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MODIFICATIONS TO THE SCIENTIFIC RESEARCH AND EXPERIMENTAL DEVELOPMENT TAX INCENTIVES

(OTTAWA) Finance Minister Don Mazankowski today released revised draft legislation and regulations to implement changes to the Scientific Research and Experimental Development (SR&ED) tax incentive program first announced October 5, 1992. The changes reflect the very constructive input that the Department of Finance received during the course of recent consultations with national industry associations and key SR&ED performers.

The draft proposals have been favourably received by the SR&ED community and are considered a major step in improving the SR&ED program both from a competitive and an administrative perspective. The SR&ED community, however, identified several aspects of the draft proposals that required additional fine tuning in the following areas:

- removing the proposed constraints on certain refundable credits under the elective method,
- removing the proposed requirement that all associated companies use the same method for determining eligible SR&ED overhead expenses,
- permitting certain lease costs on shared use equipment to be eligible for credits under the elective method; and
- improving the delivery of the new partial credit earned on the purchase of shared use capital equipment.

The draft legislation being released today reflects the suggestions made by the SR&ED community.

Mr. Mazankowski thanked his colleagues Michael Wilson, William Winegard and Otto Jelinek for their assistance during the consultations. He also expressed his appreciation to all participants and their associations for their constructive comments and suggestions. He commented on the active role played by his colleague the Honourable Otto Jelinek in reviewing administrative improvements in the delivery of this important program.

Mr. Jelinek said: "The views collected during the consultations will help us to improve our level of service."

Mr. Wilson noted that "These improvements to the legislation and administration reflect our commitment to make Canada's system of tax credits even better by removing unnecessary barriers to their use. These credits are fundamental to supporting the innovation that will make Canadian firms world competitors".

Mr. Winegard stated: "I was particularly pleased with the clarified definition of experimental development which emphasizes the eligibility of the full spectrum of technological innovation, including work in the manufacturing setting. These changes and the commitment of additional funds should assist Canadian enterprises in developing world class technologies."

Details of these proposed changes are provided in the accompanying backgrounder as well as in the draft legislation, regulations and explanatory notes.

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INTRODUCTION

The government today released revised draft legislation and regulations to improve and streamline the Scientific Research and Experimental Development (SR&ED) tax incentive program. This release represents the culmination of a process that started with the February 1991 Budget when the government announced that it would be examining ways to make the SR&ED tax credit program operate more efficiently and to reduce the administrative burden on taxpayers and the government. The Department of Finance, in collaboration with Revenue Canada Taxation (RCT) and Industry, Science and Technology Canada (ISTC) consulted extensively with the SR&ED community. Meetings were held with national industry associations concerned with SR&ED, Revenue Canada Taxation's Advisory Committee on SR&ED and many small and large SR&ED performers across Canada. Following these discussions, it was announced in the February 1992 Budget that changes would be developed to streamline the SR&ED investment tax credit program and to enrich it by some $230 million over the next five years.

Draft legislation and regulations were originally released on October 5, 1992 for further discussion and comment. These proposals addressed important concerns raised by the SR&ED community, particularly in the area of shop floor SR&ED. Changes were proposed in the following areas:

- treatment of overhead expenditures
- treatment of capital expenditures
- definition of SR&ED
- administration of the program

Following the release of these proposals in October there have been a number of additional consultative meetings with industry associations and key performers. In response to issues raised during these the consultations the government is today releasing modified proposals that contain further adjustments.

BACKGROUND

The current SR&ED tax credit program is an important part of the Government's efforts to enhance Canadian competitiveness, delivering approximately $1 billion annually in investment tax credits (ITCs) -- including almost $250 million in refundable ITCs to small corporations.

The existing system of tax incentives for SR&ED performed in Canada provides for a general tax credit of 20 percent for SR&ED expenditures. This credit increases to 30 percent for SR&ED expenditures made in Atlantic Canada and Gaspé, and to 35 percent for the first $2 million of SR&ED expenditures made in a year by

qualifying small business corporations. Current and capital expenditures (other than buildings) are eligible for SR&ED incentives. The 35 percent credit earned in respect of current expenditures is fully refundable and 40 percent of other SR&ED credits earned by qualifying small business corporations is refundable. The system is summarized below.

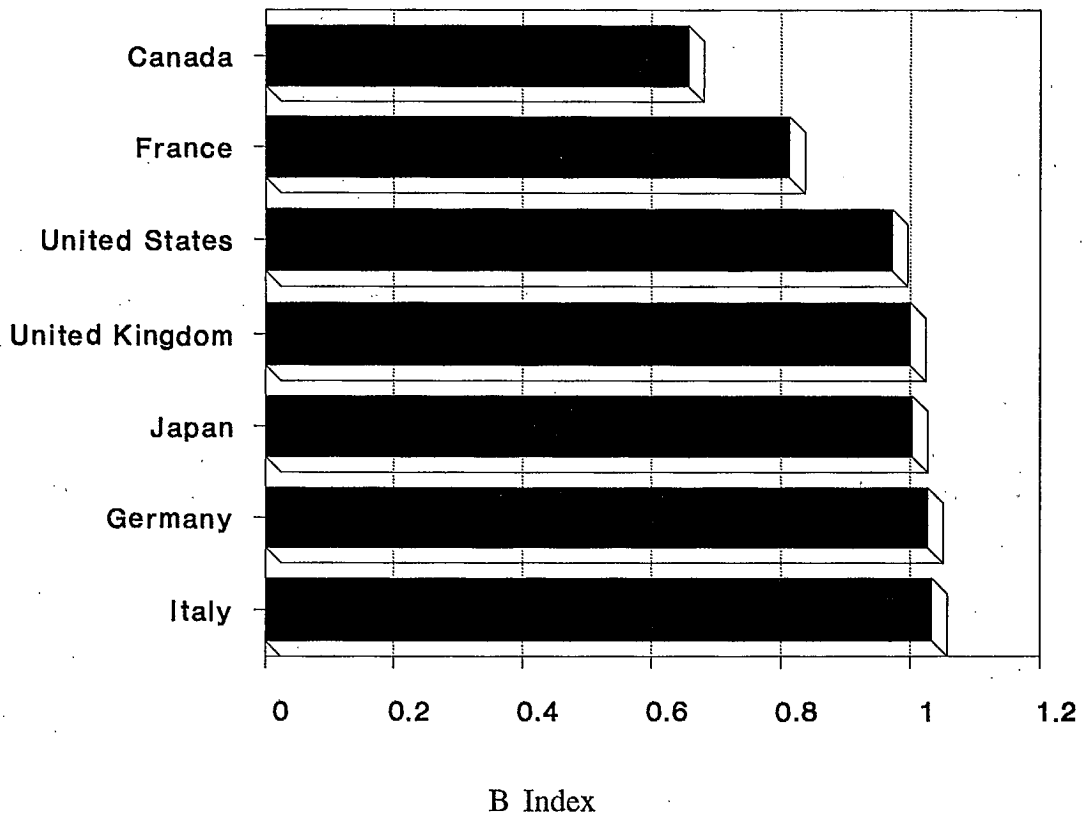
Summary of SR&ED Tax Credits

	Rates (%)	Refundability	
		Current	Capital
Large Corporations	20*	None	None
Individuals and Unincorporated Businesses	20*	40%	40%
CCPC's			
Taxable Income less than $200,000			
Expenditures under $2 million	35	100%	40%
Expenditures over $2 million	20*	40%	40%
Taxable Income exceeds $200,000	20*	None	None

The Canadian system provides one of the most generous programs of SR&ED tax incentives of all industrialized countries. A Conference Board study compared the level of tax assistance offered in Canada with the tax incentives available elsewhere.[1] This study takes into account the influence of R&D tax credits on the after-tax cost of undertaking R&D, as well as the influence of income tax rates in determining both the value of qualifying R&D deductions and the after-tax value of the returns from R&D. The following chart shows that, because of these tax incentives, Canada has the lowest threshold at which R&D becomes profitable of all G-7 countries.

1. Conference Board of Canada Report 55-90, "International Competitiveness of Canadian R&D Incentives: An Update". Jacek Warda.

COMPARISON OF RATIOS AT WHICH R&D BECOMES PROFITABLE



The B index is an analytic tool used to rank the relative attractiveness of a country's R&D tax system. The index represents a minimum benefit-cost ratio at which, in a given tax jurisdiction, an R&D investment becomes profitable. Other things being equal, the lower the B index, the greater the amount of R&D a firm will undertake.

OVERHEAD EXPENDITURES

Overhead expenditures qualify as SR&ED expenditures to the extent they are attributable to the prosecution of SR&ED activities. The current rules require that companies with non-SR&ED operations demonstrate that an expenditure would not have been incurred if the SR&ED activity had not taken place. For many taxpayers this can be a complex and uncertain exercise, especially in cases when SR&ED and other activities are carried out in the same facility (shop-floor SR&ED).

