

# Recent tax assistance for the M&D industry

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The 2008 federal budget included some measures to assist the M&D industry, an industry which has been particularly hard hit by a strong Canadian dollar, rising costs and decelerating economic activity.

Key highlights include enhanced SR&ED incentives and an extension to the accelerated write-off of certain manufacturing and processing equipment. Other recently announced tax measures also apply to this industry.

## Enhancements to the SR&ED program

Many manufacturers are involved in qualifying Scientific Research and Experimental Development (SR&ED) at some point in time.

### *Increased refunds*

Under the SR&ED program, eligible current and capital expenditures are fully deductible. In addition, these expenditures are eligible for an investment tax credit (ITC). There are two ITC rates for SR&ED. The general rate is 20%, and there is an enhanced 35% rate for small Canadian-controlled private corporations (CCPCs). Currently, CCPCs are eligible to claim the 35% ITC rate on up to \$2 million of qualified SR&ED expenditures annually.

Unused ITCs are fully refundable in respect of the first \$2 million of current expenses per year.

Unused ITCs earned in respect of current expenses exceeding the \$2 million limit, and in respect of capital expenditures, qualify for a 40% refund. The \$2 million expenditure limit is phased out for larger CCPCs, companies whose taxable income for the previous taxation year was between \$400,000 and \$600,000 or whose taxable capital employed in Canada for the previous taxation year was between \$10 million and \$15 million. When determining eligibility, taxable income and taxable capital, include those of the corporation and all associated corporations.

Specifically, the 2008 budget proposes that

- The \$2 million expenditure limit will be increased to \$3 million. As a result, the maximum amount of fully refundable ITC's will increase from \$700,000 to \$1.05 million for qualifying CCPCs.
- The phase out of the 35% ITC rate is amended by increasing the previous year taxable income threshold from \$600,000 to \$700,000 and increasing the upper limit of the phase-out range for prior-year taxable capital from \$15 million to \$50 million.

Both of these changes will be applicable for taxation years that end on or after February 26, 2008, pro-rated based on the number of days in that taxation year that are after February 25, 2008. The result of these changes will be extended accessibility to refundable ITCs at the enhanced rate for growing small- to medium-sized CCPCs. This will allow these corporations to more easily fund their SR&ED as they grow. However, it is unlikely that larger private or public companies will benefit from these proposals.

The following tables summarize the current and proposed systems.

Current and proposed expenditure limit, taxable income & capital phase-out ranges		
	Current system	Proposed system
Expenditure limit	\$2,000,000	\$3,000,000
Taxable income phase-out range	\$400,000 to \$600,000	\$400,000 to \$700,000
Taxable capital phase-out range	\$10 million to \$15 million	\$10 million to \$50 million

Proposed structure: maximum fully refundable ITC's earned with \$3 million expenditure limit				
	Taxable income (\$ thousands)			
Taxable capital (\$ millions)	400	500	600	700
10	1,050,000	700,000	350,000	0
20	787,500	525,000	262,500	0
30	525,000	350,000	175,000	0
40	262,500	175,000	87,500	0
50	0	0	0	0

### *Work outside Canada*

In addition, there are certain circumstances where a business may be required to carry on a portion of its SR&ED activities outside Canada in support of its SR&ED carried on in Canada. For example, certain taxpayers may require access to environmental conditions not available in Canada (e.g., a desert or a tropical climate).

The 2008 federal budget proposes to extend the SR&ED ITC to activities carried on outside Canada that are directly in support of Canadian SR&ED. Eligibility will be limited to a maximum of 10% of the Canadian SR&ED labour expenditures, and will apply generally to salaries and wages paid on or after February 26, 2008. The 10% limit will be pro-rated based on the number of days in the taxation year after February 25, 2008.

### *Administrative improvements/promises*

On the basis of recent consultations between stakeholders and the government, a number of improvements have also been proposed to the administration of the SR&ED program. This will include the introduction of a new SR&ED claim form and guide, as well as a significant increase in the number of CRA technical reviewers. The objective is to ensure that the program is applied in a timely, predictable and consistent manner across the country.

Write-offs and tax credits above and beyond your usual business deductions are possible if you conduct scientific research or experimental development that relates to your business. Part of the problem is the difficulty in defining what constitutes experimental development. It is equally difficult to distinguish exactly when development ceases and production begins, and production does not qualify as research and development.

