



Bay Adelaide East
8 Adelaide Street West
Suite 200
Toronto ON M5H 0A9
Canada

Tel.: 416-601-6150
Fax: 416-601-6151
www.deloitte.ca

May 27, 2024

Director General
Business Income Tax Division
Tax Policy Branch
Department of Finance Canada
90 Elgin Street
Ottawa, ON K1A 0G5

Via email : SRED-PB-RSDE-RPB@fin.gc.ca

Re: Second phase of consultations on Scientific Research and Experimental Development Tax Incentive Program – Deloitte’s comments

We appreciate the opportunity to provide our comments on the consultation paper entitled “Launching the second phase of consultations on the Scientific Research and Experimental Development (SR&ED) Tax Incentive Program” released by the Department of Finance Canada (Finance) on April 25, 2024. Based on feedback received from stakeholders following the first phase of consultations on SR&ED, the government has launched a second phase of consultations to gather feedback on further specific changes that could enhance the SR&ED program.

As a leading professional services firm, Deloitte has extensive experience in assisting businesses of all sizes and sectors in accessing the SR&ED program and other innovation incentives. We have also been an active participant in public consultations on how to improve the SR&ED program and foster a more innovative and competitive business environment in Canada. In this document, we provide our responses to the questions posed by Finance in the consultation paper, based on our professional experience and insights from our clients and stakeholders. We also draw on the recommendations from our previous submission to Finance on the SR&ED program, dated April 15, 2024.

In summary, we are supportive of several changes to the SR&ED program:

- Expand refundable investment credits to all taxpayers, at a reduced rate of between 10% and 12%, with the amount selected to be within the established budgetary framework.

- Maintain an enhanced rate of SR&ED on a refundable basis, subject to an expenditure limit of \$5.0 million, which would be subject to an annual inflationary adjustment.
- Expand the enhanced rate of SR&ED for Canadian-controlled private corporations (CCPCs) to include public corporations with annual revenue below specified thresholds. The enhanced rate should be fully eliminated when consolidated revenue exceeds \$500 million.
- Introduce a minimum expenditure threshold, similar to Quebec's approach, to streamline the administration of SR&ED and ensure that investments are meaningful relative to the size of the company.

In Appendix 1, we have provided feedback on each key consultation question provided by Finance.

We hope that our comments will be helpful in informing Finance's review of the SR&ED program and its potential enhancements. We would be pleased to meet with you, or other officials from Finance, to discuss our submission further.

We consent to the disclosure of our comments under the *Access to Information Act* and have made a copy of our submission available on our website at www.deloitte.ca.

Sincerely,

A handwritten signature in blue ink that reads "Deloitte, LLP".

Rob Jeffery, CPA, CA
National Tax Policy Leader
Deloitte LLP

APPENDIX 1 - Consultations on Canada's SR&ED Program

Responses to key questions for consideration

1. What are some of the challenges faced by research-and-development-performing small- and medium-sized Canadian public corporations when it comes to financing?

Cash flow challenges are a major concern for small companies, particularly those that have not yet generated revenue. Many government support programs that assist with R&D costs have eligibility requirements, such as revenue thresholds or upfront cash contributions. These criteria often exclude early-stage companies that have valuable intellectual property (IP) but lack cash resources. Due to the higher risk aversion of Canadian capital allocators compared to other jurisdictions, companies often need to seek capital from foreign sources at a very early stage of their progression. Below is a summary of the key challenges faced by small Canadian private and public corporations engaged in R&D when it comes to financing innovation projects:

- **Canadian risk aversion:** Canadian capital allocators tend to be more risk averse (i.e., deploy less capital per company across a narrower set of industries) than their Organisation for Economic Co-operation and Development (OECD) counterparts.¹ This is also reflected in corporate venture capital, where only 6% of public Canadian companies generating over \$1 billion in annual revenue actively take part in direct investment, compared to about 40% of their US counterparts.² This risk-averse environment results in several Canadian companies needing to seek out very expensive sources of capital at much earlier stages of their maturity (e.g., needing to go public before they are ready for public market compliance and disclosures, needing to find investors outside of Canada shifting value capture to shareholders outside of Canada).
- **Access to equity financing:** Limited access to capital markets (either private or public). Those that choose to go public much earlier than would normally be necessary in a more capital available market must comply with stringent reporting and disclosure requirements, which can be costly and time-consuming. They also continue to face competition from larger and more established companies in attracting investors and raising funds. Canada's capital markets are also not as diversified across industries as other markets, further limiting access to capital for entrepreneurs building businesses outside of these industry verticals. As a result, much of the economic impact of those successful companies is often siphoned out of Canada through the distributed capital base
- **Cost of capital:** Small and medium-sized enterprises (SMEs) often face a higher cost of capital than larger firms, due to their higher perceived risk, lower credit ratings, or lack of bargaining power. This can reduce profitability and competitiveness and result in fewer R&D investments

¹ Canada, "[Venture capital in the Canadian life science industry](#)," last updated February 22, 2024.

² Deloitte Ventures in collaboration with BDC, "[The state of corporate venture capital in Canada: Investing today to ignite tomorrow](#)," 2024.

made by Canadian public corporations from investing in R&D if they only have access to non-refundable tax credits.

