2012 BUDGET DECODED

NorthBridge Consultants

Changes to the SR&ED Program

Written by:
Gerry Fung, Director of Business Development.

The Scientific Research and Experimental Development (SR&ED) tax incentive program provided $3.6 billion in tax assistance for research and development in 2011. In the past year, the SR&ED program was reviewed by an Expert Panel which presented a series of recommendations to the federal government.

As a response to the recommendations, the Conservative Government's 2012 budget proposed four core refinements to the SR&ED program. Currently, eligible SR&ED expenditures include salary and wages, materials, overhead, contracts, and capital expenditures. The proposed changes are as follows:

1. Removal of capital from the expenditure base (for capital expenditures incurred in 2014)
2. Reduction of the proxy to calculate overhead costs from 65 percent to 60 percent for 2013 and to 55 percent after 2013 (to be fully phased in as of January 1, 2014)
3. Reduction of contract payment eligibility to 80 percent of the payment (effective January 1, 2013)
4. Reduction in the General Investment Tax Credit rate from 20 percent to 15 percent (effective January 1, 2014). This will not affect organizations that qualify for the enhanced rate of 35 percent.

Removal of Capital From Expenditure Base

The removal of capital from the expenditure base will have the largest impact on companies that incur significant costs on equipment and machinery purchased solely, or used partially, for the purpose of SR&ED.

(Continued...)

Gerry Fung M.B.A., M.A.Sc., P.Eng
Director of Business Development

Gerry is a Professional Engineer and a CMA candidate who has been involved in the SR&ED program since 2003. Gerry holds a B.Sc.E., (Computer/Electrical) from Queen's University, a M.A.Sc., (Biomedical Engineering) from the University of Toronto and an MBA from Wilfrid Laurier University.

2012 Budget Facts

This is the first majority government federal budget in eight years.

The government will scale back spending by $5.2 billion over the next three years.

The 2012 budget redirected more funds into direct funding efforts such as the Industrial Research Assistance Program (IRAP) and Venture Capital funding to support R&D for small- and medium-sized enterprises.

Reduction of Proxy

The SR&ED program allows companies to claim supporting SR&ED overhead costs by one of two methods: (1) the direct approach, or (2) the indirect approach as a percentage of direct labour costs (i.e. proxy). At present, the proxy rate is 65 percent of labour costs. However, this rate will be reduced to 60 percent for 2013, and will be reduced to 55 percent for January 1, 2014.

Reduction of Contract Payment Eligibility

Effective January 1, 2013, no more than 80 percent of eligible sub-contract payments can be part of claimed SR&ED expenditures.

Reduction in General Investment Tax Credit Rate

The general rate investment tax credit applies primarily to large corporations and foreign-owned entities. This rate has been reduced from 20 percent to 15 percent. Small- and medium-sized CCPCs are not as affected, because they receive a separate enhanced rate of 35 percent on their first $3 million of eligible expenditures.

Conclusions:
SR&ED Kept Mostly Intact for Small- and Medium-Sized Enterprises

The SR&ED program will continue to be one of the most critical programs to support research and development in Canada. Although the overhead proxy will be reduced, this should only have a minimal impact on SMEs, and the reduction of the general investment tax credit rate should not have any impact on the majority of small- to medium-sized businesses. This is a strong indication that the federal government will continue to support the SR&ED program. Introduced in the 1980s, SR&ED has evolved through various revisions and refinements. We are fairly certain that the program itself will continue to evolve, and as such, NorthBridge will work steadfast on behalf of our clients to ensure that they remain compliant with both present and future changes.

> "Looking ahead, Canadians have every reason to be confident. Other Western countries face the risk of long-term economic decline. We have a rare opportunity to position our country for sustainable, long-term growth."
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> *Jim Flaherty, March 29 2012*
> Economic Action Plan 2012
> Jobs, Growth and Long-Term Prosperity

NORTHBRIDGE:
Your Resource for Navigating in SR&ED

Written by:
Ela Malkovsky, SR&ED Team Specialist and Editor-in-Chief,
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Ela Malkovsky B.A.
SR&ED Team Specialist and Editor-in-Chief
Ela is dedicated to supporting the advancement of Canadian companies by identifying and leveraging innovative research and technology based funding options.

