# *Proposed Changes to the SR & ED Program Under the Income Tax Act*

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## Précis

Les récents changements proposés aux règles de l'impôt sur le revenu se rapportant au programme de recherche scientifique et de développement expérimental (RS & DE), telles qu'elles sont contenues dans la Loi de l'impôt sur le revenu, visent à en corriger les faiblesses et à simplifier l'administration du programme de RS & DE. Le présent article porte sur les règles existantes de RS & DE ainsi que sur les problèmes qui ont entraîné les modifications proposées, annoncées dans le communiqué de presse daté du 2 décembre 1992. L'article comporte aussi une analyse des modifications qui permettront aux contribuables d'obtenir des crédits d'impôt relativement au matériel à vocations multiples utilisé dans le RS & DE et d'autres activités, une description de la méthode facultative proposée, appelée la méthode de remplacement, pour calculer les crédits d'impôt pour les frais généraux de RS & DE, et une analyse sur l'à-propos de l'existence des sociétés entièrement vouées à la RS & DE à la lumière de la nouvelle méthode. L'article traite aussi des diverses améliorations apportées au programme de RS & DE qui ont été annoncées dans le budget du 26 avril 1993. Celles-ci incluent la possibilité, pour les sociétés fermées dont le contrôle est canadien et dont le revenu imposable est supérieur à 200 000 $, de demander des crédits d'impôt remboursables. Enfin, la politique de Revenu Canada sur les points pertinents de RS & DE figurant dans le *Bulletin d'interprétation* IT-151R4 est abordée.

## Abstract

Recent changes proposed to the income tax rules with respect to the scientific research and experimental development (SR & ED) program as contained in the Income Tax Act are intended to correct deficiencies in the rules and to streamline the administration of the SR & ED program. This article reviews the existing SR & ED rules and identifies problems that have given rise to the proposed amendments as announced in the press release dated December 2, 1992. It analyzes the amendments that will permit taxpayers to earn tax credits in respect of shared-use equipment that is used in SR & ED and other activities, describes the proposed elective method known as the proxy method for calculating tax credits in respect of SR & ED overhead costs, and analyzes whether sole-purpose SR & ED


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companies still make sense in the light of the new proxy method. The article also discusses various enrichments to the SR & ED program as announced in the April 26, 1993 budget, which include the availability of refundable tax credits for Canadian-controlled private corporations whose taxable incomes exceed $200,000. Finally, the article discusses Revenue Canada's policy on relevant SR & ED issues as set out in *Interpretation Bulletin* IT-151R4.

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## EXISTING SR & ED RULES

Sections 37, 127, and 127.1 of the Income Tax Act[1] and regulation 2900 contain the relevant tax rules relating to the scientific research and experimenal development (SR & ED) program.[2] The principal provisions relating to the program are described below.[3]

Section 37 and regulation 2900 together describe what constitutes qualifying SR & ED for income tax purposes and provide various rules for the computation of SR & ED expenditures. For example, these provisions detail the tax treatment of current and capital expenditures as well as the apportionment of expenditures between eligible and non-eligible activities. Specifically, to ensure that a taxpayer's Canadian SR & ED expenditure pool is increased only to the extent of an amount incurred for SR & ED activities, clause 37(7)(c)(ii)(A) requires that the expense (capital or current) substantially relate to the prosecution of SR & ED or the provision of premises, facilities, or equipment for the prosecution of SR & ED. Thus, where a taxpayer can demonstrate that an expenditure was incurred, substantially (generally interpreted to be 90 percent or more) for the prosecution of SR & ED or the provision of SR & ED facilities for the prosecution of SR & ED, the entire amount of the expenditure may be added to the SR & ED expenditure pool. Where a capital expenditure does not meet the substantial test, none of the costs related to it qualifies as SR & ED. A current expenditure may, however, be added to the SR & ED pool by virtue of clause 37(7)(c)(ii)(B), provided that the expenditure is directly attributable to the prosecution or the provision of SR & ED facilities pursuant to regulations 2900(2) and (3).

Regulations 2900(2) and (3) list the following expenditures as being directly attributable to the prosecution of, or the provision of, SR & ED facilities:

1) The cost of materials consumed in the prosecution of SR & ED;

2) salaries and benefits, including a portion thereof, paid to an employee (other than bonuses to non-arm's-length parties or specified share-

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[1] RSC 1952, c. 148, as amended by SC 1970-71-72, c. 63, and as subsequently amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

[2] See Canada, Department of Finance, *Release*, no. 92-088, December 2, 1992.

[3] For additional references, see Sweeney Terrance and Craig Robertson, "Income Tax Incentives for Canadian Research and Development" (1989), vol. 37, no. 2 *Canadian Tax Journal* 310-40.

holders) who directly undertakes, supervises, or supports the prosecution of SR & ED to the extent that the salaries and benefits can reasonably be considered to relate to the qualifying activities;

3) the cost of the maintenance and upkeep of premises, facilities, or equipment related to the prosecution; and,

4) other expenditures that are directly related to the prosecution or the provision of facilities that would not have been incurred if the prosecution had not occurred or if the premises, facilities, or equipment had not existed (which means, essentially, that only the incremental expenditures or costs that are directly variable with the SR & ED will qualify).

A taxpayer is allowed to claim 100 percent of the amount added to its SR & ED expenditure pool in computing its income for the taxation year. The unused portion of the pool can be carried forward indefinitely.

