



By Ela Malkovsky

PUTTING THE 'TECH' IN BIOTECH

CHANGES TO THE CANADIAN SCIENTIFIC RESEARCH & EXPERIMENTAL DEVELOPMENT PROGRAM: **WHAT TO EXPECT IN 2012**

As a world leader in health and life sciences, Canada has one of the most lucrative tax incentive programs for conducting Scientific Research and Experimental Development (SR&ED) in the world. According to Statistics Canada, the Canadian income tax system is the "most attractive in its treatment of R&D," compared to ten other major industrial countries including France and the U.S.

The SR&ED innovation incentive program is central in supporting R&D in Canada. In 2008 alone, Canadian companies spent \$15.8 billion on industrial R&D activities, providing over 155,000 full-time jobs. In 2010, \$768 million was spent on R&D by pharmaceutical and medicine manufacturers, and another \$414 million on R&D relating to navigational, measuring, medical and control instruments.

To remain competitive in the global pharmaceutical and biotechnology industries, there is a need to constantly develop and improve drugs and medical equipment through formal experimentation and testing. Here is where the SR&ED program comes into play; by refunding the costs of development and experimentation, the program enables companies to venture into projects where costs may be too high to undertake otherwise. Biotechnology sub-sectors eligible for the SR&ED tax incentive include medical equipment, biological product manufacturers, electro-medical apparatus, and many others. For example, your business may be eligible if you have worked on new devices to improve the quality of patient care, if you invested in gene therapy or experienced issues with the synthesis of a compound. The same applies for experimentation to improve drug affinity or stability, or attempts to increase the applications of a known compound. These are just a few specific examples in a sector of constant evolution and growth. The SR&ED program can offset costs of experimental development which ultimately leads to product improvement, innovation and competitive growth.

THE FUTURE OF SR&ED: THE JENKINS REPORT

Recently, much attention is being devoted to assess the SR&ED program in Canada and provide recommendations for improvement in order to ensure a more efficient appropriation of the federal budget in a recovering economy. This has brought about the question, what will revisions to the program mean for the future of companies conducting R&D in Canada?

On October 17, 2011, the federally appointed panel chaired by Open Text chief strategy officer Tom Jenkins released a report entitled "Innovation Canada; A Call to Action". Composed as a review of R&D funding, this report (commonly referred to as the Jenkins report) describes six recommended amendments to the program (Independent Panel on Federal Support to Research and Development, 2011).

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1 Create an Industrial Research and Innovation Council (IRIC), with a clear business innovation mandate (including delivery of business-facing innovation programs, development of a business innovation talent strategy, and other duties over time), and enhance the impact of programs through consolidation and improved whole-of-government evaluation.

2 Simplify the Scientific Research and Experimental Development (SR&ED) program by basing the tax credit for small and medium-sized enterprises (SMEs) on labour-related costs. Repdeploy funds from the tax credit to a more complete set of direct support initiatives to help SMEs grow into larger, competitive firms.

3 Make business innovation one of the core objectives of procurement, with the supporting initiatives to achieve this objective.

4 Transform the institutes of the National Research Council (NRC) into a constellation of large-scale, sectoral collaborative R&D centers involving business, the university sector and the provinces, while transferring NRC public policy-related research activity to the appropriate federal agencies.

5 Help high-growth innovative firms access the risk capital they need through the establishment of new funds where gaps exist.

6 Establish a clear federal voice for innovation, and engage in a dialogue with the provinces to improve coordination and impact.

The most significant changes to the program would likely result from the implementation of the second recommendation, namely, to simplify the SR&ED program by basing the tax credit for SMEs on labour-related costs. Eliminating SR&ED tax refunds on non-labour-based expenditures, such as materials, equipment and overhead costs, will expectedly result in a bias towards labour-intensive

sectors such as biotechnology and pharmaceuticals. Thus, the impact to companies conducting SR&ED in the biotechnology and pharmaceuticals sectors will be minimal. On the other hand, small and medium sized capital-intensive businesses, such as some manufacturing companies, will be impacted the most due to their high material and equipment expenditures required for prototyping and experimental production. It follows that companies requiring large non-labour expenditures will incur a decrease in R&D tax refunds if said recommendation for program simplification is implemented.

SR&ED PROJECT TRACKING

In view of the recommended amendments to the SR&ED program, it has been suggested that the CRA is requiring more extensive support documentation. The documentation requirements are largely influenced by cases such as the Northwest Hydraulics vs. Tax Court of Canada ruling against a SR&ED claim due to insufficient documentation generated throughout the project. A heavier emphasis is now placed on contemporaneous documentation (documentation generated in real time throughout the project), that is specific to the work conducted, dated and notes individuals involved. In addition, the requirement to provide documentation demonstrating Systematic Investigation has been replaced with a requirement for documentation demonstrating a rigorous 'five stage process' of scientific investigation outlining a problem statement, clearly defining project objectives, identifying uncertainties, establishing hypotheses, and performing systematic testing to collect pertinent observations and data.

To accommodate the recent program changes, a company will not have to completely overhaul its SR&ED activity process, but rather simply, the adaptation of SR&ED tracking systems will suffice. While standardized tracking software is commercially available, companies will benefit more by working with the CRA and SR&ED professionals to utilize individual and customized systems

developed in consideration of an individual company culture. Utilization of existing internal tracking systems will reduce the risk of a denied claim for several reasons. First, employees are more likely to provide pertinent contemporaneous tracking information if they are familiar with the system that they are using. Furthermore, familiarity with the system will reduce the risk that information is entered incorrectly or inconsistently and so will reduce resources required to monitor the information provided in line with current job/project tracking to ensure all activities/functions are accounted for. Customized tracking systems are superior to standardized commercial tracking software because customized tracking systems play to the strengths of the company, resulting in maximal claim returns – meaning maximal funding to put back into innovation and stay ahead of the competition.

In the end, it is vital for pharmaceutical and biotechnology companies to take advantage of government incentives such as the SR&ED program just to stay in the innovation game. But in order to get ahead of the competition, it is crucial to be aware and adapt to current incentive amendments. As such, devoting efforts to optimize internal tracking systems in accordance with CRA's increased emphasis on documentation requirements will enhance the odds that a claim is successful in the future, allowing companies to reinvest in R&D and contribute to Canadian innovation.

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