Taxpayers will be allowed to elect to use an easier, more certain, method of determining tax credits in respect of overheads. This new method involves calculating a notional overhead amount rather than specifically identifying and allocating overhead

costs. In determining a taxpayer's ITC, the amount representing these overhead expenditures (the proxy amount) will be calculated as a fixed percentage (65 percent) of the salaries or wages (the salary base) of the employees directly engaged in the SR&ED. For employees performing SR&ED and other functions the portion of the employee's salary to be included in the salary base will be determined according to the time that person spends on the SR&ED activities.

The salary base for this new method will be comprised of the salaries (including vacation pay) of employees directly engaged in the process of experimentation and analysis. The time spent by supervisors or managers directly involved in the technical aspects of the on-going SR&ED activities will generally be considered as time spent directly engaged in SR&ED. The salary base will not include benefits or bonuses.

The proxy amount is intended to cover expenditures on general purpose office equipment, such as facsimile machines and photocopiers. Computers will not necessarily be considered to be general purpose office equipment and, therefore, will be eligible to be treated as SR&ED equipment.

Companies will continue to claim certain expenses separately in calculating the tax credit. These costs include, for example, contract payments and expenditures for materials consumed in the prosecution of SR&ED.

Treatment of Expenses Under Existing and New Systems

	Existing	New
Direct Wages and Salaries	- eligible for ITC - deductible 37(1)(a)	- eligible for ITC and base for proxy amount - deductible 37(1)(a)
Overhead Expenditures (see examples below)	- eligible for ITC - deductible 37(1)(a)	- not specifically identified - covered in proxy amount - deductible as normal business expenditures
Other Specifically Identified Expenditures (see examples below)	- eligible for ITC - deductible 37(1)(a)	- eligible for ITC - deductible 37(1)(a)

Examples of Overhead Expenditures Covered by the Proxy Amount	Examples of Other Expenditures Claimed Separately
Office supplies General Purpose Office Equipment Heat, Water, Electricity and Telephones Support Staff Management not included in the salary base Travel and Training Property Taxes Any other eligible expenditures directly related to the prosecution of SR&ED that would not have been incurred if the SR&ED had not occurred Maintenance and upkeep of SR&ED premises, facilities or equipment	SR&ED materials consumed in performing SR&ED Lease costs of SR&ED equipment Contract payments Third-party payments

The use of this easier method will be optional; that is, taxpayers will have the choice of using either the new method or the existing method. However, once the choice is made, it will be irrevocable for that taxation year.

In addition, limitations will be applied in respect of salaries paid to specified employees (see b) below). A specified employee is defined as an employee who does not deal at arm's length with the employer or who is a specified shareholder of the employer.

The provisions relating to overhead expenses will come into force for taxation years ending after December 2, 1992.

For those firms which do not choose to employ the optional new method of calculating overheads, the income tax regulations dealing with the determination of SR&ED overhead expenditures will be amended to provide that a portion of an otherwise eligible expenditure may be allocated to SR&ED activities. These changes will be applicable to the 1990 and subsequent taxation years.

The original proposals are being modified in four areas.

a) Elections for Associated Companies

The original proposals required that when one corporation elects to use the proxy method, all corporations associated with that corporation would also have to use that method. This rule was intended to address situations where companies sharing facilities or employees could artificially reallocate overhead expenditures.

Many participants in the consultations suggested that the associated company rules for the election were too broad, would apply in situations that were not abusive and would prohibit many companies from using the proxy method.

The requirement that all associated companies must use the same ethod will be eliminated.

Specific situations that are of concern will be examined under the General Anti-Avoidance Rules (GAAR).

b) Restrictions for Specified Employees: Salary base/refundability of credit

Under the original proposals, credits earned in respect of the proxy amount related to specified employees would not have been refundable. This restriction was intended to address the government's concerns about paying refunds on notional amounts in these non-arm's length situations.

Consultations revealed that, while the concerns are valid, the limitation on refundability could result in relatively few small firms benefitting from this new system.

The original proposals will be modified to remove this restriction on refundability and, therefore, all credits earned on the proxy amounts will be refundable to otherwise qualified taxpayers.

The restriction on refundability will be replaced with a new limit on the amount of the wages and salaries of specified employees that can be included in the base salary. The maximum amount of a salary paid to a specified employee that can be included in the salary base will be the lesser of:

- 75 per cent of the specified employee's total salary; and,

- a ceiling amount (two and a half times YMPE -- approximately $85,000 in 1993).

The operation of this rule is illustrated below.

c) Leased Equipment

Under the original proposal, lease costs of non-general purpose office equipment that is used less than all or substantially all in SR&ED was considered to be reflected in the proxy amount. A number of participants in the consultations pointed out that, in view of the new rules proposed for shared-use capital equipment, this treatment would bias a taxpayer's decision on whether to lease or buy certain pieces of equipment.

Illustration of Rules for Specified Employees

Total Salary	Portion of time in SR&ED	Salary Allocated to SR&ED	Salary Amount Included in Salary Base
$50,000	50%	$25,000	$25,000
$50,000	80%	$40,000	$37,500
$100,000	60%	$60,000	$60,000
$100,000	80%	$80,000	$75,000
$150,000	60%	$90,000	$85,000

Where leased equipment is used primarily (more than 50 percent) for SR&ED and the taxpayer has elected to use the proxy method, 50 percent of the lease costs will be included in the SR&ED pool under section 37 of the Act and will be eligible to earn a credit.

This change will make the treatment of leased equipment under the proxy method more comparable to the tax treatment provided for the acquisition costs of shared use capital equipment.

d) Overall Limitation on Proxy Amount

In order to ensure that the proxy amount cannot exceed the overall overhead expenses -- that is, overhead expenses related to both SR&ED and non-SR&ED activities -- incurred by a taxpayer, another broader limitation will be introduced. This limitation will state that the proxy amount cannot exceed the total amount that would otherwise be deductible by the taxpayer in the absence of special rules.

CAPITAL EXPENDITURES

Expenditures on capital equipment intended to be used all or substantially all in SR&ED are eligible for investment tax credits. These credits are earned in the year that the equipment is available for use to carry on SR&ED in Canada.

Concern had been expressed over the fact that equipment used primarily in SR&ED, but less than 90 percent, was not eligible for ITC's. This concern was particularly important for companies that perform R&D in a shop-floor setting where equipment can often be used for both SR&ED and production activities.

In response to this concern, partial ITCs will be provided for expenditures in respect of shared-use equipment used primarily (more than 50 percent of the operating time) for SR&ED in Canada. Expenditures on equipment used primarily for SR&ED will be eligible for a credit at one half of the rate that would otherwise have applied if the equipment was all or substantially all attributable to SR&ED. This shared-use treatment

could involve equipment used for dual purposes in the same year, or equipment whose use changes over time.

The partial credit will be earned over time to allow it to reflect the actual use of the equipment.

Under the original proposals, these partial tax credits would have been claimable in three equal amounts over a 36 month period. To be eligible for a partial ITC, the equipment would have had to have been used primarily for SR&ED during the first twelve months after it is available for use. In other words, equipment that was not used primarily in SR&ED during the first twelve months after it became available for use would never be eligible for a partial ITC. Under that proposal, taxpayers could have claimed an ITC for the second twelve month period if the equipment was also used primarily in SR&ED during that period. Similarly, equipment that was used primarily in SR&ED during the third twelve month period would have been eligible for a partial ITC for that period.

During the consultations a number of participants raised concerns about the fact that, under the original proposals, the tax credit would be delivered over too lengthy a period -- in three stages, based on its use in each of three 12 month periods. In addition, there was concern that the end of each test period would not coincide with a company's fiscal year, so that there would be significant increased compliance costs.

The partial tax credit for shared use equipment will be delivered over a shorter time period and the qualifying period will be modified.

The SR&ED tax credit will be delivered in two rather than three "instalments". One-half of the partial credit will be delivered at the end of the first taxation year ending after the first 12 month period of the equipment's use. The other half of the credit will be delivered at the end of the first taxation year which ends after the first 24 month period of the equipment's use.

The test of whether the equipment qualifies for the partial credit begins when the equipment is first put into use and ends at the end of the tax year in which the relevant test period ends. The test will be based on the usage of the equipment during the entire time period up to the end of that tax year. As the determination of the eligibility for purposes of the second tax credit will be based on the asset's use over the entire period, qualifying use in the first time period will be taken into account to better recognize continued use applications.

The following chart illustrates how the revised system of tax credits for capital expenditures will operate.

