CATAlliance

January 17, 2017

Update: Call for the Creation of a new, Independent Administrator to Deliver, Manage, Evaluate and Improve all Government Tax Incentives in support of Innovation, and for the overhaul of Canada's System of Tax Incentives for Innovation, including the SR&ED Program

Includes input and feedback received in response to the proposals set out in CATA's draft action plan, September 27, 2016, on the need to modify and augment the current tax based incentives for innovation

Observation

Our mandate for this work has focused primarily on improving the Government's impact on the tax based incentives available to the Information and Communications Technologies (ICT) sector. However, with few exceptions, we believe that the real opportunity is in the extension of many of these approaches to all sectors contributing to Canada's innovative economy.

We strongly encourage the Government to strengthen the effectiveness of Canada's tax based incentives for innovation. The intent should be to maximize the return on these investments (ROI) to the Canadian economy. Focusing simply on direct funding and not dealing with the weaknesses in Canada's tax based incentives is not enough. Other countries are doing better with their tax based incentives and we should be doing the same. Our competitors recognize the critical role of focusing on developing results-oriented, effective tax incentives in the support of innovation. If the Government does not seize this opportunity, Canada will continue to earn a low ROI on these major investments in innovation.

Some argue that what is currently being achieved with the Scientific Research and Experimental Development (SR&ED) tax incentives is good enough. Our concern is that the leaders of the current Government's innovation agenda may not be getting the message that improvements to SR&ED can be achieved. They appear too focused on creating new programs, not realizing that they cannot get it right unless they get Canada's tax based incentives (including the SR&ED tax incentives) right.

Yet no one really knows what is being achieved. It's been decades since the current, often cited numbers for the SR&ED program were developed. Some reports do suggest a positive return. However, today's SR&ED program in no way reflects the SR&ED program of the past nor the program that was evaluated a couple decades ago where most of the positive support for the program comes from. Even the amount of the credits themselves has been reduced.

Today, the revised legislation and the CRA support a very different spectrum of SR&ED activities. Over the past decade, the CRA has set more stringent expectations and uses a more limited view of what will be supported and how to do so. This is simply not the same SR&ED incentive program that was evaluated years ago. It is much narrower, more science oriented and a more difficult program for many in the ICT sector to use; and, for that matter, for many in any area of manufacturing to use. Today, the broader understanding of what is "experimental development" is not well supported by the CRA.

The federal government is currently spending around $3 billion (down from $4.1 billion in 2008-2009) for tax incentives to encourage companies to do science oriented "SR&ED". Of this amount, a significant portion is for work that firms would carry out in any event without any incentives. How much is associated with these "retrospective" claims is unclear - the CRA has not released the numbers. However, many in the business community believe that these windfall credits are not appropriate to an incentive program.

CATA believes that it's time to move on and discontinue the rhetoric about historical evaluations. We argue that government should assign the delivery, management, evaluation and improvement of federal tax based incentives to promote innovation and the development of better incentives to a new administrator. The philosophy should be one of proactive evaluation, continuous improvement, and benchmarking of the Canadian system against the best international practices. The focus should be on making the innovation support provided through tax mechanisms as effective as possible as incentives through continuous improvement.

The proposals we have developed address major issues with the current system of tax incentives for innovation, particularly where the current system itself is a barrier to the:
- **growth of emerging technology firms; and**
- **effectiveness of credits as influencers of businesses to invest in innovation, growth, commercialization and exports.**

There are, of course, other approaches one might consider and that might work to address these issues. Fixing these issues represents a real opportunity to better support Canada's innovation efforts. Further, this is imperative to the success of the current Government's innovation agenda.

The UK and others do much better and so can Canada by using a more proactive approach to tax based incentives for innovation.

CATA*Alliance*

January 17, 2017

CALL FOR ACTION

If you believe that the Government's promised revamp of its Innovation support systems needs to include the creation of a new, independent Administrator to oversee all federal government tax based programs in support of innovation, including the Scientific Research and Experimental Development (SR&ED) Tax Incentive Program, we urge you to contact the federal government representatives below to let them know your opinion.

