

Exactera

# R&D Tax Incentives in Canada



## O Canada: Land of R&D Tax Incentives

Canada's R&D incentive regime is one of the most generous and comprehensive in the world. It's also one of the oldest, with roots dating back to the 1940s. Over the decades, the program has evolved significantly, enhancing its accessibility and effectiveness. Unlike grant programs, SR&ED is demand-driven—there's no ceiling on the payout amount in any year—and no industries are excluded.

Today, the primary vehicle for delivering these benefits, the [Scientific Research and Experimental Development \(SR&ED\) program](#), provides over CAD3 billion annually in tax assistance to upwards of 20,000 Canadian businesses of all sizes, across all sectors. Combined with provincial incentives, the total tax subsidy can reach up to 65% of eligible R&D costs for some claimants. The tax benefits of SR&ED are especially significant for startups and small businesses: refundable tax credits provide much-needed liquidity to propel growth when it matters most.

It's fair to say that the concept of stimulating economic growth by fueling innovation is deeply embedded in Canada's DNA—and the country has the hard ROI data to prove its value: It generates [\\$1.30 to \\$1.38](#) in incremental R&D spending per \$1 of tax credit.

In this white paper, we'll examine this generous and wide-ranging program in detail, compare it to the US system, and look at some of the pros and cons for MNEs considering doing business in Canada.



# The “How” and the “Why”: How Canada Defines R&D

The Canada Revenue Agency (CRA), the body that administers the SR&ED program, defines R&D not by the industry or even the work itself, but by the nature of the activities being conducted. Its framework for eligibility is essentially a two-part test: a **how** and a **why**.

The “How”	The “Why”
<p data-bbox="305 447 597 478">Looks at the <u>Process</u></p> <p data-bbox="123 506 781 678">Was a <u>systematic investigation or search</u> carried out to solve a scientific or technological problem? Did it follow the method of hypothesis generation, testing, and conclusions—and were detailed, contemporaneous records kept?</p>	<p data-bbox="1024 447 1317 478">Looks at the <u>Purpose</u></p> <p data-bbox="850 506 1495 711">Was the work undertaken to generate “new knowledge” (i.e., knowledge intended to resolve a scientific or technological uncertainty) that can lead to an advancement—for instance, creating new or improved materials, devices, products, or processes?</p>

**Drilling down on the “why,”** the company must be able to demonstrate that it has invested in one of the following types of activities:

- **Basic research:** Work that aims to advance scientific knowledge, without a specific practical application in view. (Such work often takes place in labs and may be published in scientific journals.)
- **Applied research:** Original work undertaken to acquire new knowledge, with a specific practical application in view. (For example, trying to develop a vaccine against a newly discovered virus.)
- **Experimental development:** Systematic work (as opposed to trial-and-error)—drawing on existing knowledge—aimed at producing new or improved materials, processes, products, or devices.
- **Support work:** This includes engineering, design, operations research, mathematical analysis, computer programming, data collection, testing, or psychological research, but only insofar as the work is commensurate with, and directly supports, the three forms of research specified above.

Importantly, the CRA stresses that you do not have to achieve your goal in order to gain new knowledge. (For example, if the work led you to understand that the idea you tested is not a solution for your situation, this can be considered new knowledge.) The key point is that the knowledge gained must advance the understanding of science or technology—rather than how the work advanced the taxpayer’s business.



Nonscientific endeavors such as social sciences, humanities or market research; sales promotion and quality control; routine data collection unrelated to core SR&ED work; commercial production of new products; and prospecting, exploring or drilling for minerals, petroleum or natural gas are not eligible.

Qualifying expenses include **salaries and wages** for employees directly engaged in SR&ED activities; the cost of **materials** consumed or transformed in the conduct of SR&ED; whatever portion of **overhead and other expenditures** (including lease costs of equipment) are directly attributable to SR&ED activities; and 80% of payments to arm’s-length **third parties** who perform eligible activities.