In addition to the full writeoff privilege, SR & ED expenditures qualify for generous investment tax credits. In that regard, the definitions of "investment tax credit" and "qualified expenditure" contained in section 127 allow taxpayers to compute their investment tax credit entitlements for a taxation year in respect of SR & ED expenditures other than on expenditures referred to as prescribed expenditures (described below).

## PROBLEMS IDENTIFIED WITH THE SR & ED RULES

Over the years, both taxpayers and the tax authorities have found the existing rules to be deficient in a number of areas, including the substantial-use test, the directly attributable test, and the treatment of general administration and management costs.

### The Substantial-Use Test

In general, the SR & ED provisions work fairly well where it can be demonstrated that all or substantially all expenditures are incurred for the prosecution of SR & ED or the provision of SR & ED facilities. Thus, where a taxpayer acquires supplies (for example, chemicals to develop a new product) exclusively for the prosecution of SR & ED, the cost of supplies consumed in that development clearly qualify as SR & ED expenditures. The substantial-use test, however, has given rise to some problems in the area of capital purchases. For example, where a taxpayer acquires a capital property exclusively for SR & ED and for some unforeseen reason shifts the use of the equipment from an SR & ED activity to a non-SR & ED activity, Revenue Canada often follows the practice of disallowing the SR & ED treatment in hindsight. Revenue Canada has often refused to take into account the taxpayer's intended use at the time of the purchase.[4] The wording

[4] The legislation implementing the changes was included in Bill C-136, An Act To Amend the Income Tax Act, which was tabled on June 14, 1993, but which died on the order paper on the dissolution of Parliament. The newly elected government reintroduced the legislation as Bill C-9, An Act To Amend the Income Tax Act, tabled February 4, 1994. Readers should be aware, though, that the amendments to the Act discussed in this article are based

(The footnote is continued on the next page.)

in existing clause 37(7)(c)(ii)(A) is not very clear in this regard, and as a result has created uncertainty for taxpayers. The clause does not clearly identify whether the test is to be performed at the time the asset is acquired (that is, whether the test focuses on the intention of the taxpayer) or whether it is based on factual evidence after the asset has been used (that is, whether the test focuses on the asset's actual use).

### The Directly Attributable Test

Where a taxpayer incurs an expenditure that is not substantially related to the prosecution of SR & ED, a portion of the expenditure may still be treated as SR & ED, provided that the expenditure is of a current nature and is directly attributable to the prosecution of SR & ED or the provision of SR & ED facilities. Since this allocation method is not available with respect to capital expenditures, many taxpayers find the provision to be biased in favour of lessees of SR & ED equipment. For example, where a taxpayer purchases a photocopier and uses the copier more than 50 percent of its operating time for SR & ED purposes, no part of the capital cost of the photocopier may be added to the SR & ED pool by virtue of clause 37(7)(c)(ii)(A). A taxpayer that leases a photocopier, however, is allowed to add 50 percent of the lease cost to its SR & ED pool.

Furthermore, it is my understanding that some district offices of Revenue Canada have interpreted the wording of regulation 2900(3)(c) in the strictest sense, thereby disallowing SR & ED expenses that would otherwise qualify. For example, where a taxpayer paid rent for a photocopier and claimed 50 percent of the rental cost as SR & ED, various district offices would deny the claim, arguing that the wording does not permit a taxpayer to claim a portion of such an expenditure.

### General Administration and Management Costs

The definitions of "investment tax credit" and "qualified expenditure" contained in subsection 127(9) permit taxpayers to earn investment tax credits (ITCs) in respect of their qualifying SR & ED work. Although most SR & ED expenditures within the meaning of paragraph 37(1)(a) and subparagraph 37(1)(b)(i) qualify for ITCs, taxpayers are denied ITCs on prescribed expenses under regulation 2902 even though the expenses might otherwise qualify as fully deductible SR & ED expenditures for the purposes of computing income. The following expenditures, among others, are ineligible for ITCs under regulation 2902:

1) general administration or business management costs, including the administrative salaries of a person whose duties are not all or substan-

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[4] Continued . . .
on the legislation proposed in Bill C-136. Furthermore, references to amendments to the SR & ED regulations are based on the draft regulations contained in the December 2, 1992 press release. Readers should also be aware that Bill C-9 was drafted on the assumption that the fifth supplement to the Revised Statutes of Canada will be proclaimed before the bill is enacted. Therefore, the section references in this article may not match those of Bill C-9.

tially all directed to the prosecution of SR & ED unless the person directly undertakes, supervises, or supports the SR & ED prosecution; in this case, only the relevant portion of the expenditure will be eligible for an ITC;

2) legal or accounting fees; general interest, entertainment, advertising, selling, or convention expenses; dues or fees in respect of membership in a scientific or technical society or organization; and fines or penalties; and

3) the cost of maintenance and upkeep of premises, facilities, or equipment to the extent that such expenditures are not attributable to the prosecution of SR & ED.

These restrictions are designed to ensure that the salaries of administrative staff and other general and administrative expenses do not qualify for ITCs, and reflect the government's concern about potential abuse and its desire to avoid allocation issues. By way of an exception, the restrictions do not apply to a taxpayer that derives 90 percent or more of its revenues from the prosecution of SR & ED (otherwise known as a sole-purpose R & D company). Therefore, if a taxpayer were to isolate its SR & ED expenditures in a sole-purpose R & D company, the restrictions contained in regulation 2902 would not apply and the taxpayer might be entitled to a greater amount of ITCs.

