



**CMC** | Canadian  
Manufacturing  
Coalition

November 10, 2011

The Honourable Gary Goodyear  
Minister of State (Science and Technology)  
(Federal Economic Development Agency for Southern Ontario)  
Industry Canada  
235 Queen Street  
Ottawa, ON K1A 0H5

Dear Minister:

We are writing on behalf of the members of the Canadian Manufacturing Coalition (CMC) in regard to the recent report of the independent expert panel on federal support to Research and Development (R&D) published on October 17, 2011, which provides an important reference source as the government seeks to improve the outcomes from its substantial investment in public and private sector innovation.

We would like to congratulate you for launching this important study as it shows how important business innovation in Canada is for you and your government. There is a broad consensus within Canadian society that innovation, R&D and business productivity are at the core of our nation's future quality of life and well-being. Governments, businesses and academic institutions are at the centre of innovation in Canada, and we look forward to working with all stakeholders in making sure that Canadian business fills the productivity and innovation gap that exists with other nations.

In a recent joint study conducted by Canadian Manufacturers & Exporters, Industry Canada, and McMaster University on the state of advanced manufacturing, the results indicated that innovation in the manufacturing sector goes well beyond business expenditures in R&D or product development. In fact, the manufacturing sector outperformed all other industry sectors in Canada between 2007 and 2009 in terms of the four components of innovation: product development, organizational innovation, product innovation and marketing innovation. It is important to note that process innovation is the key factor that determines a company's capacity to go up the world value chain, while product innovation and marketing innovation are the main determinants of a company's capacity to commercialize products. These are important elements to keep in mind in implementing policies in support of business innovation, since most government programs currently focus on product innovation alone – particularly fundamental and experimental research. Policy-makers need to take other elements of innovation into account, especially if we want to improve commercialization and productivity performance.

The CMC is composed of 47 business associations who collectively represent more than 100,000 companies in all sectors of the manufacturing industry. While we generally agree with the assessment of the state of private sector R&D and innovation presented in the panel's report, the Canadian manufacturing sector is deeply concerned with some of the panel's recommendations, specifically those related to the Scientific Research and Experimental Development (SR&ED) Tax Credit. We want to highlight a few areas of specific concern and outline an approach that would create what we believe would be better value and return for both government and business from Canada's SR&ED program.

First of all, we agree with the expert panel that Canada needs to achieve a better balance between direct and indirect support to business R&D. However, we strongly disagree that we should cannibalize the SR&ED program to fund new initiatives. The current SR&ED tax credit is a broadly-based program accessible to businesses across all industry sectors whose R&D activities meet the program's eligibility criteria. This scope is critical to its success. Scaling back this program as recommended to make funding support available to only certain sectors or industries, and perhaps even to a limited number of firms within them, could significantly narrow the scope of innovation currently being undertaken in Canada. The applicability of the SR&ED system across all R&D performing sectors broadens and expands the level of innovation taking place in Canada and by extension the probability of generating returns on investment made by both the performing companies and the government. This government has recognized that broad-based business support measures such as the reduction of corporate tax and the Accelerated Capital Cost Allowance for the acquisition of machinery and equipment are more effective than programs targeting specific sectors or companies. This principle should be maintained in respect to the SR&ED program.

A serious weakness of the panel's report is its failure to address the issue of the SR&ED's limited applicability for larger companies, including multinationals. To address this shortcoming, we had recommended that SR&ED credits should be made fully refundable for large as well as smaller companies, so that SR&ED credits could be fully earned and utilized as R&D investments are incurred. This would be particularly beneficial in assisting firms to continue to invest in innovation during economic downturns – the current rules only allows larger firms to apply the SRE&D tax credit against profits earned. Importantly, making the SR&ED tax fully refundable would strengthen Canada's support for market-oriented R&D and create a world class program to support private sector innovation. This program change would be similar to models found in other countries such as Germany, and would provide competitive forms of risk and cost sharing to assist Canadian firms to compete for R&D mandates within multinational enterprises.

In addition to improving the SR&ED program by making the tax credit fully refundable for all performers of R&D in Canada, regardless of size, sectoral focus and ownership, the government should selectively look to complement this measure with direct support for business R&D. This may be necessary in consideration of the size and type of the R&D activity proposed to be carried out in Canada and of the type of support that other jurisdictions may offer to secure the innovation investment.

A direct way in which government can increase chances of more commercialization activity in Canada is to expand the definition of eligible research to match or exceed the one used by OECD countries (*Frascati Manual*). Given the increasing number of multinational companies globally that are conducting a higher degree of research and development outside their walls, we believe that Canada can improve its ability to attract a higher percentage of R&D investment focused on commercialization by adopting a more current definition of eligible research under its SR&ED program. We would welcome the opportunity to further discuss with government ways in which the definition of eligible research could be expanded to apply specifically to:

- 1) Commercialization activities (i.e. development), recognizing the role Canadian firms are already playing (and are poised to play) in ICT, life sciences, and aerospace R&D, here and abroad; and
- 2) Capturing all aspects of clinical research, direct investments in clinical trials, and complementary investments in other forms of research partnerships not currently eligible for SR&ED credits.

