R&D Tax Credits

Looking to get back some of your investment in research activities? Scientific Research and Experimental Development (SR&ED) refundable tax credits may be the way to put the money back in your company's coffers. Most of us have to do research... here's how take advantage of the government tax breaks.

SR&ED is a tax incentive program offered by the federal government in partnership with some of the provinces to encourage Canadian companies to conduct research here in Canada by offsetting some of the cost of performing research through immediately refundable tax credits or future tax credits. The goal of the Canadian government with this tax incentive program is to increase the research carried out in Canada.

Thousands of companies have taken advantage of this program over its 20 year existence, and the government is now willing to double the level of tax credits from the current $1.5 billion. It is hoped that this research will result in leading-edge products, novel or significantly improved manufacturing methods and processes, and new technology that will raise the level of Canadian expertise.

Who Qualifies?

To qualify for the 35% refundable tax credit, a company must be Canadian owned and have a taxable income under $200k. There are some limits on the rebate; it only covers up to $2M in expenditures or a $700,000 maximum annual refund. (The most common expenses that are covered by SR&ED are wages, materials and some equipment.) Other corporations undertaking research in Canada may be eligible for up to a 20% tax credit on their investment. Most companies within the defense industry are typically working on leading-edge products, therefore, they will be contributing valuable intellectual property at significant technical risk to themselves and the entire development and manufacturing process, regardless of their position as prime vendors or within the supply chain.

Project Requirements

Your project must further the knowledge in your field (such as creating something new or improving on an existing product or process) in order to qualify for the tax credit. You must be trying to solve critical scientific or technological problems – and the project must involve technical risk (failed efforts are just as eligible as successful ones). You must also have properly qualified personnel leading the project (in other words, if your project is on chemical defense, you would have chemist or an engineer leading the project rather than a supply chain manager).

Sample projects that we have claimed include: waste oil recapturing; gas mask adapter kit; and new software programs that allow invisibility of function through disparate operating systems and programs

Paperwork

To apply for the SR&ED tax credit, you need to fill out a T661 form (Claim for Scientific Research and Experimental Development in Canada). Help with this form is available on the T4088 form (Claiming Scientific Research and Experimental Development Expenditures – Guide to form T661). You also need to fill out a corporate or individual tax credit form, either T2SCH31 or T2038(IND). These forms are all available on line at: www.ccra-gc.ca/sred/

This site provides the details on what activities are covered by SR&ED, who is eligible and how to properly complete the required paperwork.

Determining Overhead: You have a choice to use the traditional or proxy method to determine the overhead expenditures. Basically, the proxy method uses a formula to calculate the overhead to be considered for the SR&ED tax credit. The traditional method requires that you specify each expenditure and their allocation to SR&ED. For the traditional method, you must provide copies of all expenditures. Most smaller companies will find it easier to use the proxy method, and at 65% of eligible salaries and wages, it accurately represents typical overhead costs for most projects. However, specialized industries may be able to fully identify their costs and may want to use the traditional method.

Advisors

There are two officers assigned to review your claim – a financial advisor and a scientific advisor. The government is trying to increase the amount of research performed in Canada and they will help you identify the areas within your company which might be eligible that you may have overlooked. The financial advisor looks into the financial aspects of your claim, but the eligibility of your claim comes from the scientific advisor's recommendations. They will coordinate a visit to your company to review the SR&ED program and help you as much as possible with your claim.

Preparation

First, identify what projects you have within your organization that meet the SR&ED criteria. The project could be focused on something that has a practical application (or not) – the important thing is to determine if the effort is beyond the common knowledge of the industry or field and it involves risk, that it is not a "natural evolution" of the art. Once you have identified the project, gather all the information you have, such as back up information, project descriptions, project binders, lab books – anything that details what you are and have been working on.

There are time limits on claims, so make sure you keep up to date. You have 12 months after your year-end to claim the tax credit.