These restrictions as well as other requirements in regulations 2900(2) and 2900(3) have created administrative problems both for taxpayers and for Revenue Canada. This is evident from the recent Federal Court decision in *Imapro Corporation v. The Queen*.[5]

The question whether certain overhead-type costs are properly included in or excluded from a claim for ITCs has also been a concern to taxpayers. For example, where a taxpayer employs professional engineering staff for an SR & ED project, it is unclear whether the taxpayer is entitled to ITCs for support and administrative staff who work with the engineering staff to accomplish the SR & ED tasks. If the secretary works for both the SR & ED department and other departments, Revenue Canada could deny the SR & ED-related portion of the salary under regulation 2900(2) on the grounds that the secretary does not directly support the prosecution of SR & ED. Regulation 2902 would then be interpreted similarly to deny the taxpayer ITCs. Likewise, if the purchasing department helps procure SR & ED-related equipment and material to be consumed in an experimental development, ITCs on salaries relating to this activity could be denied on the grounds that the salaries are administrative or do not directly support the prosecution of SR & ED. In both cases, though, the SR & ED could not be performed without these types of costs.

The cost of maintenance and upkeep of premises and equipment used in SR & ED activities has also led to many disputes between taxpayers and Revenue Canada. Again, taxpayers must prove that the cost is directly

[5] 92 DTC 6487 (FCTD).

attributable to the qualifying activity and is incremental by virtue of regulation 2900(3)(b). The incremental issue is very difficult to prove in many circumstances and has led to uncertainty for taxpayers. Usually, taxpayers without a sophisticated cost accounting system face the virtually impossible task of satisfying Revenue Canada in this regard. As a result, many small companies, or companies without sophisticated cost accounting systems, do not bother to claim overhead costs since they do not wish to spend their time disputing the issue with the tax authorities.

The restrictions regarding overhead costs tend to discriminate against taxpayers whose SR & ED activities are incidental to normal business operations. For example, a software development company whose principal business is the prosecution of SR & ED is able to receive ITCs on most of its overhead and administrative costs. A manufacturing company that develops an in-house qualifying software program, however, would not be eligible for ITCs on the same overhead and administrative costs.

## PROPOSED CHANGES

The proposed changes to the Income Tax Act and Regulations as set out in the December 2, 1992 press release are designed to address the problems noted above and to clarify several other issues. These changes are summarized below.[6]

### Capital Expenditures

The proposed rules attempt to address the problems associated with capital assets used partially for SR & ED and partially for some other purpose (referred to as "shared-use equipment"). The proposed rules also address the problems associated with substantial-use equipment.

#### *Shared-Use Equipment*

Some companies find it economical, as well as environmentally friendly, to use the same equipment both for production (an ineligible activity) and for SR & ED purposes (an eligible activity). For example, a company may acquire a probing instrument that would be used for R & D purposes for, say, 60 percent of its total use and for quality control purposes for the remaining 40 percent. Under the current rules, the cost of the equipment would not qualify as an SR & ED expenditure because it was not acquired for substantial SR & ED use. To deal with the issue of shared-use equipment, the government has proposed that where the equipment is used primarily (generally understood to mean more than 50 percent of the total use) in SR & ED activities by a taxpayer, the taxpayer will be granted up to 50 percent of the ITC that is normally allowed on equipment with substantial SR & ED use. The credit will be given in two instalments over a

[6] See paragraph 21 of *Interpretation Bulletin* IT-151R3, June 24, 1988, wherein Revenue Canada states that "[w]hile this determination is usually made at the time a particular expenditure is made, the Department will normally consider subsequent events as evidence of the taxpayer's intention at the time the expenditure was made."

three-year period and will be granted on the basis of actual as opposed to anticipated use. Unlike equipment acquired for substantial SR & ED use, the shared-use equipment will be added to the undepreciated capital cost pool (subject to the half-year rule where applicable) as opposed to the SR & ED pool. This treatment will be applicable to property acquired after December 2, 1992. The following example illustrates this change.

A taxpayer acquires a piece of shared-use equipment, which would normally be included in class 8, in the first taxation year for $1,000. The taxpayer uses the equipment for more than 50 percent of the total operating time in SR & ED activities in that year and in the subsequent two taxation years. Under the proposed shared-use equipment rules, the taxpayer will be entitled to the following ITC using a 20 percent ITC rate.

| *Taxation year* | *Capital cost of the equipment* | *Capital cost eligible for ITC* | *ITC at the rate of 20%* |
|---|---|---|---|
| First year . . . . . . . . . . | $1,000 | None | None |
| Second year . . . . . . . | $1,000 | $250 | $ 50 |
| Third year . . . . . . . . . | $1,000 | $250 | $ 50 |
| Total . . . . . . . . . . . . . | | | $100 |

The table shows that the ITC under the shared-use method will amount to one-half of the ITC that would be received in respect of substantial-use equipment, and that the ITC will be paid in two instalments. The following points should be noted with respect to this initiative:

• The first partial ITC for shared-use equipment will be granted in the taxation year in which the asset has been used for at least 12 months from the date of its purchase, if the asset was used for more than 50 percent of its total operating time in the SR & ED activities.

• The second partial ITC for shared-use equipment will be granted in a subsequent taxation year, provided that the equipment has been used for a total of 24 months by the end of that year. Furthermore, the equipment must have been used for more than 50 percent of the total operating time in the SR & ED activities between the time of its purchase and the end of the taxation year. A tax credit for the second year will not be granted if the equipment did not qualify for a credit in the first taxation year.