- **Lack of alternative funding sources:** Other than the SR&ED program, there are a few other sources of funding that are specifically designed to support the R&D activities of Canadian public SMEs. Many of the existing government programs are either focused on specific sectors or regions, or have eligibility criteria that exclude or limit their participation. Alternatively, programs such as the Industrial Research Assistance Program (IRAP) can be difficult to access and have a significant overlap with the SR&ED program, adding more complexity and cost to accessing these valuable sources of capital at a time where companies need capital efficiency to survive.
- **Commercialization:** Early-stage companies that have successfully completed an initial public offering (IPO) have raised capital from their efforts. However, in going public, they have also limited their access to other private pools of capital. This is particularly the case in Canada, where many companies are driven to go public very early in their commercialization, as accented by the average market capital of a TSX.V company only being \$41 million.³ Taking their product or service to market often requires access to larger players and support in sectors that are either regulated or have significant government or Crown corporation involvement. Early-stage public companies would benefit from programs that encourage adoption of their solutions. In addition to adoption support, they can benefit from support for demonstration projects. In SR&ED, making more non-salary expenses eligible for demonstration projects would target a critically underfunded step in technology development.

In light of the above, we recommend that the SR&ED program focus on addressing these Canadian market inefficiencies and become more focused on supporting companies that are experiencing meaningful growth (e.g., by modifying expenditure limit mechanics) while also incentivizing increased business investment in R&D (e.g., by making the program fully refundable).

³ TMX, [Our Markets at a Glance](#), consulted on May 27, 2024.

2. To avoid any potential disincentives to growth, would entrepreneurs favour a program with one single rate accessible to all, even if it means somewhat lower support for small Canadian-controlled private corporations?

The SR&ED program currently offers two types of tax credits: a basic 15% non-refundable tax credit for all businesses, and an enhanced 35% refundable tax credit for CCPCs that meet certain criteria. The enhanced tax credit is subject to a \$3 million annual expenditure limit, which is reduced if the CCPC's taxable capital exceeds certain thresholds.

While the enhanced tax credit provides more generous and immediate support for small CCPCs, it also creates a potential disincentive for growth, as CCPCs may lose their eligibility or face a reduced expenditure limit as they start to scale their businesses. This can create a "tax cliff" effect where a relatively small increase in taxable capital in Canada can result in a significant reduction in cash flow. Taxable capital can often increase quickly as organizations proactively raise capital to fund multiple years of operational expenses, resulting in large increases in taxable capital to correspond with the closing of capital raises. In our April 15, 2024 submission as part of Finance's first phase of SR&ED consultations, we proposed solutions to modernize the expenditure limit rules, which have not been updated in many years.

We recognize that a single rate may mean a reduction in the level of support for small CCPCs, which are currently eligible for an enhanced refundable rate of 35%. We understand that this rate is intended to provide greater support and liquidity to CCPCs, which may face more challenges and constraints in funding their R&D activities compared to larger organizations. Therefore, we suggest that the government consider other ways to address the specific needs and circumstances of smaller organizations engaging in SR&ED.

Specifically, we recommend that Finance consider the following:

- 1) **Removing the CCPC requirement:** We recommend focusing instead on a global consolidated revenue threshold to determine access to enhanced tax credit rates. The current CCPC requirement arbitrarily restricts access to capital by scaling companies, as maintaining CCPC status in a world where capital is further globalized becomes increasingly difficult and encourages spending resources on tax structuring rather than focusing capital on growing and scaling the business.
- 2) **Extending refundability:** to all taxpayers irrespective of their size.
- 3) **Increasing the annual expenditure limit:** to at least \$5 million, with future inflation indexation, to account for the current market realities of how much capital is needed for companies to truly achieve product market fit and begin scaling their businesses. Simply accounting for inflation since the \$3 million annual expenditure limit was introduced in 2008 would increase that limit to at least \$4.26 million in today's dollars.
- 4) **Introducing a minimum expenditure threshold:** whereby SR&ED funding would focus on growing businesses. This would allow for some program cost savings to offset increased costs from other

changes and would remove some of the current program focus on micro-businesses that may not have the same economic impact. For example, consider mirroring Quebec's minimum exclusion threshold of \$50,000 to \$225,000, depending on the size of the business.

3. How should the concept of "Canadian" public corporations be defined, should the government proceed with measures to improve access to the SR&ED program's enhanced credit for Canadian public corporations?

The SR&ED program's enhanced tax credit is currently only available to CCPCs that meet certain criteria, as noted above. This means that public corporations, regardless of their ownership or location or size, are not eligible for the enhanced credit, and can only claim the basic 15% non-refundable tax credit. This creates a disparity between public and private corporations of the same size and may discourage public corporations from investing in R&D in Canada.

Therefore, we support the government's intention to improve access to the enhanced tax credit under the SR&ED program for Canadian public corporations, as this would create a more level playing field, encourage R&D investment, and attract and retain talent and capital in Canada. For example, changes to the taxation of stock options introduced in 2021 recognized that smaller public companies (i.e., those with revenue of \$500 million or less) should be subject to different rules than more established and mature public companies.

