



September 12, 2012

The Honourable James M. Flaherty  
Minister of Finance  
Department of Finance  
140 O'Connor Street  
Ottawa, ON K1A 0G5

**Re: Budget 2012 and Proposed Changes to the SR&ED Program**

Dear Minister:

On August 14, 2012, the Department of Finance launched a consultation in regards to the legislative proposal relating to the Income Tax Act and Regulations, which include the proposed changes to the SR&ED program that were included in the 2012 budget. We are writing to you today to express serious concerns in the industry about some of the proposed changes, and to provide alternatives that would mitigate the negative impacts of these changes on business R&D investments in Canada. The signatories of this letter include representatives of all of the major national business associations, as well as companies that are part of Canada's largest business R&D performers. Attached to this letter is an analysis of the economic impact of proposed SR&ED changes, and an international comparison of R&D tax credits that was recently performed by Canadian Manufacturers & Exporters.

**The effect of the Investment Tax Credit Rate reduction on Canada's international tax competitiveness**

The Department of Finance claims that the reduction of the Corporate Income Tax (CIT) rate in recent years made the SR&ED tax credit more generous for large companies. As clearly demonstrated in the CME study, the proposed 5% reduction in the tax credit rate far exceeds the benefits associated with the CIT reductions. To illustrate this, we have prepared an analysis using the OECD's B-Index to compare the "rate of support" offered through R&D tax credits among the OECD countries for each dollar invested by large companies in business R&D, in light of the various CIT rates in effect in each country.

CME's analysis clearly shows that despite the CIT reductions that have taken place in the last 5 years, Canada's ranking went from no. 9 to no. 13 internationally in terms of support to large companies conducting R&D. Canada's lower ranking can be explained by two factors: first, the SR&ED ITC rate reduction of 5% exceeds the benefits of the CIT reductions. Second, other countries have also reduced their CIT rates and/or increased the R&D tax credit rate offered to large companies. At 26%, Canada's combined CIT rate sits in the average offered in the OECD countries – Canada ranks 13 out of 22 countries for CIT rate competitiveness.

**Impact of proposed changes on business SR&ED claims**

Overall, according to the Department of Finance, the proposed measures will save the government \$500 million a year once fully implemented. CME believes that the government has underestimated the impact of these changes, for two reasons: first, according to CME's internal analysis, the impact of all these measures, once fully implemented, will represent a decrease of \$663 million a year in business R&D incentives (instead of \$500 million). Second, these changes made to the federal program will also have an impact on provincial R&D claims (\$84 million). Therefore, we estimate that the combined impact of these changes on business SR&ED claims is almost \$750 million a year, once fully implemented. This represents approximately 5% of total business expenditures in R&D in Canada in 2011.

## **Capital Expenditure related to R&D activities**

One proposed measure in the 2012 budget that will have the most negative important impact on Canadian manufacturers, after the reduction of the ITC rate, is the complete elimination of capital expenditures from the base for R&D tax credits. Since manufacturing is heavily dependent on investments in Machinery and Equipment (M&E) to conduct R&D, this measure will of course diminish the value of the SR&ED tax credit for large manufacturers.

CME's analysis concluded that most countries that do not provide R&D tax credits for capital expenditures, provide businesses with other incentives for investment in capital related to R&D. Most often, countries allow companies to use an accelerated depreciation rate for capital expenditure, the same way the federal government currently provides for M&E used in manufacturing and processing (the Accelerated Capital Cost Allowance). The federal government has already recognized the importance of capital expenditures in the manufacturing sector by providing an accelerated capital cost allowance for the acquisition of M&E. It would make sense that the same tax incentive be provided for M&E used primarily or substantially for R&D purposes, especially since most of these pieces of equipment may eventually be used in the production process at some point, or have an immediate impact on productivity.

We recommend that the federal government allow businesses to deduct 100% of capital expenditures (Machinery and Equipment) associated with R&D activities, the same year the expenses are incurred, or at least provide an accelerated depreciation rate (over 2.5 years) using the ACCA model.

## **The refundability of the SR&ED tax credit**

If the government intends to proceed with the proposed reduction of the ITC rate from 20% to 15%, our view is that the only way to mitigate the expected huge impact of this measure on large companies' R&D expenditures is to provide for a partial tax refund in addition to the non-refundable 15% tax credit. According to the CME analysis, a refundable tax credit would be the most efficient way to increase direct support to business R&D, while allowing companies to plan their R&D investments over the medium and long term, and also by reducing the administrative costs associated with other forms of direct support, which are estimated to be as high as 20% of the total funds allocated.