• If the equipment is used for more than 50 percent (say, 80 percent of the total operating time) in the first 12-month period but for less than 50 percent in the second period (say, 30 percent of the total operating time), it may still qualify for a partial credit for the second taxation year, because the definition of second-term shared-use equipment will look at the use over the 24-month period as opposed to the second-term period on a stand-alone basis.

• General purpose office equipment or furniture will not qualify for the shared-use equipment rules.

The changes to the shared-use rules will be implemented by way of amendments to section 127 of the Act. The expressions "first term shared-use-equipment" and "second term shared-use-equipment" will be added to the definitions in subsection 127(9). "First term shared-use-equipment" will be defined to mean depreciable property that is used in SR & ED activities for 50 percent or more of its total operating time for a period beginning at the date of its purchase and ending in the taxation year that ends at least 12 months after its acquisition. "Second term shared-use-equipment" will be defined to mean property that was first-term shared-use equipment and that is used for 50 percent or more of its operating time during a period of not less than 24 months beginning at the date of its purchase and ending in a taxation year that ends at least 24 after its acquisition. Where a taxpayer does not meet the primary-use test in the second year, the wording of the definition of second-term shared-use equipment is such that the remaining tax credit may be available in a later year when the requirement can be met.

Under the proposed rules, a taxpayer will be entitled to claim an ITC in each of the first two taxation years on one-quarter of the capital cost to it (see the example above). Proposed paragraph 127(11.1)(e) will codify this entitlement so that a taxpayer's ITC claim in respect of qualifying equipment will be restricted to one-quarter of the capital cost of the equipment. Furthermore, the capital cost used for the second year for this computation will be the same as that used for the first taxation year; therefore, any grants or assistance received in respect of the equipment after the first claim will not affect the capital cost amount for the second taxation year.

Given that the cost of shared-use equipment is added to the undepreciated capital cost of a particular class, any ITC earned in a taxation year on the equipment will be credited to the undepreciated capital cost pool in the following year.

Finally, the definition of "qualified expenditure" in subsection 127(9) will be amended to include references to first- and second-term shared-use equipment, thereby permitting taxpayers to earn ITCs on such equipment.

### *Substantial-Use Capital Expenditures*

As discussed above, the existing wording of subparagraph 37(7)(c)(ii) with respect to capital expenditures has caused administrative difficulties. To remedy this problem, new wording has been proposed in subclause 37(7)(c)(ii)(A)(III) to clarify the timing of the test. The proposed subclause reads as follows:

> an expenditure of a capital nature *that at the time it was incurred* was for the provision of premises, facilities, or equipment *where at that time it was intended*
>
> 1. that it would be used during all or substantially all of its operating time in its expected useful life for, or
>
> 2. that all or substantially all of its value would be consumed in,
>
> the prosecution of scientific research and experimental development in Canada [emphasis added].

The amendment will remove the ambiguity from the existing wording and make it clear that one should look at the intended use of equipment at the time of purchase. Actual use will no longer be relevant for the test. Revenue Canada may still use hindsight in applying the rule, though, because hindsight is often the best indication of the actual intention of the taxpayer. Readers may wish to review paragraph 29 of *Interpretation Bulletin* IT-151R4[7] for Revenue Canada's recent position in this area.

## Overhead and Administrative Costs

The treatment of overhead and administrative costs is discussed first in terms of the concept and then in terms of the specific legislation proposed.

### *Concept*

To address the concerns with respect to overhead costs and to simplify the computation of SR & ED ITCs for small and medium-sized companies, the proposed legislation will allow taxpayers to compute all their qualifying SR & ED expenditures for a taxation year under a new optional simplified method. Because the new method is optional, taxpayers will be free to calculate their overhead and administration costs under the current item-by-item method if they find that method to be more beneficial.

The proxy amount method (a name adopted to suggest that something is given in lieu of what one would ordinarily get) is designed to relieve taxpayers from the complex and time-consuming method of computing their overhead and administrative costs on an item-by-item basis. Under the alternative method, overhead costs are calculated simply as a percentage of direct SR & ED salary costs. To avoid double counting, taxpayers will not be allowed to include in the SR & ED pool costs that are covered by the proxy amount.

Table 1 illustrates the differences between the existing system and the proposed system.

Under the existing method, each overhead cost must be supported on an item-by-item basis, and each expenditure must be shown to be of an incremental nature and directly attributable to the SR & ED activity. In contrast, under the proxy method, overhead costs will simply be calculated as a factor of direct SR & ED salaries.

### *Legislation*

The conceptual change in respect of overhead costs will be reflected in a number of legislative changes. Subparagraph 37(7)(c)(ii) of the Act will be rewritten to offer taxpayers a choice of using either the item-by-item method or the alternative proxy amount method in computing all the SR & ED expenditures for a taxation year.

#### *Clause 37(7)(c)(ii)(A): The Item-by-Item Method*

Proposed clause 37(7)(c)(ii)(A) will preserve the existing item-by-item method for calculating current, capital, and overhead type expenditures,

[7] *Interpretation Bulletin* IT-151R4, August 16, 1993.

