Canadian Manufacturing Coalition

May 7, 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 SR&ED Program

Dear Minister:

We are writing on behalf of our members regarding the 2012/2013 Federal Budget and in particular the proposed changes to the Scientific Research and Experimental Development (SR&ED) tax credit program. Our associations, as part of the Canadian Manufacturing Coalition (CMC), represent more than 100,000 companies across the country from all sectors of the economy.

First we want to congratulate the Government for the general direction of the Budget and several of the important economic and policy proposals contained within. Actions announced on deficit reduction, as well as on implementing the Canada/US perimeter security and economic competitiveness action plan, expanding market access in foreign markets, regulatory simplification and harmonization, immigration and skilled worker reforms, and the measures aimed at making research more centred on business needs, are fully supported by the members of our associations. However, we must also express our deep concern regarding the proposed changes to the SR&ED program, and the negative impacts that they will have on Canada's innovation performance and the manufacturing sector specifically.

Over the past decade, Canada's manufacturers have made major efforts to improve their investment and research and development (R&D) performance. With the rapid appreciation of the Canadian dollar and growing international competition at home and in foreign markets, Canada's manufacturing sector responded aggressively by accelerating investments in productivity and R&D. Today, despite representing less than 14 per cent of total GDP, Canada's manufacturing sector accounts for nearly 60 per cent of all private sector R&D. This R&D is focused on product innovation and commercialization, as well as on process improvement that is critical to global competitiveness. As a result, today about half of all SR&ED claims originate from Canadian manufacturers. The changes proposed in Budget 2012 could significantly and negatively impact these efforts, undermine future R&D investments in Canada, and limit the growth of companies as they attempt to develop from small start-ups to larger, globally competitive companies.

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We wish to be clear: Even with recent reductions in corporate tax rates, Canadian manufacturers are at a disadvantage when they compete for new or increased R&D mandates. Especially in instances where corporate ownership is located outside Canada, we do not have home court advantage, and it has become increasingly difficult for Canadian divisions of large multinationals to compete for R&D mandates. The proposed changes to the SR&ED program make this an even greater challenge for our manufacturers.

We have two specific concerns with the proposed changes contained in Budget 2012:

- **Reducing the SR&ED Investment Tax Credit (ITC) rate from 20% to 15% will directly and negatively affect Canada's top R&D performers.** This measure will take $770 million out of the SR&ED program between 2014 and 2017, reducing the capacity of larger firms to reinvest this money in R&D activities in Canada. In 2010, half of all private sector R&D in Canada was performed by only 75 companies, all of which are large corporations, and many with headquarters outside Canada. All are able to invest in R&D around the world. The reduction of the ITC rate will impact the ability of Canadian divisions of multinational corporations to attract global R&D mandates in Canada and will require Canadian headquartered companies to examine outsourcing R&D as a more cost-effective way of driving innovation and productivity. The current SR&ED program, while not perfect, provides the necessary financial incentive to conduct R&D in Canada compared to other jurisdictions. The reduction of this rate will diminish this influence. Unfortunately, the signal that the proposed SR&ED changes send are two-fold: (1) Canada does not value or welcome large R&D mandates; and, (2) companies with large R&D projects should look elsewhere in the future. Large R&D projects, affiliated with existing manufacturing operations, are the prime driver of innovation and commercialization in Canada. While it is true that many enterprises will continue to invest in R&D, the proposed changes to the SR&ED program mean that those investments are much less likely to be placed in Canada.

- **Eliminating capital expenditures from eligible expenses will significantly and negatively impact the largest users of SR&ED – Canada's manufacturing sector – which is much more capital intensive than other sectors.** Innovative manufacturers need production facilities and special machinery and equipment to conduct their R&D mandates. Between 2014 and 2017, $95 million will be taken out of the SR&ED program with this measure. However, it will have a much broader impact on the ability to retain and attract investment in Canada. Some manufacturers may continue to invest in R&D and carry additional costs, other companies will simply move the R&D to other jurisdictions where overall R&D costs are lower, providing a greater return on these investments. This will further undermine Canada's innovation and commercialization performance. Members of the Coalition understand that it was administratively difficult to manage capital cost eligibility within the SR&ED program. Our manufacturing members wish to be on record that it is even more difficult to compete for global R&D mandates and this proposal, if implemented, will make it much harder. We believe that there are other measures that can be adopted to address the difficulties of determining eligibility, rather than eliminating eligibility because it is "hard to administer".

The Budget included other measures in support of science and technology, including increasing funding for NRC-IRAP and the Canadian Foundation for Innovation. However these will not offset the proposed changes to the SR&ED program on the manufacturing sector.

We strongly recommend that the Government review the proposed changes to the SR&ED program in light of the effects they will have on Canada's manufacturing sector and the importance of manufacturing to Canada's overall innovation performance. We believe that we can work together to help shape these Budget proposals into a more comprehensive innovation strategy for Canada that supports all of Canadian industry and meets government objectives of reducing overall costs with better outcomes.

In particular, we recommend that:

- **Canada should focus on rewarding the products of innovation through a smart tax system for products that are a result of a patent developed in Canada.** The United Kingdom has an interesting model that imposes a lower tax rate of five per cent on income generated by products and patents that are related to a firm's R&D completed in the U.K. We believe that Canada could explore the adoption of a similar model to strengthen its record of commercialization of R&D in the country.

- In order to compensate the manufacturing sector for the elimination of the capital expenses, the coalition recommends making the **accelerated write-off a permanent feature of the tax system**. A permanent extension is supported across all business sectors and political parties and will help Canada fill the productivity gap with other industrialized nations. The current temporary extension of the two-year write-off has already demonstrated very positive results, as demonstrated by the increase in machinery and equipment investment shown in the last two years.

- **Technical assessments and audits of SR&ED claims should be conducted by subject area experts to provide more clarity and certainty.** We strongly support the intent to review the Canada Revenue Agency`s (CRA) administration of the SR&ED program, including the assessment of eligible activities. Today, 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 to be claimed. 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.

- **Complete, with sufficient industry input, the proposed study of contingency fees charged by tax advisors to prepare SR&ED claims.** Tax advisors have a very important role to play in helping SMEs access the SR&ED program; however, their role has changed rapidly over the past several years. We fully support the government's study of the accountability of service providers to their clients, as well as their costs to the SR&ED system and look forward to participating in the consultations.

- Finally, and probably most importantly for manufacturing companies engaged in R&D today, **commit to fully review the potential impact of the two key proposed changes (tax credit reduction and elimination of capital expenditure eligibility).** Based on that review, consider steps for restoring both of these measures with a view to specifically improve the climate for new manufacturing sector R&D.

On behalf of our 100,000 member companies and their 1.8 million employees across Canada, we thank you for your attention to these critical matters. We hope to meet with you in the near future to discuss these proposals and work constructively with you and your department to create a strong innovation program for Canada.

Yours sincerely,

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CC:

The Hon. Gary Goodyear, Minister of State (Science and Technology) and Federal Economic Development Agency for Southern Ontario
The Hon. Christian Paradis, Minister of Industry
The Hon. Gail Shea, Minister of National Revenue