Projects need to be written up in a specific way for the application. There are five sections to be addressed. Here is an example interpretation:

- **Scientific or Technological Objectives**

What are you trying to achieve with your project? What is the technological or scien-

tific objective of your project? Include how you will measure your success (how will you know you have achieved your objectives?)

• Technology or Knowledge Base Level

What was the level of knowledge in your field that you needed to extend in order for your project to go forward? What was the base level that caused you to take on this project?

• Scientific or Technological Advancement

What are you trying to achieve and why is this considered advancement in your field? What did you have to overcome that could not be solved with current information? If you know exactly how to resolve a problem without trying alternatives, chances are it will not qualify.

• Description of Work in this Taxation Year

What did you do this year on this project? Include information on what you achieved and what knowledge was gained.

• Supporting Information

You need all information you have proving the technological advancement including time sheets, log books, project books, meeting minutes, prototypes, drawings, technical records, etc.

Once you have your project descriptions written up, you can start considering filling out the rest of the T661 form. I have found the best way to address the figures required for the T661 was to create a spreadsheet with all expenditures for each project with the assigned line number. For example, line 300 is the total for all wages of employees for the year that are working on SR&ED. While the form requires the total, your financial advisor will be asking to see the individual values for each employee and will be looking for a justification of the level of participation claimed. Therefore, if you have a spreadsheet set up with this information, it is easy to just print a copy of your spreadsheet for your advisor.

It is best to have each line identified on the spreadsheet in the same way it appears on the T661 form (the most common are Line 300 – wages, and Line 320 – materials consumed). *See Figure 1.*

On the same note, you will be asked to provide copies of information (such as invoices and T4's) that you furnish; it is easy to have copies of all information in a project-specific binder ready to give to the advisor when asked. This works only if you do not have huge amounts of information.

FIGURE 1
Project: Widget Improvement

Line	Vendor	Amount	Description	Date	Comments
300	John Doe – employee	$4,500	100 hrs @ $45/hr	Jan 2004 to Apr 2004	Design of new Prototype (refer to eng doc xxx to xxxx)
300	Jane Chow – employee	$12,000	240 hrs @ $50/hr	Jan 2004 to May 2004	Developing and evaluating algorithms for design application
320	ABC Widgets	$24,000	Initial prototypes	June 2, 2004	Provider of prototypes that were consumed in testing
320	XYZ Design	$5,000	Chemical prototypes	July 2004	Provider of chemical mix required for project

FIGURE 2
Time sheet for January 2004: Employee A

Project	Subtasks		Hrs	R&D /S/A	Comments/Description of Work
xxxxxx1	1	Basic Modeling - design work			
	2	Basic Modeling - documentation			
	3	Prototype - design of algorithms			
	4	Tool Design & Creation - list updates			

You will be asked to provide time sheet information to prove the hours that your staff worked on the research projects. You might want to set up your time sheets initially with the actual project sub tasks listed (including all non-claimed tasks) so the percentage of effort claim can be substantiated. (See figure 2)

The R&D/S/A refers to research and development (new technology – pushing the envelope of existing knowledge, and tasks that involve technical risk), and associated activities: *S* stands for support activities and *A* is administrative activities. *Only the R&D activities can be claimed for the SR&ED program*, but it is important to have all activities on your time sheets. Generally, most people spend less than 80% of their day on actual productive work – a lot of time is spent on routine activities and administration, and those "obvious" elements of the project that are not eligible for SR&ED credit.

The more information you have available, the better you can address any questions from the advisors. This will also aid you in future years as you will have the advisors' input into exactly how they want the information for your company expressed and detailed.

There are consulting firms available to assist you in preparing a claim, however, I have found that the effort involved in putting together the submission for this SR&ED tax credit is something most companies can do themselves without outside help. Someone within your organization that has access to the wages and expenditures, usually someone within the finance department, is the best person to compile the claim. If you need assistance, the government advisors provide excellent support with this program. The government is committed to increasing the total tax credits for Canadian companies – consider this your effort to help the Canadian government with their goal, and this time the money comes to you! FL

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