Montréal ∞ Toronto ∞ Vancouver ∞ Moncton ∞ Halifax ∞ Québec

February 17th, 2011

The Government of Canada has appointed an independent panel to review the federal support of R&D in Canada. This document is in response to the panel's request for input into a series of questions posed in their consultation paper.

Overview:
Alma Consulting Group (formerly Pinchevsky & Co) has been providing SR&ED support and tax credit services to taxpayers in Canada for over 12 years. The firm has successfully assisted in the delivery of thousands of SR&ED claims over that time. The SR&ED program has been critical in the development, growth and success of thousands of companies across Canada. It is an integral part of a taxpayer's means to invest in their future and to compete globally, from a technology standpoint. The United States and many European governments continue to maintain a strong commitment to R&D investment through these difficult times. Other nations are evaluating or have recently introduced R&D incentives. Canada has been one of the leaders in this area and must continue to support and encourage industry to invest in Canada's future through Incentive Tax Credit Programs, such as the SR&ED program.

Q1. In addition to the R&D activity defined by the OECD, should government be funding other business activities related to the commercialization of R&D? If so, what and why?

As a point of reference, it is our understanding that none of the European tax incentives (specifically R&D) take into account commercialization expenditures. Should Canada decide to do so, it would provide a further incentive to companies to locate projects within Canada.

Q4. Regarding ideas and knowledge, do you believe it is important for Canadian firms to perform their own R&D and if so, what do you believe are the key factors that have been limiting business R&D activity in Canada?

Yes, it is important for Canadian firms to perform their own R&D:

A. It encourages the development of local expertise.
B. It allows for full control and ownership over their development cycle and intellectual property.
C. A firm can leverage the knowledge gained for future projects through the company's own advances of knowledge within its team.
D. Would mitigate the effect of creating a marketing & distribution economy in Canada, wherein the knowhow and advances are developed and imported from outside the country due to the cost barriers of financing and developing an R&D team.

Some factors limiting R&D activity in Canada are the following:

- The high labour cost associated with hiring skilled & educated people to develop in-house ideas and knowledge is a limiting factor. If business owners have the guarantee that a portion of their technical personnel salaries conducting R&D would be recovered through tax credits, the financial risk would be reduced. Without the government support, it is difficult to compete with the cost structure of other countries offering those same services.
- Based on the size of the Canadian market, the length of time to have new products approved in foreign markets (i.e. USA) and the currency exchange risk, it is expensive and a financial risk to undertake the full financial burden of the development activities and certification process without other financial support or partnering. This is especially true for CCPC's.

4141 Sherbrooke St. West
Suite 410
Montréal, Québec H3Z 1B8
www.almacg.ca
Tel : (514) 931-0166
1-866-931-0166
Fax : (514) 931-0858

Q6. Regarding the creation of demand for business innovation, what role, if any, do you believe that government should play in being a "first customer" for R&D investments in Canada?

The government should only support sound viable scientific or innovative projects. Yes, the government should play a "first customer" role for R&D investment in Canada. It reduces the barrier of entry for start-ups. It also accelerates or increases the number of projects a company may undertake as the additional funding provides the means necessary to support the development of new technologies until other forms of financing become accessible.

It would allow the taxpayer to retain full ownership of their intellectual property to the point where it is proven and has commercial value.

It would allow for other financing vehicles to be used to run other portions of the business, whether it is commercialization, scale-up, development of infrastructure or operational expenses. Many businesses would not have grown and potentially would not be in business if it were not for the financial support of the SR&ED program. The program has allowed for invest and reinvest in order to remain leaders in their specific lines of business. As a result, businesses able to utilize the SR&ED program have done considerably better than many others during the down turn in the economy and will be well positioned through their recovery.