## Who Benefits—and How?

The SR&ED program is particularly advantageous for Canadian-controlled private corporations (CCPCs), who make up the bulk of recipients (up to 75% of claimants are small businesses). CCPCs enjoy a combination of refundable and non-refundable investment tax credits (ITCs): a generous 35% refundable ITC applies to the first CAD3 million of eligible expenditures annually, providing immediate cash-flow benefits, and a 15% non-refundable ITC for expenditures beyond that annual limit.

Canada's R&D largesse is not limited to smaller companies. Non-CCPCs, including foreign-controlled and public corporations, can earn a 15% non-refundable ITC on their qualified SR&ED expenditures. Sole proprietorships, partnerships, and trusts can also apply for the tax incentives.

In addition to the ITC, businesses can also claim a deduction for their eligible SR&ED expenditures, providing immediate tax relief by reducing their taxable income. These expenditures can be deducted in the year they are incurred, or carried forward indefinitely.

The two incentives—ITC and deduction from income—are designed to work together to optimize tax relief for taxpayers. Here's how: Businesses first determine and calculate their pool of deductible SR&ED expenditures, which can be used to reduce their net income for the current year or carry it forward to future years, reducing the overall tax liability. Once this is done, they can then calculate the ITCs, which can be applied to reduce the taxes payable. Non-refundable ITCs can be carried back three years or forward 20 years to offset future tax liabilities.

The generosity is not limited to the federal government. From [Alberta to Yukon](#), most Canadian provinces and territories offer supplemental R&D tax credits, ranging from 3.5% to 30%—with Quebec's being the most generous (not to mention, refundable). While these provincial credits can significantly increase the overall tax benefit, they do reduce the pool of deductible SR&ED expenditures and the amount of federal ITC earned.

## The Compliance Picture

Canada's SR&ED program is generous, but its regulatory regime is rigorous, requiring stringent substantiation of claims. Claimants must maintain detailed documentation to support their eligibility assessments, including project planning documents, experimental evidence and analysis, time, cost and payment records, and more. This documentation is included in Form T661, which must be filed within 18 months of the fiscal year-end in which the expenditures were incurred.

The CRA reviews claims in great technical and financial detail, often requesting additional information. The Agency also frequently conducts audits, making proper documentation and adherence to guidelines crucial. (Pre-claim consultations and support services are available to assist claimants.)

# Comparing Canada to the United States

While both Canada and the United States offer substantial R&D tax incentives, they differ significantly in scope, generosity, qualifications, and compliance.

## Scope and Flexibility

The US R&D tax credit system allows for a broader range of qualifying expenses and offers multiple credit options, making it more flexible in terms of the types of activities and expenses that can be claimed. In contrast, Canada's SR&ED program has a more focused scope on scientific and technological advancements, and includes specific rules for different types of expenses and claimants.

## Generosity

The Canadian regimen offers higher potential credit rates for small businesses (up to 35% refundable to CAD3 million for CCPCs; 15% non-refundable for others). The US system offers a 20% credit for incremental increases in qualified research spending or a 14% Alternative Simplified Credit, with additional options for small businesses to offset payroll taxes. On refundability, Canada clearly has the edge. (Both countries of course also have state or provincial incentives, but Canada once again tips the scales in terms of generosity.)

## Compliance

Both systems require detailed documentation, but Canada has a more rigorous (and historically more frequent) audit process. The Canadian government has been working to simplify its program to make it both more accessible and less burdensome. On the US side of the border, however, recent developments point to an increased complexity in claims, including proposed significant changes to Form 6765 for tax year 2024.