However, defining the concept of "Canadian" public corporations for the purpose of the SR&ED program is not a straightforward task, as there are various factors and criteria that could be considered, such as:

- The location of incorporation, management, or operations of the public corporation;
- The ownership or control of the public corporation by Canadian residents or entities;
- The listing of the public corporation's shares on a Canadian stock exchange;
- The proportion of the public corporation's R&D activities or expenditures that are carried out or incurred in Canada; and
- The contribution of the public corporation's R&D activities or outcomes to the Canadian economy or society.

We recommend making the SRED credit fully refundable for all taxpayers and extending enhanced tax credit rates to corporations with less than \$500 million in global revenues. We would encourage simplicity in introducing these measures as opposed to further complexity in accessing the SRED program.

4. The SR&ED program currently has rules to prevent the multiplication of the expenditure limit by Canadian-controlled private corporations with common control. If enhanced support were extended to public corporations, how should relationships among legal entities be delineated?

The SR&ED program currently has rules to prevent the expenditure limit from being multiplied by CCPCs with common control. These rules require related CCPCs to share the \$3 million annual expenditure limit and the taxable income and taxable capital employed in Canada thresholds. These rules are intended to prevent CCPCs from artificially splitting their income or capital to access the enhanced credit or to avoid the reduction in the expenditure limit. These rules are consistent with the common principles of Canadian tax policy developed over the years that require entities in the same corporate group or under the same control to share tax incentives or deductions. These important principles are designed, in particular, to avoid the multiplication of incentives simply by creating new entities within the same group. We believe that these fundamental principles must be maintained in an improved SR&ED program, particularly to protect the tax base. Therefore, if enhanced support were extended to public corporations, similar rules would be needed to prevent the multiplication of the expenditure limit or the enhanced credit rate by public corporations with common control. However, the delineation of legal entity relationships for public corporations may be more complex and challenging than for CCPCs because public corporations may have more diverse and fluid ownership structures, involving various shareholders, investors, or partners, both domestic and foreign.

Therefore, we recommend that the government consider the following factors and options in designing the rules to delineate the relationships among legal entities for public corporations:

- The degree of control or influence that one legal entity has over another, either directly or indirectly, through stock ownership, voting rights, or contractual arrangements;
- The alignment of interests or objectives among legal entities that are engaged in R&D activities, either jointly or separately, in Canada or abroad;
- The consistency and compatibility of the rules with existing tax concepts and definitions, such as associated corporations, affiliated persons, or related persons;
- The simplicity and clarity of the rules and their application to various scenarios and situations;
- The balance between preventing abuse or manipulation of the rules and ensuring fair and equitable treatment of public corporations that are truly independent or unrelated.

A simple approach to determine common control is to leverage existing definitions of “consolidated financial statements” found in section 233.8 of the Income Tax Act⁴ used for country-by-country reporting, which are also found in section 237.5 regarding uncertain tax treatments. To the extent that a corporation is included in “consolidated financial statements” (or would be, had consolidated financial statements been prepared) would be indicative of a degree of control. Furthermore, the definitions would be consistent with a regime all public corporations are subject to (i.e., uncertain tax treatments).

⁴ RSC 1985, c. 1 (5th Supp.), as amended, herein referred to as “the Act”.

5. Current global initiatives rely on accounting concepts of relationship and control to determine whether entities are included in a large business corporate group. Should existing international practices of this sort be adapted for determining relations for public corporations in the context of the SR&ED program?

Current global initiatives, such as the Base Erosion and Profit Shifting (BEPS) project led by the OECD and the G20, rely on accounting concepts of relationship and control to determine whether entities are included in a large business corporate group. For example, the country-by-country reporting (CbCR) requirement under BEPS Action 13 applies to multinational enterprise (MNE) groups that have total consolidated group revenues of €750 million or more in the preceding fiscal year. An MNE group is defined as a group of enterprises that are required to prepare consolidated financial statements for financial reporting purposes, or that would be required to do so if equity interests in any of the enterprises were traded on a public securities exchange.⁵

Using the accounting concepts of relationship and control to determine relations for public corporations in the context of the SR&ED program may have some advantages, such as:

- Consistency and alignment with international standards and practices, which could enhance Canada's reputation and competitiveness as a destination for R&D investment;
- Reliability and objectivity of the criteria and data, which could reduce ambiguity and disputes in determining relations;
- Simplicity and efficiency of the reporting and verification process, which could reduce administrative burdens and compliance costs for both taxpayers and the Canada Revenue Agency.

However, using the accounting concepts of relationship and control to determine relations for public corporations in the context of the SR&ED program may also have some drawbacks, such as:

- Lack of flexibility and adaptability to the specific objectives and circumstances of the SR&ED program, which could result in unintended consequences or inequitable outcomes;
- Potential mismatch or conflict with existing tax concepts and definitions, such as associated corporations, affiliated persons, or related persons, which could create confusion and inconsistency.

Therefore, despite the risk of inconsistencies between using new accounting concepts alongside existing and reliable Canadian tax policies, we are supportive of modifying the boundaries of a large business corporate group through the use of existing definitions in the Act such as "consolidated financial statements" found in section 233.8 of the Act. Thresholds for eligibility should be reviewed in light of the responses to the other questions in this consultation.

⁵ For example, see the MNE group definition in Canada Revenue Agency, "[RC4651 Guidance on Country-By-Country Reporting in Canada](#)."