**Table 1 Treatment of Overhead and Administrative Costs Under the Existing and Proposed Rules**

| Qualified expenditures by expenditure type | Qualifying amount for ITC under existing rule | Qualifying amount for ITC under proposed proxy rules |
|---|---|---|
| Salaries: | | |
| Administration and management . . . . . . . . . | None, unless employee is involved in R & D 90% of time (reg. 2902) | Portion directly involved in R & D (draft reg. 2900(4)) |
| Technical support and Canadian R & D . . . . . . . | Portion directly related to R & D | Portion directly related to R & D |
| Foreign R & D, administrative support, and marketing . . . . . . . . . | None | None |
| Proxy amount . . . . . . . . . . . . . | na | 65% of above salaries excluding benefits, bonuses, and profit sharing |
| Overhead costs[a] . . . . . . . . . . . . | Portion directly related to R & D | None |
| Other[b] . . . . . . . . . . . . . . . . . . . . | All | All |

[a] Includes rent; hydro, heat, light, and telephone; maintenance; office supplies; office equipment leases; and travel, printing, and training. [b] Includes third-party payments related to R & D, direct materials consumed in R & D, and R & D equipment leases.

but with minor adjustments. Taxpayers will be allowed to add the following expenses to their SR & ED pool for a taxation year:

- expenditures of a current nature substantially attributable to the prosecution of SR & ED or the provision of premises, facilities, or equipment for the prosecution of SR & ED in Canada;

- expenditures of a current nature that are directly attributable to the prosecution and the provision of R & D facilities as prescribed by amended regulation 2900(2) (essentially, this provision will allow taxpayers to include overhead costs on an item-by-item basis); and

- expenditures of a capital nature for the prosecution of SR & ED (the capital expenditure wording of subparagraph 37(7)(c)(ii) will be changed slightly, as discussed above).

Taxpayers will be able to choose between the two methods in any taxation year, but if a taxpayer does not elect the proxy method, the item-by-item method will apply by default. Therefore, taxpayers are advised to make annual calculations to determine the suitability of a particular method.

Regulation 2900(2) describes expenditures that are directly attributable to SR & ED. The wording of the regulation is preserved under the proposed rules with two significant changes. First, the use of the word “paid” in regulation 2900(2)(b) means that accrued salaries technically do not qualify for the ITC until they are paid. This anomaly will be corrected by the substitution of the word "incurred" for the word "paid." Second, where a taxpayer incurs expenses such as heat for its manufacturing facilities, the taxpayer may not obtain an ITC on a portion of the heating costs attributable to the SR & ED department since the wording of regulation 2900(2)(c) does not recognize portions of an expense as being eligible. This defect will be corrected by the addition of the words "or those portions thereof." This change will be effective for the 1990 and subsequent taxation years. Therefore, affected taxpayers may wish to consider filing amended tax returns for the 1990 and subsequent taxation years to take advantage of the change.

*Clause 37(7)(c)(ii)(B): The Alternative Proxy Amount Method*

Amended clause 37(7)(c)(ii)(B) sets out the simplified method of calculating the SR & ED costs relating to overheads. By design, this clause includes all the normal expenditures described in clause 37(7)(c)(ii)(A), but with one notable omission—namely, it lacks wording similar to that in subclause 37(7)(c)(ii)(A)(II). As a result, taxpayers will not be allowed to include overhead-type expenses in their SR & ED pool. The non-inclusion of overhead costs in the SR & ED pool should not be a concern to many taxpayers since overhead costs are generally deductible in computing a taxpayer's income in any event. However, because these overheads are not "pooled" with the SR & ED amounts in section 37, they will be subject to a seven-year carryforward instead of an indefinite carryforward. The ITCs with respect to overhead costs are nevertheless made available to taxpayers that carry out SR & ED by way of amendments to section 127, as described below.

As noted above, clause 37(7)(c)(ii)(B) is an elective provision. Therefore, the importance of filing elections with the tax returns cannot be overemphasized. If an election is not filed for a taxation year, the taxpayer's SR & ED pool will automatically be calculated under the item-by-item method.

Furthermore, if a taxpayer discovers eligible SR & ED at a later date and amends its tax return, there is no provision to file an election at a later date. It is my understanding, however, that Revenue Canada would allow a late election, provided that no T661 form was filed with the original return. It is my further understanding that the election (or non-election) to use the proxy method cannot be amended. Taxpayers who file a tax return with an SR & ED claim but without the election to use the proxy amount must use the item-by-item method.

Taxpayers will be allowed to add the following expenditures to the SR & ED pool under the alternative proxy amount method as described in proposed clause 37(7)(c)(ii)(B):

- the full cost of the rental of premises, facilities, or equipment for the prosecution of SR & ED where the expenditures are of a current nature and are incurred for substantial SR & ED use; the rental cost of certain buildings will not qualify; costs relating to the purchase and rental of general purpose office equipment or furniture will not be eligible;

• 50 percent of the rental cost of expenditures described above where the premises, facilities, or equipment in question are used primarily for the prosecution of SR & ED, where "primarily" is generally understood to mean greater than 50 percent; the rental cost of certain buildings will not qualify; cost relating the rental of general purpose office equipment or furniture will not be eligible;

• expenditures incurred in respect of the prosecution of SR & ED directly undertaken on behalf of the taxpayer (that is, subcontracting work);

• the cost of material consumed in SR & ED;

• expenditures of a capital nature (see the discussion above on limitations) other than the cost of general purpose office equipment and furniture; and

• the portion of salaries[8] of an employee who is directly engaged in SR & ED where the salary can reasonably be considered to relate to such work having regard to the time spent by the employee thereon; furthermore, where an employee's SR & ED activities represent 90 percent or more of the total salaries and benefits, the entire amount of the salaries and benefits will be eligible for SR & ED treatment.