Proposed Rules for Capital Equipment:
(Investment Tax Credits @ 20%, $100 Capital Expenditure)

	Percentage of Asset used for SR&ED		
	0-50%	more than 50% (primarily)	90% or more (ASA[1])
Year 1	0	0	20
Year 2	0	5	0
Year 3	0	5	0
Total Tax Credit	0	$10	$20
Deduction in Calculating Income	CCA rate	CCA rate with subsequent base reduction	$100 year one with subsequent base reduction

Equipment used during the SR&ED phase of the assembly, construction or commissioning of a project, but which is intended to be used in a commercial, manufacturing or processing facility, plant or line (and therefore is not intended to be used primarily for SR&ED throughout its useful life), will not be eligible for partial ITCs. Although this limitation will apply to capital expenditures, current expenditures on commercial equipment associated with the SR&ED phase will continue to be SR&ED expenditures and to qualify for ITCs.

These provisions relating to capital expenditures will come into force for property acquired after December 2, 1992.

CHANGES TO THE DEFINITION OF SR&ED

The definition of SR&ED will be modified to clarify that experimental development includes work performed with the intent of achieving a technological advancement, including incremental improvements, for the purpose of creating new, or improving existing materials, devices, products or processes. Other changes will define more clearly the eligibility of specific types of work, such as data collection or testing, which are directly in support of SR&ED. These changes provide greater certainty as to what constitutes a SR&ED activity.

ADMINISTRATION

The administration of the SR&ED program will be changed to increase the certainty and timeliness of the delivery of the tax credit. These changes will include:

- increasing service and education;
- creating a "First Time SR&ED Claimant service" to address the special needs of first time claimants, including showing new clients how to structure and submit their first claim;
- expanding the review of SR&ED T-661 forms for completeness;
- committing to issue refunds faster than the present 180 days;
- earlier identification of potential areas that may cause problems for the other clients; and
- expanding efforts to promote the program.

DRAFT LEGISLATION

1. (1) Paragraph 37(1)(e) of the *Income Tax Act* is repealed and the following substituted therefor:

(*e*) that part of the aggregate of all amounts each of which is an amount deducted under subsection 127(5) in computing the tax otherwise payable by the taxpayer under this Part for a preceding taxation year that may reasonably be attributed to a prescribed proxy amount of, or expenditures of a current nature made in, a preceding taxation year that were qualified expenditures in respect of scientific research and experimental development for the purposes of section 127;

(2) Subparagraph 37(7)(*c*)(ii) of the said *Act* is repealed and the following substituted therefor:

(ii) where the references occur other than in subsection (2), include only

(A) expenditures incurred by a taxpayer in a taxation year (other than a taxation year for which the taxpayer has made an election under clause (B)) each of which is

(I) an expenditure of a current nature for and all or substantially all of which was attributable to the prosecution, or to the provision of premises, facilities or equipment for the prosecution, of scientific research and experimental development in Canada,

(II) an expenditure of a current nature directly attributable, as determined by regulation, to the prosecution, or to the provision of premises, facilities or equipment for the prosecution, of scientific research and experimental development in Canada, or

(III) an expenditure of a capital nature that at the time it was incurred was for the provision of premises, facilities or equipment where at that time it was intended

1. that it would be used during all or substantially all of its operating time in its expected useful life for, or

2. that all or substantially all of its value would be consumed in,

the prosecution of scientific research and experimental development in Canada, and

(B) where a taxpayer has elected in prescribed form and in accordance with subsection (9) for a taxation year, expenditures incurred by the taxpayer in the year each of which is

(I) an expenditure of a current nature for and all or substantially all of which was attributable to the purchase or lease of premises, facilities or equipment for the prosecution of scientific research and experimental development in Canada, other than an expenditure in respect of general purpose office equipment or furniture,

(II) an expenditure in respect of the prosecution of scientific research and experimental development in Canada directly undertaken on behalf of the taxpayer,

(III) an expenditure described in subclause (A)(III), other than an expenditure in respect of general purpose office equipment or furniture,

(IV) that portion of an expenditure made in respect of an expense incurred in the year for salary or wages and related benefits of an employee who is directly engaged in scientific research and experimental development in Canada that can reasonably be considered to relate to such work having regard to the time spent by the employee thereon, and, for this purpose, where that portion is substantially all of the expenditure, the portion shall be deemed to be the amount of the expenditure,

(V) the cost of materials consumed in the prosecution of scientific research and experimental development in Canada, or

(VI) one-half of an expenditure of a current nature in respect of a purchase or lease of premises, facilities or equipment used primarily for the prosecution of scientific research and experimental development in Canada, other than an expenditure in respect of general purpose office equipment or furniture or an expenditure described in subclause (I);

(3) Section 37 of the said Act is further amended by adding thereto the following subsections:

Salary or wages

(8) For the purposes of clauses (7)(*c*)(ii)(A) and (B), an expenditure of a taxpayer does not include remuneration based on profits or a bonus, where the remuneration or bonus, as the case may be, is in respect of a specified employee of the taxpayer.

Time for election

(9) Any election under clause (7)(*c*)(ii)(B) made by a taxpayer for a taxation year shall be filed with the taxpayer's return of income for the year on or before the day on or before which the taxpayer's return of income for the year is required to be filed under section 150 or would be so required if tax under this part were payable for the year by the taxpayer.

2. Paragraph 88(1)(*e.3*) of the said Act is amended by adding thereto, immediately after subparagraph (ii) thereof, the following:

and, for the purposes of the definitions of "first term shared-use-equipment" and "second term shared-use-equipment" in subsection 127(9), the parent shall be deemed to be the same corporation as, and a continuation of, the subsidiary;

3. All that portion of subsection 96(3) of the said Act preceding paragraph (a) thereof is repealed and the following substituted thereof:

Election by members

(3) Where a taxpayer who was a member of a partnership during a fiscal period has, for any purpose relevant to the computation of the taxpayer's income from the partnership for the fiscal period, made or executed an election under or in respect of the application of any of subsections 13(4), (15) and (16), 14(6), 20(9)and 21(1) to (4), section 22, subsection 29(1), section 34, clause 37(7)(*c*)(ii)(B), subsections 44(1) and (6), 50(1) and 97(2) that, but for this subsection, would be a valid election, the following rules apply:

4. (1) The definition "investment tax credit" in subsection 127(9) of the said Act is amended by striking out the word "and" at the end of paragraph (*e*) thereof, by adding the word "and" at the end of paragraph (*e*.1) thereof and by adding thereto the following paragraph:

(*e*.2) the total of all amounts each of which is the specified percentage of 1/4 of that part of a repayment made by the taxpayer in the year or in any of the 10 taxation years immediately preceding or the 3 taxation years immediately following the year that can reasonably be considered to be a repayment of government assistance, non-government assistance or a contract payment that reduced the amount of an expenditure made by the taxpayer under paragraph (11.1)(*e*) in respect of first term shared-use-equipment or second term shared-use equipment, and, for this purpose, a repayment made by the taxpayer in any taxation year preceding the first taxation year ending coincidentally with the first period or the second period in respect of first term shared-use-equipment or second term shared-use-equipment, respectively, shall be deemed to have been made by the taxpayer in that first taxation year.

(2) All that portion of the definition "qualified expenditure" in subsection 127(9) of the said Act preceding paragraph (*a*) thereof is repealed and the following substituted therefor:

"qualified expenditure"

"qualified expenditure" means an expenditure in respect of scientific research and experimental development incurred by a taxpayer that is an expenditure in respect of first term shared-use-equipment or second term shared-use-equipment or an expenditure described in paragraph 37(1)(*a*) or subparagraph 37(1)(*b*)(i) and includes an amount that is a prescribed proxy amount of a taxpayer, but does not include

(3) Subsection 127(9) of the said Act is further amended by adding thereto, in alphabetical order, the following definitions:

"first term
shared-use-equipment"

"first term shared-use-equipment" of a taxpayer means depreciable property of the taxpayer (other than prescribed depreciable property of a taxpayer) that is used by the taxpayer, during its operating time in the period (in this subsection, and subsection (11.1) referred to as the "first period") commencing at the time the property was acquired by the taxpayer and ending at the end of the taxpayer's first taxation year ending at least 12 months after that time, primarily for the prosecution of scientific research and experimental development in Canada, but does not include general purpose office equipment or furniture;

"second term
shared-use-equipment"

"second term shared-use-equipment" of a taxpayer means property of the taxpayer that was first term shared-use-equipment of the taxpayer and that is used by the taxpayer, during its operating time in the period (in this subsection and subsection (11.1) referred to as the "second period") commencing at the time the property was acquired by the taxpayer and ending at the end of the taxpayer's first taxation year ending at least 24 months after that time, primarily for the prosecution of scientific research and experimental development in Canada;

(4) Paragraphs 127(11.1)(*b*) and (*c*) of the said Act are repealed and the following substituted therefor:

(*b*) the capital cost to a taxpayer of a property shall be deemed to be the capital cost to the taxpayer of the property, determined without reference to subsections 13(7.1) and (7.4), less the amount of any government assistance or non-government assistance, that can reasonably be considered to be in respect of, or for the acquisition of, the property and that, at the time of the filing of the taxpayer's return of income for the taxation year in which the property was acquired, the taxpayer has received, is entitled to receive or can reasonably be expected to receive;

(*c*) the amount of a qualified expenditure (other than a prescribed proxy amount or an amount determined under paragraph (*e*)) made by a taxpayer shall be deemed to be the amount of the qualified expenditure, determined without reference to subsections 13(7.1) and (7.4), less the amount of any government assistance, non-government assistance or contract payment, that can reasonably be considered to be in respect of the expenditure and that, at the time of the filing of the taxpayer's return of income for the taxation year in which the expenditure was made, the taxpayer has received, is entitled to receive or can reasonably be expected to receive;

(5) Subsection 127(11.1) of the said Act is further amended by striking out the word "and" at the end of paragraph (*c*.1) thereof, and by adding thereto the following paragraphs:

(*e*) the amount of a qualified expenditure made by a taxpayer in the taxation year ending coincidentally with the end of the first period or the second period in respect of first term shared-use-equipment or second term shared-use-equipment, respectively, of the taxpayer shall be deemed to be 1/4 of the capital cost of the equipment that would be determined in accordance with paragraphs (*a*) and (*b*) if paragraph (*b*) were read as

"(*b*) the capital cost to a taxpayer of a property shall be deemed to be the capital cost to the taxpayer of the property, determined without reference to subsections 13(7.1) and (7.4), less the amount of any government assistance, non-government assistance or contract payment, that can reasonably be considered to be in respect of, or for the acquisition of, the property and that, at the time of filing of the return of income for the taxation year ending coincidentally with first period, the taxpayer has received, is entitled to receive or can reasonably be expected to receive;"; and

(*f*) the prescribed proxy amount of a taxpayer for a taxation year shall be deemed to be the prescribed proxy amount of the taxpayer for the taxation year less the amount of any government assistance, non-government assistance or contract payment, that can reasonably be considered to be in respect of an expenditure described in subparagraph 37(7)(c)(ii) other than an expenditure described in clause (B) thereof and that, at the time of the filing of the taxpayer's return of income for the taxation year in which the expenditure was made, the taxpayer has received, is entitled to receive or can reasonably be expected to receive.

5. The definition "refundable investment tax credit" in subsection 127.1(2) of the said Act is repealed and the following substituted therefor:

"refundable
investment tax
credit"

"refundable investment tax credit" for a taxation year means, in the case of a taxpayer that is

(*a*) a qualifying corporation for the year,

(*b*) an individual other than a trust, or

(*c*) a trust each beneficiary of which is a person referred to in subparagraph (*a*) or (*b*),

an amount equal to 40% of the amount, if any, by which

(*d*) the total of all amounts included in computing the taxpayer's investment tax credit at the end of the year

(i) in respect of property acquired or a qualified expenditure incurred (other than an expenditure in respect of which an amount is included under paragraph (*f*) in computing the taxpayer's refundable investment tax credit for the year), by the taxpayer in the year, or

(ii) because of paragraph (*b*) of the definition "investment tax credit" in subsection 127(9) in respect of a property acquired or a qualified expenditure incurred (other than an expenditure in respect of which an amount is included under paragraph (*f*) in computing the taxpayer's refundable investment tax credit for the year),

exceeds

(*e*) the total of

(i) the portion of the total of all amounts deducted under subsection 127(5) for the year or a preceding taxation year (other than an amount deemed by subsection (3) to be so deducted for the year) that can reasonably be considered to be in respect of the total determined under paragraph (*d*), and

(ii) the portion of the total of all amounts required by subsection 127(6) or (7) to be deducted in computing its investment tax credit at the end of the year that can reasonably be considered to be in respect of the total determined under paragraph (*d*),

plus, where the taxpayer is a qualifying corporation for the year, other than an excluded corporation for the year, the amount, if any, by which

(*f*) the total of

(i) the amount required by subsection 127(10.1) to be added in computing its investment tax credit at the end of the year in respect of a qualified expenditure (other than an expenditure of a capital nature) incurred in the year, and

(ii) the amount determined under paragraph (*a*) of the definition "investment tax credit" in subsection 127(9) in respect of an expenditure for which an amount is included in subparagraph (i)

exceeds

(*g*) the total of

(i) the portion of the total of all amounts deducted by it under subsection 127(5) for the year or a preceding taxation year (other than an amount deemed by subsection (3) to be so deducted for the year) that can reasonably be considered to be in respect of the total determined under paragraph (*f*), and

(ii) the portion of the total of all amounts required by subsection 127(6) to be deducted in computing its investment tax credit at the end of the year that can reasonably be considered to be in respect of the total determined under paragraph (*f*).

6. (1) Subsection 248(1) of the said Act is amended by adding thereto, in alphabetical order, the following definition:

"specified employee"

"specified employee" of a person means an employee of the person who is a specified shareholder of the person or who does not deal at arm's length with the person;

7.(1) Sections 1, 2 and 3, subsections 4(1), (2), (4) and (5) and sections 5 and 6 apply to taxation years ending after December 2, 1992.

(2) Subsection 4(3) applies to property acquired after December 2, 1992.

DRAFT AMENDMENTS TO THE INCOME TAX REGULATIONS PART XXIX

1. (1) Subsection 2900(1) of the *Income Tax Regulations* is revoked and the following substituted therefor:

"2900. (1) For the purposes of this Part and paragraphs 37(7)(*b*) and 37.1(5)(*e*) of the Act, "scientific research and experimental development" means systematic investigation or search carried out in a field of science or technology by means of experiment or analysis, that is to say,

(*a*) basic research, namely, work undertaken for the advancement of scientific knowledge without a specific practical application in view,

(*b*) applied research, namely, work undertaken for the advancement of scientific knowledge with a specific practical application in view,

(*c*) experimental development, namely, work undertaken for the purposes of achieving technological advancement for the purposes of creating new, or improving existing, materials, devices, products or processes, including incremental improvements thereto, or

(*d*) work with respect to engineering, design, operations research, mathematical analysis, computer programming, data collection, testing and psychological research where such work is commensurate with the needs, and directly in support, of the work described in paragraphs (*a*), (*b*) or (*c*),

but does not include work with respect to

(*e*) market research or sales promotion;

(*f*) quality control or routine testing of materials, devices, products or processes;

(*g*) research in the social sciences or the humanities;

(*h*) prospecting, exploring or drilling for or producing minerals, petroleum or natural gas;

(*i*) the commercial production of a new or improved material, device or product or the commercial use of a new or improved process;

(*j*) style changes; or

(*k*) routine data collection."

(2) All that portion of subsection 2900(2) of the said Regulations preceding paragraph (*a*) thereof is revoked and the following substituted therefor:

"(2) For the purposes of clauses 37(7)(*c*)(i)(B) and subclause 37(7)(*c*)(ii)(A)(II) of the Act, the following expenditures are directly attributable to the prosecution of scientific research and experimental development:"

(3) Paragraphs 2900(2)(*b*) and (*c*) of the said Regulations are revoked and the following substituted therefor:

"(*b*) where an employee directly undertakes, supervises or supports such prosecution, the portions of the amount incurred for salary or wages and related benefits of the employee that can reasonably be considered to be in respect of such prosecution; and

(*c*) other expenditures, or those portions thereof, that are directly related to such prosecution and that would not have been incurred if such prosecution had not occurred."

(4) All that portion of subsection 2900(3) of the said Regulations preceding paragraph (*a*) thereof is revoked and the following substituted therefor:

"(3) For the purposes of subclause 37(7)(*c*)(ii)(A)(II) of the Act, the following expenditures are directly attributable to the provision of premises, facilities or equipment for the prosecution of scientific research and experimental development:"

(5) Paragraph 2900(3)(*b*) of the said Regulations is revoked and the following substituted therefor:

"(*b*) other expenditures, or those portions thereof, that are directly related to such provision and that would not have been incurred if those premises or facilities or that equipment had not existed."

(6) Subsection 2900(4) of the said Regulations is revoked and the following substituted therefor:

"(4) For the purposes of the definition "qualified expenditure" in subsection 127(9) of the Act, a prescribed proxy amount of a taxpayer for a taxation year in respect of a business in respect of which the taxpayer elects under clause 37(7)(*c*)(ii)(B) of the Act is the amount (not exceeding the amount, if any, by which

(*a*) the total of all amounts deducted in computing the taxpayer's income for the year from the business,

exceeds the total of all amounts each of which is

(*b*) an amount deducted in computing the income of the taxpayer for the year under section 20, 24, 26, 30, 32, 37, 66 to 66.8 or 104 of the Act, or

(*c*) an amount incurred by the taxpayer in the year in respect of any outlay or expense made or incurred for the use of, or the right to use, a building other than a prescribed special-purpose building)

which is 65% of the total of all amounts each of which is that portion of the amount incurred in the year by the taxpayer in respect of salary or wages of an employee who is directly engaged in scientific research and experimental development carried on in Canada that can reasonably be considered to relate to such work having regard to the time spent by the employee thereon, and, for the purpose of this subsection, where the portion is substantially all of the expenditure, the portion shall be deemed to be the amount of the expenditure.