Thin profit margins, growth and development costs do not always allow for the budgets required to continue the development of new products and innovations, especially in an economic downturn. Should recessionary or currency variability impact a business, SR&ED funds allow them to retain their development teams when they are most needed. This ensures they can retain the technical expertise necessary to further advance their technologies or products to compete in an ever changing global market place. Limited accessibility to R&D support does factor into and prevent business from investing in R&D.

Q8. Can you describe whether and how your firm employs students currently enrolled in community colleges, polytechnics and universities, and what government measures could make it easier to work with students during their academic programs and to recruit them after their graduation?

Currently we do not employ students or recent graduates. What would make it easier to recruit them after graduation would be an improved awareness of student work programs by schools. We have not been contacted or made aware of the talent pool available via new graduates other than the traditional means of hiring people. We would review the opportunity and support these types of programs as we employ 50 highly experienced employees with university and post graduate science or business degrees. Financial incentives to hire directly out of school to cover the investment cost of training and the learning costs of becoming a fully contributing member of the company would be of interest.

Q9. With which federal programs supporting business or commercially oriented R&D in Canada do you have direct experience and knowledge? In your view:

a. Which of these programs are working, and why?

SR&ED:

- The program provides the funding necessary to support a broad range of companies, as long as SR&ED is being conducted. Our firm actively supports taxpayers in preparing their R&D claims in over 7 countries. Canada is considered to have one of the most generous and effective programs in the world, dependant on the taxpayer's corporate structure and taxable position.
- With no budget cap on funding, taxpayers minimize their risk of having funding cut or their project refused based solely on budgetary reasons. Budget pool limitations, can jeopardize a development project from reaching completion and therefore jeopardizing the long term health of the business or prevent projects from moving beyond the conceptual stage.

b. Which programs are not working, and why not?

SR&ED:

- The program has been working well; however, recently the review process has shifted towards increasing the demands on SR&ED specific evidence to support the claims, causing taxpayers to evaluate if the efforts are worth the tax credit. The pendulum has shifted to a compliance review process rather than an incentive program to encourage companies to invest in science and technology.

We hope that CRA will reconsider its present policy and accept the level of documentation that companies naturally generate in the course of running their business. This is especially concerning in the experimental development portion of the program where RTA's with academic or laboratory environment backgrounds are evaluating and demanding supporting evidence that is not found or reasonable in a manufacturing or commercial setting.

IRAP:

- Of our 300+ clients, very few utilize IRAP funding. Due to the demands and requirements of the program, if a project is not significant in expenditure value, the additional administrative burden to receive the funding does not merit taking advantage of the program.
- The cap on the funding pool also deters businesses from investing time into the program. A general concern is that, should a company qualify for the program; will the required funds be available throughout the duration of a project, which could last for multiple years? The prospect of funds being cut part way through the project is too much of a risk to merit taking on the project.
- As a result of taxpayer inability to hire experts to assist in the evaluation and preparation of their claim submissions, firms pass on it due to the time investment of their key technical people.

Q10. If you have direct experience and knowledge of the SR&ED tax credit, what are your views in relation to the following:

a. Does the current structure of the SR&ED tax credit encourage incremental investment in R&D?

Based on our experience with our 300+clients, clearly the program encourages incremental investment in R&D. For many of our clients, it is the eligibility to receive tax credits that is a crucial factor in deciding whether to undertake a project, defer a project or investing in additional technical staff. SR&ED is factored into a company's decision making process in order to determine which division / plant should be awarded a project based partially on the incentives available by the country or province in which their facilities are located. Clients hire additional technical staff, as companies have many projects but usually not the necessary capital to hire people without SR&ED support.

Does it free up capital to invest in other aspects of innovation activities in the firm? Does this vary by size, ownership, sector or nationality of firm?

