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The Issue: The Importance of SR&ED to ICT R&D

The ICT industry is the most research and development intensive (R&D) sector in the Canadian economy accounting for 35% of Canadian private sector R&D. R&D is a vital activity for our industry, driven as it is by an insatiable quest for persistent improvement and innovation. Recent changes proposed for the Scientific Research and Experimental Development (SR&ED) tax credit to encourage R&D investment will have a costly impact on the performance of R&D in Canada, especially for some of Canada's largest R&D performers. These changes are scheduled to begin in 2013. The ICT industry seeks a deeper understanding among policy makers of the implications of these changes and needs more time to adjust to these changes before they take place.

The ITAC community includes some of the very largest R&D intensive companies. 4 of the top 10 companies on Research Money's list of Top 100 Corporate R&D Spenders are members.¹ R&D is also a crucial activity for many small and medium sized ICT companies as well. Sixty-five percent of ITAC's members are SMEs. Many of them, particularly start-ups, invest proportionately more of their revenue in R&D than larger firms.

New discoveries and persistent innovation are essential in our highly competitive global industry. R&D is essential to this process. Deciding whether or not to perform R&D is not an issue for our sector. Deciding where to perform it, however, is.

One of the unique characteristics of R&D in ICT is that it is highly mobile. Where we conduct R&D is really dependent on only one factor. Where enterprises can find the skilled technicians, engineers and scientists to address the problems they want to solve in the most cost-effective manner. Canada, which is highly ranked for excellence in post-secondary education, has been well situated to play a significant role in ICT R&D.

But increasingly other nations with aggressive strategies to compete effectively for science-based jobs have changed the global R&D landscape. They started off with approaches capitalizing on lower wage rates and super abundance of human capital. And they rapidly established themselves as serious contenders. Now they are moving just as aggressively up the value chain demonstrating capabilities in qualitatively differentiated areas of expertise.

Canada competes against these R&D producing countries handicapped by a high wage rate, a high-value currency and a relatively small market and population. This makes decisions about where to place R&D activity anything but simple. For example, executives who operate a Canadian lab for a large multinational corporation must build business cases that demonstrate why the R&D performed is best situated in Canada. This is a highly competitive exercise among peers within the company seeking to win or expand mandates in their jurisdictions. Canadian companies face similar decisions. They must deliver R&D inputs to the production process as cost effectively as possible in order to remain competitive. Many large, medium and even small companies maintain R&D facilities in other jurisdictions in order to maximize the best returns on the full spectrum of R&D activity.

Complicating this process further is that national jurisdictions compete furiously to attract high value R&D jobs into their country, province or city. They use a broad array of direct and indirect incentives in order to do so. Consequently, Canadian executives seeking to keep or expand their R&D mandates in Canada need all the help they can get.

Generally speaking, the single best mechanism for helping to win the fight to keep research mandates in Canada has been SR&ED which is a tax-based indirect incentive available to all R&D performers. ITAC has consistently articulated the view that this approach is the best approach to encouraging business research and development for two reasons. First, it is predictable. Companies

¹ %Canada's Corporate Innovation Leaders, +Research Infosource, November 4, 2011.

occasionally must defend a claim but, generally speaking, the beauty of a tax-based measure is that if an enterprise performs the R&D it can predict what the impacts of the credit will be on its costs. Direct programs, such as the former Technology Partnerships Canada or even IRAP, are binary. Companies qualify for funding or they don't, and the outcome is not predictable.

The other reason ITAC members prefer tax-based incentives are that they are generally accessible to all R&D performers. There are of course some exceptions. Tax-based measures imply that companies must be profitable to access the value of the credits and some foreign-based multinationals cannot access credits due to tax treaty issues. In fact, it can be argued that SR&ED is the only incentive mechanism in the Canadian ecosystem for large R&D players.

ITAC believes that a healthy innovation ecosystem contains a number of small, medium and large players. And while we have many start-ups and emerging companies in the Canadian ICT industry, there are only about 100 ICT companies in Canada with more than 500 employees.

Beyond the sheer size of these companies, they bring additional assets to their geographies and ecosystems. The global reach of their supply chains can propel local partners into a worldwide marketplace. And their C-suites of talent adept at managing growth and all other dimensions of research based commerce provide the feeder-stock for the next generation of start-ups. Above all, their success stands as an aspirational objective for emerging companies seeking a leadership position in global markets. Large companies play an important role in the ICT industry. But they need a good reason to maintain their operations in Canada. SR&ED is very important to them. In many respects, ITAC believes that SR&ED helped to build our industry from a standing start fifty years ago to 5% of Canadian GDP today (as much as mining and forestry combined).

The Economic Action Plan of March 29, 2012 contained a number of measures which seriously diminished the value of SR&ED to small, medium and especially large R&D performers. These changes include a reduction in the general 20% SR&ED investment tax credit rate applicable to SR&ED qualified expenditure pool balances at the end of taxation year to 15%. The Budget also excludes expenditures of a capital nature from SR&ED eligibility. It also aims to reduce the rate at the prescribed proxy amount of calculating overhead expenditures from 65 to 60% in 2013.

These reductions are all earmarked to support the \$1 billion of direct innovation support contained in the Budget, which includes a doubling of available IRAP funding and \$400 million in new venture capital.

These changes will have severe bottom-line impacts on many R&D performing companies. ITAC recently surveyed its R&D performing members and learned that 80 per cent anticipated that these changes would adversely affect their companies, reducing the value of their SR&ED claims up to 50 per cent annually. R&D is an economic, not philanthropic or patriotic, activity. If it costs more to perform R&D in Canada, then we have made the fight for global research mandates in Canada harder to win. ITAC believes this will produce outcomes that we don't want in our quest to build a strong more innovative nation.

In spite of the criticism, SR&ED has received (including from industry) we know that SR&ED produces a clear 11% return on investment² to the Canadian fiscal system. If we are reducing our investment in an innovation policy instrument that delivers a clear and solid return, in favour of higher investments in an array of direct programs to support innovation, we need to have clear information about what these changes in Canada's innovation portfolio produce. We need ongoing analysis of the return on investment from programs such as IRAP and Business Led Centres of Excellence. And we need a clear picture that validates that the shift we are currently implementing by the transfer of funds from indirect to direct instruments produces the outcomes we desire – more high value employment, stronger enterprises and greater wealth. If this proves not to be the case, we must have the resolve to change our course and restore the proven benefits of SR&ED to their former investment levels.

If the next Canadian grown global technology leader is to be fostered, we must be careful to ensure that any changes do not undermine the unique scope or strength of a leading program like SR&ED. SR&ED in its current form can be reformed. Fundamentally the entire ICT sector needs more transition time before implementation of such significant and costly changes to R&D intensive companies.

² M. Parsons and Phillips, Tax Incentives for Scientific Research and Experimental Development, Consultation Paper, Finance Canada, 2007.