Having been involved in SR&ED for over 20 years, NorthBridge witnesses the benefits of the SR&ED program on a daily basis to a range of businesses from small, ad hoc operations with big ideas to larger businesses improving large scale processes. Our customers consistently reinvest funds into continued R&D — a train of progress fueled by the SR&ED program. Recent government efforts to propose an efficient federal budget for a recovering economy, as outlined in the proposed 2012 federal budget, have brought about the question: What will revisions to the SR&ED program mean for the future of companies conducting R&D in Canada?

While high concerns were looming that the proposed 2012 federal budget would make a significant cut to the overall return rate and eliminate proxy rebate for costs of machinery and equipment, the budget was a pleasant surprise. The actual changes outlined for the SR&ED program were essentially fine-tuning efforts to improve the administration of the program. Furthermore, the increased focus on the SR&ED program in this year's budget is a strong demonstration of how important this program is for the Canadian economy.

As such, the Canadian government will continue supporting to small- and medium-sized CCPCs by maintaining a 35 percent rate on eligible SR&ED expenditures, while larger corporations and foreign-owned entities will experience a five-percent reduction in the general investment tax credit rate. Although direct capital was eliminated from the credit, most companies use the Prescribed Proxy Amount method for claiming expenditures on machinery and equipment. It was therefore encouraging to hear that the proxy method will remain in place with a minor ten-percent reduction. In order to facilitate continued levels of innovation in non-labour intensive industries, the program revisions provide a two-year timeframe for implementation. This timeframe presents an opportunity to prioritize labour and capital expenditures and leverage funding solutions for continued R&D support. The revised budget also takes into consideration the significant contribution of collaborative R&D by continuing to credit subcontract payments, with a slight reduction to 80% as of January 1, 2013.

With the program currently receiving so much attention, it is a great opportunity to review your company's SR&ED practices, keeping in mind that change is the nature of innovation. At NorthBridge, we welcome progress, and commit to providing continued superior SR&ED support to all existing and new partners. We are also dedicated to expanding our knowledge base and services to serve you better, and have added an Ontario Interactive Digital Media Tax Credit (OIDMTC) team to offer full-service OIDMTC consulting to companies developing interactive digital products. As the state of technology advances, the SR&ED program must change accordingly to continue providing better opportunities for innovation and growth.

It's About More Than Just SR&ED

Written by:
James Ro, Vice President of NorthBridge Consultants.

There are many reports stating that Canadian businesses are falling behind in terms of productivity and innovation. While I do not disagree, there are a number of reasons for this as you can't just point to one single factor (i.e., SR&ED). The SR&ED program is simply one aspect of the overall tax incentive system in Canada, which sets the stage for R&D investment. The issue of tax is one of the key factors in making a decision to do R&D in one country or another.

What some people forget is that Canada is no different than a company competing in the global marketplace — our country needs to market itself, communicate the advantages it provides (e.g., attractive tax environment, skilled labour force, etc.) and compete with other countries in attracting R&D investment.

Once known as a manufacturing powerhouse, Ontario faces the pressures of global low cost manufacturers, which has helped turn the province into an expensive supplier of goods and services. When you take into account a low Canadian dollar, coupled with attractive tax incentives, you can quickly see how Ontario was cheaper than other countries many years ago — unfortunately, this is not the case anymore. The Canadian dollar has risen approximately 40 percent against the U.S. dollar over the past 10 years, which has eliminated any cost advantage that this country once held.

As such, it is not uncommon to see companies headquartered in Canada willing to outsource R&D and/or manufacturing activities to lower cost jurisdictions to minimize costs. Furthermore, President Barack Obama recently announced that he plans to slash the U.S. corporate tax rate from 35 percent to 28 percent, which will hinder Canada's capacity to compete in the highly competitive global economy. At the same time, British Columbia announced that it may raise its corporate tax rate and Ontario is expected to delay plans for further corporate tax cuts.