- Yes, the funding frees up capital to invest in other aspects of innovation activities. The SR&ED program only covers a portion of all costs associated with the development and commercialization of a product or process. The program only covers the costs associated with resolving hurdles in an attempt to achieve advancement. Other capital is necessary to support the overall execution of a project, in addition to the costs associated with investing in such things as an R&D laboratory or department, which is also usually used to conduct other innovation activities associated with the operations of a plant, lab or other non- SR&ED related activities.
- Yes, the corporate structure and taxable position of the firm has a major effect on the capital investment allocation of a firm. A company that is not in a cash refund or tax reduction position has no capital freed up to reallocate to other activities. For many companies, especially those that are heavily invested in R&D activities, but are not a CCPC, the program provides no immediate benefit to them. In many cases, due to the delay in time for which they are able to apply the tax credit, (could be 5 or more years) companies do not take advantage of the program based on the present cost to prepare and defend a claim.

b. What are the strengths and weaknesses of the refundable portion of the SR&ED tax credit for Canadian-controlled private corporations and to what extent does it encourage the growth and commercial success of SMEs?

- The strength of the refundable portion of the credit is that it provides the financial means for early stage companies and CCPC's, to hire talented people, hire more people and continue to investment into future technologies.

- The speed at which the claimant receives the refundable portion of the credit is excellent, should a review not be called.
- Many of our clients would not have developed the technologies they have and some would not be in business today if it wasn't for the support of the SR&ED program, specifically the refundability portion of the program.
- Many of our clients, once they have been through their first experience with the SR&ED program, have increased the size and experience of their development teams. The program allows taxpayers to be more ambitious and take on projects they may have not otherwise taken on as they have a partner in the project.
- CRA's claim review cycle has increased over the last 18 months resulting in delays in receiving the cash injection necessary for CCPC's to continue their R&D activities.

c. Bearing in mind the improvements being made by the Canada Revenue Agency, are there additional opportunities for change to simplify the administration of the SR&ED tax credit and facilitate the applications process?

We agree with the requirement that a tax payer must be able to demonstrate and provide evidence of the project undertaken and the cost associated with the work. Where improvements can be made are at the execution of the review process by CRA. On the most part, our clients' experiences have been fair and reasonable, however; more recently, inconsistent interpretation of the requirements (both technical and financial) does occur from a reviewer to reviewer basis, not only in separate regions but also within local offices. In general, the demands on the taxpayer to support and justify a technological advancement or obstacle have increased both from a technology perspective as well as a documentation perspective. This has resulted in increased claim acceptance unpredictability, additional resource requirements to defend or justify claims and inefficient use of both the CRA and the tax payer's time. CRA's evaluation approach has shifted to a compliance and justification review versus the incentive and the encouragement spirit of the program.

There is a subjective element to the determination of SR&ED under subsection 248(1) of the ITA. In order for the program to be effective, it requires consensus, consistency and predictability of SR&ED scientific determinations. The determination of what is and what is not SR&ED work in any industry is a subjective decision. If CRA tries to unilaterally define the line between SR&ED and "non-SR&ED", the outcome of a review will be contentious. Therefore, it is paramount that joint CRA – industry consultation sessions be reinstated in order to clarify to all participants as to how to apply the legislation to specific industries and/or situations. CRA intends to abolish the Sector Specific Guidance Documents in an effort to streamline the application policies. Without Sector Specific guidelines, each decision will be based on the reviewer's experience, standards, work ethics and training. We believe this will add to the distorted and inconsistent interpretation of the legislative rules and ask that these guidelines be reviewed and updated with industry.

Often the Research Technical Advisors (RTA's) have the academic credentials but lack practical industrial research and development experience required to evaluate within the business environments. They are asked to make judgments on technical innovation in fields of science beyond their specialized areas of expertise. Rather than engaging in a dialogue with the claimant to clarify the state-of-the-art of the specific technology, increasingly, we are witnessing RTA's coming in with the attitude that only they understand SR&ED and that the claimant has to be "educated". They ask to see "SR&ED documentation" and use their academic training as their point of reference and not what is reasonable for a taxpayer to maintain in that specific business sector. The net result is, that from the corporation's tax planning perspective, SR&ED tax credits are not a predictable incentive. Since businesses cannot predict the success of their SR&ED claims with confidence, they lose confidence in the incentive program and reduce their research and capital expenditures accordingly.