The panel also recommended that the government should eliminate non-labour related expenses, which are currently eligible under SR&ED, as well as eliminate part of the tax refunds for Canadian Controlled Private Corporations. This would have significant negative impacts on Canadian innovation and weaken

business investment in R&D over time. For larger firms, the panel raised the prospect of a similar shift in the funding calculation, but only in general terms, rather than providing specific direction. Such uncertainties further undermine the confidence that businesses have in the tax credit as an important incentive for industrial innovation. If anything, the report would actually weaken support for industrial innovation, particularly on the part of multinational enterprises that are fiercely competing for research and product mandates for Canada.

The rationale used by the panel for adopting a labour-based approach to SR&ED eligibility is the complexity of the current formula related to the allocation of overheads, equipment, materials, and third-party contracts. This complexity has no doubt given rise to a thriving business for tax advisors, raising concerns that funding support is leaking too much into the hands of consultants. CME believes that better solutions to this problem can be found. We recommend that:

1. Businesses be given the option of adopting the simpler labour-based formula with an increased credit rate recommended by the panel or using the current formula that would include other non-labour costs; and,
2. IRAP be given the mandate to pre-approve R&D projects eligible for the SR&ED tax credit and verify usage rates for equipment and materials. This approach would allow the Government to lower administrative costs within CRA, reduce uncertainty with respect to the technical eligibility of projects, and verify cost allocations. It could also increase the level of certainty for Government about how much funding is available or being provided through the R&D tax credit system.

Over the past year, many companies have noticed significant changes in the way the CRA has audited their claims, and have complained that some activities, which were eligible in previous years, are no longer eligible for claim. This not only creates uncertainty among businesses, it also raises the need for a clear policy mandate as it pertains to assessing SR&ED claims. This is why CME strongly recommends that technical assessments be based on reviews by experts outside the CRA, as with IRAP's technology advisors, in order to provide more clarity and certainty.

In our view, the report makes some constructive recommendations with respect to encouraging business innovation through government procurement and proposals for programs that would provide more direct support for commercialization. For example, the idea of a Commercialization Vouchers Pilot Program is worth exploring in more detail with businesses from all sectors. We strongly recommend however, that the implementation of this program should not be linked with the re-organization of current federal support programs, for example, through the creation of an Industrial Research and Innovation Council (IRIC) and the transformation of the National Research Council's institutes. While we do not oppose these changes in structure, we believe that the Commercialization Vouchers Pilot Program, as well as a strategy to use government procurements to drive innovation, should not have to wait for these structural changes to be implemented.

The creation of ICI has also raised a number of concerns related to unnecessary centralization of the administration of direct R&D funding programs. For example, regional economic development agencies account for 14% of current direct Government expenditures in business innovation. These agencies have the knowledge, networks and the expertise at the local level that could be lost by a transfer of responsibilities to a central agency that would become in charge of administering these programs. We strongly recommend that the administration of direct R&D funds continue to be managed at the local and regional levels.

Finally, there are a number of important issues that are not raised in the report and that deserve attention from the Government and from all stakeholders.

First, we believe that all government support programs for innovation should have been assessed. By focusing on a narrow remit of funding for business innovation, the panel missed the opportunity to evaluate and improve funding models for academic and government research. None of its recommendations deal with the fundamental issue of how to generate greater economic benefits from the \$14 billion dollars that are currently being invested in academic and public research. We believe that funding programs for academic research should be directed to provide greater support for collaborative R&D activities with business, increasing technology transfer to Canadian businesses, and the placement of talented and skilled personnel in business. Other countries have found effective means of transferring academic research findings to businesses where they can be successfully commercialized. In Canada, best practice can be found in the AUTO21 Centre of Excellence and the former Ontario Centre of Excellence, Materials and Manufacturing Ontario.

Another issue not addressed by the expert panel is the need for Canada to better reward the products of innovation. As recommended by Mark Parson, the author of the CD Howe Institute paper on SR&ED reform, a good solution to explore would be to adopt a smarter tax system for products that are a result of a patent developed in Canada. The U.K. is an interesting model. It imposes a lower tax rate (five per cent) on income generated by products and patents that are related to a firm's R&D completed in the U.K. In Canada, products of innovation are taxed at the same rate as any other income. CME strongly believes that this could be a very good complement to Canada's model, centered on basic and experimental research.

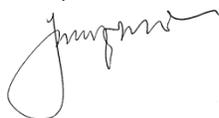
There is also no mention of the important role that international technology and knowledge transfer plays in business innovation within Canada. How should programs be structured to support global product research and development mandates? How can Canada's trade commissioners better support access to R&D in other countries and identify international commercialization opportunities for Canadian businesses? How should Canada's patenting process be improved? And, what support should be given to assist businesses in patenting, testing, standards certification, technology enhancement, process improvement, and market development? – all very important aspects of the commercialization process.

The CMC congratulates you and your government for examining current and future policies as it relates to R&D and innovation policy in Canada. We look forward to working with you and other stakeholders to improve Canada's performance in innovation, R&D and business productivity.

Yours sincerely,



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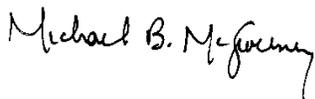
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