If Canada wants to remain competitive on a global scale, it is critical to have the proper tax incentive program in place, including SR&ED. For example, in 1996, only 12 Organization of Economic Co-operation and Development (OECD) countries offered R&D tax incentives; whereas today, 37 OECD countries offer such incentives — make no mistake, the competition for attracting global R&D investments is intensifying.

With a strong Canadian dollar and soon-to-be relatively higher corporate tax rates, the government cannot afford to tinker with the SR&ED program to the extent where it makes Canada an unattractive place for R&D investment. Enhancing the federal government's support for innovation through the SR&ED incentive program is an important step that will allow this country to be a strong export market and leader in innovation.

James Ro
Vice President of NorthBridge Consultants
James has over 10 years of experience in a wide range of business areas, including SR&ED, management, debt and equity financing, mergers, acquisitions and divestitures.

> "What some people forget is that Canada is no different than a company competing in the global marketplace — our country needs to market itself, communicate the advantages it provides..."

Building a Sustainable

Renewable Energy Industry with SR&ED

Written by:
Ruth Cooper, Client Manager — Renewable Energy Sector.

Within the Clean Technology sector on March 22, all eyes were on the fledgling Renewable Energy Industry in Ontario as the eagerly awaited Feed-in Tariff (FIT) Two-Year Review Report was released by the Ministry of Energy. The report provided the blueprints for the OPA to develop and launch FIT 2.0. Ontario's FIT program combines stable, attractive prices and long-term contracts for energy generation using renewable resources.

Homeowners, business owners and developers may apply to the FIT program if they use one or more forms of renewable energy including wind, waterpower, solar photovoltaic (PV) power and bioenergy. Ontario's is the first comprehensive FIT program in North America, launched through the Green Energy and Green Economy Act in 2009. Continuing to build on the success of Ontario-based manufacturing and clean energy job creation, the FIT Review Report recommends the advancement of a Clean Energy Economic Development Strategy to leverage Ontario's significant expertise and strengths to become a global leader in the sector.

Product and process innovation is transforming the renewable energy industry through various collaborative arrangements, including partnership between Ontario-based wholly-owned subsidiaries of international companies and Ontario's Colleges & Universities. However, numerous entrepreneurial start-ups attempting to gain foothold are hampered by the funding gap between R&D and commercialisation. Current funding opportunities involve long timelines (during which opportunities are lost) and/or require the security that comes through funding a consortium, while consortium-forming and IP protection-related expenses remain the responsibility of the small entrepreneur.

From an SR&ED perspective, the FIT Program's Domestic Content criteria are spurring economic development and growth of Ontario's Renewable Energy Industry. Following the increase in domestic content for solar PV systems last year (from 40 percent to 60 percent), numerous new solar module and inverter assembly plants have come online. As market competition increases, so does the need to innovate in order to remain competitive. Through the SR&ED program, companies can increase their bottom line AND conduct the requisite R&D for sustainable growth. Revenue created through SR&ED investment tax credits may also mitigate FIT rate reduction implications.

For International companies establishing a complex mix of business arrangements in order to support Ontario's Renewable Energy Industry through the FIT program, a reputable SR&ED consulting firm can best align your endeavours with the criteria of the CRA's SR&ED program to realize the benefits of conducting R&D in Ontario. For Small- and Medium-sized Enterprises (SMEs), contacting an SR&ED consulting firm early on so that your expenditure tracking and documentation practices are in line with eligibility criteria will ensure that you achieve the greatest level of financial support for undertaking SR&ED within the Renewable Energy Industry.

As active members of both the Ontario Sustainable Energy Association (OSEA) and the Canadian Solar Industry Association (CanSIA), NorthBridge advocates for SR&ED as the foundation for future sustainable autonomy of the clean technology sector. With industry experts in sectors from renewable energy to information technology, NorthBridge is equipped to support your clean-tech projects.

Your company should focus on innovation. We can take care of the rest.

Ruth Cooper P.Eng, M.A.Sc.
Client Manager —
Renewable Energy Sector

Ruth is currently leveraging her profound understanding of Ontario's renewable energy industry, as a Client/Business Development Manager for NorthBridge Consultants.

> "From an SR&ED perspective, the FIT Program's Domestic Content criteria are spurring economic development and growth of Ontario's Renewable Energy Industry."