Unlike the item-by-item method, the alternative proxy amount method is quite specific about the types of expenses that will qualify. To prevent taxpayers from doubling up on ITCs with respect to overhead costs, the proxy amount method will not allow taxpayers to include any overhead-type expenditures.

To compensate taxpayers for the forgone ITC on general overhead costs, the new provisions will allow taxpayers to earn an ITC on a notional overhead amount (referred to as "the proxy amount") that substitutes for the item-by-item accounting of general overhead costs. The delivery of an ITC on the proxy amount is achieved through the definition of "qualified expenditure."

*Regulation 2900(4): The Proxy Amount*

Proposed regulation 2900(4) defines the proxy amount to be equal to 65 percent of that portion of the amount incurred in the year by a taxpayer in respect of the salary or wages of an employee who is directly engaged in SR & ED that can reasonably be considered to relate to such work having regard to the time spent by the employee thereon. Furthermore, where the portion of the salary or wages represents 90 percent or more of the total

[8] Under Bill C-136, supra footnote 4, the relevant provision contained the words "related benefits." This reference has now been dropped from new subclause 37(8)(a)(ii)(B)(IV) as contained in Bill C-9. Therefore, a taxpayer that uses the proxy method will not be allowed to claim ITCs with respect to employee benefits (for example, the employer's share of unemployment insurance and pension plan contributions) related to SR & ED salaries.

salary or wages, the whole amount of the salary or wages will qualify for the proxy amount calculation. Proposed regulation 2900(7) defines "the salary or wages" for proxy purposes to exclude employee benefits, remuneration based on profits, and bonuses. Regulation 2900(4) contains a number of additional restrictions on the proxy amount, each of which is discussed below.

The proxy amount for a taxation year shall not exceed the amount of the actual overhead and general administration expenditures otherwise deducted in computing the taxpayer's income. This amount will include both SR & ED and non-SR & ED expenditures. As a result, if a taxpayer has no actual overhead costs, the taxpayer will not be entitled to any proxy amount. To determine whether a taxpayer has incurred actual overhead costs in a taxation year, regulations 2900(4)(a) to (c) require the taxpayer to compute the company's total actual overhead costs incurred in the year. First, the taxpayer will be required to compute all the deductions made by it in the year in computing business income. The resulting amount will then be reduced by deductions, if any, made in the year under section 20, 24, 26, 30, 32, 37, 66 to 66.8, or 104 of the Act, as well as rental costs of buildings other than special-purpose buildings. The resulting amount is intended to be the overhead costs incurred by the taxpayer. If the proxy amount otherwise calculated is less than the result of the above calculation, the whole proxy amount will be eligible. If it is more, the proxy amount will be reduced to the amount of the above calculation.

The calculation under regulation 2900 appears to be rather complicated, and in my view it raises many questions. For example, should the cost of goods sold be treated as a deduction in computing business income? The cost of goods sold is generally deducted in computing profit under section 9 of the Act. Since that section is not specifically listed in regulation 2900(4)(b), the cost of goods sold effectively becomes overhead costs in the calculation. This result is presumably not what was intended by the regulation. Furthermore, some assessors may apply the provision rather strictly and thus eliminate the benefits of simplicity introduced through the alternative proxy amount method.

The Department of Finance recognizes that in owner-manager situations, the employer can influence the salary levels of its owners, particularly in view of the fact that owner-managers generally pay out large salaries to themselves to keep the taxable income below $200,000. To prevent taxpayers from earning higher ITC claims through large salaries in owner-manager situations, proposed regulation 2900(5) will limit the amount that can be treated as an SR & ED salary for proxy purposes where the salary is paid to a specified employee. A new definition of specified employee will be added to subsection 248(1) of the Act. Under this definition, a specified employee is someone who is a specified shareholder of the employer, or who does not deal at arm's length with the employer. The term "specified shareholder" is currently defined in the Act and in general means a shareholder of a corporation who owns 10 percent or more of any class of the capital stock of the corporation or a related corporation.

Where an employer pays wages or salaries to a specified employee in a taxation year, the proxy amount in respect of the salary is limited to the lesser of 75 percent of the salary amount otherwise incurred in the taxation year of the employer and 2.5 times the year's maximum pensionable earnings (YMPE) for the calendar year in which the taxation year of the employer ends. An allocation formula adjusts the YMPE where the employee is employed for less than 365 days. The YMPE for 1992 (within the meaning of section 18 of the Canada Pension Plan) is $32,200, which means the maximum proxy amount in respect of a specified employee cannot exceed $80,500 for 1992. This maximum increases to $83,500 for 1993.

Proposed regulation 2900(6) will ensure that the limit of 2.5 times the YMPE is not increased by way of multiple employment with associated companies. For this reason, associated companies will be required to share the YMPE limit. Proposed regulation 2900(8) will further expand the definition of associated companies by stating that certain individuals and partnerships related to a particular corporation will be considered to be associated corporations. Since individuals and partnerships also compute SR & ED-related ITCs, this rule is designed to block potential abuses.

*Subsection 127(9): Qualified Expenditure*

The definition of "qualified expenditure" in subsection 127(9) will be amended to include a reference to "prescribed proxy amount." This amendment will allow taxpayers to claim an ITC on a prescribed proxy amount at the applicable ITC rate.