(5) Subject to subsection (6) and for the purpose of determining the total referred to in subsection (4), the amount included in the prescribed proxy amount of a taxpayer for a taxation year in respect of a specified employee of the taxpayer for a taxation year of the taxpayer that ends in a calendar year shall not exceed the lesser of

(*a*) 75% of the amount incurred by the taxpayer in the year in respect of salary or wages of the employee, and

(*b*) the amount determined by the formula

$$2.5 \times A \times B/365$$

where

A is the Year's Maximum Pensionable Earnings for the calendar year within the meaning assigned by section 18 of the *Canada Pension Plan*; and

B is the number of days in the taxation year in which the employee is an employee of the taxpayer.

(6) For the purpose of subsection (4), where

(*a*) the taxpayer is a corporation,

(*b*) the taxpayer employs in a taxation year ending in a calendar year an individual who is a specified employee of the taxpayer,

(*c*) the taxpayer is associated with another corporation (referred to as the "associated corporation") in the taxation year of the associated corporation ending in the calendar year, and

(*d*) the individual is an employee of the associated corporation in the taxation year of the associated corporation ending in the calendar year,

the total of all amounts taken into account in respect of salaries or wages of the individual by the taxpayer in its taxation year ending in the calendar year and by all associated corporations in their taxation years ending in the calendar year shall not exceed the amount that is 2.5 times the Year's Maximum Pensionable Earnings for the calendar year within the meaning assigned by section 18 of the *Canada Pension Plan.*

(7) For the purposes of subsection (4), salary or wages of an employee incurred in a taxation year does not include employment benefits, remuneration based on profits nor bonuses.

(8) For the purposes of subsection (6),

(*a*) an individual related to a particular corporation, and

(*b*) a partnership any member of which is an individual related to a particular corporation or is a corporation associated with a particular corporation,

shall be deemed to be a corporation associated with the particular corporation.

(9) For the purposes of the definition of "first term shared-use-equipment" in subsection 127(9) of the Act, prescribed depreciable property of a taxpayer is

(*a*) a building,

(*b*) a leasehold interest in a building, or

(*c*) a property including a part thereof that, at the time it was acquired by the taxpayer, the taxpayer, or a person related to the taxpayer, intended that it would be used in the prosecution of scientific research and experimental development during the assembly, construction or commissioning of a facility, plant or line for commercial manufacturing, commercial processing or other commercial purposes (other than scientific research and experimental development), and

(i) that it would be used during its operating time in its expected useful life primarily for purposes other than scientific research and experimental development,

or

(ii) that its value would be consumed primarily in activities other than scientific research and experimental development."

2. (1) Subparagraph 2902(*b*)(i) of the said Regulations is revoked and the following substituted therefor:

"(i) the acquisition of property, except any such expenditure that <u>at the time it</u> was incurred

(A) was for first term shared-use-equipment or second term shared- use-equipment, or

(B) was for the provision of premises, facilities or equipment that, at the time of the acquisition thereof, it was intended

1. that it would be used during all or substantially all of its operating time in its expected useful life for, or

2. that all or substantially all of its value would be consumed in,

the prosecution of scientific research and experimental development in Canada,"

3. All that portion of section 2903 of the said Regulations preceding paragraph (a) thereof is revoked and the following substituted therefor:

"2903. For the purposes of this Part and paragraph 37(7)(*f*) of the Act, a special-purpose building is a building the working areas of which are designed and constructed to have a displacement in any direction of not more than .02 micrometre and to have, per .028 cubic metre of interior airspace."

4.(1) Subsections 1(1), (2), (4) and (6) and section 3 are applicable for taxation years ending after December 2, 1992 except that, subsection 2900(9) of the said Regulations, as enacted by subsection (6) is applicable to property acquired after December 2, 1992.

(2) Subsections 1(3) and (5) are applicable to the 1990 and subsequent taxation years.

(3) Section (2) is applicable to property acquired after December 2, 1992.

EXPLANATORY NOTES

BACKGROUND

Under the current income tax provisions there are two main components to the R&D tax incentive system. First, expenditures that qualify as R&D expenses incurred in Canada are fully deductible in the year incurred. Secondly, these expenditures earn investment tax credits which can be used in full, or in part, to reduce income tax payable in that year. Both the expenditure and credit provisions have generous carry-over rules. Deductions in respect of R&D expenditures may be carried forward indefinitely to be used to reduce future income. Tax credits may be carried back three years to reduce taxes paid in any of those preceding years or forward ten years to reduce taxes payable in any of those subsequent years. Instead of carrying forward credits, certain Canadian-controlled private corporations may opt to have those credits refunded at rates of either 40% or 100% depending on the corporation and the type of expenditures.

The R&D provisions comprise essentially four areas of the Income Tax Act (the "Act") and Regulations (the "Regulations") - sections 37, 127 and 127.1 of the Act and Part XXIX of the Regulations.

Section 37 of the Act sets out the type of expenditures incurred by a taxpayer that qualify as expenditures in respect of scientific research and experimental development (SR&ED). These expenditures are included in the "SR&ED pool" provided for in subsection 37(1) and may be deducted in the year incurred or carried forward and deducted in future years. The size of this pool may change annually - new expenditures are added while investment tax credits claimed in earlier years, and other adjustments, are subtracted. If a negative balance exists at the end of a year, the negative balance is included in income for the year.

Section 127 of the Act which relates to investment tax credits generally sets out, among other things, the SR&ED expenditures that are eligible to earn investment tax credits and the rates at which these credits may be earned. As in the case of the pooling of SR&ED expenditures under subsection 37(1), investment tax credits are also pooled. Section 127.1 provides rules relating to the refundability of investment tax credits.

Sections 2900 to 2903 of the Income Tax Regulations provide the definitions of various expressions used in sections 37 and 127 of the Act. For example, subsection 2900(1) defines the expression "scientific research and experimental development", subsections 2900(2) and (3) enumerate SR&ED expenditures while section 2902 enumerates expenditures not eligible for investment tax credits.

Two areas of particular concern with the SR&ED income tax provisions were identified during the consultation period. They are the treatment of general overhead expenses and the treatment of capital expenditures incurred in acquiring depreciable property where neither all nor substantially all of the expenditures are attributable to the carrying out of SR&ED in Canada. The following proposed amendments address these concerns. The proposals concerning overhead expenses are effective in respect of taxation year ending

after December 2, 1992. The proposals concerning shared-use property are effective in respect of property acquired after December 2, 1992.

Clause 1

Scientific Research and Experimental Development

ITA
37

Section 37 of the Act sets out the rules for the deductibility of expenditures incurred by a taxpayer for SR&ED both inside and outside Canada. Subsection 37(1) allows a taxpayer carrying on business in Canada to deduct certain current and capital expenditures incurred in respect of SR&ED carried on in Canada. Subsection 37(2), on the other hand, provides for the deduction only of current expenditures incurred in respect of SR&ED carried on outside Canada. SR&ED expenditures incurred in Canada are pooled under subsection 37(1) and may be deducted in the year incurred or carried forward indefinitely. Current SR&ED expenditures incurred outside Canada are not pooled, but rather must be deducted in the year they are incurred.

Subclause 1(1)

ITA
37(1)(e)

Subsection 37(1) of the Act provides for the pooling of certain SR&ED expenses incurred in Canada by a taxpayer carrying on business in Canada. The size of the pool changes in accordance with any annual additions to and deductions from the pool. New SR&ED expenditures are added to the pool while investment tax credits earned in respect of qualifying SR&ED expenditures, and claimed in earlier years, are subtracted from the pool. Paragraph 37(1)(e) provides for this reduction of the SR&ED pool by amounts claimed in respect of investment tax credits. Paragraph 37(1)(e) is amended as a consequence of the introduction of a "prescribed proxy amount" in the definition of qualified expenditure in subsection 127(9). This amendment ensures that the pool is similarly reduced by investment tax credits claimed in respect of a prescribed proxy amount.

