



Business Council of
British Columbia

SUBMISSION ON THE FEDERAL REVIEW OF TAX INCENTIVES FOR SCIENTIFIC RESEARCH AND EXPERIMENTAL DEVELOPMENT

The Business Council of British Columbia is pleased to provide our views in connection with the federal government's consultation process on "Improving the Scientific Research and Experimental Development Tax Incentives." Established in 1966, the Business Council is an association representing 210 large and medium-sized enterprises engaged in business in British Columbia. Our members are drawn from all major sectors of the provincial economy, including forest products, mining, manufacturing, transportation, agri-food, telecommunications, information technology, financial services, energy, utilities, tourism, retail, construction, life sciences, engineering, healthcare, education and the professions. Taken together, the corporate members and the associations affiliated with the Business Council are responsible for one-quarter of all jobs in British Columbia.

1. Background

The Scientific Research and Experimental Development (SR&ED) program is the most important federal initiative supporting business R&D in the country. In 2006, the program provided more than \$3 billion in assistance to a diverse range of Canadian enterprises engaged in R&D. Most of the provinces, including British Columbia, maintain their own R&D tax incentives which top up the support available through this key federal program.

Under the SR&ED program, all eligible current business expenditures on R&D can be expensed for tax purposes in the year in which they are incurred. Eligible expenses include wage/salary costs for R&D personnel, expenditures on materials and supplies, and outlays



on certain equipment used mainly in R&D. Unused deductions may be carried forward. The SR&ED program also includes an investment tax credit (ITC) component that is applied to corporate income taxes otherwise payable. For small Canadian-controlled private corporations, the credit is 35% on the first \$2 million of qualifying R&D expenditures. For other businesses, the ITC rate is 20%. Qualifying Canadian-controlled private corporations may be eligible to have their SR&ED tax credits refunded directly to them if they are not in a tax-paying position. For other businesses, SR&ED tax credits are non-refundable. Unused investment tax credits may be carried forward for up to 20 years and back for three years.

Studies undertaken by the Conference Board, the OECD, and various academic experts confirm that Canada provides generous public support for private sector R&D. Despite this, business investment in R&D in Canada has remained low compared to other leading industrialized countries. For example, within the OECD Canada ranks 15th in “business R&D intensity” (proxied by business R&D outlays relative to business output). Of interest, the level of business research intensity in Canada is quite similar to that in the United States in several industries often considered to be part of the “high technology” sector – e.g., pharmaceuticals, medical devices, communications equipment, and computing equipment. Where Canada falls behind in private sector R&D is in service industries and other parts of manufacturing.¹

Stimulating business R&D is sensible public policy. According to the OECD, a one percentage point rise in private sector R&D intensity leads to as much as a 12% increase in per capita income over the long-term – a remarkable result.² A recent Department of Finance analysis shows that each dollar spent on the SR&ED program yields a positive net gain for the Canadian economy.³ Because R&D spending has positive “spillovers” (economic

¹ Expert Panel on Commercialization, Volume I: Final Report (April 2006), pp. 17-18.

² Organization for Economic Cooperation and Development, The Sources of Economic Growth in OECD Countries (2003).

³ M. Parsons and N. Phillips, “An Evaluation of the Federal Tax Credit for Scientific Research and Experimental Development,” Department of Finance Working Paper (2007).



benefits that are not captured by the entity undertaking the research), most governments and economists believe there is a persuasive case for providing public support to R&D.⁴

2. Innovation Policy and Wealth Creation

As noted, Canadian tax incentives for R&D are generous by the standards of other industrialized countries. A large portion of the R&D undertaken in the Canadian private sector is based, at least in part, on the availability of this tax support. Looking ahead, a major challenge for Canada is to leverage the considerable public and private resources being devoted to R&D (and to innovation more broadly) to create additional wealth and build a more prosperous economy. This, in turn, requires developing more globally competitive industries and firms that can grow from a Canadian base. It is in this area – where research and innovation are converted into commercial success – that Canada’s record has been less than stellar. An improved performance depends on establishing an economic and policy environment that facilitates successful commercialization. Better results in this area would help to address the country’s most worrisome economic shortcoming – lagging productivity. As the Expert Panel on Commercialization observed in its 2006 Final Report:

“An important element of Canada’s productivity challenge is its inability to capitalize on innovation and discover new and better ways to add value to what it sells. The key to solving this is in commercializing knowledge – the surest path to enhancing productivity and sustaining economic prosperity.”⁵

In recent years, the federal government has done much to boost support for research and development in universities and colleges by expanding the supply of skilled researchers, investing in research infrastructure, and increasing the budgets of granting agencies. Now, the priority should be to foster the commercialization of research – whether it is undertaken in academia, by private enterprises, or through university-business partnerships.

⁴ Richard Harris, “Canada’s R&D Deficit and How to Fix It,” C.D. Howe Institute, Commentary (May 2005), p. 4.