6. What is the optimal size-based metric (e.g., taxable capital employed in Canada, revenue) to phase out enhanced support for public corporations, including those in a corporate group?

The optimal size-based metric for phasing out enhanced support for public corporations, including those in a corporate group, should be one that is simple, objective, transparent, and consistent with existing tax frameworks (i.e., such as OECD's Pillar Two or Canada's stock option deductibility regime). The current approach of using taxable capital employed in Canada is quite cumbersome, as this concept is overly complex and tax specific and results in companies planning to move capital outside of Canada, potentially leading to less business investment in Canada.

The current thresholds were set in 2008. Inflation alone would increase the current maximum threshold of \$50 million by more than 50% to \$75 million. In our experience, the average winners in Deloitte's Fast 50 program, companies that represent Canada's fastest growing innovators in the country, and who are still far from becoming sustainable, global businesses (i.e., are still high risk and have a high cost of capital), often no longer qualify for enhanced rates under the current rules of the SR&ED program. This is indicative of a program that is no longer designed for current market realities and is potentially further limiting access to capital for companies that are still in very high-risk, critical stages of their commercialization.

We would recommend that Canada move towards a global revenue-based threshold, where, for example, all taxpayers with consolidated global revenues below CA\$500 million, or alternatively €750 million, would be eligible to access enhanced SR&ED tax credit rates. We believe that businesses would welcome this consistency and simplicity. We would recommend that these thresholds (i.e., both expenditure limit and revenue thresholds) be indexed to inflation on a go-forward basis.

7. How does refundability under the SR&ED program influence investment decisions and planning? To what degree would Canada become a more competitive location to undertake research and development (R&D), compared to other jurisdictions, if credits earned at the general rate were partially or fully refundable?

Businesses frequently and consistently tell us that refundability under the SR&ED program is a key factor that influences their decisions to invest in R&D in Canada. Refundable tax credits provide immediate and direct cash flow support to businesses, regardless of their profitability or tax position, and reduce the financial risk and uncertainty associated with R&D activities. This encourages businesses to invest more in R&D in Canada, especially startups and SMEs that may face cash flow constraints or difficulties in accessing capital markets.

Following the bust of the dot-com sector in the early 2000s, Canadian technology businesses have increasingly sought to move certain development work offshore to reduce costs. Initially, most of this work involved activities that would not qualify as SR&ED in Canada (such as routine testing, bug fixing, and product enhancements). However, as these offshore developers continue to advance their capabilities and knowledge, they are becoming increasingly attractive as a low-cost means of performing SR&ED that would otherwise be performed in Canada. In addition, many of the jurisdictions in which this work is performed are aggressively seeking to expand their global competitive advantage and advanced technology capabilities through their own SR&ED incentive programs. In this broader and rapidly changing context, Canada's ranking for innovation competitiveness has slipped from 8th place in 2011 to 15th place in 2023, according to the World Intellectual Property Organization (WIPO) Global Innovation Index.⁶ While several factors have contributed to this decline, it is notable that in 2021 Canada's R&D intensity (the nominal share of gross R&D expenditures as a percentage of gross domestic product [GDP]) ranked below the Group of Seven (G7) average. Within the OECD, Canada fell two places to 19th.⁷

Canada would become a more competitive location to undertake R&D, compared to other jurisdictions, if credits earned at the general rate were partially or fully refundable. This would increase the attractiveness and accessibility of the SR&ED program for all businesses, especially those that are not eligible for the enhanced refundable credit, such as public corporations, large CCPCs, or foreign-owned corporations. This would also create a more level playing field and eliminate the disincentive to growth that currently exists for CCPCs that may lose their eligibility for the enhanced refundable credit as they grow their income or capital. It would also align Canada's SR&ED program with other jurisdictions that

⁶ WIPO, *Global Innovation Index 2011: Accelerating Growth and Development*, (Geneva: WIPO, 2011), p. 18; WIPO, *Global Innovation Index 2023: Innovation in the face of uncertainty*, (Geneva: WIPO, 2023), p. 19.

⁷ Statistics Canada, The Daily, *Gross domestic expenditures on research and development, 2021 (final), 2022 (preliminary) and 2023 (intentions)*, December 22, 2023, p. 2.

offer refundable R&D tax credits, such as France, Australia, Germany, and Denmark, and enhance Canada's reputation and competitiveness as a destination for R&D investment.⁸

Currently, only CCPCs can access refundable SR&ED tax credits at the enhanced rate of 35% on the first \$3 million of qualified expenditures, subject to certain limits based on taxable capital employed in Canada. Other businesses, such as large and/or publicly traded corporations, partnerships, and CCPCs with large taxable capital, can only access non-refundable SR&ED tax credits at the general rate of 15%, which can only be used to offset income taxes payable. This creates a disparity in the level of support and incentive for R&D investment among different types of businesses and limits the effectiveness of the SR&ED program for many businesses that may not have taxable income or may have accumulated carryforward pools of unused credits. If credits earned at the general rate were partially or fully refundable, Canada would become a more competitive location for R&D compared to other jurisdictions for several reasons. It would:

