewed efforts in encouraging innovation within Canada in recent years. The SR&ED program is part of the larger network of resources offered by the federal government to encourage research and development activities in Canada. The Consultation Paper identifies four

key federal platforms in addition to the SR&ED program to support business innovation and growth in Canada:

- **The Industrial Research Assistance Program** supports the innovation development of small and medium-sized businesses through financial assistance, advisory services and connections to expertise.
- **The Strategic Innovation Fund** subsidizes large-scale (at least $20 million in total project costs), transformative and collaborative projects over all sectors of the economy, with the goal of supporting the Canadian innovation network.
- **The Regional Development Agencies** form a network within Canada that supports business innovation and economic growth with regional-specific initiatives and programs.
- **The Trade Commissioner Service** is a network of global Trade Commissioners that assists Canadian companies to connect with contacts and resources to operate and grow internationally.

This initiative is partly in response to the declining SR&ED expenditures claimed. The Consultation Paper states that the amounts of SR&ED expenditures claimed, especially by Canadian-controlled corporations, have been steadily decreasing in the past decade. This data reflects Canada's weak performance in research and development relative to its international peers.

The Canadian federal government is reviewing the SR&ED program to ensure it is effective in encouraging research and development initiatives that benefit Canada, and to explore opportunities to modernize and simplify it. The consultation adopts a cost-neutral approach, meaning that any enhanced benefits from changes to the program must be funded through reductions in costs and benefits within other areas of the program. In conjunction with the review, the CRA has also undertaken a multi-prong approach to improve the administration of the existing SR&ED program, seeing how the cost and complexity of complying with Canadian SR&ED claim requirements have been a frequent source of taxpayer complaints.

Key questions relevant to the consultation

Given the consultation's background and objectives, the Department of Finance is seeking feedback from stakeholders on the following questions:

- How can the SR&ED program remain effective in supporting R&D investment by businesses of all types in Canada? How can the SR&ED program better support the growth and success of R&D-intensive Canadian businesses going forward?
- What improvements to the definition of SR&ED, the program's eligibility criteria, and/or the program's overall architecture should be considered?
- How does the SR&ED program complement the existing suite of support programs for R&D in Canada? How could this complementarity be improved?
- Are there more effective ways in which the overall level of assistance provided within the SR&ED program could be targeted? If so, what changes could be made to the SR&ED program to offset the costs of any proposed enhancements?
- How can the SR&ED program effectively ensure the retention of intellectual property (IP) within Canada, particularly to support innovative Canadian businesses to remain Canadian-owned and operated?

- How can the SR&ED program be improved and streamlined to make it easier for entrepreneurs to access support?
- How can your suggested enhancements be funded by existing support available through the SR&ED program? What potential changes could best focus support to benefit Canada, including by creating economic opportunities for Canadians?

Takeaway

The consultation on SR&ED tax incentives represents a welcome effort on the part of the Canadian government to encourage innovation from Canadian businesses. Interested parties should ensure that they make submissions by the April 15 deadline. Comments are to be sent to SRED-PB-RSDE-RPB@fin.gc.ca with "SR&ED Review" as the subject line.

If you have any questions about Canada's SR&ED program or the submission process, please reach out to any member of BLG's Tax Group.

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