The Honourable William Francis Morneau
Minister of Finance
Bill.Morneau@parl.gc.ca

The Honourable Navdeep Singh Bains
Minister of Innovation, Science and Economic Development
Navdeep.Bains@parl.gc.ca

The Honourable Bardish Chagger
Minister of Small Business and Tourism
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To find your local MP, go to: http://www.parl.gc.ca/Parliamentarians/en/members .

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January 17, 2017

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CATA commentary on the input and feedback received in response to the proposals set out in CATA's draft action plan, September 27, 2016, "CATA Call for Action: Major Improvements in Canada's System of Federal Support for Business Innovation";

and

Updated proposals from September 27, 2016, draft action plan

start. Require only Initial Submission (<u>without</u> Certification, which was originally proposed) for SR&ED tax credits. Permit non-refundable claims to be made at the program level, as well as at the project level, from a technological perspective. [1]

7-3. Implement effective, timely, independent, authoritative third party redress of problems as they arise in the reviews of SR&ED claims.

7-4. Modify the non-refundable SR&ED program to support Above-the-Line (ATL) Accounting (booking) of the credits. For details, see item 5 above.

7-5. Consider phasing out the refundable SR&ED tax credits for the ICT sector as experience is gained with the Digital Innovation tax credit.

Links to Key References

[1] A "program" is an integrated and linked group of "projects" with a common technological advancement(s) as the goal.

CATA commentary on the feedback and input received on the Proposals set out in the September 27, 2016, draft action plan; and updated versions of the Proposals

Very useful comments and suggestions have been made to us about the proposals outlined in our draft action plan of September 27th, 2016. The comments and our responses are set out here. In addition, we have included our original proposals, updating them where appropriate to reflect the input and feedback.

Please note that the draft September 27th, 2016, Call for Action paper, "CATA Call for Action: Major Improvements in Canada's System of Federal Support for Business Innovation", *has not itself been revised to reflect the current thinking of CATA as a result of the community's input and feedback. The paper does contain a detailed analysis of why CATA believes that change is required and change should be looked upon as an opportunity to catch up with competing programs of other countries. For the September 27th draft action plan, please go to:* http://www.cata.ca/Advocacy/SRandED_Tax_Credits/CATA_Proposal_ICT_innovation_Sept.28,_2016.pdf

1. Proposal to establish a new, independent Administrator to oversee - deliver, manage evaluate and improve - all federal government tax based programs in support of innovation, including the Scientific Research and Experimental Development (SR&ED) Tax Incentive Program. Management of the SR&ED program to be moved to the new Administrator.

CATA has no doubt that tax support for business innovation can work better and that getting it right is critical. Each year, the Canada Revenue Agency (CRA) provides more than $3 billion dollars of assistance to businesses through the SR&ED Tax Incentive Program. While this expenditure is down from $4.1 billion in 2008-2009 due to the actions of the previous Government, this tax incentive is still the largest source of support for business innovation in Canada. [2]

[2] Aggregate "tax assistance" (i.e., tax credits) delivered by the CRA through the SR&ED program has gone down by $4.2 billion in six years over 2009-2010 through 2014-2015. This does not include the legislated reduction in the SR&ED incentives announced in the 2012 Budget of $500 million a year. In 2008-2009, the amount of "tax assistance" provided per claimant was $227,778. By 2012-2013, it had dropped to $156,522 per claimant, the last year for which the number of claimants was included in the CRA's Annual Report to Parliament. For details, please see CATA's paper, "What's Known About the Size and Cost of the SR&ED Program over the Past Decade?", dated November 22, 2016, page 1: http://www.cata.ca/files/PDF/Statistics_SRED_November22_2016.pdf

NOTE: On November 23, 2016, the day after our paper was released, the CRA released some SR&ED statistics in its performance report for 2015-2016. These statistics did include the number of claimants (over 19,000) for 2015-2016. However, the amount of tax assistance provided per claimant did not change appreciably from what we'd calculated for 2012-2013. The amount for 2015-2016 was $157,895 per claimant ($3 billion tax assistance / 19,000 claimants).