## OTHER CHANGES

Other changes to the SR & ED rules are consequential in nature or serve to clarify existing provisions.

- A consequential amendment to the definition of "refundable investment tax credit" found in subsection 127.1(2) will ensure that the refundable ITC is earned on proxy amounts.

- ITCs deducted from taxes payable or refunded in a taxation year are essentially taxed through the reduction of either the SR & ED pool or the undepreciated capital cost pool in the following year. Although no amounts are added to the SR & ED pool with respect to the proxy amount as described above, the ITC earned with respect to the proxy amount will nevertheless be taxed through the reduction of the SR & ED pool in the following year by virtue of the amendment to paragraph 37(1)(e). This treatment is consistent with the policy of taxing government assistance.

- Regulation 2900(1) defines what constitutes scientific research and experimental development. Specifically, paragraph (c) thereof currently reads as follows:

> development, namely, use of the results of basic or applied research for the purpose of creating new, or improving existing, materials, devices, products or processes.

The paragraph will be amended to read as follows:

> experimental development, namely, work undertaken for the purposes of achieving technological advancement for the purposes of creating new, or improving existing, materials, devices, products or processes, including incremental improvements thereto.

The addition of the phrase "for the purposes of achieving technological advancement" suggests that the existing wording could allow certain development work to qualify without a demonstration of technological advancement. Although *Information Circular* 86-4R2[9] states that a taxpayer must demonstrate technological advancement, one could argue that the requirement is not supported by law, or that it applies only with respect to activities described under regulation 2900(1)(a) or (b), where the phrase "advancement of scientific knowledge" is used. I suspect that this change has been put forward because one could argue that routine development work that involves the use of existing knowledge would qualify as SR & ED even though no technological uncertainty exists. For example, where a sophisticated expert system software program is developed for a particular industry and the software is then adapted by another industry without breaking any new ground, the activities relating to the adaptation of the software could arguably qualify as experimental development. The amendment to regulation 2900(1) also raises the question whether the Act and Regulations require a taxpayer to meet the criterion of uncertainty as set out in the information circular when dealing with development activities.

• Proposed regulation 2900(1)(c) will also include the phrase "including incremental improvements thereto." This is a relieving provision and codifies Revenue Canada's administrative practice. This change will ensure that development work done in stages will qualify as SR & ED.

• Wording previously contained in the middle of regulation 2900(1) will be transferred to new regulation 2900(1)(d) to clarify that it is an additional provision. Furthermore, the wording will refer to the activities of data collection and testing as qualifying activities if they can be linked to the main SR & ED activities. This change essentially codifies the existing administrative position of Revenue Canada. Routine data collection or testing not linked to SR & ED activities is disqualified by virtue of existing regulations 2900(1)(f) and (k).

## SOLE-PURPOSE R & D COMPANIES: DO THEY STILL MAKE SENSE?[10]

In the light of the new alternative proxy amount method, one wonders whether sole-purpose R & D companies are still advantageous. The advantage of isolating SR & ED expenditures in a company that derives substantially all of its revenue from the prosecution of SR & ED (that is, a

[9] *Information Circular* 86-4R2, August 29, 1988.

[10] Note that since the February 22, 1994 budget proposes to remove the preferences given to sole-purpose R & D companies, this issue is no longer relevant effective after taxation years beginning after February 22, 1994.

sole-purpose R & D company) is that expenditures that otherwise meet the definition of prescribed expenditures, which include general administration and management expenditures, are fully eligible for ITCs (see the discussion above). For example, the cost of an accounting department in a manufacturing company that carries SR & ED generally would not be eligible for an ITC. The same costs in a sole-purpose R & D company would be eligible for an ITC.

Under the new proxy amount method, isolating SR & ED in a separate company will often cause the proxy amount to be limited to the total overhead costs of the R & D "department." If the proxy amount is greater than the total overhead costs incurred by the R & D department, isolating the SR & ED activity in the sole-purpose company results in the "leakage" of ITCs, because the ITCs earned will be lower than those earned when the R & D department is operated within a manufacturing company.

At the same time, the amount of eligible expenditures generally gives rise to greater ITCs in a sole-purpose R & D company because administrative and management costs are not excluded from the definition of prescribed expenditures. Therefore, the use of a separate sole-purpose R & D company may be advantageous in some cases, even after the proxy amount leakage is taken into account. A thorough analysis must be performed to compare the total ITCs earned by both entities before it can concluded whether a sole-purpose R & D company is advantageous. The same analysis was required in the past, only now the analysis must consider the alternative proxy amount.

## PROPOSED CHANGES AS ANNOUNCED IN THE APRIL 26, 1993 BUDGET

The April 26, 1993 budget proposed three significant changes to the SR & ED program. The current limit[11] on the deductibility of ITCs will be eliminated effective for taxation years beginning after 1993. A Canadian-controlled private corporation (CCPC) is currently entitled to earn ITCs at a rate of 35 percent on up to $2,000,000 of SR & ED expenditures incurred in a taxation year, provided that its taxable income for the immediately preceding year does not exceed its business limit (within the meaning of subsection 125(2) of the Act). Where a CCPC's income exceeds the business limit, its ITC rate for all expenditures drops to 20 percent and its right to refundability is totally denied.