Subclause 1(2)

ITA
37(7)(c)(ii)

Subsection 37(7) of the Act sets out definitions and interpretations of various expressions used in the section. Paragraph 37(7)(c) provides the interpretation of the expression "expenditures on or in respect of scientific research and experimental development" which is used throughout in subsections 37(1), (2) and (5). Subparagraph 37(7)(c)(i) applies to

subsection 37(2) for SR&ED expenditures incurred outside Canada. Subparagraph 37(7)(c)(ii) applies to subsection 37(1) for SR&ED expenditures incurred in Canada.

Subparagraph 37(7)(c)(ii) of the Act provides that an expenditure will qualify as an SR&ED expenditure incurred in Canada, and accordingly, be included in the SR&ED pool under subsection 37(1), if the expenditure is incurred for SR&ED carried on in Canada and if it is all or substantially all attributable to the prosecution or to the provision of premises, facilities or equipment for the prosecution of SR&ED in Canada. Furthermore, an expenditure will so qualify if it is of a current nature and is directly attributable to the prosecution or to the provision of the above property for the prosecution of SR&ED activities. Subsections 2900(2) and (3) of the Income Tax Regulations further define what expenditures are directly attributable to the prosecution and to the provision of premises, facilities and equipment for the prosecution of SR&ED in Canada.

The amendment to subparagraph 37(7)(c)(ii) of the Act has two purposes. First, it clarifies the intent of the phrase "all or substantially all" in former clause 37(7)(c)(ii)(A) which is provided for in new subclauses 37(7)(c)(ii)(A)(I) and (III). Secondly, it provides an alternative method for determining which expenditures incurred in Canada will qualify as SR&ED and will therefore be included in the SR&ED pool in subsection 37(1). This alternative method is provided for in new clause 37(7)(c)(ii)(B) of the Act.

New subclauses 37(7)(c)(ii)(A)(I) and (II) of the Act provide that an expenditure of a current nature will be considered to be a SR&ED expenditure if it is directly attributable to, or if it is for and all or substantially all attributable to, the prosecution of, or the provision of premises, facilities or equipment for the prosecution of, SR&ED in Canada. Subsections 2900(2) and (3) of the Regulations set out for the purposes of subclause 37(7)(c)(ii)(A)(II) the expenditures that are directly attributable to the prosecution of, or the provision of premises, facilities or equipment for the prosecution of, SR&ED in Canada.

New subclause 37(7)(c)(ii)(A)(III) of the Act provides that an expenditure of a capital nature in respect of premises, facilities or equipment will be considered to be a SR&ED expenditure if it was intended that the premises, facilities or equipment would be used during substantially all of its operating time on SR&ED in Canada or that substantially all the value of the property would be consumed in the carrying out of SR&ED in Canada.

New clause 37(7)(c)(ii)(B) contains the new alternative method for determining SR&ED expenditures. It is anticipated that in many cases the alternative method will be simpler for taxpayers. The taxpayer has a choice of using either the current method or the alternative method. The taxpayer must elect in prescribed form for each taxation year the alternative method is being used; otherwise the current method will apply automatically. If the taxpayer does elect the alternative method, the following expenditures will be considered to be for SR&ED carried on in Canada and therefore included in the taxpayer's SR&ED pool in subsection 37(1) of the Act:

(1) an expenditure of a current nature (generally a lease expense) that was for and all or substantially all attributable to the use of premises, facilities or equipment for the prosecution of SR&ED in Canada, unless the expenditure was for general purpose office equipment or furniture. An expenditure for leasing general purpose office equipment or furniture used for the prosecution of SR&ED in Canada is not included in the subsection 37(1) SR&ED pool, but is accounted for in the prescribed proxy amount under the new definition of "qualified expenditure" in subsection 127(9) of the Act. The prescribed proxy amount is eligible for investment tax credits;

(2) an expenditure in respect of SR&ED undertaken in Canada on behalf of the taxpayer;

(3) an expenditure of a capital nature that was for, and all or substantially all attributable to, the provision of premises, facilities or equipment where it was intended that the premises, facilities or equipment would be used during substantially all of its operating time on SR&ED in Canada, other than an expenditure for general purpose office equipment or furniture;

(4) an expenditure of a capital nature that was for, and all or substantially all attributable to, the provision of premises, facilities or equipment where it was intended that substantially all of the value of the premises, facilities or equipment would be consumed in the prosecution of SR&ED in Canada, other than an expenditure for general purpose office equipment or furniture;

(5) the portion of an expenditure incurred in respect of salary, wages or related benefits of an employee directly engaged in SR&ED in Canada that can reasonably be considered to relate to such work having regard to the time spent by the employee in carrying out the SR&ED, and, for these purposes, in certain cases the time spent by an employee directly engaged in the management of scientific and technical aspects of SR&ED will be considered to be time spent by the employee directly engaged in SR&ED and the portion of the expenditure will be the whole amount of the expenditure if the time spent by the employee directly engaged in SR&ED is substantially all of the employee's working time;

(6) an expenditure made for materials consumed in the prosecution of SR&ED in Canada; and

(7) one-half of an expenditure of a current nature that was for the lease of equipment used primarily for SR&ED in Canada, other than an expenditure in respect of general purpose office furniture and equipment or an expenditure included in (1) above. An expenditure for leasing general purpose office equipment or furniture used for the prosecution of SR&ED in Canada is not included in the subsection 37(1) SR&ED pool, but is accounted for in the prescribed proxy amount under the new definition of "qualified expenditure" in subsection 127(9) of the Act. The prescribed proxy amount is eligible for investment tax credits.

This new elective method (new clause 37(7)(c)(ii)(B)) for determining SR&ED expenditures of a taxpayer does not account for expenditures of a general overhead nature even if they are directly attributable to the prosecution or the provision of premises for the prosecution of SR&ED in Canada. Tax recognition for expenditures of this type is provided by way of the "prescribed proxy amount" in the new definition of "qualified expenditure" in subsection 127(9). Prescribed proxy amount is defined in new subsection 2900(5) of the Income Tax Regulations.

The prescribed proxy amount is a proxy for the otherwise item-by-item accounting and apportioning of certain expenditures that could otherwise be considered directly attributable to SR&ED carried on in Canada. This elective method should be particularly attractive to taxpayers carrying on a diversified business including SR&ED. The proxy amount is relevant only for the purposes of calculating investment tax credits in respect of that amount. It does not form part of the subsection 37(1) SR&ED expenditure pool nor do any of the expenditures for which it is a substitute form part of the pool. Investment tax credits earned in respect of the prescribed proxy amount and claimed by the taxpayer do, however, reduce the SR&ED expenditure pool. Prescribed proxy amount investment tax credits claimed in earlier years must be credited to the pool in the year under paragraph 37(1)(e) of the Act in the same manner as are other SR&ED investment tax credits. Those substituted expenditures, which would be included in the pool but for the proxy, need not be specifically identified as SR&ED expenditures, but rather will be treated as ordinary expenses and thus generally deductible in the year incurred or eligible for capital cost allowance.

New subsection 2900(4) of the Income Tax Regulations establishes the proxy amount as 65% of that portion of salaries of employees directly engaged in SR&ED in Canada that relates to that work. In the case of a specified employee, the amount of salaries and wages of the employee taken into account in calculating the proxy amount shall not exceed the lesser of 3/4 of the employee's full salary and 2.5 times the Year's Maximum Pensionable Earnings as defined in section 18 of the *Canada Pension Plan*. The Year's Maximum Pensionable Earnings for 1992 is $32,200. In determining the portion of any employee's salary that relates to SR&ED, a reasonable allocation must be made of the time spent by the employee in the execution of SR&ED activities. The time spent by an

employee, such as a supervisor or a manager, directing the course of on-going SR&ED activities will generally be considered, for these purposes, to be time in which the employee was directly engaged in SR&ED. Consequently, this time may be included in determining the portion of the employee's salary to be taken into account in calculating the proxy amount. Where substantially all of an employee's time is spent on SR&ED in Canada, the whole amount of the employee's salary will be included in determining the base for the proxy amount.

The prescribed proxy amount for a taxation year cannot exceed the total amount that would otherwise be deductible by the taxpayer for the year in the absence of special rules.

For the purposes of the refundable investment tax credit in section 127.1 of the Act, credits earned in respect of the prescribed proxy amount will be treated in the same manner as credits earned in respect of expenditures of a current nature.

A "specified employee" of a person is defined in subsection 248(1) of the Act. A "specified employee" of a person is an employee who is a specified shareholder of the person or who does not deal at arm's length with the person. In subsection 248(1) of the *Act* a specified shareholder of a corporation is defined as a person who owns 10% or more of any class of shares of the corporation.

Subclause 1(3)

ITA
37(8) and (9)

New subsection 37(8) of the Act provides that, for the purposes of new clauses 37(7)(c)(ii)(A) and (B) of the Act, salary or wages does not include remuneration based on profits nor a bonus, where the remuneration or bonus is for a specified employee of the taxpayer. Subsection 248(1) of the Act is amended to include a definition of the expression "specified employee" of a person. A specified employee of a person is an employee who does not deal at arm's length with the person or who is a specified shareholder of the person. In subsection 248(1), a specified shareholder of a corporation is generally defined as a person who owns 10% or more of any class of shares of the corporation.