See also:

Studies of tax based instruments used in competitor nations to promote investment in innovation show that results can be quite positive when the instruments are designed and managed correctly. However, studies of Canada's SR&ED program show that there is significant room for improvement. For example, the recent paper by RDP Associates Inc. highlights that the UK gets much better returns with a system based on a similar definition to that of Canada's for what is to be supported. The paper argues that the UK achieves much better results by using more balanced management techniques, i.e., ones much less focused on compliance and more on effective delivery of an incentive. [3]

The vast majority of the feedback that CATA is receiving supports the importance of tax based incentives to both the small and medium (SMEs) corporations and larger corporations. However, the commentary we have received since the release of our Call for improvements in September 2016 overwhelmingly argues that the current SR&ED program is not working as well as it could.

Numerous executives experienced with the refundable tax credits told us in very clear terms that, in its current form, the SR&ED program is simply too much of a hassle and too unreliable to be considered as an incentive. This is so even when these companies are getting the credits. Some strongly question whether what the CRA supports is appropriate.

The CRA tells us that the increased compliance focus is because of aggressive claiming practices. Albeit, to our knowledge, neither the CRA nor the Government has ever provided any support for the CRA's allegation. Cases going to litigation are resulting in mixed outcomes for the CRA.

Importantly, 85% to 90% of the respondents to our polling strongly support the creation of a new, independent Administrator to oversee Canada's tax based support for innovation. This includes delivering, managing, evaluating and improving all federal government tax based programs in support of innovation, including the SR&ED program. Management of the SR&ED program would be moved to the proposed Administrator.

Many argue that, after 30 years, simply refining the current SR&ED administrative system will not be enough if left to the CRA. In spite of calls for improvement by CATA and others, including the suggestion by the Canadian Manufacturers & Exporters (CME) that the Senate review the SR&ED program, the CRA and Finance seem content with the status quo. When questioned, the CRA is saying that it is not hearing of a review. And, in response to our questions this spring, a Finance official indicated to us that there is always noise around SR&ED.

CATA, "Three Decades of SR&ED: Can we afford not to do better?" February 8, 2016. http://catalogca.ca/Media_and_Events/Press_Releases/cata_pr02081601.html .

[3] Brian Cookson, RDP Associates Inc. *A comparison of the administration of the Canadian Scientific Research and Experimental Development (SR&ED) tax credit program*. May 20, 2016, First page, “Purpose”. http://catalogca.ca/files/PDF/CDA_UK_R_D_Tax_Credits.pdf .

<u>Up dated Proposal to establish a new, independent Administrator to oversee - deliver, manage, evaluate and improve - all federal government tax based programs in support of innovation, including the Scientific Research and Experimental Development (SR&ED) Tax Incentive Program. Management of the SR&ED program to be moved to the new Administrator.</u>

These programs would include the $3 billion **SR&ED Tax Incentive Program, the proposed new refundable "Digital Innovation" tax credit, and the proposed new "Innovation Box" incentive.**

Specifically, because of the depth and complexity of the issues in the ICT sector and the inability of the CRA to resolve these longstanding and contentious issues over the 30 years of the SR&ED program's existence, we propose creating an Administrator of senior, independent leaders with private sector experience, e.g., computer scientists and technologists, business people, and tax experts.

This Administrator would <u>not</u> be driven by performance measures of tax recovery. Rather, the objective would be to manage the tax incentives so they effectively incentivize the companies that use them and so they achieve an increased level of commercialization and export. The Administrator would be measured on its success in establishing and refining programs that demonstrably contribute to the increase in return on investment (ROI) that Canada receives on its tax based investments in innovation.

The CRA could still review financial issues. **Note:** A comment we heard repeatedly while consulting on this proposal was that the CRA should not do the financial reviews, because of the potential conflicts between the expectations of the CRA and the proposed Administrator. There are examples over the years where this model has worked, e.g., film tax credits, but the concern would need to be recognized and addressed in the mandate given to the new Administrator in order to avoid conflicts.

2. Proposal to set up an independent working group to consult on and to develop the details on the proposals for a new, independent Administrator; a new, refundable labour based Digital Innovation tax credit; and a new Innovation Box incentive

We suggest that the Government may want to task an independent working group of business leaders, tax experts, and a senior Finance official with the responsibility for consulting on and developing the details of the proposals for: a new, independent Administrator; the new, refundable labour based Digital Innovation tax credit; and the new Innovation Box incentive for commercialization and export. (For details of these proposals, see item 1, item 3 and item 4.)