- Provide a more equitable and inclusive level of support for R&D investment across all types of businesses, regardless of their size, sector, or corporate structure, and create a level playing field for domestic and foreign investors;
- Increase the attractiveness and accessibility of the SR&ED program for businesses that are currently ineligible or disincentivized from claiming SR&ED tax credits, such as large and/or publicly traded corporations, partnerships, and CCPCs with large taxable capital, which often have significant R&D expenditures and potential for economic impact;
- Improve the cash flow and liquidity of businesses, especially during periods of economic downturn or uncertainty, when they may not have taxable income or may face financial constraints in conducting R&D activities, and enable them to maintain or increase their R&D spending and innovation output;
- Align Canada's SR&ED regime with the best practices and standards of other OECD countries that offer competitive and refundable R&D tax incentives, such as France, Australia, Germany, and Denmark, and position Canada as a leading destination for R&D investment and talent;
- Provide a valuable source of cash to drive growth in small businesses that otherwise face challenges in accessing capital markets.

⁸ France is offering an R&D credit equal to 30% of the first EUR 100 million of qualifying R&D expenditures incurred during the tax year, and the rate is reduced to 5% for qualifying R&D expenditures exceeding that amount. Australia is offering a 38.5% non-refundable tax offset for large enterprises and 43.5% refundable tax offset for SMEs (less than AUD 20 million aggregate turnover). Germany and Denmark offer a 25% R&D tax credit. See Deloitte US, [Survey of global investment and innovation incentives](#), October 2020; and the [OECD's INNOTAX](#) portal.

Assessing the impact of refundability on R&D investment with the global tax compliance landscape

The introduction of Pillar Two, developed by the OECD to ensure MNEs pay a minimum level of tax on income in each jurisdiction, may significantly influence the behaviour of large organizations when investing in R&D. By adjusting the refundability of the Canadian SR&ED tax credit, the government can mitigate the impact of Pillar Two and enhance its competitiveness in attracting R&D activities. Companies might reduce their R&D efforts if the benefits from tax credits are immediately negated by top-up taxes under Pillar Two rules. Therefore, understanding the implications of refundable SR&ED tax credits on investment decisions is critical to assessing Canada's competitiveness in fostering R&D activities and maintaining its attractiveness as a leading destination for innovation.

Assessing the benefits and challenges of refundable tax credits

A refundable R&D tax credit, even at a reduced rate, offers significant advantages. It ensures higher calculated ETRs, minimizes top-up tax liabilities, and improves cash flow for companies, thereby encouraging sustained R&D investment. The refundable rate must be carefully set to balance the immediate fiscal impact with the long-term economic benefits. A slightly lower refundable rate than the current non-refundable rate could maintain incentivization for substantial R&D activities.

Transitioning to a refundable R&D tax credit regime may increase the government's short-term fiscal burden due to higher initial payouts. However, this can act as a catalyst for economic growth. Increased cash flow from refundable credits would allow companies to invest more in innovative projects, leading to technological advancements and higher productivity. The cost of this refundability can also be offset with other structural changes, such as a lower enhanced refundability rate and the introduction of minimum expenditure thresholds, as we have outlined in other sections of our submission.

From an investment planning perspective, the certainty of receiving refunds even in loss years makes Canada a more attractive destination for R&D. The increased predictability of funding would lead to more ambitious and sustained R&D efforts, positioning Canada competitively with other jurisdictions that may not offer similar refundable credits.

We believe that making R&D tax credits refundable would incentivize higher levels of R&D investment within Canada and enhance the country's attractiveness as a leading destination for innovation. Policymakers must carefully design the refundability aspect to balance fiscal responsibility with the goal of fostering a robust and competitive R&D environment.

8. Would it be preferable that the government make the general rate refundable, but at a reduced rate? What would be an acceptable trade-off in this regard?

It may be preferable for the government to make the general rate refundable, but at a reduced rate, as this could strike a balance between providing adequate and timely support for R&D activities and ensuring the fiscal sustainability and cost effectiveness of the SR&ED program. A reduced refundable rate could also mitigate the potential revenue loss or distortion that could result from making the general rate fully refundable.

An acceptable trade-off in this regard would depend on the objective and design of the measure, as well as the impact and implications for different types of businesses and sectors. However, some possible factors and options that could be considered include:

- The level of the reduced refundable rate: The reduced refundable rate should be sufficiently attractive and competitive to encourage R&D investment and innovation, while being fiscally responsible and neutral. The reduced refundable rate could be set at a fixed percentage, such as 10% or 12%, or it could vary depending on the business's size, profitability, or sector.
- Alternatively, the government could consider making the general rate partially refundable, such as 50% or 75%, but maintaining it at 15%. This would provide some immediate cash flow benefit to businesses, while preserving some future tax savings for businesses that may have taxable income in subsequent years. However, this option may not provide sufficient incentive or relief for businesses that have large carryforward pools of unused credits or that face significant financial risks in conducting R&D activities.
- The eligibility and availability of the reduced refundable rate: The reduced refundable rate should be accessible and predictable for businesses that need and benefit from the SR&ED program, while avoiding duplication or overlap with other support programs. The reduced refundable rate could be available to all businesses, or it could be targeted to certain types of businesses, such as public corporations, large CCPCs, or foreign-owned corporations, that are currently ineligible for the enhanced refundable credit, while maintaining an enhanced refundable rate for small CCPCs.
- The refundable rate should be coordinated with a legislated time frame in which a business can expect to receive the credits, as the availability of credits often guides the planning, timing, and execution of further R&D investments.

