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Advances in the R&D Tax Credit Program

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Moderator: Dr. Geoff Hill, Deloitte

PSAC
Petroleum Services
Association of Canada

CATA*Alliance*

sepac
Small Explorers and Producers
Association of Canada

Agenda

1. Overview of the program
2. Recent changes
3. Possible future changes
4. Next Steps

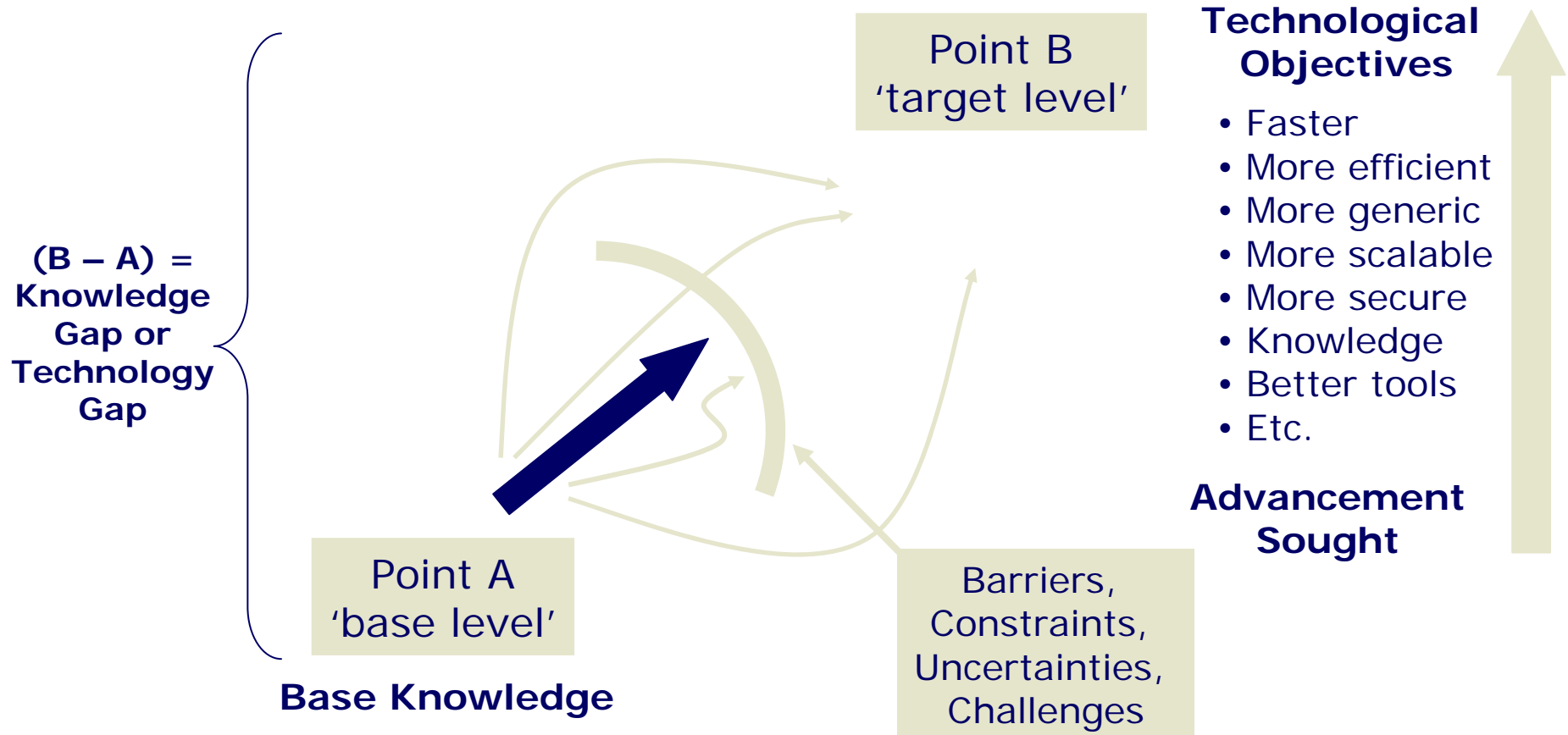
Overview of the SR&ED program

- Canada's largest source of government funding for R&D
- Currently over \$2 billion in tax credits annually
- Administered by the CRA
- Dept. of Finance is responsible for legislation

Overview of the SR&ED program

- Benefits
 - Immediate deduction of expenditures
 - 20 - 35% additional Investment Tax Credit (ITC)
 - Eligible expenditures - complex, but can include:
 - Salaries and labor
 - Contractor Costs
 - Overheads
 - Materials
 - Capital

What makes a project eligible?



Recent Changes

- They do not affect the program's general framework
- However, they do affect many aspects of the filing:
 - The 18 month rule
 - ITC carry-forward
 - Territorial limits
 - Outsourcing
 - Small business limit increase
 - The Alcatel case
 - Others

The 18 month rule

- All claims must be filed within 18 months after the taxation year-end or all rights are lost
- In order to be accepted the claim must be complete
- Prior to this the Minister had discretion to accept late filed claims if for example, one piece of information had been inadvertently omitted

The 18 month rule

- Now, for late filings (or filings missing information), the Minister's discretion has been removed
 - There will now be no exceptions to the filing deadline
- Important that all claims be complete when filed
- All other deadlines in the Act contain provisions for late filing

ITC carry-forward

- Legislation enacted to extend the carryforward of ITCs from 10 years to 20 years
- Will this incent companies to perform R&D currently?
- System requires universal access

Territorial limit

- SR&ED work may now be carried on within the 200 mile limit, the airspace above the zone, or the seabed or subsoil below that zone
- This now allows, for example, oil companies to claim SR&ED activities carried on offshore of Canada, such as developing new drilling techniques

Outsourcing

- Rules for contract expenditures depend on which overhead method is used – proxy or traditional
- Eg: a prototype is sent out to have holes drilled
 - Ineligible under proxy method (routine activity)
 - Eligible as overhead under traditional method (directly related and incremental to SR&ED)
- Is a contract for R&D or for services?