The goal should be to design incentives and delivery systems that:

- maximize certainty;
- minimize administrative hassle;

- maximize the cost-effectiveness of these tax instruments from both the business community's and government's points of view; and
- provide timely data on the types of innovation projects receiving government support and the size of related government expenditures in order to enable continuous improvement through transparent evaluation and refinement.

3. Proposal to create a new, refundable labour based Digital Innovation tax credit for smaller businesses coupled with a new Innovation Box incentive to support commercialization and export

The creation of a refundable labour based Digital Innovation tax credit linked to an innovation benchmarking requirement was seen as a simple, useful and workable approach to getting at what is important to support as innovation in the ICT sector.

The proposed new Digital Innovation tax credit is seen as a way to avoid the current disputes about how SR&ED applies in the sector and how SR&ED claims should be supported in the sector. It was suggested that the requirement for a formal, documented, upfront innovation benchmarking of the state of the art and a description of the opportunities created by the anticipated advancements; and the initial submission of these along with a project plan with cost projections before the start of a project or within 3 months of its start would simplify governmental reviews.

We believe that it's important to require the certification of projects eligible for the proposed Digital Innovation tax credit, as it would provide much better certitude for government, as well as for companies and their investors and make it a truly more focused and effective credit. However, problems with the use of certificates in Ontario have given rise to processing delays. This must not happen.

<u>Updated Proposal to create a new, refundable labour based Digital Innovation tax credit for smaller businesses coupled to the new Innovation Box incentive to support commercialization and export</u>

For refundable (smaller businesses - to be defined in parallel with the SR&ED program) claimants, create <u>outside</u> the SR&ED program, a new, refundable labour based Digital Innovation tax credit as an alternative to the existing SR&ED tax credit for refundable claims and couple it with a new "Innovation Box" incentive to support commercialization and export (item 4, below).

The proposed Digital Innovation tax credit would be designed to avoid duplicate SR&ED and Digital Innovation tax credit claims, i.e., "double dipping."

The proposed new, refundable Digital Innovation tax credit would apply to reduce income taxes, payroll taxes and other tax levies owing by claimants. The objective is to increase the effectiveness of tax credits in creating jobs in Canada. The cost to the Government of this labour based tax credit would be offset to a degree by the income taxes paid by the individuals in these additional Canadian jobs.

The advanced developments to be supported by the proposed new Digital Innovation tax credit would be characterized by:

- the formal benchmarking of the proposed innovation against the documented existing state of the art;
- the opportunities created by the anticipated advancements; and
- a formal, supported development plan, including initial cost projections.

These initial development documents for the project would constitute the application for the certificate of eligibility by an applicant for the Digital Innovation tax credit and would be filed before the start of a project or within 3 months of its start. Based on this submission, the proposed new Administrator (item 1) would determine the eligibility of the project and issue certification for it, if appropriate.

The upfront nature of the certification would enable the government to track the proposed Digital Innovation tax credit program on a timely basis, providing up-to-date data on the type of innovation projects receiving government support and on the size of related government expenditures.

However, a concern highlighted in the feedback, particularly from Ontario, was the slowness of the certification process experienced in their existing certificate based incentive program. Therefore, strict timelines and processing targets would need to be established and adhered to for the Digital Innovation tax credit. To optimize the effectiveness of the credit, consideration should be given to setting a *de minimis* rule on the size of projects.

The definitions for what an innovation is under the proposed Digital Innovation tax credit could parallel those used by some provinces, which have tended to be specifically targeted areas rather than broadly targeted like the SR&ED tax incentive. However, this approach is seen as being too narrow. The innovation benchmarking approach outlined here is seen as more appropriate and as a less subjective reference point.

In fact, requiring the submission, including the benchmarking and certification, as outlined above, is seen to be advantageous to companies, as it would help them focus and better see where to invest their resources and creative efforts.

4. Proposal to create outside the SR&ED program a new Innovation Box incentive to support commercialization and export of SR&ED and Digital Innovation tax credit successes for both small and large businesses. Claimants would have the option of applying the incentive to reduce the grind on the availability of refundable credits or to reduce income taxes.