9. In your view, should SR&ED-eligible activity be broadened from the existing OECD definition of SR&ED, generally used by Canada and other countries offering R&D tax credits? If so, how would you propose to amend the current definition? Why would any additional activities warrant government support?

In our view, the scope of SR&ED-eligible activity should be broadened from the existing OECD definition of SR&ED, which is generally used by Canada and other countries that offer R&D tax credits, to ensure the relevance, clarity, and competitiveness of Canada's SR&ED regime in the 21st century. The current definition of SR&ED may not fully capture the scope of all eligible R&D activities undertaken in Canada, especially in emerging areas of innovation. To amend the current definition, we would recommend the following:

- **Align the definition of SR&ED with the current international standards**, such as the updated Frascati Manual (2015)⁹ and the Canadian Research and Development Classification (CRDC) standard (2020),¹⁰ to ensure the consistency and competitiveness of Canada's SR&ED regime with other OECD countries. The Frascati Manual is a recognized international standard for collecting and reporting data on research and experimental development. It provides definitions and classifications of R&D activities, and was revised in 2015 to reflect the complexity and globalization of R&D, as well as the cultural and linguistic changes in the definition of R&D. The CRDC is a standardized classification system for research developed by federal research granting agencies in Canada. It addresses the challenges posed by different research classifications used across programs and aims to provide an up-to-date and conceptually sound classification of research activities that are somewhat broader than the activities contemplated in the current SR&ED definition. As the custodian of the CRDC, Statistics Canada ensures its relevance and alignment with international standards. In addition, the CRDC enables comparisons with other national and international classifications, facilitating international benchmarking and collaboration. The definition, scope, and classification of R&D activities in the CRDC align with the guidelines outlined in the OECD's Frascati Manual 2015. By updating the definition of SR&ED to align with the latest edition of the Frascati Manual and the CRDC standard, the government can ensure that the definition is up to date, inclusive, and supportive of the diverse range of R&D activities in Canada. This alignment is important to ensure comparability of measures of SR&ED program effectiveness with other OECD reporting countries.
- **Periodically review and update the definition:** Implement a process to periodically review and update the definition of SR&ED to keep pace with the evolving R&D landscape. This would prevent the definition from becoming outdated and ensure its effectiveness in supporting R&D activities in Canada and maintaining competitiveness with other OECD countries.

⁹ OECD (2015), *Frascati Manual 2015: Guidelines for Collecting and Reporting Data on Research and Experimental Development, The Measurement of Scientific, Technological and Innovation Activities* (Paris: OECD: Publishing, 2015).

¹⁰ Statistics Canada, [Canadian Research and Development Classification \(CRDC\) 2020 Version 1.0](#), October 5, 2020.

- **Recognize emerging areas of innovation:** Modernizing the definition of SR&ED can help the government encourage and support emerging areas of innovation, such as AI, blockchain, biotechnology, genomics or bioinformatics, which are advancing rapidly and have the potential to drive Canada's future economic growth. The current definition of SR&ED is the "systematic investigation or search that is carried out in a field of science or technology by means of experiment or analysis." Conducting R&D activities only through "experiment or analysis" may not be suitable for new areas of innovation. By updating the definition to specifically include new ways of conducting R&D, such as virtual/simulation-based development, the government can explicitly include these emerging areas that have significant potential to drive Canada's future economic growth and provide targeted support to businesses engaged in these areas.

Other activities that warrant government support are those that contribute to the advancement of science or technology, generate new knowledge or capabilities, or solve scientific or technological uncertainties. These activities are essential to fostering innovation, enhancing productivity, and creating economic and social benefits for Canada.

For a more comprehensive explanation of our recommendations, we invite you to consult our April 15, 2024 submission related to phase 1 of the SR&ED consultations.

10. Can you provide specific examples of activity that you think should be eligible for the SR&ED program that are not currently eligible? Would such a change bring additional predictability to claimants?

We believe that the current definition of SR&ED is outdated and does not fully capture the scope and diversity of R&D activities performed in Canada that have the potential to drive Canada's future economic growth. As science and technology rapidly evolve, the definition of SR&ED should be updated to reflect the changing technological landscape and to recognize emerging areas of innovation, such as AI, blockchain, biotechnology, genomics, or bioinformatics. Furthermore, the current definition of SR&ED requires that R&D activities be conducted through traditional "experiment or analysis" to be eligible, which may not be a suitable requirement in the context of virtual/simulation-based development. We therefore recommend that the following types of activities be explicitly included in the definition of SR&ED and be eligible for the SR&ED program:

- Virtual/simulation-based development: This type of activity involves creating and testing virtual models or prototypes of products or processes using computer simulations or software tools. This can reduce the need for physical experimentation or trials, which can be costly, time-consuming, or impractical. Virtual/simulation-based development can be used to conduct R&D in various fields, such as engineering, aerospace, automotive, biotechnology, and AI, and can lead to significant advancements. However, the current definition of SR&ED requires that R&D activities be carried out by means of "experiment or analysis," which may not be suitable for virtual/simulation-based development. By explicitly including this type of activity in the definition of SR&ED, the government can recognize the value and potential of virtual/simulation-based development as a method of conducting R&D and support businesses that use this method to advance science and technology.
- Optimization and continuous improvement during commercial production: This type of activity involves improving the performance, efficiency, quality, or reliability of products or processes during commercial production. It may involve testing, measuring, analyzing, or modifying existing products or processes to achieve optimal results. Optimization and continuous improvement are vital for bringing solutions to the market and helping businesses become more productive and competitive. However, the current definition of SR&ED excludes activities related to "commercial production," which may prevent businesses from claiming SR&ED credits for optimization and continuous improvement activities. By removing the "commercial production" exclusion and introducing provisions that clarify the eligibility of optimization and continuous improvement activities, the government can recognize the importance of these activities in developing new or improved products or processes and encourage businesses to invest in them.
- Social sciences: The exclusion of social sciences from the definition of SR&ED creates ambiguity and inconsistent results for AI-related claims. Many cutting-edge applications involve predicting human behaviour or financial markets, blurring the lines between social sciences and technology.

To address this, the government should consider including certain cross-disciplinary social sciences activities within the scope of SR&ED, allowing for more accurate assessment and recognition of R&D efforts in the field of AI.

- Interdisciplinary and collaborative research: This type of activity combines different fields of science and expertise to solve complex problems or create innovative solutions. It may involve collaborating with other businesses, academic institutions or research organizations to share knowledge, resources and skills. Interdisciplinary and collaborative research can lead to breakthroughs and discoveries that would not be possible within a single discipline or organization. However, the current definition of SR&ED may not adequately address the challenges and opportunities of interdisciplinary and collaborative research, such as the allocation of SR&ED credits, documentation requirements, and evaluation criteria. By updating the definition of SR&ED to reflect the collaborative nature of research, the government can provide clarity and guidance to businesses engaged in interdisciplinary and collaborative research and support them in accessing the SR&ED program.

We believe that including these types of activities in the definition of SR&ED would provide additional predictability for claimants by giving them a clearer understanding of the eligibility criteria and documentation requirements. This would also reduce the ambiguity and inconsistency in the application and evaluation processes and provide greater certainty in claim outcomes. Furthermore, it would encourage greater participation in the SR&ED program, particularly among small businesses and startups that may not be aware of the program or may find it too complex or burdensome to apply. By expanding the scope of eligible activities, the government can also foster a culture of innovation and investment in Canada and support businesses in conducting R&D in the digital age.

11. How could the SR&ED program be enhanced to support businesses conducting R&D in the digital age, particularly in respect of software development and the emergence of artificial intelligence?

Enhancing the SR&ED program to better support businesses involved in software development and AI in Canada can be approached in several strategic ways:

- **Update and expand guidelines for software development and AI:** The SR&ED program should provide updated, detailed guidelines and illustrative examples that are specific to software development and AI. These guidelines must reflect the latest developments in these fields and provide clear definitions of what qualifies as R&D in the digital age. This clarity will help businesses better understand how their activities fit within the SR&ED framework and reduce the uncertainty around filing claims.
- **Introduce targeted incentives for digital R&D:** Implement additional incentives specifically tailored to digital R&D activities, particularly in software and AI. These could include enhanced tax credits or super-deductions for expenditures on software development and AI research. A patent box regime, where income earned from IP developed in Canada is taxed at a lower rate, could also be introduced to encourage businesses to develop and retain their innovations within Canada.
- **Capital expenses:** Recognize and reinstate capital expenses as eligible costs under the SR&ED program, particularly those that are critical for AI research, such as high-performance computing systems and data storage solutions. This adjustment would recognize the significant upfront investment required to conduct advanced digital R&D.¹¹
- **Support for computational resources:** Given the intensive computational demands of AI, including costs associated with cloud computing services, graphics processing units (GPUs), or other specialized hardware in SR&ED claims, could significantly alleviate the financial burden. This support would help level the playing field for Canadian firms, especially startups and SMEs that may struggle with the high cost of computational resources.
- **Enhanced support for collaboration with academic and research institutions:** Strengthen partnerships between industry and academia to foster a more robust digital R&D ecosystem. Encouraging collaborative projects through SR&ED incentives could lead to more innovative R&D that integrates cutting-edge academic research with practical, commercial applications.

By addressing these key areas, the SR&ED program can better support the evolving needs of businesses engaging in R&D activities within the rapidly changing landscape of the digital economy and ensure that Canada remains competitive on the global stage.

¹¹ For example, Australia, the United Kingdom, and Mexico consider capital expenditures, or tools and software used for performing R&D or experimental tests. See Deloitte US, [Survey of global investment and innovation incentives](#), October 2020.

12. To what extent do businesses face financial challenges and trade-offs in protecting their intellectual property (IP) in Canada and abroad? Would it be appropriate for the government to provide additional support to these activities under the SR&ED program? If so, what would be a cost-effective approach?