Under the budget proposal, CCPCs with taxable incomes between $200,000 and $400,000 in a preceding year will be entitled to enriched ITCs in the current taxation year, but their expenditure limit of $2,000,000 will be reduced by $10 for each $1 of taxable income in excess of $200,000. The following table illustrates the accessibility level under the current and pro-

[11] Under subsection 127(5) of the Act, a taxpayer is not allowed to deduct ITCs in excess of the annual ITC limit as defined under subsection 127(9). A corporation's annual limit is equal to three-quarters of its part I tax liability. CCPCs enjoy slightly higher annual limits.

posed rules. An ITC rate of 20 percent is assumed where taxable income exceeds $200,000 in a preceding year.

| | Total credit earned | | Maximum refundable ITC | |
|---|---|---|---|---|
| *Taxable income* | *Existing* | *Proposed* | *Existing* | *Proposed* |
| $200,000 . . . . . . | $700,000 | $700,000 | $700,000 | $700,000 |
| 250,000 . . . . . . | 400,000 | 625,000 | nil | 525,000 |
| 300,000 . . . . . . | 400,000 | 550,000 | nil | 350,000 |
| 350,000 . . . . . . | 400,000 | 475,000 | nil | 175,000 |
| 400,000 . . . . . . | 400,000 | 400,000 | nil | nil |

The changes proposed in the April 1993 budget are reflected in Bill C-136 by way of amendments to section 127 of the Act. The definition of "annual investment tax credit limit" in subsection 127(9) will be repealed. As a result, corporations will be allowed to deduct their ITCs to the extent of their part I tax liability otherwise payable. This change will be effective for taxation years beginning after 1993.

Subsection 127(10.1) of the Act will be amended to allow CCPCs with taxable income of up to two times their business limit (that is, up to $400,000) to earn ITCs at the rate of 35 percent, subject to the reduced expenditure limit. The definition of expenditure limit in subsection 127(10.2) will be amended so that the existing $2,000,000 limit is reduced by $10 for each $1 of taxable income for the preceding taxation year that exceeds the expenditure limit. Thus, under the formula in that subsection, a CCPC's access to the enriched ITC will be forfeited only when its taxable income exceeds two times the business limit.

The budget also proposed to create a special 25 percent declining balance method capital cost allowance class for patents and rights. The patents and rights are currently amortized over a longer period.

Finally, the federal government has stated that it will renegotiate various tax treaties with a view to eliminating withholding tax on arm's-length payments with respect to rights to use patented information or information concerning scientific expertise.

## INTERPRETATION BULLETIN IT-151R4

*Interpretation Bulletin* IT-151R4, which has been revised as of August 16, 1993, deals with SR & ED expenditures and is applicable with respect to expenditures for periods after December 15, 1987. It does not include the proposed changes issued on December 2, 1992. Some of the changes in the bulletin, however, are similar to the proposed changes discussed above. The following discussion summarizes the relevant changes to the bulletin.

In paragraph 8 of the bulletin, Revenue Canada states that the SR & ED must be related to a business carried on by a taxpayer. To meet this criterion, the business must have some interconnection or link between the SR & ED activities and the business of the taxpayer. To meet this test, a taxpayer must show that if the SR & ED is successful, it will result in some direct and beneficial application to a business that is carried on by the taxpayer. Paragraph 9 of the bulletin explains that a business related to the taxpayer also includes the business of a related corporation.

Paragraph 15 of the bulletin changes Revenue Canada's position on what a taxpayer must do with the proceeds of sale of experimental production. As a result of the decision of the Tax Court of Canada in *Cultures Laflamme (1984) Inc. v. MNR*,[12] Revenue Canada has reversed its previous position. Previously, it required that the proceeds of sale of experimental production be applied to reduce the amount of qualifying SR & ED expenditures that are eligible for ITCs.

Paragraph 17 of the bulletin clarifies that salaries do not have to be paid to be eligible for ITCs as qualifying expenditures. As a result, accrued salaries are eligible for ITCs in the year in which they are accrued. This change has been codified by the December 2, 1992 proposed changes, but Revenue Canada has also changed its administrative practice at the same time in the bulletin.

Paragraph 18 of the bulletin clarifies Revenue Canada's administrative position with respect to overhead and administration expenses. As discussed above, taxpayers often face difficulty in convincing Revenue Canada that overhead costs incurred by the R & D department were directly related to the SR & ED. As a result, taxpayers often found themselves unable to claim ITCs on overhead costs. Revenue Canada has clarified its position by stating that amounts directly allocable to the R & D department are eligible as qualifying expenditures and, therefore, eligible for ITCs. In particular, the bulletin discusses the costs of light, heat, and long distance telephone charges, and states that they are generally considered to be directly attributable to SR & ED if a matching can be established. This change, again, is partially addressed in the December 2, 1992 proposed changes dealing with the alternative proxy amount.

The remaining changes in the bulletin are mostly consequential changes that accommodate the various ordering and numbering changes in the Ac and the previous version of the bulletin.

## CONCLUSION

The introduction of the alternative proxy amount method, the availability of ITCs with respect to shared-use equipment, and the enrichments to the program as announced in the April 26, 1993 budget reflect the government's desire and commitment to stimulate R & D activities in Canada. The fine-tuning of this program will continued in the future as problems are identified. Indeed, the federal government has announced further changes to the program in its February 22, 1994 budget. Readers are therefore advised to consider the comments in this article in the context of the budget changes as well as that of the legislation proposed in Bill C-9.

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[12] 93 DTC 603.