The proposal for having an Innovation Box incentive tied to the exploitation of Canadian innovations arising from SR&ED and the proposed new Digital Innovation tax credits was well supported. The Innovation Box is seen as an important, functional and effective way to encourage all firms to expand their Canadian businesses on the basis of their innovations developed with government support. This proposal is specifically aimed at promoting the development of markets in Canada and export.

It was noted that until equity funding becomes a viable option for startups (say, in 5-10 years), Canadian firms must turn offshore for financing to survive as commercially, growth-oriented businesses. A consequence is the premature loss of our innovation/SR&ED investments, as these firms are sold to offshore parties and/or integrated into offshore firms.

> In the case of SR&ED, currently, the refundable tax credits drop off the table as the cap on expenditures eligible for the 35% refund is ground down from $3,000,000 to zero. This occurs when a firm loses its Canadian Controlled Private Corporation (CCPC) status, as a firm's/associated group's previous year's taxable income goes up beyond $500,000 to $800,000; and, also there are limits on capital. The loss of access to the SR&ED refundable program creates additional stress for firms focused on growth through innovation.

While the Innovation Box incentive would be available to all taxpayers, large or small, it was suggested that firms should be able to apply the Innovation Box incentive to reduce the grind on the availability of refundable credits. This would be in lieu of the application of the incentive to reduce a firm's income taxes. The Box would be linked to earnings from the revenue streams associated with both export and domestic sales of the innovations. It would not be refundable, but could be carried forward. The intention would be to incentivize Canadian firms to expand Canadian investments, as well as to attract new investments.

Updated Proposal to create outside the SR&ED program a new Innovation Box incentive to support commercialization and export of SR&ED and Digital Innovation tax credit successes for both small and large businesses. Claimants would have the option of applying the incentive to reduce the grind on the availability of refundable credits or to reduce income taxes.

Outside the SR&ED program, create a new incentive for commercialization and export: an Innovation Box for both small and large businesses. This incentive would apply to innovations resulting from work supported by the proposed new refundable Digital Innovation tax credit (item 3, above) and to successful digital innovations supported by the SR&ED program. Claimants would have the option of applying the incentive to reduce the grind on the availability of refundable credits or to reduce income taxes.

5. Proposal to modify the non-refundable SR&ED program in a way that supports Above-the-Line (ATL) Accounting (booking) of the credits

We have clarified our proposal and are calling for the rules governing the non-refundable SR&ED tax credits to be modified so they meet the test for "above the line ('ATL')" accounting in a way that is similar to the UK's ATL credit. The UK ATL credit is, subject to certain limits, effectively a refundable tax credit. The credit is first applied to income taxes otherwise payable. Any excess is refundable, providing the R&D performer has paid sufficient payroll taxes deducted at source during the period in respect of staff involved in qualifying R&D activities.

If such a credit were available to taxpayers in Canada for SR&ED performed in Canada, it could, for accounting purposes under the relevant accounting standards [4], be applied against the expenditure (aka "above the line") as opposed to a reduction of tax expense, (aka "below the line"), which is the treatment in certain cases, including US GAAP.

The advantages of such a system are numerous as they relate to encouraging investment in R&D and include:

- improves cash flow to companies otherwise not eligible for the refundable tax credit that are in a loss and/or non-cash-taxable position. Examples include non-CCPCs in the life sciences sector that experience long lead times in the development of new or improved technologies;
- increases the Earnings before Interest, Taxes, Depreciation and Amortization ("EBITDA") a key financial measurement used, among others, in investment decisions, and which may help stimulate future investment in R&D; and
- is beneficial where internal budget approvals or measurement of performance is done on a pre-tax basis.

These factors would appear to be solutions to what have been invoked by some large/multinational corporations as significant barriers to sitting their R&D investment in Canada in spite of our above average tax credits.

As this is effectively transforming what is otherwise a non-refundable tax credit into a refundable tax credit, this recommended change would affect cash flow to government. Impact studies will

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[4] IFRS, accounting standards for private enterprises (ASPE), as well as US GAAP.

be needed to determine whether this can be countered by increased tax revenues from economic activity generated by increased investment in R&D.