IP is a valuable asset for businesses conducting R&D and innovation in Canada. IP can provide a competitive advantage, generate revenue, attract investment, and foster collaboration. However, businesses also face financial challenges and trade-offs in protecting their IP both domestically and internationally. These include:

- The high cost of filing, maintaining, and enforcing IP rights such as patents, trademarks, and copyrights in multiple jurisdictions: These costs can be prohibitive for small businesses and startups that have limited resources and cash flow.
- The complex and lengthy processes for obtaining and defending IP rights, which can involve multiple agencies, legal systems, and regulations: These processes can create uncertainty and delays for businesses seeking to protect their IP and commercialize their innovations.
- Trade-offs between investing in R&D and allocating funds for IP protection: Limited budgets force companies to choose between advancing their innovations and protecting their IP, potentially jeopardizing future revenue and competitive advantage.
- The risk of losing or compromising their IP, due to infringement, theft, or disclosure, by competitors, hackers, or others: These risks can undermine the value and potential of their IP and discourage investment in R&D and innovation.

We believe that it would be appropriate for the government to provide additional support to businesses in protecting their IP in Canada and abroad as part of its broader strategy to foster a culture of innovation and investment in Canada. IP protection is an integral part of the innovation cycle, as it enables businesses to reap the benefits of their R&D activities and to secure their competitive position in the global marketplace. By providing additional support for IP protection, the government can help businesses overcome the financial challenges and trade-offs they face and encourage them to retain and leverage their IP in Canada.

Cost-effective and tailored solutions

1) Expand the SR&ED program:

- Include IP protection costs: Modify the SR&ED tax credit to include costs associated with IP protection, such as filing, maintenance, and enforcement expenses, as well as the cost of IP advisory services. This can help businesses offset the significant costs associated with securing IP rights and ensure that they do not have to divert resources away from critical R&D activities.
- Deferred cost mechanism: Implement a mechanism that allows IP-related expenses to be claimed after technical uncertainties have been resolved, recognizing that these costs are often incurred post-R&D.
- Ensure that the SR&ED tax credit provides targeted support by requiring a company to have an R&D project in order to claim IP-related costs. This ensures that the support is directly linked to innovation activities. Additionally, it may be more cost-efficient to provide this support through

the SR&ED program than by creating a separate tax credit specifically for IP because it leverages the existing administrative framework and reduces complexity. By targeting only innovation resulting from R&D, this approach can focus on IP created in Canada, potentially reducing costs compared to a specific IP tax credit. It also incentivizes companies to engage in more R&D to help cover the costs of trademarks and IP advisory. Furthermore, it ensures that the government is not subsidizing trademarks and marketing-related IP, thereby maintaining the focus on true innovation.

- Focus on Canadian ownership: Tailor the credits to prioritize Canadian-owned companies. This approach would incentivize domestic innovation and ensure that the benefits of IP protection support the Canadian economy. By focusing on Canadian ownership, the program can help prevent the outflow of IP rights to foreign entities, thereby retaining valuable intellectual assets within the country and fostering a stronger national innovation ecosystem. This strategy aligns with the broader economic goals of enhancing national competitiveness and maintaining technological leadership.

2) Introduce a federal patent box:

- Preferential tax treatment: Establish a patent box regime that provides a preferential tax treatment for income derived from patented innovations. Countries such as the Netherlands and the United Kingdom have successfully implemented patent box regimes, resulting in an increase in investment in the United Kingdom¹² and a positive impact on local R&D activities in the Netherlands,¹³ demonstrating the cost effectiveness of this approach.
- Leverage existing infrastructure: Utilize the existing SR&ED infrastructure to administer the patent box regime, minimizing the administrative complexity and costs.

Beyond the SR&ED program and the patent box regime, several additional initiatives can help foster a culture of IP in Canada. For instance, integrating IP education into business and engineering curricula at universities and colleges is essential for preparing future entrepreneurs and innovators to protect their intellectual assets. For example, the U.S. Patent and Trademark Office (USPTO) has partnered with educational institutions to integrate IP courses and created the Global Intellectual Property Academy,¹⁴ which has increased IP awareness and competency among graduates, SMEs, and government officials. In Canada, a similar approach could be taken by collaborating with universities and colleges to develop standardized IP courses and modules, alongside providing funding and resources for IP education programs. Additionally, organizing workshops and training programs on IP management and protection can further educate businesses on the processes involved and best practices for protecting their innovations. Programs such as those run by the World Intellectual Property Organization (WIPO)¹⁵ have proven effective in enhancing IP knowledge and management skills among participants, leading to better IP strategies and outcomes for businesses.

¹² HM Revenue & Customs, "[Patent Box Evaluation](#)," November 2020.

¹³ Pierre Mohnen, Arthur Vankan, and Bart Verspagen, "[Evaluating the innovation box tax policy instrument in the Netherlands](#)" (2007–13) 33:1 *Oxford Review of Economic Policy* 141-156.

¹⁴ See [The Global Intellectual Property Academy](#) for more details.

¹⁵ See [WIPO Academy](#) for more details.

By integrating these measures, the Canadian government can significantly improve IP protection for businesses. Expanding the SR&ED program to include IP protection costs and introducing a patent box regime are cost-effective strategies that have shown positive results in other countries. These initiatives, along with fostering an IP culture through education and public awareness, will help businesses protect their innovations, foster a competitive innovation ecosystem, and attract investment. Such recommendations could play a crucial role in ensuring that Canada's innovation ecosystem thrives with strong IP protection and strategic support from the SR&ED program.

For a more comprehensive explanation of our recommendations, we invite you to refer to our April 15, 2024 patent box submission.