Outsourcing

- The CRA are now treating the services of all 'placement agency' workers as a contract for services and not SR&ED
- Therefore the costs are ineligible under proxy if you elect to use the proxy method
- Administrative concession if <90% time for a contract employee is spent in eligible SR&ED activities
- Important as to which method of calculating overhead that you use and structuring your contracts appropriately

Small business limit increase

- CCPCs may be entitled to refundable investment tax credits on the first \$2,000,000 of expenditures
- Subject to limits
 - Taxable income
 - Taxable capital
 - Expenditure limit (\$2,000,000)

Small business limit increase

- Proposed to increase one of these limits
- The small business limit is to be increased from \$300,000 to \$400,000 - for years after 2006
- For SR&ED, proposed to increase the income phase-out limits from \$400,000 to \$600,000
- The \$2,000,000 expenditure limit has not been increased since 1984
 - Is it time to raise this limit to recognize the impact of inflation?

The Alcatel case

- Re: including stock options benefits as salaries and wages for ITC purposes
- Claim denied by the CRA – “stock options were not expenditures incurred”
- Tax Court allowed appeal
 - Found the Act must be applied in a way so SR&ED is an *incentive program*
- CRA did not appeal and Finance later introduced draft legislation limiting stock options issued or exercised on or after November 17, 2005
- Thus – options exercised *before that*, are eligible

Possible Changes

- Several changes are being proposed
 - Recent announcements by Minister Flaherty
 - Taxation of trusts
 - Economic agenda
 - CATA's reports
 - Enhancements for CCPCs
 - Enhancements for other Canadian corporations
 - Other proposed legislative changes to simplify the credit
 - Promotion of the successful exploitation of innovation

Taxation of Trusts

- In the past, most trusts did not claim SR&ED either because of the type of operations undertaken and/or the taxation structure, but...
- On October 31, 2006, Minister of Finance Jim Flaherty announced the proposed implementation of a “distribution tax” on publicly traded income trusts and listed partnerships
 - Effective immediately for new such entities
 - Effective for 2011 taxation year if already listed

Taxation of Trusts

- The details are still undetermined at this time and the effect on SR&ED could be substantial
- Questions to answer:
 - Do the business activities of your trust qualify?
 - Will trusts be able to obtain the benefit of SR&ED under the new system, similar to corporations?
 - Will re-conversion be required anyway?
 - In the 4 year transition period, does the benefit of SR&ED outweigh the effects/costs of re-conversion such that the structure change should be fast-tracked?
- Should we provide comment to Finance?

Economic Agenda

- Minister of Finance Jim Flaherty released a new economic agenda
- It contained several positive references to R&D
- It is still undetermined what will be included in the next budget
 - Should we provide comment to Finance?

Trends in the International Scene

- Achieving universal access
- Increased support for SMEs
- Increased refundability
- Supporting work done outside the country

CATA's process

- CATA is Canada's largest high-tech group
- CATA was key in previous changes to SR&ED
- In 2006, they launched a campaign on how to improve the SR&ED system, based on:
 - Research reports
 - On-line consultations and surveys
 - Roundtable discussions
- Supported by many industry associations
- 2006 report delivered to the Minister of Finance

Increased access

- The report recommends the government:
 - allow companies in loss position to access tax credits refundable in cash within limits
 - let the credits be applied to other taxes besides income taxes, including payroll taxes
 - make the SR&ED incentives available to limited partners up to their “at risk amount”
- ...

Increased access

...

- increase the SR&ED expenditure limit for the high rate refundable credits (35%) to at least \$4 million
- increase the taxable income limit from \$400,000 (as proposed for 2007) to \$600,000 for 2007, and in subsequent years to \$800,000
- remove the capital tax restriction or at least raise the threshold at which the capital restriction applies

Contract payments

- Joint SR&ED between two parties can be complex
- The report recommends the government:
 - allow both parties to elect in the contract which party will be permitted to claim any SR&ED.

Foreign work

- Often not possible or practical for all SR&ED work to be conducted in Canada
- The report recommends the government:
 - allow some of the work on a Canadian funded project carried on outside of Canada to be eligible **if** the project is funded and led from Canada, the intellectual property and learning will reside in Canada and Canadians can exploit the results

Commercialization

- Canada has a poor record of successfully commercializing what it creates at home
- Need to better reward companies that developed start-up technology
- Need to better reward mature companies that invest in the creation of technologies

Commercialization

- The report recommends for these types of investments, the government allow:
 - flow through shares
 - accelerated depreciation rates
 - investment pools
- Designed to encourage passive investment where the benefits accrue with success

Next Steps

- Do we need to further endorse CATA's report?
- Do we need to provide comment to Finance?
- Other steps?