We are aware that, historically, the federal government has resisted suggestions to apply the SR&ED investment tax credits (ITC) as a credit against tax levies other than the claimant's Part I tax. The proposal has invoked concerns about adding complexity for Finance, given that the various tax levies are tracked and administered differently within the government. However, we would argue that the suggested changes are certainly possible, as demonstrated by other jurisdictions (e.g., the UK) which use this opportunity to increase the versatility of their tax incentives to business.

This recommended change also breaks from the principle, as reflected in current tax law, that only small CCPCs are entitled to refundable tax credits. We are of the view that in an era of cross border capital mobility, as well as the presence of public venture capital markets, the economic reality of a CCPC *versus* a non-CCPC is not clear cut in every case. There are, for instance, a significant number of early stage, entrepreneurially driven small- to medium- size Canadian businesses that are not CCPCs and thus cannot avail themselves of the federal refundable SR&ED ITC.

It is also our view that to limit the refund of the credit of SR&ED to small CCPCs as is currently the case is inappropriate. It creates an artificial barrier to the growth of Canada's innovators that needs to be removed. The current cap on the refundable SR&ED tax credits encourages firms using the refundable credits to limit their earnings model and promotes the premature exit of emerging technology firms.

Federal income tax deducted at source would be in line with one of the program's policy objectives, as it relates to Canadian jobs. Finally, in terms of examples, Québec is a jurisdiction that does not limit the refundability of its credits.

Updated Proposal to modify the non-refundable SR&ED program in a way that supports Above-the-Line (ATL) Accounting (booking) of the SR&ED tax credit

Introduce "above the line ('ATL')" accounting for all SR&ED tax credits so that the benefit of the credit is treated as a reduction of SR&ED expenditure within the profit and loss account (income statement) of the claimant.

In respect to the above the line tax credit introduced in the UK, the EY July 2013 Tax Services document, "Above the line R&D Tax Credit", states that:

> *The principal intention for the introduction of an ATL R&D tax credit scheme is to increase the visibility and certainty of UK R&D relief. Additionally, it is to provide greater financial support to loss making companies through having the R&D tax credit repayable where there*

is no corporation tax liability.

See the Ernst & Young LLP July 2013 Tax Services document, "Above the line R&D Tax Credit" at: http://www.ey.com/Publication/vwLUAssets/EY-Tax-services-Above-the-line-RD-Tax-Credit/$FILE/EY-Tax-services-Above-the-line-RD-Tax-Credit.pdf

Also, see the UK Association of Chartered Certified Accountants (ACCA) newsletter, *In.Practice*, 25 October 2013, at: http://accainpractice.newsweaver.co.uk/accainpractice/tatbc6xt3qh .

6. Proposal to develop Cost Estimates and Full Details of Proposals

Some feedback expressed concern that we had not provided cost estimates and the full details of the proposals. We believe that the Government needs to set up an **independent working group** to develop the details on the proposals for an independent Administrator; the new, refundable labour based Digital Innovation tax credit; and the new Innovation Box incentive for commercialization and export. (See item 2, proposed independent working group; item 1 for proposed new independent Administrator; item 3, proposed Digital Innovation tax credit; and item 4, proposed innovation Box incentive for commercialization and export.)

7. Proposals to improve the SR&ED Tax Incentive Program

7-1. Proposal to eliminate Retrospective claims for SR&ED tax incentives

Considerable positive and negative comment was received about eliminating retrospective claims for SR&ED tax incentives.

Some feedback, particularly from SR&ED advisors/practitioners in the community, questioned whether eliminating retrospective claims was appropriate. They also tended to support the status quo as being good enough. However, the majority of comments we receive from the business community on the issue of retrospective claims strongly view these after-the-fact claims as windfalls and as inappropriate. The business community sees that eliminating windfall claiming to be a way of greatly reducing the complexity of the support process for the claims and increasing the incentive nature of the SR&ED tax credits. The proposal actually came from the senior advisory/practitioner community as a simple and effective way of dealing with the CRA's suggestion (not publicly explained) some years ago that the program was being abused.

To our knowledge, neither the CRA nor the Government has supported the CRA's allegation that the program was significantly abused. This includes requests through Access to Information to obtain information on the issue.