Under new subsection 37(9), an election under clause 37(7)(c)(ii)(B) must be filed on or before the day on which the taxpayer is required to file the taxpayer's return of income for the year under section 150 of the Act.

Clause 2

Windings-up

ITA
88(1)(e.3)

Paragraph 88(1)(e.3) of the Act provides for the flow-through of investment tax credits from a subsidiary corporation to a parent corporation on a winding-up of the subsidiary. Paragraph 88(1)(e.3) is amended to ensure that, for the purposes of the new definition of first term shared-use-equipment and second term shared-use-equipment in subsection 127(9) of the Act, the parent will be treated as the same corporation as the subsidiary. Consequently, the time periods stipulated in respect of first term shared-use-equipment and the second term shared-use-equipment will not be severed as a result of a subsection 88(1) winding-up. Paragraph 87(2)(qq) of the Act addresses this issue in the case of a section 87 amalgamation.

Clause 3

Partnership Elections

ITA
96(3)

Subsection 96(3) of the Act provides rules that apply where a member of a partnership makes an election under certain provisions of the Act for a purpose that is relevant to the computation of the member's income from the partnership. In such a case, the election will be valid only if it is made on behalf of all of the members of the partnership and the member had authority to act for the partnership. This subsection is amended to include elections made under new clause 37(7)(c)(ii)(B) in respect of the new alternative method for determining SR&ED expenditures.

Clause 4

Investment Tax Credits

ITA
127

Section 127 of the Act permits a deduction from tax otherwise payable for certain tax credits, including the investment tax credit.

Subclauses 4(1), (2) and (3)

ITA
127(9)

Subsection 127(9) of the Act provides definitions for terms and expressions used throughout section 127, and is generally applicable to all investment tax credits including SR&ED tax credits that may be earned under the Act. The subsection is amended by making a consequential amendment to the definition of "investment tax credit", by providing a new definition for "qualified expenditure" and by adding the new definitions "prescribed proxy amount", "first term shared-use-equipment" and "second term shared-use-equipment".

The definition of "investment tax credit" in subsection 127(9) provides for the calculation of a taxpayer's investment tax credit at the end of a taxation year. This calculation provides for certain additions and deductions. One such addition in paragraph (e.1) is for the repayment by the taxpayer of assistance where that assistance previously reduced the amount on which a credit was earned. New paragraph 127(9)(e.2) similarly provides for the addition of 1/4 of the repayment amount for assistance received in respect of first term shared-use-equipment or second term shared-use-equipment where that assistance previously reduced the cost of the equipment under new subsection 127(11.1)(*e*).

The definition of "qualified expenditure" in subsection 127(9) defines the type of expenditures that are eligible to earn investment tax credits. Expenditures included in the SR&ED pool under paragraph 37(1)(a) and subparagraph 37(1)(b)(i) of the Act, other than prescribed expenditures, are eligible to earn investment tax credits. The rate at which the credits are earned may be 20%, 30% or 35% depending on where in Canada the expenditure was incurred and whether the taxpayer was an individual, public corporation or Canadian-controlled private corporation.

The definition of "qualified expenditure" is extended to include expenditures on first term shared-use-equipment and second term shared-use-equipment and a prescribed proxy amount. The term "prescribed proxy amount" is defined in new subsection 2900(5) of the Income Tax Regulations. This amount is the proxy for certain expenditures which would otherwise have been claimable on an item-by-item portion by portion basis if the election under clause 37(7)(c)(ii)(B) were not made, and the alternative method of determining SR&ED expenditures were not used. Consequently, a prescribed proxy amount does not apply where the taxpayer uses the existing method for determining the SR&ED expenditures included in the SR&ED pool under subsection 37(1). For further discussion of the proxy amount, and its determination, reference may be made to the commentary on paragraph 37(7)(c) above.

The expression "first term shared-use-equipment" of a taxpayer is defined to mean depreciable property of the taxpayer (other than prescribed depreciable property) that is used by the taxpayer, during the period commencing with the time the property was acquired by the taxpayer and ending at the end of the first taxation year of the taxpayer

ending at least 12 months after that time, primarily (more than 50%) for the prosecution of SR&ED in Canada. Given the interaction of this rule and the "available-for-use" rules, the time when a property is acquired for these purposes is considered to be the time when the property becomes available for use by the taxpayer. First term shared-use-equipment does not, however, include general purpose office equipment or furniture.

The expression "second term shared-use-equipment" of a taxpayer means property of the taxpayer that was first term shared-use-equipment of the taxpayer and that is used by the taxpayer, during the period commencing with the time the property was acquired by the taxpayer and ending at the end of the first taxation year of the taxpayer ending at least 24 months after that time, primarily (more than 50%) for the prosecution of scientific research and experimental development in Canada.

It should be noted that these provisions relating to shared-use-equipment implement a test based upon the actual use of the property and not the intended use.

For property to qualify as second term shared-use-equipment of a taxpayer it must have first qualified as first term shared-use-equipment of the taxpayer. If property qualifies as first or second term shared-use-equipment, 1/4th of its capital cost is a qualified expenditure eligible for an investment tax credit in the first taxation year ending after the first period or second period, as the case may be. The 1/4 fraction reflects the fact that 1/2 of the capital cost of the property is eligible for an investment tax credit and that the credit in turn is earned over two periods resulting in 1/4 thereof being earned in respect of each period. The capital cost of the first or second term shared-use-equipment of taxpayer for a particular taxation year is determined under new paragraph 127(11.1)(e) of the Act.

Subclause 4(4)

ITA
127(11.1)(b) and (c)

Subsection 127(11.1) of the Act sets out various rules for determining amounts to be included in the investment tax credit calculation in subsection 127(9). These rules provide for the reduction of capital cost and qualified expenditures by certain amounts that qualify as assistance or contract payments.

Paragraph 127(11.1)(b) of the Act provides that for investment tax credit purposes the capital cost of property is reduced by government and non-government assistance that the taxpayer has received, is expected to receive or may reasonably be expected to receive in respect thereof at the time the taxpayer's return of income is filed under section 150 for the year the property was so acquired. Paragraph 127(11.1)(b) is amended to clarify that the government or non-government assistance need only reasonably be considered to relate to the property to cause the capital cost of the property to be reduced by such assistance.

Paragraph 127(11.1)(c) of the Act provides that in determining the amount of a "qualified expenditure" for investment tax credit purposes, the expenditure will be reduced by the amount of government assistance, non-government assistance or contract payments that the taxpayer has received, is entitled to received or may reasonably be expected to receive in respect of the expenditure at the time of the filing of the return of income for the year the expenditures were incurred. Paragraph 127(11.1)(c) is amended to clarify that the reduction applies to the amount of assistance and contract payments that can reasonably be considered to be in respect of the expenditures. This paragraph is also amended to remove from the calculation qualified expenditure amounts in respect of a prescribed proxy amount and first term shared-use-equipment. The determination of these amounts is provided for in new paragraphs 127(11.1)(e) and (f) of the Act.

Subclause 4(5)

ITA
127(11.1)(e) and (f)

New paragraph 127(11.1)(e) of the Act determines the portion of the capital cost of first term shared-use-equipment or second term shared-use-equipment that will be treated as a qualified expenditure for purposes of the investment tax credit. The portion of the capital cost included as a qualified expenditure of a taxpayer for the taxation year ending coincidentally with each of the first period or second period in respect of first or second term shared-use-property of the taxpayer is 1/4 of the capital cost of the property, after accounting for related assistance and contract payments.

New paragraph 127(11.1)(f) of the Act provides that the prescribed proxy amount of a taxpayer for a taxation year must be reduced by the amount of related assistance and contract payments that can reasonably be considered to be in respect of an expenditure described in new subparagraph 37(7)(c)(ii) of the Act other than expenditures described in clause 37(7)(*c*)(ii)(B) of the Act. This reduction is intended to ensure that the prescribed proxy amount, and therefore the amount eligible for investment tax credits, is reduced by assistance or contract payments received in respect of those expenditures of which the proxy is in lieu.

Clause 5

Refundable Investment Tax Credits

ITA
127.1

Section 127.1 of the Act provides for the refundability of investment tax credits. Investment tax credits are earned on qualifying SR&ED expenditures incurred in Canada. They can be earned at the rate of 20%, 30% or 35% depending on the taxpayer and the province in which the expenditures are incurred. However, they are only refundable to

taxpayers that are qualifying corporations, individuals and certain trusts. The rate of refund is 40%, except in the case of certain expenditures of Canadian-controlled private corporations, where the rate of refund is 100%. The full refund of investment tax credits applies for credits earned in respect of SR&ED expenditures of a current nature of up to $2,000,000 annually incurred by a qualifying Canadian-controlled private corporation and its associated corporations. A qualifying Canadian-controlled private corporation for a taxation year is a corporation that throughout the year is a Canadian-controlled private corporation and the aggregate of its taxable income for its preceding taxation year and the taxable incomes of all corporations with which it was associated in the year for their preceding taxation years does not exceed $200,000.