⁵ Expert Panel on Commercialization, Volume I: Final Report (April 2006), p. 6.



3. Issues of Program Design and Administration

The SR&ED program has produced significant benefits for Canada by stimulating research and innovation. But the main components of the program, including the basic credit rates and eligibility criteria, have remained largely unchanged for the past two decades. During this period, many other countries have taken steps to increase support for private sector R&D, thus eroding the competitive advantages that Canada previously enjoyed. Discussions with Business Council members and a number of other BC companies familiar with the program point to several issues that are relevant to the current review process.

Support for commercialization

Encouraging commercially relevant innovation would raise the overall economic returns from government's sizable investments in R&D. This raises the question of whether the SR&ED program can be modified in a manner that will spur commercialization. As now structured, the program is heavily focused on the "science" portion of innovative activity and does not really support other elements of commercialization. This issue is particularly important for smaller companies that often lack the financial means to perform effective market research for an innovative product or technology.

A 2005 Conference Board of Canada report suggested establishing a "pilot program" to enhance the effectiveness of the SR&ED tax credit by including a wider range of corporate expenses related to the broader innovation process, not just direct R&D expenditures.⁶ Extending the SR&ED program to include business expenditures on selected "go-to-market" activities would be beneficial to smaller technology firms and increase their odds of achieving commercial success. As part of the SR&ED review, we recommend that the government examine how this might be done in a cost-effective way.

⁶ Conference Board of Canada, Leaders' Roundtable on Commercialization, Six Quick Hits for Canadian Commercialization (April 2005).



Access to the program

Certain features of the SR&ED program limit its ability to stimulate business innovation. At present, many companies that conduct (or that would like to undertake) R&D in Canada are not eligible for the full suite of tax incentives available under the program. Companies in this situation include those that are not profitable, since they do not pay taxes against which the credits can be claimed; and those that are not organized as Canadian-controlled private corporations – that is, they are publicly traded or foreign-controlled. We do not believe there is a sound public policy basis for differentiating between companies that conduct R&D based on their business structure or ownership status. All firms performing significant R&D in Canada bring economic benefits to the country.

We thus recommend that the SR&ED program be changed to treat all companies conducting R&D equally in terms of access to tax incentives. If non-Canadian controlled companies gain access to refundable SR&ED credits, there may be concern that some of these firms could transfer the benefits of their research outside of the country. This issue can be dealt with by setting the rules of the program so as to discourage such behavior.

Administrative complexity

The Canada Revenue Agency (CRA) has made improvements to the SR&ED application process in recent years. However, there is a widespread view within the British Columbia business community that the SR&ED program is still overly complicated and imposes high “overhead” costs on companies of all sizes. Specific concerns include the time needed to process claims, long delays in auditing and appealing claims, discrepancies in the way the CRA applies its policies and practices, and the general unpredictability of the process. Many companies complain that they have to retain expensive consultants and advisers in order to understand and work with the SR&ED program. Even large British Columbia companies report that there continues to be significant uncertainty about the definitions and requirements of the program.



We recommend that the government take further steps to streamline and simplify the SR&ED application process and expedite the assessment of claims. Greater clarity about the program's rules and requirements would reduce uncertainty for applicants. In addition, better support and educational materials would be particularly useful for smaller technology companies and first-time applicants.

Administrative fairness

Concerns have also been raised about the fairness of the CRA's administration of the program. Some companies believe the CRA is the wrong government agency to have responsibility for the SR&ED program, since its fundamental mandate and expertise is to enforce compliance with the *Income Tax Act*, not to encourage innovation and economic development. Another issue relates to how appeals are dealt with. In at least some cases, it appears that appeals of SR&ED claims are handled by the same personnel who did the initial audit. This is inappropriate and serves to nurture doubts about the fairness of the administrative process.

Perhaps consideration should be given to shifting responsibility for administering the SR&ED program to another federal department. But regardless of which federal agency is responsible for the program, the officials charged with handling appeals of SR&ED claims should be kept separate from those involved in reviewing applications and carrying out initial audits.

At a more general level, it may be time to revisit the current institutional arrangement which gives administration of the SR&ED program to the CRA while the Department of Finance has jurisdiction over all of the relevant policy aspects. Arguably this arrangement adds to the complexity of the SR&ED regime and makes it harder to keep the program up to date with changing business realities. Finance officials are required to set policy to foster R&D even though they are unlikely to have the technical knowledge and industry-specific expertise possessed by those who administer the program.



4. Conclusion

The Business Council endorses the government's decision to review the SR&ED program as part of the broader economic development agenda outlined in its Advantage Canada strategy. Although the program has been successful in many respects, it makes sense to examine whether current public incentives for industry R&D can be made more effective in generating the levels and kinds of business innovation needed to enhance Canada's long-term economic prosperity in today's increasingly knowledge-driven global economy.

The Business Council appreciates the opportunity to provide our advice and recommendations on the SR&ED tax incentive program.