The most common position heard from the business community over the years is that SR&ED incentives must influence the R&D investments of a firm, i.e., must increase the SR&ED component of a company's investment in R&D, in order for the incentives to be considered more than windfall revenues.

It is argued that when SR&ED tax credits subsidize SR&ED work that firms happen to conduct anyway, then the credits do not truly function as incentives. In these instances, SR&ED tax credits are not causing firms to undertake more R&D than they otherwise would have or to change the spectrum of R&D they perform. What is being asked is if there are not more productive uses for taxpayer investment in R&D than supporting retrospective claims for SR&ED.

The inappropriateness of subsidizing R&D that firms would undertake even without government R&D tax incentives has been highlighted by others. For example, the economist Mark Parsons has observed that R&D tax incentives do not create value for the overall economy just because the R&D conducted by individual firms using them inherently "creates knowledge benefits that 'spill over' to the Canadian economy." [5] He stipulates that businesses themselves must actually "respond" to the incentives.

> *Large spillovers do not of themselves justify R&D tax incentives. Business R&D must also respond to these incentives. If tax credits subsidize firms that would have undertaken R&D in any event, they are not fulfilling their intended purpose of stimulating more R&D.* [6]
> (Mark Parsons, C.D. Howe Institute, *Commentary Fiscal And Tax Competitiveness*, "Rewarding Innovation: Improving Federal Tax Support for Business R&D in Canada", No. 334, September 2011, page 9.
> https://www.cdhowe.org/sites/default/files/attachments/research_\papers/mixed/Commentary_334_0.pdf.

[5] Mark Parsons, C.D. Howe Institute, Commentary Fiscal And Tax Competitiveness, "Rewarding Innovation: Improving Federal Tax Support for Business R&D in Canada", No. 334, September 2011, "The Study in Brief", which is the first page after the cover page.
https://www.cdhowe.org/sites/default/files/attachments/research_papers/mixed/Commentary_334_0.pdf

[6] It should be noted that with respect to R&D tax incentives, Parsons indicates that "...deeper analysis reveals that tax incentives are effective in stimulating more R&D - that is, Canada would have lower levels of business R&D in the absence of these inducements." (See footnote 3 above.) However, it is not clear whether the studies Parsons analyzed in reaching this conclusion took into account the fact that the SR&ED tax incentive has built right into it a non-incentive component that allows firms to retrospectively claim and receive SR&ED tax credits for work that the firms themselves had not initially viewed as being SR&ED. In other words, the portion of retrospective claims made for work that firms had not initially viewed as being SR&ED is not an inducement at all and we do not believe that it should be considered to have triggered a higher level of business investment in R&D!

It was pointed out that the 18-month claiming period after a company's year end is useful to some claimants. Preparation costs can be reduced when using advisors, as claims for two years can be prepared at the same time. Of course, there is an alternative: emulate the UK approach and focus on the validity and effectiveness of companies' upfront claiming systems/processes. This can give profile to the SR&ED in the corporate decision process. However, because of the complexity of the SR&ED program, CRA review (i.e., audit) requirements and the compliance/recovery focus of the CRA, this approach has not worked in Canada. The CRA has phased out the limited number of "Process Reviews" it had previously permitted for some of the largest claimants.

Updated Proposal to eliminate Retrospective claims for SR&ED tax incentives and apply the savings to new tax based incentives to support innovation

Eliminate retrospective claiming and apply the savings to new tax based initiatives to support new tax based incentives.

Currently, companies are allowed to file a claim up to 18 months after the end of the fiscal year for which the SR&ED claim is being made. Require that:

- all claims for SR&ED be filed in a complete state a maximum of six months after fiscal year end (the same deadline as for income tax returns); and
- an initial submission outlining the key technology benchmarks supporting the claim and the plans be filed within 3 months of the start of a project or program.

Allow program level claiming, as well as project level claiming, for currently non-refundable SR&ED claims. (A "program" is an integrated and linked group of "projects" with a common technological goal.)

The elimination of retrospective claims should produce an efficiency/effectiveness gain for both government and businesses. Retrospective claims give rise to time-consuming controversies and complexities during reviews, because they tend to be of poorer quality due to the loss of documentation and changes in claimant staff over time.

