

>>> **Reveal** Your Inner **R&D**

These days, with unsettled economic conditions in certain sectors in Canada as well as south of the border, Canadian manufacturers are working hard with every dollar that comes through the door.

Interestingly, many have not zeroed in on a generous cache of cash being offered by the federal and provincial governments through the Scientific Research and Experimental Development (SR&ED) Tax Incentive program. Canadian Manufacturers & Exporters' *2005-2006 Management Issues Survey* shows that only 39 per cent of surveyed companies currently use the SR&ED tax credit system. Many manufacturers ignore this opportunity because they believe their enterprise doesn't conduct appropriate research and development.

But before you dismiss these credits as unavailable to your company, you might be interested to know a couple of important facts. First, today's program is very different from the one introduced by the federal government in the 1980s to encourage research and development in Canada. The government wants more companies to participate in the program and has introduced numerous initiatives to facilitate the application process and make it easier for companies to comply with requirements.

Second, the credits are available not only to organizations that conduct formal

scientific research, but to virtually any company that can demonstrate that it has created a new process or improved an existing one. Many manufacturers have daily activities that qualify for these incentives. In fact, 70 per cent of SR&ED claimants are small and mid-size businesses.

For example, one of our clients in the tool and die sector that had been in business for 20 years, received investment tax credits of over \$200,000 in one year – and will be receiving a similar amount next year.

CME, recognizing how valuable these credits can be for its members, has been lobbying the federal government to enhance the existing program by making the credits refundable, excluding them from the calculation of the tax base, providing an allowance for international collaborative R&D and extending the tax credit to cover costs for pre-commercialization activities such as patenting, prototyping and product testing.

While it remains to be seen whether the government will act on these suggestions, it is committed to encouraging innovation among Canadian enterprises. In fact, this country has one of the world's most generous research and development tax incentive programs.

Businesses that qualify for R&D incentives receive three important benefits. First, they receive a full tax deduction in the year that expenditures

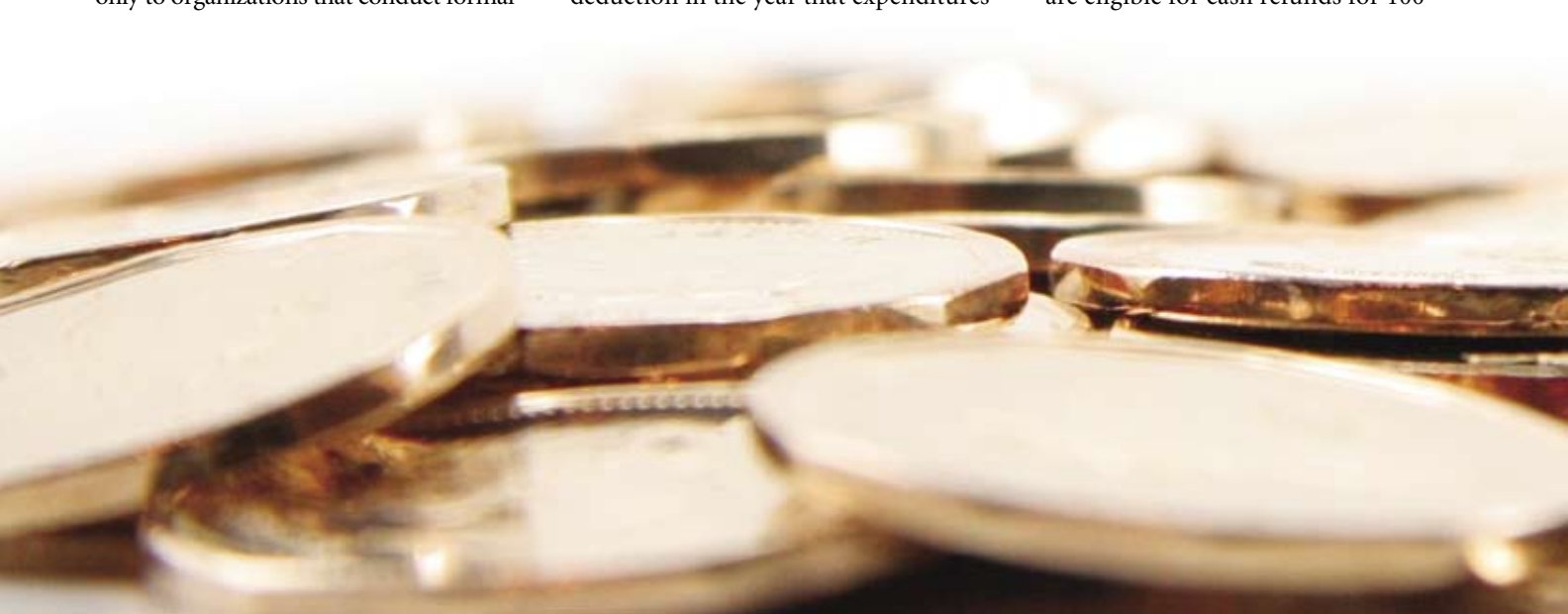
are incurred. The program allows a 100 per cent deduction of qualifying current and capital expenditures. Current expenditures include salaries of personnel involved in R&D and materials and other expenses used specifically for R&D activities. Capital expenditures include facilities and equipment, but exclude buildings.