In addition, a refundable tax credit is the most market-driven way to provide direct support to business R&D. Finally, a partial tax refund would address one of the main issues associated with the SR&ED program in Canada: the large pool of unused credits. While the SR&ED program looks very attractive on paper, in reality many businesses cannot claim their credits unless they are in a profitable situation. Since the federal government allows companies to carry credits forward over 20 years, and given that many sectors have been severely hit by the US recession in recent years, the pool of unused credits has probably never been as significant as today. According to the CME analysis, between 2000 and 2004, the pool of unused SR&ED tax credits in Canada had grown to \$4.0 billion – without considering the accumulated pool of earned and unused credits prior to 2000 and after 2004. With the decline in the corporate tax rates and recent recessions, this balance in the pool of unused credits would be substantially higher and will continue to grow. If the government's objective is to substantially increase business R&D investment, it must provide incentives so that companies can access these unused credits. A partial tax refund would, in our view, be the best way to address it. By providing the right incentives to companies to invest in R&D, the federal government could substantially boost business R&D in Canada in a relatively short period of time.

CME's analysis clearly shows that some of the savings made by the government following the implementation of the proposed 5% ITC rate reduction could be reinvested under the form of a refundable tax credit without adding pressure on the government's budget. In fact, CME's analysis shows that if every non-CCPC eligible for SR&ED tax credit had access to a 5% refundable tax credit, it would cost the government about \$479 million annually, based on the 2011 Business Expenditures in R&D. By restricting the tax refund to specific types of business projects such as those related to productivity improvement for example, the cost of such direct support mechanism would be lower. We strongly recommend that the government apply the \$295 million (or \$356 million as estimated by CME) savings as a result of the 5% decrease in the general R&D tax credit to provide a refundable tax credit to non-CCPCs.

Another very important improvement that the Government could implement to the SR&ED program is to eliminate the taxation of R&D tax credit after it is claimed. Under the current system, SR&ED tax credits are subject to corporate income tax the year after they are claimed, which really reduces the incentive for business R&D expenditures. CME therefore recommends that SR&ED tax credits be excluded from business taxation.

In conclusion, we urge the Government to consider CME's recommendations in order to mitigate the negative impact of the proposed tax credit changes on the R&D investments in Canada of large companies – and in fact to enhance the environment for increasing R&D intensity and creating and keeping high-value-added jobs in Canada. These recommendations are:

- Provide a partially refundable tax credit to large companies to offset the loss incurred as a result of the proposed ITC reduction from 20% to 15%.
- Expand the refundability to unused tax credits so that businesses have access to these funds and invest it in future R&D projects.
- Provide an accelerated depreciation rate for capital expenditures (M&E) associated with R&D.
- Review the reduction of the overhead proxy rate from 65% to 55% in light of the increased complexity and administrative burdens this measure will have on business cost of compliance and on the Canada Revenue Agency.
- Exclude the proposed changes to R&D tax credits from the second Budget Implementation Bill and include them in a separate Bill. Given the huge impact these measures will have on Business R&D in the future, it is critical that the government does not rush the implementation and takes more time to consult with industry and provinces.
- Consider a longer transition period for implementing the proposed changes.

We look forward to hearing back from you on our proposed measures to mitigate the negative impacts of the measures proposed in the 2012 budget to lower the value of the SR&ED program and we are hopeful that the implementation of these measures will be done outside the Budget Implementation Bill.

Respectfully,



Jayson Myers  
President & CEO  
Canadian Manufacturers & Exporters  
Chair, Canadian Manufacturing Coalition



James Quick  
President & CEO  
Aerospace Industries Association of Canada



Jerry Engel  
President  
AMC - Agricultural Manufacturers of Canada



Shannon Coombs  
President  
Canadian Consumer Specialty Products Association



Murray Abramovitch  
President  
Canadian Die Casters Association



Roger Larson  
President  
Canadian Fertilizer Institute



Richard Docherty  
Chairman  
Canadian Fluid Power Association



Jim Keon  
President  
Canadian Generic Pharmaceutical Association



Bob Elliott  
President  
Canadian Printing Industries Association



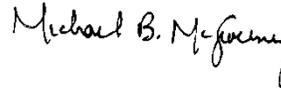
Ron Watkins  
President  
Canadian Steel Producers Association



Donald E. Moore, P.Eng.  
Executive Director  
Canadian Transportation Equipment Association



Mark Nantais  
President  
Canadian Vehicle Manufacturers' Association



Michael B. McSweeney  
President & Chief Executive Officer  
Cement Association of Canada



Richard Paton  
President & CEO  
Chemistry Industry Association of Canada



Nancy Croitoru  
President and Chief Executive Officer  
Food and Consumer Products of Canada



David Lindsay  
President and CEO  
Forest Products Association of Canada



Karna Gupta  
President & CEO  
Information Technology Association of Canada (ITAC)



David Andrews  
Executive Director  
Paper Packaging Canada



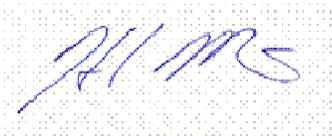
Mark Lievonen  
President  
SANOFI PASTEUR



Emerson Suphal  
President  
Canadian Tooling & Machining Association



Pierre Gratton  
President and Chief Executive Officer  
The Mining Association of Canada



T. Howard Mains  
Canadian Public Policy Advisor  
Association of Equipment Manufacturers (AEM)



Carol Hochu  
President & CEO  
Canadian Plastics Industry Association