Other countries like the Netherlands are exploring and using new approaches to avoid the problems associated with retrospective claims.

Presumably, eliminating retrospective windfall claiming would help address the types of undefined "abuse" of the SR&ED program that CRA officials often allude to; albeit, as noted, neither the CRA nor the Government has yet publicly explained what the CRA is alleging and provided some examples. Cases going to litigation are resulting in mixed outcomes for the CRA.

7-2. Proposal to require Initial Submission of Technology Benchmarking and Plans for all projects (and/or "programs", in the case of non-refundable claims) for SR&ED before the start of a program/project or within 3 months of its start. Require only Initial Submission (without Certification, which was originally proposed) for SR&ED tax credits. Permit non-refundable claims to be made at the program level, as well as at the project level, from a technological perspective. [7]

The proposal for certification for refundable and non-refundable SR&ED tax credits was seen to be too cumbersome. It was noted that experiences with certification for certain incentives has resulted in delays and uncertainty. We agree that this is correct and must be avoided.

This proposal has been modified to require that in the case of SR&ED, firms contemporaneously document their initial plans for their SR&ED project, their support for the technology benchmark and need for an advance, their document retention plans, and provide the CRA with a summary in a short submission before the start of a project/program or within 3 months of its start. Certification would not be required for SR&ED projects.

Upfront submission is intended to reduce retrospective claims for SR&ED and to improve a company's ability to support what they do claim. As a result, the overall cost of compliance from the perspective of all parties should be reduced**.**

Updated Proposal to require Initial Submission of Technology Benchmarking and Plans for all claims for SR&ED before the start of a project/program or within 3 months of its start. Require only Initial Submission (without Certification, which was originally proposed) for SR&ED tax credits. Permit non-refundable claims to be made at the program, as well as at the project level, from a technological perspective

For both refundable (smaller businesses) and non-refundable SR&ED claims in the ICT sector, require the contemporaneous development at the concept phase of:

- an initial submission outlining the technology benchmark for the advanced technological capabilities being sought, the supporting documentation; and
- detailed work plans for the project with projected costs.

These would be filed before the start of the project/program or within 3 months of the start of the associated work.

This requirement for initial submission would increase the effectiveness of the SR&ED tax credits as an incentive for investments in R&D, rather than using them just as a windfall after-the-fact. Companies and their investors would have much greater assurance about the value of their claims.

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[7] A "program" is an integrated and linked group of "projects" with a common technological advancement(s) as the goal.

Permit non-refundable claims to be made at the program level, as well as at the project level in a from a technological perspective. (A program is an integrated and linked group of projects with a common technological advancement(s) as the goal.)

7-3. Proposal to implement effective, timely, independent, authoritative third party redress of problems as they arise in the reviews of SR&ED claims

This is an outstanding recommendation made by many parties over the years. The development of a third party review system could go a long way to establishing the program's operational credibility for all parties if the logic behind how common disputes are resolved was made public.

> See CATA's report and recommendations to the Minister of National Revenue in association with seven other associations, May 1998, issue # 4 at: http://catalogca.ca/Advocacy/SRandED_Tax_Credits/federal-system.html.
>
> See independent report by Paul Daniel Muller, consultant, to the Minister of National Revenue in November 2009. See pages 28 to 36 of this report dealing with dispute resolution process, second reviews, and appeals that was obtained under an Access to Information request to the Department of Finance: http://www.cata.ca/files/PDF/2014/Muller_and_CRA_Action_Plan_for_Linked-in.pdf.

7-4. Proposal to modify the non-refundable SR&ED program in a way that supports Above-the-Line (ATL) Accounting (booking) of the credits

For details, see item 5 above.

7-5 Proposal to consider phasing out the refundable SR&ED tax credits for the ICT sector as experience is gained with the refundable labour based Digital Innovation tax credit

As the proposed new, refundable labour based Digital Innovation tax credit is phased in, refundable SR&ED tax credits for the ICT sector would likely become redundant. Therefore, consideration should be given to phasing out the refundable SR&ED tax credits for the ICT sector as experience is gained with the Digital Innovation tax credit. We do not see that both incentives should be claimed for the same projects.

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