The definition "refundable investment tax credit" in subsection 127.1(2) of the Act defines the portion of investment tax credits of a taxpayer that are refundable in a taxation year. Included in the definition are investment tax credits earned by the taxpayer in respect of qualified expenditures which are Canadian SR&ED expenditures including amounts in respect of a prescribed proxy amount. The definition "refundable investment tax credit" is amended to delete a number of references that are no longer relevant and to refer to "qualified expenditures" in order to extend refundability to credits earned in respect of a prescribed proxy amount.

Clause 6

Interpretation

ITA
248(1)

Section 248 of the Act defines a number of terms which apply for the purposes of the Act, and also sets out various rules relating to the interpretation and application of various provisions of the Act.

Subclause 6(1)

ITA
248(1)

"specified employee"

Subsection 248(1) of the Act is amended to include the term specified employee which is used in new subsection 37(8) of the Act and new subsection 2900(5) of the Income Tax Regulations. A "specified employee" of a person is an employee who is a specified shareholder of the person or who does not deal at arm's length with the person. Subsection 248(1) defines a specified shareholder of a corporation generally as a person who owns 10% or more of any class of shares of the corporation.

INCOME TAX REGULATIONS
PART XXIX

Section 2900

Section 2900 of the Regulations sets out the meaning of terms and expressions used in section 37 of the Act.

Subsection 2900(1) of the Regulations defines scientific research and experimental development for the purposes of the Income Tax Act. This subsection enumerates activities that will be considered scientific research and experimental development as well as those which do not qualify. For example, basic and applied research undertaken for the advancement of science is considered to qualify while activities that constitute routine testing or quality control of products would not. This subsection is amended to clarify the type of activities that qualify as scientific research and experimental development. This is only a clarification, consequently there are no policy changes intended. As an example, the amended subsection clarifies that development work that is experimental in nature and that is undertaken for the purpose of achieving technological advancement for the purpose of creating new or improving existing materials, qualifies, but development work that is routine in nature does not qualify. It also clarifies that work in respect of activities such as engineering, design and computer programming, qualify if they are directly in support and commensurate with the needs of the qualifying activities.

Subsections 2900(2) and (3) of the Regulations provide, for the purposes of clauses 37(7)(c)(i)(B) and (ii)(B) of the Act, a description of expenditures that are considered directly attributable to the prosecution, or the provision of premises, facilities, or equipment for the prosecution, of SR&ED. First, these subsections are amended as a consequence of the renumbering of clause 37(7)(c)(ii)(B) to new subclause 37(7)(c)(ii)(A)(II). Secondly, paragraphs 2900(2)(c) and (3)(b) are amended to provide that a portion of an expenditure may be considered on account of SR&ED where that portion is directly related to the prosecution of SR&ED or to the provision of premises, facilities or equipment for such prosecution and that portion of the expenditure would not have been incurred but for such prosecution or the existence of such premises. Thirdly, paragraph 2900(2)(b) is amended to provide that an amount in respect of salary or wages and related benefits need only be incurred, and not paid, to be a SR&ED expenditure. As well, the amendment makes this paragraph consistent with the new provision of the Act (subclause 37(7)(c)(ii)(B)(IV)) relating to salary, wages and related benefits.

Subsection 2900(4) of the Regulations is revoked. This subsection provided that certain employment amounts were not considered SR&ED expenditures where the payor and payee were not dealing at arm's length or where the payee was a specified shareholder of the payor. These amounts are now excluded under new subsection 37(8) of the Act.

New subsection 2900(4) of the Regulations sets out the method for determining the amount of a "prescribed proxy amount" for the purposes of the definition of "qualified expenditure" in subsection 127(9) of the Act. The prescribed proxy amount is the amount that a taxpayer may use, under the new elective method for the determination of certain expenditure amounts (new clause 37(7)(c)(ii)(B) of the Act), instead of determining amounts directly attributable on an item-by-item portion by portion basis. Subject to an overall cap constraining the prescribed proxy amount to the amount of the taxpayer's deductible expenditures (otherwise than by reason of certain specific provisions of the Act) the prescribed proxy amount of a taxpayer for a taxation year is generally 65% of the total of the eligible portion of salaries of employees directly engaged in SR&ED in Canada. The eligible portion is determined by a reasonable allocation based on the time spent by each such employee in the execution of such SR&ED activities. In certain cases, time spent by an employee directly engaged in the management of scientific and technical aspects of the SR&ED is considered for these purposes to be time spent by the employee directly engaged in such SR&ED. Where substantially all of an employee's time is so spent, the whole amount of the expenditure is included.

New subsection 2900(5) of the Regulations provides that, for the purposes of subsection 2900(4), and subject to new subsection 2900(6), the salary of an employee that may be included in calculating the proxy base is restricted where the employee is a specified employee. In determining the taxpayer's prescribed proxy amount for a taxation year, the portion of specified employee's salary that may be taken into account shall not exceed the lesser of 75% of the employee's salary and wages and the amount determined under the formula 2.5 x A x B/365. A is the Year's Maximum Pensionable Earnings (section 18 of the *Canada Pension Plan*) of an employee for the calendar year in which the taxpayer's taxation year ends and B is the number of days in the taxation that the employee is an employee of the taxpayer. The Year's Maximum Pensionable Earnings for 1992 is $32,200.

New subsection 2900(6) provides that, for the purposes of subsection 2900(4), where a corporation is associated with another corporation in a taxation year and the corporation employs in the taxation year an individual who is a specified employee and the associated corporation also employs in its taxation year in which they are associated the individual, the total amount of the employee's salary for the taxation year cannot exceed 2.5 x the Year's Maximum Pensionable Earnings (section 18 of the *Canada Pension Plan*) of an employee for the calendar year in which the taxation years end.

Subsection 248(1) includes the meaning of the new expression "specified employee" of a person. A specified employee of a person is an employee who is a specified shareholder of the person or who does not deal at arm's length with the person. Subsection 248(1) of the Act generally defines a specified shareholder of a corporation to be a person who owns 10% or more of any class of shares of the corporation.

New subsection 2900(7) provides that for the purposes of subsection 2900(4), salary or wages does not include any employment benefits, remuneration based on profits or bonuses.

New subsection 2900(8) provides that certain individuals and partnerships will be considered to be associated corporations for the purposes of subsection 2900(6) in order to ensure the effectiveness of the limit set out in that subsection.

New subsection 2900(9) of the Regulations provides a definition of "prescribed depreciable property of a taxpayer" for the purposes of the new definition of "first term shared-use-equipment" in subsection 127(9) of the Act. Prescribed depreciable property is excluded from being considered "first term shared-use-equipment" and as such its capital cost is not eligible for investment tax credits. Prescribed depreciable property of a taxpayer is:

1. a building,

2. a leasehold interest in a building, or

3. a property where, at the time it was acquired, the taxpayer, or a person related to the taxpayer, intended that it would be used for SR&ED during the assembly, construction or commissioning of a commercial facility and that it would be used during its operating time in its useful life primarily for, or its value would be consumed primarily in, non-SR&ED activities. This includes all facilities that are not "pilot plants" as defined in Appendix A of Information Circular 86-4. Property used in pilot plants is not "prescribed depreciable property". In other words, property used for SR&ED during the start-up phase of a commercial facility is "prescribed depreciable property" unless the property will be used during its operating time in its useful life primarily for SR&ED or its value will be consumed primarily in SR&ED.

Section 2902 of the Regulations enumerates the expenditures that are "prescribed expenditures" for the purposes of the definition of "qualified expenditure" in subsection 127(9) of the Act. Prescribed expenditures do not qualify as expenditures eligible for investment tax credits.

The amendments to subparagraph 2902(b)(i) of the Regulations are consequential on the introduction of the definitions of "first term shared-use-equipment and second term shared-use-equipment in subsection 127(9) of the Act and the clarification of the term "all or substantially all" in new clause 37(7)(c)(ii)(A) of the Act.

The amendment to section 2903 is consequential on the reference to a prescribed special purpose building in new regulation 2900(4).

The provisions relating too the prescribed proxy amount are generally effective for taxation years ending after December 2, 1992. The provisions relating to shared-use property are generally effective for property acquired after December 2, 1992. The amendment to Regulations 2900(2)(c) and 3(b) are effective for the 1990 and subsequent taxation years.