Although CRA has published a new Claim Review Manual that clearly stipulates how SR&ED reviews are to be conducted, when RTA's are not consistent in following or applying the guide, there is no real recourse for the claimant to have the claim reviewed by an unbiased reviewer. Should a taxpayer disagree with the RTA's scientific opinion of a claim but the reviewer has followed the protocol of due processes, the taxpayer has little recourse without spending significant resources, adding delays to the process. The recent shift in the CRA review practices is negatively impacting the delivery of an effective tax credit program. These practices have recently created a mood shift in of "I can't depend on the SR&ED claim" or "my advances and efforts are being trivialized" or "it is too onerous to justify submitting future claims".

Q11. How could the Government of Canada lighten the administration requirements of its programs on recipients and improve outreach to business?

The awareness of the SR&ED program is well known throughout industry as it has been available for 26 years. The administrative requirements of the program by the taxpayer are too arduous and outcomes are unpredictable for claimants. Any type of funding and form of financing requires justification and documentation to demonstrate the application of the funds and evidence that the funds were applied appropriately. The challenge in administering the SR&ED program is that the review process is conducted based on subjective measures. What is advancement? What is an obstacle? What level of documentation is required to justify the science and financial aspects of a claim? Each CRA reviewer will apply the policies based on their own education, understanding of the science and their experience. A tax payer prepares and supports their claims in the same fashion.

The administration requirements of the SR&ED program could be changed as follows:

- Improved training of the RTA's to achieve an improved application consistency of the program criteria and the documentation requirements of the program from RTA to RTA and from region to region.
- Improved training in interviewing taxpayers in order to truly understand their R&D, not only from a technology standpoint but why the claimant understands a claimed project to be SR&ED versus routine or standard practice. Too often, the RTA's will pose leading question in order to support their first impression based on the technical submission rather than asking leading questions to understand the context of the business and the eligibility of a project.
- Develop criteria that minimize variability in the interpretation of those criteria and the supporting requirements.
- Shift the review process back to an incentive approach versus a compliance approach.

Q13. Are there any gaps in the Government of Canada's support to business and commercially-oriented R&D? Do firms performing R&D in other countries have an advantage over Canadian firms because of access to programs that are not available in Canada? What would be the principal features of new programming to fill these gaps?

Alma Consulting Group provides R&D recovery services in 7 countries in Europe, as well as Canada. We also conduct an annual survey to taxpayers throughout Europe to evaluate the most effective R&D programs from a benefit and administrative points of view. Our firm also has benchmarked many other R&D programs across the world to assist our clients in determining where the best place for them to conduct their R&D. We would be happy to meet to discuss and share this information with the Panel and the SR&ED national team.

Q15. Is there a difference between R&D and innovation? If yes, how are they different? Should government focus on R&D or Innovation? What should the balance be?

Yes, there is a difference between R&D and innovation. Innovation does not necessarily mean that science has to be an integral part of a projects success. A novel or innovative idea or an innovative business culture may require significant investment and bring business challenges that can provide significant benefit, success and longevity to a business. Typically innovation continues to occur once SR&ED has been completed. A business that is innovative by nature will continue to invest in ideas and solutions to advance their products and ideas beyond the science in order to provide longevity to its products, processes and business. These innovations can require significant investment with qualified people but do not require scientific advancement, however can provide a competitive advantage. Is Apple successful due to their R&D or Innovation?

What should be the balance? The mix should be based on the nature of a business. For some businesses, their success is dependent on innovation and not R&D and others it is the opposite. Both generate positive and successful businesses that generate value to the Canadian economy, both domestically and for exports purposes.

Conclusion:

Any further questions, comments or follow-up can be directed to Terry Trotic, President & CEO of Alma Consulting Group Canada Inc.