The Canada Revenue Agency (CRA) has released a number of application policies in recent years to clarify which expenses may be claimed for R&D purposes. For this reason, consulting with a professional who is experienced with the SR&ED tax incentive program will help to ensure that a company claims all relevant expenditures for which it is eligible.

Second, qualifying companies have the option of claiming all, a portion or none of the R&D pool in the current taxation year, or in any future taxation year. This provides flexibility to claim tax deductions when they are most helpful.

Third, Canadian Controlled Private Corporations (CCPCs) are eligible for R&D investment tax credits of 35 per cent for current and capital expenses. Other Canadian corporations, proprietorships, partnerships and trusts are eligible for an ITC rate of 20 per cent.

As well, if available credits exceed income tax payable, qualifying CCPCs are eligible for cash refunds for 100



Discover a Tax Windfall

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per cent of their R&D tax credits on current expenses and 40 per cent on capital expenses.

For a CCPC that qualifies for a 35 per cent investment tax credit rate, the after-tax cost of R&D is only about 53 per cent of the actual expenditure.

For businesses that qualify for investment tax credits of 20 per cent, the savings are even more significant because they pay income tax at higher rates.

While all of this sounds great, many companies are deterred before they even begin. The very name of the program sounds intimidating: Scientific Research and Experimental Development (SR&ED). This translates, however, pretty simply; “experimental development” refers to creating new products or processes, or even simply improving existing ones.

In order to qualify as R&D, business activities must also meet two other criteria: uncertainty and documentation. The outcome of the work cannot be pre-determined – there must be some uncertainty as to whether the goals can be achieved. In fact, the endeavour doesn’t even have to be successful to qualify for R&D benefits, because failure to achieve objectives increases knowledge and is therefore considered to be research.

Finally, to qualify for the program, the work must be conducted in a

methodical manner and supported by documentation.

What if you don’t have the knowledge or the resources to pull this together?

The secret to revealing your inner R&D is adopting the right process. If we return to the case of the tool and die manufacturer, here’s how it worked. The controller of the company contacted us to do an R&D feasibility study. This is a relatively simple undertaking. We met with the controller and the production manager to review where the company had been experiencing production challenges. We also looked at minutes of management meetings. Our review indicated that production waste was an issue. The company had been trying to reduce the percentage of waste composition for a number of years. We then looked at the ways the production department had tried to address this issue – and found that it had been involved in R&D.

Next, we assembled an R&D team comprising the plant manager, a senior manager in the finance department and one of our own professionals with extensive experience in securing SR&ED tax credits. The president of the company awarded responsibility for the project to the plant manager by requiring him to submit an SR&ED application by the end of the year; his annual evaluation was adjusted to include SR&ED

application goals. Management subsequently adjusted the plant manager’s annual goals to include SR&ED claims, providing him with direct motivation to manage the process efficiently.

Also to expedite progress, we undertook responsibility for interviewing the individuals who could provide the necessary details for the projects. We compiled a list of the documentation available to support their work, such as e-mails, minutes of production meetings, etc.

To qualify for benefits, applicants must file these forms within one year after the filing due date for the taxation year in which they incurred the R&D expenditures. For corporations, this is 18 months after taxation year-end.

We also provided guidance through the final phase of the claims process. After filing for R&D incentives, a CRA science advisor and a business auditor will visit a company to verify the information submitted. When we were available to assist the client with the CRA audit process, this final phase moved forward quickly and problem-free.

Ready to give the SR&ED program a try? It’s always worthwhile to investigate; more often than not, manufacturers reveal their inner R&D – and discover a bonanza of after-tax funds.

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