# Additional Innovation Goodies

In addition to the SR&ED tax credit program, there are a variety of new grants, loans and tax incentives now available to qualifying companies. Here's a short summary of what's on offer:

## Accelerated Capital Cost Allowance (CCA) Rate and Manufacturing and Processing Tax Credit

Certain R&D assets used in connection with eligible manufacturing and processing activities may qualify for accelerated depreciation (and in some cases, immediate expensing) under Class 53. Other R&D assets, such as computer hardware, may qualify for even more generous accelerated depreciation, under Class 50. (Quebec offers additional "Super/Bonus CCA" deductions for eligible property.) The assets may also qualify for federal and/or provincial manufacturing or processing investment tax credits ranging from 4% to 10% of qualifying expenditures.

### Strategic Innovation Fund (SIF)

While not strictly speaking an R&D tax credit, the SIF [aims](#) to accelerate economic growth, strengthen the role of Canadian businesses in regional and global supply chains, and attract investment that creates significant employment benefits for Canadians. Available to organizations across all industrial and technology sectors, the SIF provides favorable loans and, in exceptional cases, cash grants for large-scale projects.

### Canadian Entrepreneurs' Incentive

Introduced in Canada's "Budget 2024," this new incentive reduces the inclusion rate to 33.3% on a lifetime maximum of CAD2 million in eligible capital gains, allowing entrepreneurs to pay less tax on up to CAD6.25 million in capital gains when selling shares of their small business corporation.

### Venture Capital Catalyst Initiative

The federal government is investing CAD200 million over two years to increase access to venture capital for equity-deserving entrepreneurs and underserved communities, supporting the growth of innovative startups.

### Federal Research Support

Budget 2024 also provides for nearly CAD5 billion for investments in high-quality research facilities and infrastructure, with about half of that sum—CAD2.6 billion—dedicated to core research grants and post-secondary education deemed essential for breakthroughs in Canadian research and science.

## Clean Technology Investment Tax Credits

Qualifying taxpayers can apply for a [refundable tax credit](#) equal to 30% of the cost of investments in eligible machinery and equipment used for manufacturing or processing clean technologies. There's also a 15% refundable tax credit for investments in eligible clean electricity generation equipment (such as wind, solar, hydro, and nuclear), electricity storage equipment (like batteries and pumped hydroelectric storage), and equipment for transmitting electricity between provinces and territories.



## Putting It All Together: The Pros and Cons

The appeal of Canada as a destination—especially for a US-based MNE—is obvious. Beyond the country’s size and physical proximity, its skilled workforce, and the tenure and stability of its system, Canada’s tax incentive program is recognized as one of the most generous in the world—the more so when you add in the many provincial incentives on offer.

But the SR&ED program is not without its problems and its critics. Some business leaders [bemoan](#) the complexity and stringency of the application rules, its narrow eligibility definitions, and the [lack](#) of a patent box incentive (though the government is [toying](#) with the idea). The federal government is also working to better leverage its highly educated workforce and robust university research, which some argue has not translated enough into business innovation.

Beyond the stringent compliance requirements, MNEs must also consider the overall corporate income tax landscape, including its middling corporate income tax (CIT) rates. Combined, these range from 23% to 31% for general corporations in 2024, depending on the province/territory. Also, the SR&ED tax credit is considered government assistance: it reduces the pool of deductible R&D expenditures for CIT purposes, effectively increasing the marginal tax rate on R&D.

Still, the relative stability of Canada’s CIT and SR&ET regimes over time, coupled with strengths in non-tax factors like talent and economic conditions, strongly and consistently support Canada’s overall attractiveness for any company considering long-term R&D investments.

The SR&ED program’s evolution over the years reflects Canada’s commitment to adapting to the changing needs of its businesses and economy. The introduction of new digital tools to streamline the claims process, and the dedication to continual improvement in subsequent annual budgets, are a testament to this commitment to prioritizing innovation—they are, in fact, a form of innovation in and of themselves. For MNEs looking to maximize their R&D investments, Canada offers a compelling blend of generous incentives, a supportive ecosystem, and a forward-thinking approach that’s unlikely to waver.