Our SR&ED specialists can assist you in assessing whether or not your business activity qualifies or what you may have to do to ensure that your SR&ED activities are recognized by the CRA. We can also assist in identifying the types of expenditures that qualify.

### Extension of ITC carry-forward period for SR&ED tax credits

As noted above, a CCPC is entitled to claim a 35% ITC on up to \$2 million of qualifying expenditures (with a proposed increased to \$3 million) if it meets certain conditions. For such corporations, the ITC is first applied to reduce a company's federal taxes payable for the year. If there is any amount remaining, the excess can generate a refund.

Corporations not eligible for the 35% rate can still earn credits at the rate of 20%. Such credits must be applied to reduce taxes payable and are not refundable.

Under current rules, for credits earned prior to 2006, the ability to claim unused investment tax credits to offset income tax in future years is limited to a 10-year carry-forward period. For credits earned in 2006 and subsequent years, the carry-forward period is 20 years.

The government has recently announced that any company with unused investment tax credits earned between 1998 and 2005 may now be able to claim these credits for up to 20 years.

### SR&ED Small Business Action Plan

The CRA's SR&ED Program has recently released an "SR&ED Small Business Action Plan." This move is part of a continued goal to refocus the program towards small & medium enterprises (SME's).

In summary, the Plan has four primary objectives:

- 1 Ensure public awareness of the SR&ED program and services;

- 2 Make SR&ED publications easier to understand;
- 3 Improve accessibility to the SR&ED pages on the CRA Web site; and
- 4 Introduce a simplified SR&ED claim form and an eligibility self-assessment tool.

It is intended that these objectives will be implemented by the end of 2008.

### Accelerated write-off of certain manufacturing assets

Although the acquisition of certain capital property used in qualifying SR&ED activities can be written off in the year acquired. (There are many other situations where equipment purchases have to be written off over a number of years.) For example, equipment that is used 50% or less in SR&ED activities, does not qualify for SR&ED incentives. Also, your manufacturing business may not be currently involved in SR&ED activity, in which case there is no provision to write-off equipment in the year acquired.

To assist the manufacturing industry, the 2007 federal budget introduced a temporary incentive for businesses engaged in manufacturing and processing (M&P) in Canada by providing for an accelerated 50% straight-line CCA rate for M&P machinery and equipment (that would otherwise be included in Class 43) acquired on or after March 19, 2007, and before 2009. This effectively allows the acquisition cost of the property to be written off over three years (25%, 50% and 25%).

This year's federal budget proposes to extend this accelerated CCA treatment for

three more years. This will be accomplished by allowing a one-year extension of the 50% straight line CCA discussed above, followed by a two-year period during which accelerated CCA will be provided on a declining basis. For example, eligible assets acquired in calendar year 2010 will be eligible for a 50% declining balance rate in the first taxation year ending after they are acquired, a 40% declining-balance rate in the following taxation year, and the regular 30% declining balance rate thereafter. Eligible assets acquired in 2011 will be eligible for a 40% declining-balance rate in the first taxation year ending after they are acquired, and the regular 30% declining-balance treatment thereafter.

Although this measure sounds good, the tax savings would have been much greater had the accelerated write-off been extended to buildings and if the half-year CCA rule did not apply.

#### Other changes to the CCA system

In addition to the above measures, the 2008 federal budget also proposes the following CCA rate changes:

- Eligibility for inclusion in Class 43.2 (Clean Energy Generation - 50% CCA rate) is extended to include a broader range of ground source heat pump systems, additional feedstock for eligible biogas production systems; and equipment used to produce heat from waste sources and equipment used to produce bio-oil (regardless of whether the taxpayer operates the facility that uses the energy).
- The CCA rate for rail locomotives acquired on or after February 26, 2008, is increased to 30% (from 15%).
- The CCA rate for carbon dioxide pipelines is increased to 8% (from 4%), and the rate for pumping and compression equipment (and ancillary equipment) on a carbon dioxide pipeline is increased to 15%.

The above is intended to provide a brief summary of some of the recently announced tax measures that might be of interest to your business. Certain provinces also provide tax incentives for the M&D industry. In addition, there may be several GST/HST and provincial sales tax incentives or rebates for M&D activities that may assist in reducing your tax burden. Consult with your tax adviser to ensure that you get the maximum benefit from these and other tax measures.

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